

# DECENTRALISATION AND LOCAL FINANCIAL AUTONOMY – OPPORTUNITY FOR ADMINISTRATIVE UNITS OF THE REPUBLIC OF MOLDOVA

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"In the frame of national economic policy, authorities from local government have the right for own resources, sufficient, which may have freely in the execution in their duties"  
(European Carta of Local Self-Government  
Strasbourg, 15.X.1985, article 9, p.1.)

## Abstract

In this article is investigated the process of elaboration of local government budgeting in terms of autonomy and fiscal decentralization. The new funding formula of territorial administrative units increase stimulus of administrative units to supplement local incomes and improve their services. Motivation is supported by indicators underlying the calculation of financial balance transfers: fiscal capacity per capita, area and population of that territory - all of these indicators are calculated in relation to national indicators.

**Keywords:** administrative territorial unit, fiscal capacity per capita, general transfers (equalization), special transfers, specific weight, distribution parameter, the fund for financial support

**JEL Classification:** H5, H77

In Moldova, the amendments to the Law no. 397-IV of October 16, 2003 on Local Public Finance and Tax Code 1163-XIII of April 24, 1997, there have been significant changes in the way of budgeting administrative units both income formation ATU budgets and the expenses. Completely new is the method of calculating equalization transfers and transfers to special purpose. The new vision creates real opportunities for strengthening the financial autonomy and fiscal decentralization.

The transition to the new formula of budgeting administrative units has started drafting ATU budgets for fiscal year 2014. For this purpose, all administrative - territorial units of Republic of Moldova received indication from the Ministry of Finance to prepare draft budgets for fiscal year 2014 in two variants: Variant I - the existing formula and variant II - after the new funding formula.

Distinct budgeting for administrative territorial units highlights new conditions determined by the new method of calculating general transfers (equalization) and special transfers for both: level I and level II.

Talking about calculating the general transfers (equalization) for administrative territorial units (ATU) of first level is noted that for the calculation of equalization transfers are counted three financial indicators, such as:

- Fiscal capacity per capita (measured as revenue collected from income tax deductions of individuals and number of inhabitants of ATU);
- Concrete land area;
- Number of population of a specific territory.

These indicators find expression in the new formula for calculating general transfers (equalization). In addition to these indicators "local" in the formula are found weighted indicators specified as:

$PS_{CFL}^1$  - specific weight indicator per capita of fiscal capacity;

$PS_p^1$  - specific weight of the population indicator;

$PS_s^1$  - specific weight of the area indicator;

$P_e$  - supraunitar parameter;

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where,

$$PS_{CFL}^1 = 80 \%;$$

$$PS_p^1 = 10 \%;$$

$$PS_s^1 = 10 \%;$$

$$P_e = 1,3.$$

Below we present the method of calculating equalization transfers for ATU level I (A); level II (B) and special purpose transfers (C).

### A) Calculation of general purpose transfers (equalization) for ATU first level:

Step 1. Calculation per capita of fiscal capacity for each capita of ATU of first level-  $CFL_i$ , as a ratio of tax revenue collected from the breakdown of personal income in the territory of the ATU and respective number of inhabitants of ATU;

Step 2. Calculate the capacity of national fiscal average per capita of all ATU at first level -  $CFL_n$ , as the ratio of revenue collected from income tax deductions of individuals pooled from all ATU first level and the number of cumulative population of all ATU first level.

According to the data execution for 2012,  $CFL_n$  used to calculate transfers for 2014 is equal to 107.3 lei.

Estimated value of  $CFL_n$  used to calculate transfers for 2015 and 2016 is equal to 113.6 lei, respectively, 124.6 lei.

Step 3. Calculate the product of greater than one parameter  $CFL_n$  and  $P_e = 1,3$ ;

Step 4. For all ATU of first level is calculated expression (difference):

$$(P_e \times CFL_n) - CFL_i;$$

Step 5. Calculate the expression  $\sum_i (P_e \times CFL_n - CFL_i)$ , expression summand only positive values calculated above  $(P_e \times CFL_n - CFL_i)$ , thus not included in ATU of first level, where the expression  $(P_e \times CFL_n) - CFL_i < 0$  (negative).

