MODERNIZATION OF FINANCIAL RELATIONS BETWEEN PUBLIC CENTRAL AND LOCAL AUTHORITIES

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Abstract

Financial relations improvement between public central authorities and public local authorities represents, at the same time, a need for the modernize the state administration and a challenge for the policy makers. In this respect, many governments successfully applied performed structurals reforms, from their experiences we can highlight some principles and good practices which can be used to rise the performance of the public financial management.These principles and good practices refer to some aspects that deep the devolution, such as:

- emphasizing the public local authorities responsibilities regarding public expenditures;
- improvement local taxation and other own local revenues;
- better enforcement central – local grants mechanisms;
- rising indebtedness capacity, including local public entities repayment capacity.

Among the improvement solutions to finance devoluted public services, financial grants from central budgets and funds to local budgets have multiples forms, which present both advantages and disadvantages, depending on economic and social conjuncture and keeping in mind the needs of transparency in public administration.

Keywords: *devolution, taxation, equilibrum, grant, indebtedness*

Introduction

Achieving the economic development of a locality or region is a complex undertaking, insofar as it is subject to the influence of factors beyond local, regional or national have no control. The tools available to finance local development vary significantly from one jurisdiction to another, even when they are designed for similar purposes. There are significant differences between States as to how public funds are collected and distributed to local goverments - that is to say regarding the amount of taxes collected or spent at the local level and the extent to which local communities are dependent on transfers from higher levels of government.

The countries where the tax burden is higher tend to rely on public funding to support economic development efforts made under the government management, while countries where taxes are lower tend to assume that the private sector more involved in economic development.

Where local governments depend heavily on local taxes to fund their budgets, they are more likely to consider the local economic development as a means of broadening their tax base to finance services, asset and local amenities.

When the local government budget is supplied largely by the national administration, they are more likely to see local economic development a remedy for social and spatial disparities. This type of local development is often focused more on the activities of public and social sector - to

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help the unemployed find jobs and find new sources of entrepreneurship and employment. In this case, the financing of economic development is primarily related to investments in infrastructure to promote private investment, and often requires close relationships with higher levels of government for funding.

Intergovernmental fiscal relations analysis

The analysis of the new financial relations between the levels of deliberativ and executiv power varies from country to country. The internationally proposal differences between the means of descentralization can be approached from two viewpoints: by comparision with the relevant exemplary practices revealed by the studies undertaken by the international financial institutions- first of all The World Bank, and also the prolonged experience of some european developed states[1]

In terms of public services quality, the decentralized financial systems achieved statisticaly best results, because the action of various factors, among which the most relevant are:

- participation of citizens in the act of decision, because of stability and political liberties enjoyed by people of local communities;
- guide local authorities by act of government effectiveness, both in its legal, administrative and management capacities, including a very low phenomenon of corruption;
- the development of community from the social point of view, this assumption of human resources performance improvement, with an equitable distribution of income;
- the realization of economic management orientated outward, together with the existence of a of a genuine autonomy from the monetary state authority.

By analyzing the best practices of local government they are refering to some key issues:

- the responsibility of local public authorities regarding effective and efficient manager of public expenditure;
- their own sources of income, taking into account, taking into account the restrictions and tax incentives;
- mechanisms for financial transfer, mainly from central public authorities towards the local one, by many responsibilities, which have been decentralized to achieve and / or distribute the public services;
- debt capacity, which can measure the economic entity capacity, whether public or private, to repay the loan and pay the costs (interest, commissions, etc..)
- their own benchmark entities involved. The benchmark refers generally to the performance indicators, the creditworthiness of the entity in terms of financial stability to business functionality, plus, with an impact at least as important, the restrictions introduced by the tax environment and / or economically.

Of major importance are the responsibility assumed, first by the central government, on the other side by the local one in public expenditure management:

- sharing duties in the public expenditure and taxation between different levels of public authority represents a fundamental problem in a public administration that implements decentralization as a key reform of the state;
- following the example of good practice on the transfer of responsibilities for public services from central level to the local authority must take into account some benchmark, so as to determine whether:
  - volume of general transfers causes an easier management of business;
  - such transfers favors economies of scale;
  - public services must meet a minimum standards of performance;

[1] Anwar Shah et Jeff Hunter, "A Simple Measure of Good Governance and It's Application to the Debate on Appropriate Level of Fiscal decentralization", World Bank, Washington DC, 2007

