DECENTRALIZATIONS AND FINANCIAL AUTONOMY – OPPORTUNITY FOR MOLDOVAN LOCAL AUTHORITIES

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Abstract*: In this article the author analyses the process of decentralization and financial autonomy as a result of using the new methodology for drafting the local budgets based on formulas. The key element is researching the impact of the new financing system on changes occurring in the communities. The new financing system is a chance for the citizens of communities to have quality services and local public administration has new opportunities to increase the tax base, supplement their incomes and provide a higher level of living to citizens.*

Keywords*: local public finances, territorial administrative unit, (general) balancing transfers, fiscal capacity per capita, number of population, area, specific weight, decentralization, financial autonomy.*
JEL Classifications: *E62, E63.*

„Definition of the territorial unit role leads logically
to state restatement of their main leaders,
elected representatives and local public body”
(Xavier Frège, Paris, 1986)

1. Introduction

The political, economic and social developments from the last years in the Republic of Moldova highlighted the need of a deep and real reform in the field of public administration and management of public finances, especially locally. Decentralization of authority and insurance of local and financial autonomy is one of the strategic priorities of the government and one of the main goals defined by a number of documents and strategies.

The Republic of Moldova has achieved and continue to carry out strict reforms in the field of public finances management both centrally and locally. Adoption and implementation of strategy for development of public finances management 2013-2020 marks an important stage to promote reforms in this field contributing to the consolidation of the public finances system.

The Law no. 397-XV of October 16, 2003 on local public finances with the amendments by Law no. 267 of November 1, 2013 which approves a new methodology for drafting local budgets taking as a base the principle of incomes has an important role.

In this article there are investigated the advantages of implementing new ways of drafting the territorial administrative units budgets based on new calculation formulas of (balancing) general transfers *[see Article annex]*, taking into account the fiscal capacity per capita, number of population and territorial area – all in relation to the national level. This new methodology is a safe condition to continue the process of decentralization and financial autonomy.

Therefore, currently in the Republic of Moldova there are a number of factors which argue pro decentralization and financial autonomy by strenghtening the fiscal base of communities. The desire of everyone to live, work, decide at home, the dynamism of Small and Medium Enterprises, will of territorial administrative units to not be limited to transfers only from the state budget but to increase their incomes make the decentralization and financial autonomy real factors which could contribute to the creation of a favourable climate for solving the problems which community needs.

2. Research of qualitative and quantitative criteria to measure the impact of new financing formula for local public authorities

Decentralization is a process of transfer of administrative and financial competence from the central public administration to local public administration or to private sector.

Financial decentralization starts to function over the limit when the use of public goods and services of national interest starts to collapse and the comparative cost of decisions making at the central level becomes too high.

In this context, the use of local finances implies not only taking over some tasks of central finances but also efforts to increase the local resources (especially by self-financing) which led to winning of some competences in the way of judicial and budgetary control.

The local public budget is the instrument by which the local communities financing is achieved. Through it, the relation between public incomes (represented especially by taxes and local fees) and social needs is established, aiming to avoid the inequalities in the distribution of fiscal tasks on local communities needs simultaneously with their social needs.

The local budgets are forecasting, planning and leading tools of financial activities of the administrative territorial units. Their structure reflects the autonomy level of local administration against central one, financial flows of local administration, public incomes and expenditures at territorial level, method of financing the expenditures by destinations and how to resolve the deficits, respectively.

The impact of implementing the new system is measured according to some **qualitative and quantitative criteria:**

a) Qualitative criteria:

- creation of stimuli for consolidation and development of a proper incomes base for the local public administration;
- predictability and stability of the system;
- transparency and responsability;
- modesty;
- consolidation of financial autonomy of local public administration as a main tool to develop the local democracy;
- support of local economic development;
- mentaining the macro-financial stability (Activity programm of Moldovan Government: ”European Integration: Freedom, Democracy, Welfare 2011-2014”).

The final result of the changes impact assessment provided by the new system shows a significant positive impact compared to the present situation. The impact assessment (positive or negative) was performed by multi criteria analysis according to the qualitative criteria,with 4 positive or negative threshold/levels: impact (positive/negative) low (Sz = +/- 1), impact (positive/negative) medium (M = +/- 2), impact (positive/negative) significant (Sf = +/- 3) and impact (positive/negative) high (R = +/- 4) (Table no. 1).

