# LOCAL FINANCE MANAGEMENT UNDER CRISIS CIRCUMSTANCES IN ROMANIA

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***Abstract:***
*The paper overviews the evolution of the legal framework and management of local public finance in Romania under the impact of crisis, seeking to highlight the changes made through legislation and potential empirical evidences, as support for formulating some policy recommendations for local development implicitly.*
*With this aim, we compute and analyze relevant indicators of Romanian local public finance as local development, local taxes, inter-administrative transfers, etc. The data we use mainly come from the reports and yearbooks of relevant national authorities, such as the Ministry of Public Finance, the National Institute for Statistics, the Ministry for Regional Development and Tourism, or international institutions such as the European Commission.*

***Key Words:*** *crisis impact, local public finance, local budget, financial management*

***JEL classification: H71, H72, H12***

## 1. Introduction

Europe's financial system has been in a continuous stage of systemic fragility since 2007-2008. The inability of European policymakers to resolve their financial crisis can be explained by deeply-embedded features of their respective countries' financial systems and political economy structures. The current phase of financial crisis in European Union, Romania was oriented to reach the same occidental standards in local public administration and local development as Western European Union countries. The decentralization process was continuous generating the implication of Romanian local authorities in local public finance, as a result of exclusive competences and, so, the necessity of ensuring a good management of resources and expenditures. Therefore, the decentralization of funding and program authority from State to local governments was a major Romanian political theme for about two decades and a first rank component of management of local public finance, as main driving instrument for local development. Depending on how decentralization is undertaken, it is possible that it might contribute to financial crises. Rodriguez-Pose and Gil (2005) argue that, in the few instances where there are not strict regulations for local government borrowing, a separation between fiscal freedoms and responsibilities can cause problems leading to financial disarray. For example, in Italy, devolving revenue raising responsibilities to the region was used to deal with soft budget constraints that had led to the financial crises of 1992 through subnational borrowing (Rodriguez-Pose and Gil, 2004).

However, reaching the same level of local development as other EU Member States proved to be a difficult task for Romania, not yet completed, as the global economic crisis added further challenges to the already existing unsolved issues at national level.

The aim of this paper is to provide an overall survey on the management of Romanian local public finances under the impact of the economic and financial crisis. So, following this introduction, next section gives a discussion on the background of the management on local public finances. The empirical results are set out and discussed in the penultimate section of this research, and finally we offer some conclusions.

## 2. Background of the management on local public finances

Globally, the problem of delimitation the framework of local financial management is reflected in the so-called fiscal federalism. As originally defined by Musgrave (1959) and Oates (1972), "fiscal federalism:" concerns the division of public sector functions and finances among different tiers of government. Okigbo (1965) defined fiscal federalism as the existence in one country of more than one level of government, each with different expenditure responsibilities and taxing powers. Federalism could be considered to be legal and administrative relationships structured of operation among sub-nationals to empower them to exercise different degree of real authority and jurisdictional autonomy.

In a more analytical perspective, conceptual content of fiscal federalism prefigures the idea that the scope, content and direction of manifestation of local financial management are under the influence of several factors, including: the legal regulation of the specific financial activities, the institutions involved, the framework of local public finances in relation to central government finance, the structuring of public budget system etc.. (Oprea, 2012, p. 28).

An overview on optimal management of local public finances was conducted by Walter Honadle, Costa and Cigler:

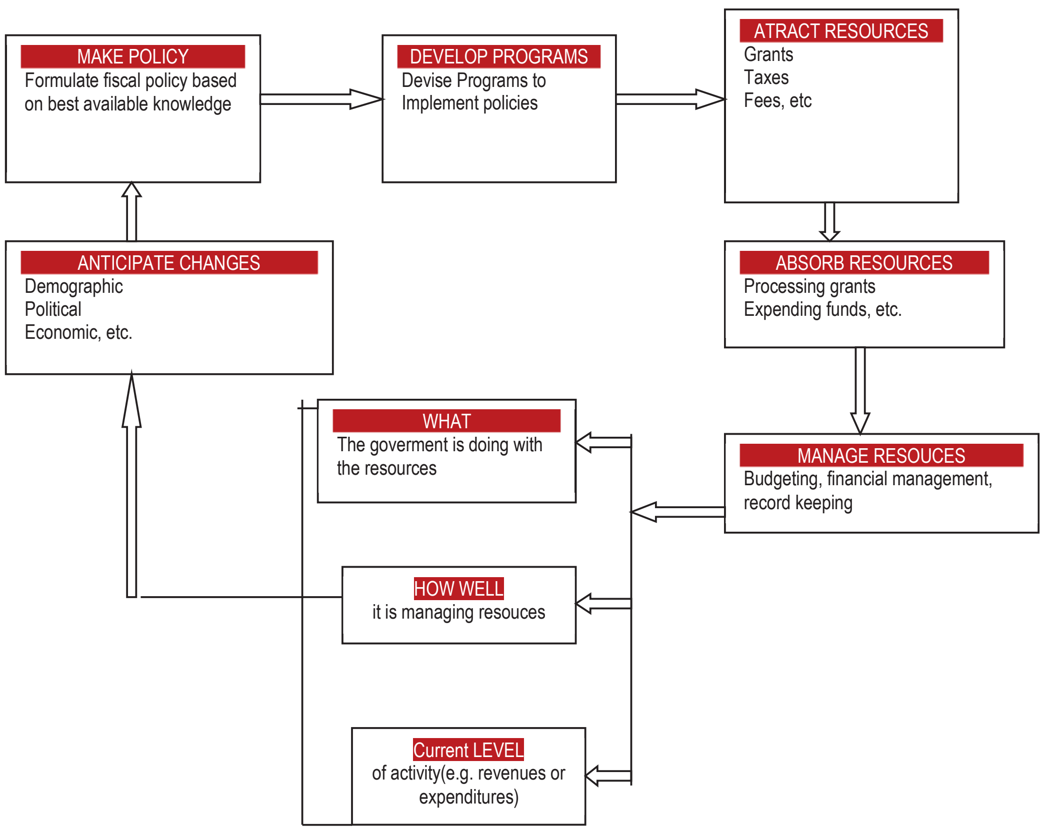


**Figure 1: Local fiscal management**

Source: Walter Honadle, Beth; Costa M., James; Cigler A., Beverly, *Fiscal Health for Local Government. An Introduction to Concepts, Practical Analysis, and Strategies*, p. 12

The particularities of local financial management derive primarily from the specific conduct of this activity, with the key feature of the legal regulation [Oprea, 2012, p 10]. The sources of income of local budgets are established by law, ordered according to the principle of specialization, locally funded expenditures have a similar regime, local loan can be promoted only on local public finance law and so on, amid legal recognition of a degree of decisional discretion (right judgment).

Specific legal framework of local financial management is found to the European level in the European Charter of Local Self-Government and to the national level in specific legislation on local public finances primarily (Act no. 273/2006), but also other incidents regulations regarding local government (Act no. 215/2001), decentralization (Act no. 195/2006), the provision of local public services (e. g, GUO no. 34/2006, GUO 54/2006), local field operation, control and performance audit implicitly on financial activity (GO no. 119/1999, Act no. 84/2003, Act no. 94/1992, modified by Act no. 72/2002 and Act no. 217/2008), local public debt etc.

## 3. Empirical evidences of Romanian local public finances in the context of crisis

Since 2008, the global financial crisis has made its impact felt more and more on Europe's towns and regions, having a cumulative effect. An increasing number of local authorities find themselves affected by the credit crunch and falling resources at time when many of their citizens face economic problems due to the recession. In general terms, the consequences of the crisis can be felt on four levels (Poulais Thierry, 2009):

1) Revenue, either generated by local governments or derived from State transfers, which may be subject to sharp declines;

2) Expenditures, which are rising because of the slowdown in economic activity and the corresponding increases in unemployment and social welfare needs;

3) Financing capacities, which are shrinking owing to the difficulty in obtaining loans and the increase in the cost of money;

4) Foreign investment, which has declined; operations underway, which have been put on hold in many instances; and projects, which have either been cancelled or delayed.