- these transfers are accompanied by a new revenue-sharing of the public incomes;
- it is being taken into the account of local or regional community preferences.
- the central public authorities should be responsible for implementing / distribution of public services that have targeted the entire population of the country, as follows:
- they are being addressed the whole population, as, for example, national defense;
- they are having national effect, as the monetary policy;
- it creates economies of scale, for example, infrastructure networks;
- it is aimed at income redistribution, such as the implementation of social assistance and protection programs;
-etc.
- the local authorities must be responsabiles only for the public services whose aplicability domain is limited to the teritory of the respectiv local communities, so that they can exercise without limits the authority and, implicitly, to asume the responsibility for the quality and quantity of the distributed service. The clear example are the preuniversitary invatamant, the health public services, the local transport networks, the protection of the older persons etc.;
- local public authorities should be responsible only for public services whose scope of applicability is limited to within the local community, so that they could freely exercise their authority and thus to take responsibility for quality and service quality available. Telling examples are those of undergraduate education, public health services, local transport networks, protection of elderly, etc.

The main objective of local authorities in financial management is to achieve a balance between spending responsibilities and ability to attract financial resources in order to reduce the need for consolidated shipments[2] likely to introduce distortions.

If they can`t be avoided, however, transfers with the lowest negative impact on local autonomy are unconditional transfers, in which the local authorities have the greatest power of decision.

Conceptually, the basic principles of fiscal transfers between local and central public concern:

- equity between the territorial-administrative units, which must be treated according to the same criteria during the approach of the transfers;
- neutrality, meaning that a local authority must not- be able to exercise influence on the subsidy enjoyed by actions on local expenditures or the tax that she applies;
- simplicity of the transfer mechanism so as to be easily understood and applied;
- consolidated transfers predictability and flexibility, to accommodate cyclical economic and social developments, ensuring also the possibility of elaboration of budgets and development plans in the short to medium term;
- autonomy of local public authorities to set their own priorities and manage local public services to meet the needs of the community;
- stimulate local authorities to conduct an effective financial management of decentralized public services, without the result that the application of the transfer mechanism will penalize the very communities that are well managed in financial terms;
- transparency in granting the transfer and use by the responsible authority for people to be able to consider the effectiveness of community use of public funds in their interest.

You can notice some contradictions between the basic principles that apply to financial relations between public authorities - for example, the principle of fairness tends to complicate the

[2] Acording to the in place legislation (The Law nr. 200/2002 of the public finance, The Law nr. 273/2006 of the local public finance etc.), by consolidated transfer is being understood the sums transfer between the public budgets, from the state budget to the local budget.

mechanism of transfer beeing required, among other things, the regression statistical calculations, which affects the simplicity of approach - but integration of all principles, in fact of the rules of good practice in public government actions leads to a performance management of local and central public authorities.

Regarding the fiscal relations between levels of government are emerging two kinds of models:

- a type model where local government authorities receiving an average fiscal asieta[3] per capita wich top the national average transfers funds to the authority which records asiete per capita under the national average. This model is much disputed by rich communities, but that formula makes an equity very close to perfection, especially since it does not involve additional financial efforts from the central government;

- a group of models by which local authorities that show a asietã fiscalã per capita under national average receive a subsidy that provides full or equity, or a subsidy corresponding to a certain percentage of the national average in order to reach that average[4]. This model meets most of the interests of local communities, because the poor communities have the impression of winning, the richest communities have the impression that they are not losing.

The need to spend is more difficult to define and administer than tax capacity, for various reasons: to define a standard of equalization has serious problems, identify cost differentials from input-output relationship is not easy; understanding the differences in service areas, between the populations, and draw on local needs require the trial, and finally obtain the necessary data can cause significant problems.

Regarding the problem of needs in terms of transfer costs, the designers have a choice between the same two models - the first model in which the jurisdictions where costs are lower accepted to transferre sommes to jurisdictions where costs are high and the model donor, as in the case using the component of fiscal capacity. In each of these two models, there are various possible alternatives, including the following:

- historical spending levels are the basis for calculations and this base is adjusted each year using an appropriate index this index consisting of a set of factors such as population growth and the average growth in spending in the provinces and territories;

adopt as standard the average expenditure per capita - this approach ensures that each sub-national government has sufficient resources to meet the average spending levels, but it is of no help when needs are greater than the average;

adopting an average expenditure per capita, weighted with a factor or an index - for example, if in an entity, the lower density of population means higher costs, so in a given level, the entities whose population density is less would benefit from additional grants;

adoption of uniform spending levels for municipalities grouped according to their similarities - entities may be grouped according to size and population density, according to their location, employment levels and others, and within each group, provided that each entity has different needs and similar costs;

- a combination of the above three approaches - for example, group the municipalities with a set of basic similarities, and provide an index of corrections to take into account some additional factors.