Table no. 1. Impact assessment of implementing new financing system according to qualitative criteria

Indicator	Assessed impact
Creation of stimuli for consolidation and development of a proper incomes base for the local public administration	High - R positive = 4
Predictability and stability of the system	High – R positive = 4
Transparency and responsability	Significant – Sf positive = 3
Modesty	Low – Sz positive = 1
Consolidation of financial autonomy of local public administration as a main tool to develop the local democracy	High – R positive = 4
Support of local economic development	Significant – Sf positive = 3
Mentaining the macro-financial stability	High – R positive = 4
Total Obtained Score / Average	**23/3,28 = Significant positive impact. Explication: Total 23 assessed points : 7 = 3,28 (positive assessed impact)**

Source: *Informative note. Draft Law on amendment and completion of some legislative acts.*

b) Quantitative criteria:

- Number of „failure" administrative territorial units at both levels of local administration;
- A set of indicators reflecting the level of financial autonomy of local administration:
  - weight of own incomes in total incomes;
  - weight of autonomous incomes (own incomes + incomes of breakdown share of income tax from individuals) in total incomes;
  - weight of general incomes (own incomes + incomes of breakdown share of income tax from individuals + incomes of transfer with general purpose) in total incomes (Law on amendment and completion of some legislative acts. No. 267 of 01.11.2013. In: Official Journal of the Republic of Moldova, 22.11.2013, no. 262-267).

The results of implementing the new financing system obtained from the analysis of calculations made according to these criteria for administrative territorial units of level I are presented in Table no. 2 and for administrative territorial units of level II in Table no. 4.

Table no. 2. Impact assessment of implementing new financing system in administrative territorial units of level I according to quantitative criteria

Type of administrative territorial units of level I	Number of administrative territorial units of level I	Number of failure – result from simulation
<1500 inhabitants	249	67
1501–5000 inhabitants	547	167
5001–10000 inhabitants	66	30
10001–50000 inhabitants	34	6
>50000 inhabitants	0	0
Total	**896**	**270**

Source: *Informative note. Draft Law on amendment and completion of some legislative acts.*

As mentioned above, the total number of these mayoralties is 270 of 896 administrative territorial units of level I according to the preliminary calculations.

Table no. 3. Number of failure administrative territorial units of level I after implementing a new financing system

Loss percentage of total budget 2010 – administrative territorial units of level I	Number of failure – result from simulation
<5%	48
5% - 10%	39
10% - 15%	42
15% - 20%	35
20% - 25%	31
>25%	75
Total	**270**

Source: *Informative note. Draft Law on amending and completion of some legislative acts.*

Table no. 4. Impact assessment of implementing new financing system in administrative territorial units of level II according to quantitative criteria

Type of administrative territorial units of level II	Number of administrative territorial units of level II	Number of failure – result from simulation
<50000 inhabitants	5	3
50001 – 100000 inhabitants	23	11
>100000 inhabitants	7	2
Total	**35**	**16**

Source*: Informative note. Draft Law on amendment and completion of some legislative acts.*

The changes produced with the implementation of the new financing system of the local public authorities are in general:

The system of transfers to local public administration based on incomes. This new approach in management of incomes collected by institutions is also intended to lead to a better planning of budget by link consolidation between policies and resources allocation (allocation efficiency); to a better use of budgetary resources (technical efficiency) by avoiding the request situations of financing from general incomes of budgets when on the accounts of public institutions are accumulated funds in substantial volume attributing improperly the expenditures to general incomes; to consolidation of general budgetary-fiscal discipline by facilitating control on macro-budgetary targets (incomes, expenditures, deficit); to decrease of risks on financial frauds and simplifying the procedures and costs rationalization on budgetary management. To increase the flexibility and perfection of budget management and an efficient use of resources it is suggested the cancellation of drafting and approval practice of financing plans of the budgetary institutions with monthly distribution of budgetary allocations.

The total volume of funds transferred by the central public administration to local public administration remains practically at the same level (keeping financial covering).

The shared functions (social performances and secondary education – which in 2014 is transferred to local public administration's responsability of level II) are already financed by conditional transfers based on formula under the number of beneficiars of services specific to decentralized competences. The delegated and shared competences (social payments, pre-university education) are financed by the state budget through special purpose transfers *(As to financing the pre-university education – schools, middle schools and lyceums – see below).*

The own functions are financed by local fees, taxes and tariffs, shared incomes and balancing transfers. They form the general incomes and the local public administration takes advantage of a full autonomy in allocating these resources according to local priorities. The own competences are financed by their own incomes, shared incomes and (general) balancing transfers. The local public administration will benefit by a full autonomy in allocating these resources according to local priorities because „they are well managed below".