In Romania, the crisis was transmitted to local governments through higher unemployment and social needs, and through difficulties in investment financing.

To understand how local public finances were managed in Romania, we will analyze, as a first step, the financial indicators. Basic condition and direct effect of administrative decentralization of powers was the disposal of income source by central authorities (sources previously reflected in the state budget), to the public budget components managed by decentralized authorities. From this perspective, is suggestive for the period under review (2006-2010) evolution of transfers from state budget to local budgets.

**Table 2: The size and share allowances and amounts deducted to the local level from some of the state budget revenues in Romania between 2000-2010**

| Year | 2006 | 2008 | 2010 |
|---|---|---|---|
| Amounts and share deducted from income tax | 7550.30 | 14242.00 | 14425.8 |
| Amounts broken down from value added tax | 14539.00 | 18634.30 | 14982.4 |
| Subsidies | 923.40 | 4221.50 | 5340.9 |
| Total | 23012.70 | 37097.80 | 34749.10 |
| % transfers in total revenues of LB | 81.97% | 83.05% | 85.03% |

Source: computed by the authors using data from Statistical Yearbook of Romania on www.insse.ro

According to the table, amounts and allowances deducted from certain state income taxes to the local level in the period 2006-2010 saw an overall upward trend, but especially for amounts deducted from VAT it was a decrease in 2010. What is important to specify is that the most of this revenue is unconditional transfer for balance, local authorities could treat them as their income and could so to use for making local investments.

In Romania, own revenues are established by Local public finances Act (art. 5 (1)): local taxes, contributions, quotas from income tax (in total amount of 71,5%) and others. In terms of strengthening local budgets, the Government Ordinance no. 45/2003 establishes share deducted from income tax as own revenues of local budgets. In this light, we use calculations revenues of local budgets according to their legal definition.

**Table 3: The ratio of own revenues and income/total expenditure of local government in Romania during 2000-2010**

| Indicator/Year | 2006 | 2008 | 2010 |
|---|---|---|---|
| Total Revenues | 27706.60 | 43629.10 | 50018.30 |
| Total Expenditures | 25392.80 | 42210.20 | 50631.20 |
| Own Revenues | 12152.10 | 20587.70 | 24008.78 |
| The degree of financial autonomy (%) | 43.86 | 47.19 | 48.00 |
| Degree of self-financing (%) | 47.86 | 48.77 | 47.41 |

Source: computed by the authors using data from Statistical Yearbook of Romania on www.insse.ro

Between 2000 and 2002, the degree of financial autonomy not exceeding 25.75% and the degree of self-financing was quite low, 25.93% in 2000. With the reconsideration of own revenues category, the degree of financial autonomy increased in 2004 to 60.85% and the degree of self-financing to 62.48%. Should be noted also the "sensitivities" of these indicators, represented by an increase for the degree of financial autonomy in 2010 vs. 2008 and the decrease of the degree of self-financing 2008 vs. 2010.

Poulais Thierry (2009) consider that the two major financing systems, bond issues and banks whether specialized or not, have been heavily impacted by crises. In this case, Governments have adopted different measures depending on political and institutional environment. In Romania, an important prudential rule of borrowing, adopted in 2006 was modified in 2010, in the middle of the crisis. So that, the local authorities access to contract a loan is stopped if the total debt representing annual the payments on loans contracted and / or guaranteed, interest and fees, including the loan to be contracted and (or) guaranteed in that year exceeding the limit of 30 % of the arithmetic average of their own revenues, reduced by revenue from asset sale over the last three years preceding the year in which is requested the authorization of reimbursable financing to be contracted and (or) guaranteed (Act no. 273/2006, art. 64 (4), modified by GO no. 63/2010).