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[3] Asieta (the way to put the impôt)-all the measureas that is being taken by the tax organs taxable related to each subject, for the identification of the taxable object, the establishment of the level of the taxable mater and the deternmination of the tax due to the states (Iulian Vãcãrel-coordonator, Finanțe Publice, Editura Didacticã şi Pedagogicã, Bucharest 1999

[4] This model of local community financial balancing applies, for example, in Canada, where provinces whose fiscal capacity is below average per capita is given a subsidy the from federal authorities that allows them to achieve the average per capita.

Regarding the implementation of best practices related to financial transfer schemes, the following aspects stand:

- it would be wise to adopt a gradual approach and begin by setting up a representative tax system for a period of five years, then moving a representative system of expenditure;

- a system fully based on costs requires much effort, it is an exercise of significant judgments, and requires a high degree of cooperation between the parties to find an effective implementation;

- it is understood that a less ambitious approach as regards the expenditure side would be desirable in the short term - one might use such general indicators of relative need or limit equalization payments to poorer entities;

- it will probably be easier to get hold of data for measuring expenditure needs caused by different sides, unless measuring expenditures arising from incremental costs - this requires a different approach, namely that it must use available data to measure the needs of the demand side and make common sense and practicality to assess cost differences;

- generated data and analysis that is made, which are somehow sub-products of detailed spending plans, can be leveraged to achieve efficiencies in the public sector.

The transfer of responsibilities to local government must be accompanied by the resources spent by the central government to the exercise of powers transferred. This principle was introduced in the laws of local finances[5], which provides that "any transfer of powers between the state and local governments is accompanied by the allocation of resources equivalent to those which were devoted to their exercise."

The principles of compensation

Financial compensation for expenses resulting from the transfer of powers enshrined in the Laws of local public finances responds to a number of principles aimed at ensuring the neutrality of such transfers, both on the state budget than that of local government beneficiaries.

The compensation is as follows:

- entirely: the resources transferred are equal to the expenditure incurred by the central government under the powers transferred. All expenses, direct and indirect, related to the exercise of powers transferred are taken into account;

- in the same time: any increase in charges resulting from the transfer of powers is accompanied by a concomitant transfer of resources necessary to exercise these powers. Financial compensation for transfer of competences is established in two stages, in strict compliance with the principle of the simultaneous transfer of obligations and resources:

- from the Law of local public finances the transfer of competences, budgetary appropriations are enrolled on a provisional basis to give local authorities the financial means to exercise their new obligations;

- the amount of the right to compensation is finalized, it is making the necessary corrections, also in tax laws, and in the laws in local public finance.

In many countries, local administrations and national public agencies are also key financial partners in the local economic development. Another type of funding is for local authorities to borrow to support investments in productive infrastructure of a local economy.

Borrowing capacity

In general, governments should borrow only for the purpose of making investments, otherwise future generations will be restrained by the obligations of the benefits enjoyed by previous generations. That said, there is a wide diversity of approaches to control by central government the loans made by the subnational governments, for various reasons ranging from the

[5] In Romania, Laws no.273/2006 regardind local public finances.

state of development of financial markets of a country to the other question which is whether there are serious macroeconomic problems (eg., problems that may be linked to exchange rates, management of foreign exchange reserves and others). In this regard, four générales approaches, each with its advantages and disadvantages, is defined as follows:

- rely on market discipline - is the approach recommended by many developed contries regarding provincial borrowing;
- cooperative approach in controlling debt - in the context of this approach, subnational governments participate in the formulation of macroeconomic policies, including the establishment of borrowing limits to be observed by sub-national entities;
- approaches with well known rules for the control strategies being adopted by subnational governments - a number of countries, both unitary and federal, have adopted rules in their constitutions or their laws, which contain, among other things, limits on debt levels or that specify the objects of loans;
- direct controls on borrowing by subnational entities - these controls take many forms, including the establishment of annual borrowing limits, permission to borrow a part and the centralization of all loans with terms of surrender to subnational governments for purposes approved.

The main conclusions on control of subnational government borrowing are:

- though attractive in principle, the option is to capitalize on market discipline is unlikely to agree in many situations because one or even more of the conditions for its effective functioning will be absent (eg. the existence of free and open markets, the availability of reliable data on the outstanding debt of the borrower, the apparent lack of opportunities bailout in case of default, and others);
- it is expected, according to the current global trend to devolution, there is a reduction of administrative controls that are exercised on subnational borrowing in the domestic market;
- borrowing abroad by subnational governments should be strictly limited, inter alia, macroeconomic considerations;
- all loans should be made solely for investment purposes;
- even in the context of approaches to matching rules, there is room for greater cooperation from all levels of government regarding the issue of debt levels.