The direct allocation of transfers (shared taxes and balancing transfers) to local public administration authorities of level I and separately to level II. At the same time, the change in managing the collected resources by budgetary authorities/institutions is planned, aiming to be directed to total expenditures financing approved by the respective authorities/institutions without being conditioned for concrete expenditures. Thus, the expenditures of budgetary authorities/institutions will be approved, executed and reported as a whole without division on financing sources. The resources for projects financed by external sources will be the only exception continuing to be used for the purposes agreed with the grantees according to the concluded agreements.

Compensation Fund (of transition) was created for the local public authorities with a low level of economic development to cover the differences between the total local incomes accumulated as a result of the new system implementation and the volume of incomes in the reference year (Temporary Compensation Transfer). This fund is limited by **1% of state budget.** This Compensation Fund has a temporary character and it will be stoped with the improvement of the economic situation locally.

Regarding the essence of (general) balancing transfers:

The balancing transfers are performed by the **Financial Support Fund** formed in the state budget frame. This fund consists of income tax of individuals unallocated in the form of distributions based on the implemetation of the budget in the previous year. **The Support Fund is allocated at a level of 45% to local public administration of level I and 55% to local public administration of level II.**

The (balancing) general purpose transfers are allocated based on formula distinct for administrative territorial units of level I and II (direct allocation on levels), under calculations performed by the Ministry of Finance.

The estimation of **balancing transfer** need of **level I** for local public administration is based on the fiscal capacity of the **locality – measured by the weight of income tax of individuals in that locality (60% of transfer), population (30%) and area (10%).**

The general transfer for the local public administration **of level II (district**) is calculated **on the basis of number of population (60%) and district area (40%).**

The result of these changes obviously should to contribute to the consolidation, extension and significant increase of the local autonomy to the foundation and administration of own incomes system. Moreover, in the new system, the stimulus of own incomes collection by the local public administration is much higher since any addition of own income remains in the community budget and can be used according to the priority needs by the local council decision. Gradually there will took place an improvement in the general transfer allocation. These advantages are based on a set of indicators which approach both the local financing capacity and the needs of public services locally: fiscal capacity per capita, population and area of administrative territorial unit. Respectively, the level of transparency, predictibility and stability will automatically increase.

The new financing methodology of local public authorities will register a significant indicators improvement in financial autonomy and decentralization. The researches show that the local financial autonomy increase by 8 times to local public administration of level I and 6 times to local public administration of level II (Table no. 5).

Table no. 5. Indicators development of financial autonomy after implementing the new financing system of local public authorities (%)

	Weight of own incomes		Weight of autonomous incomes (including shared ones)		Weight of general incomes (including balancing transfers)	
	under current conditions	under new conditions	under current conditions	under new conditions	under current conditions	under new conditions
ATU II	4,98	10,59	4,98	14,68	4,98	36,88
ATU I	2,76	10,08	2,76	14,87	2,76	21,05

Source: *Informative note. Draft Law on amending and completion of some legislative acts.*

The actions which are foreseen with the implementation of the new system imply the amplification of the local autonomy in administration and collection of local fees and taxes including defining tha base or tax rate, including property tax, vehicles tax and administrative fees. The local fees and taxes are excluded in the process of calculation of balancing transfers volume. ***The local public administration will have the right to introduce special fees to ensure the capital investment in the infrastructure of the communal services (proper functions). Moreover, the local public administration will have the right to set tariffs for the local communal services (water/sewerage, public transport, waste collection, central heating). We consider that these opportunities are real to happen in the near future. In this case, we need reforms in the fiscal policy which could ensure the fiscal decentralization too.***

Considering the role of the Ministry of Finance in the process management it is necessary **to implement a series of activities which could support the reform promotion:**

- Periodic assessment of the new system impact of own incomes and transfers (including conditioned and balancing transfers, fiscal administration, grants and loans, internal and external audit, public acquisitions).
- A set of other measures associated with financial decentralization will be approached by regulatory changes. The sectoral strategies will give additional clarifications and guidances on conditioned transfers (with special purpose), grants, tariff regulation.
- The Ministry of Finance as a leader of decentralization efforts will need a strong subdivision to ensure the relations between the administration levels.