Such a regulation is likely to exclude those situations where local authorities would be excessive exploited the potential of indebtedness in the years who obtained substantial revenues from asset sale, then not having the real possibility of reimbursement the loan or the financial liabilities from guaranteeing loans. However, However, it should be noted that it was intended to limit the access to local resources borrowed of local administrative-territorial units with arrears or an increase of their arrears, and such regulation is absolutely rational, arrears representing basic clue for assessing the financial health and creditworthiness of local budgets[199].

However, prudence is recommended when employing local indebtedness for Romania because of the nominal convergence criteria which says that the ratio of

[199] There are excluded from the provisions the administrative territorial units that are in financial crisis or insolvency proceeding and which require loans or guarantees for refinancing local debt, according to the recovery of the financial crisis or insolvency plan.

government debt to GDP must not exceed the benchmark value of 60%. The practice of local indebtedness in the context of a big central government debt stock can generate the unfulfilment of the convergence criteria. For Romania the situation is not a worrying one because total public debt is less than 60%. If the public deficit ratio to Gross Domestic Product (GDP) exceeds the reference value of 3% (convergence criteria of The Treaty of Maastricht, also stipulated in the Stability and Growth Pact), no project will be financed from the Cohesion Funds, until the deficit problem will be solved. So, it is necessary to practice a prudent local indebtedness for not limiting the access to EU funds.

On the other hand, the global financial crisis and financial difficulties in the banking sector affect the availability of credits. Even if the local government has generally high ratings as borrower, the requested volumes of credits are not available, or are available at high cost, due to liquidity shortage on the market. It should be noted, that in some countries especially banks, which traditionally provided loans to the local government, have been affected by the crisis (e.g. *Kommunalkredit* in Austria, *Kommunekreditt* in Norway, *Dexia* in Belgium, France and Luxembourg).

Even crisis was widespread over the world, Romanian local authorities in their management try to explore the possibility to benefit by non-reimbursable financial assistance through the funds allocated in accord with the European Union policies. Regarding non-reimbursable financial assistance through the funds allocated in accord with the European Union policies, where the fundamental policy is the Economic and Social Cohesion Policy, the implementation is realized with the help of three structural instruments, as structural funds (European Regional Development Fund – ERDF - and European Social Fund - ESF) and the Cohesion Fund - CF.

The total amount of Cohesion and Structural Funds allocated for Romania for 2007-2013 is 19668 million Euro, representing 5,66% of the total funds. 12661 million Euro are allocated through Structural Funds in the „Convergence" objective, 6552 million Euro are allocated through Cohesion Fund and 455 million Euro are allocated to the "European Territorial Cooperation" objective. The distribution of Structural Funds – Convergence objective- and of the Cohesion Fund for Operational Programs makes evident the priority of investments in transport (23,8%) and environment (23,5%).

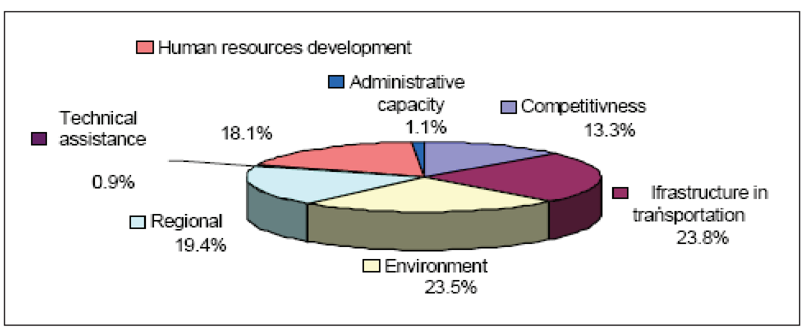


**Figure 2: Estimative allocation on operational programs for Romania, 2007-2013**
Source: The Romanian National Strategic Reference Framework (RNSRF) 2007-2013

Though, there are two important aspects which must be taken into consideration. First, the rules of Cohesion and Structural Funds impose the necessity of co-financing by the member states. The maxim level of EU contribution is established by the Council Rules no.1083/2006, according to the EU financial perspectives for 2007- 2013. Romania can benefit by a maximum communitarian financing rate at the level of OP of 85% for all three funds: ERDF, ESF and Cohesion Fund. The RNSRF allocation within the “Convergence” objective needs a national co-finance estimated at 5.07 billion Euro, proceeded from public sources (2/3 from the total of co-finance) and from private sources (1/3). The public co-financing will be assured from the state budget by the Romanian Government and from the local budgets of the public authorities which will apply structural instruments for financing.