The reform of financial relations between governments requires institutional mechanisms comparable for purposes of coordination, planning, budgeting and implementation between the different .

Almost any system that is established on the basis of a consensus can work, insofar as those who are concerned show goodwill, they will make the necessary efforts and demonstrate the flexibility that fits. These conditions are more likely to be met, whether formal coordination mechanisms are in place.

Similarly, any system of intergovernmental transfers should be explicit about who is responsible for conducting audits, program evaluations and other mechanisms for monitoring the performance of subnational governments. These functions are often performed by several agencies, although efforts are coordinated, to ensure that their implementation is entrusted to a single agency would improve overall efficiency.

The decentralization of responsibilities and the rationalization of intergovernmental transfers should be accompanied by a strategy to strengthen the institutional capacity of subnational governments. Central government (or associations of subnational governments) can identify training needs, provide training programs, providing guidelines about management issues, establishing twinning arrangements with more experienced entities, provide technical assistance and provide operational tools for the needs of a range of functions, from managing staff to monitoring programs.

Conclusions

There is not "ideal path" or magic formula to apply to the establishment of financial relations between levels of government. Economic principles and best practices on the international scene can provide useful insights, but the political and historical factors may be equally or more important for the establishment of financial relations. Accordingly, a highly egalitarian approach to equalization, modeled on the first pattern can operate properly in developed north european countries like Sweden, but they may well not be appropriate for a federal state like Canada, in which regional differences are important.

Balancing expenditures, as opposed to the equalization of income, is an option that seems to be controversial politically, for a variety of reasons, some indices are at best approximations of what is to be measured, and the data are often outdated or are not available, the mathematical aspect becomes complicated (eg. the use of regression analysis, statistics) and, more fundamentally, the cost differences between different jurisdictions are sometimes difficult to understand or explain, so that equalization of spending two features somewhat contradictory: on the one hand, it is highly technical and yet, on the other hand, it is highly political. Given the nature of the analysis - which is to allocate a specific amount of funds from a given number of entities – considered essential to the financial agreement, controversy still exists and is likely to be even more serious in the contries where own fiscal sources of income are relatively modest. In addition, one should consider the use of equalization to the extent that the principle of equity spending supports a broad consensus.

A contentious aspect of any financial relationship between levels of government concern the algorithm to determin the total amount to be transferred to subnational governments. Generally, the central government fixes the amount in its budget process, but there are different ways, for example, in the UK, the amount is set according to a set of factors which are made public, in Denmark, it is done under a set of principles, with the support of a joint forum for the debate of the issue, in Australia, the amount is determined at a Annual Premiers' Conference.

An important conclusion is needed to get out, namely that the size or scale of subnational governments appears to be important. One of the benefits arising from expenditure equalization schemes is the fact that countries are more accurate, albeit imperfect, factors that influence the cost of services in the public sector. The number of people present in a particular jurisdiction and their geographical dispersion also seem to be important factors. In the unitary countries, the trend seems to have been to reduce the number of local governments, primarily for reasons of scale and efficiency.

An important conclusion is needed to get out of the exemples from developed and developing countries, namely that the size or scale of subnational governments appears to be important. One of the benefits arising from expenditure equalization schemes is that countries are more accurate, albeit imperfect, factors that influence the cost of services in the public sector. The number of people present in a particular jurisdiction and their geographical dispersion also seem to be important factors.

The public authorities involved in the strategic economic building should carry out research on the experience in other entities regarding the funding mechanisms, particularly to determine how we could adapt the most effective these mechanisms to the context of a relationship between the central government and local authoritees:

- systems of performance indicators and comparative reporting methodologies;
- mechanisms for audit and other review mechanisms similar to a set of entities;

- common systems of accountability and financial reporting;
- mechanisms of action, eg. an ombudsman[6].

As final conclusions, we can enunciate a few principles:

- the concept of "neutrality" should be central to any system of financial transfer, neutrality is understood here in the sense that the recipient government should not be able to influence the amount of subsidies it receives by groping for spending or tax decisions;
- any statement of principles should recognize that certain principles may be contradictory - in particular, applying the "principle of fairness" seems to have the effect of removing the transfer mechanism of the "principle of simplicity";
- the proper functioning of a financial agreement requires a commitment from all parties to the ongoing management of this relationship, because of the ever-present possibility of conflict between Aboriginal governments and federal governments and between Aboriginal governments themselves , about the implementation of the compensation system.

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[6] An **ombudsman** is a person who acts as a trusted intermediary between an organization and some internal or external constituency while representing the broad scope of constituent interests. The word 'Ombudsman' is based on a Swedish word meaning 'Agent' (http://en.wikipedia.org)