3. Consolidation of local public administration capacity by implementing developments

The general goal proposed in the new financing system of the local public administration is to improve the current system of local public finances ensuring decentralization and financial autonomy, mentaining the financial discipline and efficiency maximizing as well as ensuring equity in resources allocation.

We consider that the new financing system of the local public administration will have a beneficial impact on consolidation and development of own incomes of the local public administration**.** The expenditures of the local public administration are determined based on incomes to the administrative territorial units. A better collection of own incomes does not influence the amounts of (balancing) general transfers.

The new balancing and shared system of the state general incomes aims to create stimuli for consolidation and development of the incomes base of the local public administrations through the following **instruments:**

- Firstly, the expenditures of the local administrations, after the implementation of the new system, are determined by the level of incomes earned by each administrative territorial unit **not** by the estimated value at a central level as in the old system (average cost for a child, pupil, employee etc.). Thus, every administrative territorial units is directly interested to collect incomes in its territory as much as possible in order to spend more according to their specific needs and to ensure a better quality for the provided services;
- Secondly, to the calculation of the *fiscal capacity per capita (FCC)* indicator there are used the incomes only from the shared quota of the income tax of individuals, disregarding the own incomes of the administrative territorial unit, hereby a better collection of the own incomes does not influence the balancing amounts received by the local public authority. The income excess is up to the administrative territorial unit;

In conclusion, we mention that the general impact of applying the new system of transfers, and, respectively, amendments proposed to the Law of Local Public Finances (2003) contributes to the following developments for the benefit of the community:

- Consolidates, amplifies and increases significantly the local autonomy, contributes to the foundation and administration of the own incomes system;
- Encourages the interest of collecting the own incomes, increasing their volume by the local public administration;
- Transparency, predictibility and stability become real;
- Gradually the allocation of the general transfer is improved because it relies on a set of indicators which approximate well both the local financial capacity and needs of public services locally. These indicators are: fiscal capacity per capita, population and area of the administrative territorial unit;
- The indicators of financial autonomy show a significant improvement.
- Contributes to the financial decentralization deeping.

In the old system, the opportunities of an administrative territorial unit to spend budgetary funds were determined by the average expenditures per capita, employee, child/pupil being set by the Ministry of Finance centrally. These do not reflect the real and specific needs of the administrative territorial units: generally there were used available norms without allowing for the needs and preferences specific to each local collectivity, services which did not have norms and the introduction of new services was very difficult. In addition to this the budgets and decisions of the administrative territorial units of level I were dependent on the budgets and decisions of the district related councils without sure stimuli for the development of an own fiscal basis for the increase of collecting the local fees and taxes or the local economic development. As a result, the old system does not fully comply with the provisions of the European Charter of Local Autonomy, as recommended by the Congress of Local and Regional Authorities.

The new system tries to eliminate the largest part of these negative effects. Firstly, a part of the expenditures amount locally is not anymore determined as central but depending on the local amount of collected incomes. Thus, on the one hand, the interest of local authorities to develop the local fiscal base, collect better the local fees and taxes, reduce the fiscal evasion and shadow economy, develop the local economy increases. On the other hand, the power of local authorities to decide the level and purpose of expenditures according to the needs and preferences specific to the comminity increases.

4. General conclusions and recommendations

Basing on the above we can identify **the main features of the new system:**

- the amount of expenditures is determined by incomes: own incomes (local fees and taxes), shared incomes of the income tax of individuals, transfers with general purpose, transfers with special purpose either for current expenditures (education, social payments) or for investment. The amount of expenditures is not anymore determined by the average expenditures per capita established centrally;
- the local authorities become directly interested to develop the own fiscal base, collect more local fees and taxes, reduce the fiscal evasion and shadow economy, develop the local economy by attracting investors that could create jobs and increase the income tax base of individuals;
- shares and formulas of transfers allocation are established by law both for level I and level II. The transparency and clarity of financial allocations increase greatly;
- there are no financial dependence relations between the administrative territorial units of level I and II. The autonomy of administrative territorial units of level I increases significantly;
- financing by transfers with special purpose mentain the opportunity to meet the objectives of the Government in important fields such as education. The conditioned transfers allow a transparent finance for important fields assumed by Government: education, social benefits. The local authorities manage these fields and can contribute with own sources to the improvement of finance;
- there is an efficient balancing system which uses three fundamental indicators: **a) fiscal capacity per capita** (calculated only on the basis of income tax of individuals); **b) population; c) area.** Thus, the poorest communities have access to a finance which can insure a minimum quality of the local public services;
- the financial autonomy increaseas significantly: if in the old system this is limited amounting to 3% - 5% of total expenditures, then in the new system this increases over 20% for local public administration of level I and 30% for local public administration of level II.