Considering the lowest financial capacity of many local authorities to assure this co-financing, the Romanian Government decided to reduce as far as possible the local budget contribution. Thus, the principle which will be applied in the operational programs tell us that the personal co-financing which the local authority need to assure for a project will be in general 2% from the eligible value, a major exception being the projects which generates incomes. Consequently, the approved contribution of the local authorities is under 5% from the total of national co-finance.

National absorption rate is approximately 6.56%. Program with the lowest rate is SOP Environment - 3.38%, and the program with the best performance is ROP that there is a rate of 11.73%. SOP HRD (which disbursements were stopped in February by the European Commission) has an absorption rate of 5.48%.

**Table 4. Absorption of Structural and Cohesion Funds on each Operational Programme in March 2012**

| | Alocări ue 2007-2013 (mil.lei) | Proiecte depuse | | Proiecte aprobate | | Contracte semnate | |
|---|---|---|---|---|---|---|---|
| | | Nr. | Valoare totală (mil. lei) | Nr. | Valoare UE (mil. lei) | Nr. | Valoare UE (mil. lei) |
| SOP Transport | 19 853 | 129 | 42 602 | 77 | 11 430 | 62 | 7 801 |
| SOP Environment | 19 620 | 465 | 35 955 | 328 | 17 867 | 259 | 17 543 |
| ROP | 16 201 | 8 093 | 55 441 | 3 104 | 14 716 | 2 723 | 13 449 |
| SOP HRD | 15 114 | 10 217 | 43 257 | 2 999 | 15 160 | 2 468 | 12 687 |
| SOP IEC | 11 106 | 11 806 | 68 990 | 3 313 | 7 914 | 2 275 | 5 007 |
| OP ACD | 904 | 1 371 | 3 675 | 397 | 981 | 354 | 709 |
| OP TA | 740 | 102 | 461 | 86 | 302 | 77 | 266 |
| TOTAL | 83 538 | 32 183 | 250 381 | 10 304 | 68 370 | 8 218 | 57 462 |

Source: Ministry of European Affairs, Romania, http://www.dae.gov.ro/338/stadiul-absorb-iei-fondurilor-structurale-i-de-coeziune

Romania's performance in terms of absorption of EU funds is very low. In this context, Romania should have the first priority to urgent and substantial increase in EU funds absorption.

From the regulatory perspective of the local public finance in the context of crisis can be noted several aspects with substantial implications on local public financial management (Oprea, 2011, pp. 316-321).

A positive aspect that creates a realistic framework of judging local financial capacity, is that the amounts of donations or sponsorships can be include in local budgets only by budget rectification when are to be received. Such a legal requirement should to be imposed undoubtedly as a result of economic and financial rules of rationality, such income cannot be accurately sized when developing drafts of public budgets as there is no regulated tax base. In the absence of such rules, including amounts as donations and sponsorships as revenues of public budgets based on expectations (more or less rational) was likely to distort the real image of local revenues and expenditures, the relationship between them (budget balance) or local financial capacity.

Another issue concerns the regime from asset sale amounts from private domain of administrative-territorial unit. Indicating that the main option local financial managers should be oriented towards exploiting these assets and ultimately to sell them, for preserve economic capacity and the local fiscal potential, we subscribe to directing the amounts obtained in this way in principle only to development section of local budgets, serving the development of local economic base by financing activities with maximum positive effect (regulation on local public finances established such a rule in 2010). Also followed similar regime of revenues generated from donations or sponsorships, these revenues should be included in local budgets after their receipt by budget rectification, as there is no realistic basis for their foundation. Otherwise, the inclusion in local budgets of these revenues from the sale of assets of local private sector by simple anticipation can substantially affect local budget reality, that financial viability of local decisions. It is important to note in this context that the loans contracted or guaranteed by local authorities for financing local projects receiving financial grants are taken into account, encouraging local authorities' access to such resources.