A beneficial impact both in terms of regulation and from the economic and social point of view has the **Law on public finances and fiscal-budgetary responsability no. 181 of 25.07.2014.** This law is drawn up to ensure a sustainable development of public finances, fiscal-budgetary discipline consolidation and insurence of an efficient and transparent management of public financial resources increasing the management system of the public finances to a new qualitative level. The new approaches regarding the management of collected incomes by budgetary authorities/institutions will lead to an efficient use of budgetary resources. The complex regulation and procedures consolidation of budgetary resources management and the clear limitation of roles and duties in the budgetary fiscal field will contribute to the improvement of the budget management and will make easier the process of decision making on the budget (Decentralization reform, 2010).

The improvement rules of local public finances system and transparent procedures of budget management, especially of external financial assistance will raise awareness among the external parteners and will make easier the attracting of external investment.

At the same time, the implementation of this law will show new challenges for all the participants involved in the public finances management. Thus, the Parliament, especially the specialist committee has to consolidate its analyses capacity of the budget in the process of examining the macro budget limits on a minimum term and annual budgetary laws. The Government will need better capacities to establish the policies priorities to allocate resources. The Ministry of Finance will need enhanced abilities to establish a realist micro financing frame, implement and use the new informational system of the integrated financial management. The Ministries and other public administration bodies will need enhanced abilities for analysis and strategic planning, formulation of some strict realistic budget proposals as well as formulation, implementation and reference of budget programms based on performance. An important role in a successful implementation of this law belongs to complementary reforms in other related fields such as public administration reform, reform of public financial control and audit, fiscal decentralization reform and so on.

Financial decentralization will generate beyond the socio-economic consequences beneficial for some communities and cultural, psihologycal and management effects. This requires a new managerial approach on behalf of the local elected officials, more science and conscience in direct representation and management and responsability of local interests.

Thus, there is an obvious need of financial decentralization, local autonomy consolidation, transparency urging in public authorities and local democracy frame, citizens participation in the decisions making process.

At the same time we can mention that nowadays there is no guarantee that the undertaken reforms will not be compromised by a growing importance given to the state. For that purpose we mean that it can happen that due to the lack of necessary money, the services of the territorial units can be left to the state either giving up to the given power or calling systematically its information and advices. In order not to create inconveniences to the collection of information of local interest, it would be welcome that the regional and local statistical information to be introduced in the national accounting.

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Annex[1]

Calculation formula of (balancing) general transfers for local authorities of level I

$$TE_i = FEB1\ x\ [(\mathrm{PS}^1_{\mathrm{CFL}}\ x\ \frac{(P_e\ x\,CFL_n - CFL_i)}{\sum_i (P_e\ x\,CFL_n - CFL_i)}) + (PS_p{}^1\ x\ \frac{P_i}{P_n}) + (PS_s{}^1\ x\ \frac{S_i}{S_n})]$$

$PS^1_{CFL} + PS^1_p + PS^1_s = 100\%$ **,** *<u>where</u>*

TE_i - balancing transfer for an ATU of level I;
FEB1 **-** balancing fund of ATU of level I budget;
CFL_i - fiscal capacity per capita of an ATU of level I;
CFL_n - national average fiscal capacity per capita;
P_i - population of an ATU of level I;
P_n - total population of an ATU of level I;
S_i - area of an ATU of level I;
S_n - total area of an ATU of level I;
PS^1_{CFL} - specific weight of fiscal capacity indicator per capita;
PS^1_p - specific weight of population indicator;
PS^1_s - specific weight of area indicator;
P_e - superunitary parameter;
<u>where</u>, ***PS^1_{CFL}*** **= 80 %;** ***PS^1_p*** **= 10 %;** ***PS^1_s = 10 %; P_e*** **= 1,3.**

[1] *Law on amendment and completion of some legislative acts no. 267 of* 01.11.2013 // Official Journal of the Republic of Moldova, no. 262-267/748 of 22.11.2013.