Another progress of legislation on local public finances in Romania was organization of local budgets in two distinct sections, the operation and development, imposing specific conditions, revenues and expenditures separate for each. Separate consideration of capital expenditure from current expenditure and the requirement that section to be balanced so that the project, as well as execution, limiting the possibility to make payments from operation section to development section if there is an budgetary surplus of first section, are steps to ensure efficient local financial relations, or local financial management more efficient. Also establish the general rule that the cover of local budget expenditures to be made by revenue and eventual deficit to be covered by the surplus of previous years, excluding the possibility of funding the deficit of operating section of the budget by borrowing, represent a condition for responsible local public financial management and healthy budget management as a support for functionality of budget system.

Another measure with a positive impact in terms of performance of local public financial management in the context crises is the requirement that in the local investment program should be included only those projects (goals) for which there are provided (specifically defined) full funding sources through draft multi-annual budget. Such a regulation is likely to counteract the negative effects that would result from the inclusion in investment programs of objectives for which funding sources determined for only a part of the ongoing years of the investment; the implementation being then blocked for lack of sufficient funding and recording conservation spending quite high. Following the experience and direction of reform EU member states in the field of public finance, the Romanian legislature in 2010 established a requirement that in drafting local budgets to be used appropriate tools such as forecasts for the main macroeconomic and social indicators of fiscal year for which to prepare the draft budget, and for the next three years. Establishing medium-term budgetary projections in local financial management activity is undoubtedly a positive measure of ensuring realistic local budgets, on the background of local public investment projects running which often exceed the annual limit for achieving.

We note that the version of the Act no. 273/2006, which stated that the draft local budgets are developed taking into account fiscal and budgetary policies, national and local, without providing a specific reference on how to take them into account, was likely to create a favorable environment interpretations different local and allow local public financial management decisions questionable. In this context, regulation since 2010 has instruments such as fiscal strategy, fiscal and budgetary framework with budget forecasts and the medium term expenditure framework, as measures with positive impact on fiscal stability and public budgetary system, are essential parts of creating an appropriate framework favorable to increase local financial management performance.

**Conclusion**

Decentralization processes in Romania are inherently intricate and mined with challenges, as they must consider conflicting local and central interests and navigate the complexity of simultaneous administrative and financial decentralizations. Financial crises add another layer of complexity, altering the balance of the economy and creating fiscal pressure for local governments. The effects of a crisis on an economy will vary according to the nature of the crisis and the economy's structure; thus creating appropriate policies requires detailed, grounded research. In our opinion, a successful local financial management in the context of crisis take into consideration general patterns such as: 1) the importance of supporting local investments on long-term growth and, 2) the need to seek a balance between central and local governments, a balanced based on solid communication and mutual support, to maximize the strength of local governments and use these strengths to support countries' struggle out of crises.

To be effective, Romanian local governments must have both the managerial and financial capacity to assume wider responsibilities. At the same time, the statute of Romania as an EU member state imposes restrictions on local authorities, but, also, offers them the opportunity to access new financing resources for local investments projects (EU Cohesion Policy 2014-2020). For our country, the local finance management in the circumstances of crisis supposes aspects such as:

- Optimization of local taxation;
- Local public authorities' incentives to attract additional financial resources;
- Processes more efficient to mobilize local financial resources;
- Processes more efficient for allocation and use of local public funds;
- Efficient management of local public debt;
- Processes more efficient for collecting tax debts;
- Ensuring and increasing financial credibility of the local community;
- Ensuring and increasing local fiscal sustainability;
- The effective use of the potential territorial administrative unit.

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