According to the 2012 execution of the expression  $\sum_i (P_e \times CFL_n - CFL_i)$  used to calculate transfers for 2014 is equal to 62 565.3 lei.

Estimated value of the expression  $\sum_i (P_e \times CFL_n - CFL_i)$ , used in calculating transfers for 2015 and 2016 is equal to 66 636.7 lei, respectively, 73 083,2 lei.

Step 6. Calculate the expression  $\frac{(P_e \times CFL_n - CFL_i)}{\sum_i (P_e \times CFL_n - CFL_i)}$  for ATU first level, where the expression

$(P_e \times CFL_n - CFL_i) > 0$  (positive), and if the ATU first level for expression  $(P_e \times CFL_n - CFL_i) < 0$  (negative) is automatically assigned the value 0 (zero);

Step 7. For all ATU of first level is calculated expressions:

$$PS_{CFL}^1 \times \frac{(P_e \times CFL_n - CFL_i)}{\sum_i (P_e \times CFL_n - CFL_i)}; PS_p^1 \times \frac{P_i}{P_n}; PS_s^1 \times \frac{S_i}{S_n}$$

Step 8. Calculate the expression:

$$[(PS_{CFL}^1 \times \frac{(P_e \times CFL_n - CFL_i)}{\sum_i (P_e \times CFL_n - CFL_i)}) + (PS_p^1 \times \frac{P_i}{P_n}) + (PS_s^1 \times \frac{S_i}{S_n})]$$

for all ATU first level, so it summarizes the results obtained in step 7);

Step 9. Finally is determined for each of the first ATU the transfer of general purpose by multiplying the result obtained in step 8), according to the formula:

$$TE_i = FEB1 \times [(PS_{CFL}^1 \times \frac{(P_e \times CFL_n - CFL_i)}{\sum_i (P_e \times CFL_n - CFL_i)}) + (PS_p^1 \times \frac{P_i}{P_n}) + (PS_s^1 \times \frac{S_i}{S_n})].$$

where:

$TE_i$  - balancing transfer for some ATU of first level;

Feb1 – ATU budget fund balance of the first level;

$CFL_i$  - per capita fiscal capacity of some ATU first level;

$CFL_n$  - the national average per capita of fiscal capacity;

$P_i$  - population of a certain ATU of first level;

$P_n$  - total population of administrative-territorial units of the first level;

$S_i$  - particular area of the first level ATU;

$S_n$  - total area of the administrative units of the first level;

$PS_{CFL}^1$  - specific weight of indicator per capita of fiscal capacity;

$PS_p^1$  - specific weight of the indicator population;

$PS_s^1$  - specific weight of the indicator area;

$P_e$  – supraunitary parameter;

### **B). Transfers of budget balancing for ATU of second level**

Feb2 is intended to balance budgets of ATU of second level and is distributed according to the following indicators:

a) population;

b) the area ATU, according to the formula:

$$TE_j = FEB2 \times \left( \frac{PS_p^2 \times P_j}{P_n} + \frac{PS_s^2 \times S_j}{S_n} \right);$$

$$PS_p^2 + PS_s^2 = 100\% ,$$

where:

$TE_j$  - balance transfer for a certain ATU of second level;

Feb2 - fund of balance budgets ATU of second level;

$P_j$  - the population of a certain ATU of second level;

$P_n$  - ATU of the total population of the second qualifying assignment;

$S_j$  - ATU surface of a certain second level;

$S_n$  - ATU total area of the second qualifying assignment;

$PS_p^2$  - Specific weight of the indicator population;

$PS_s^2$  - Specific weight of the indicator area;

where,

$$PS_p^2 = 60\% \quad \text{and} \quad PS_s^2 = 40\%$$

Calculation of general purpose transfers (equalization) for ATU of second level is directly proportional to the population and ATU area, balancing local budgets being qualified to the second level, with the exception of municipal budgets Chisinau, Balti and autonomous territorial unit budget (ATU) with special legal status.

### **Calculation of general purpose transfers (equalization) for ATU second level:**

Step 1. Calculate expressions  $PS_p^2 \times \frac{P_j}{P_n}$  și  $PS_s^2 \times \frac{S_j}{S_n}$  for all second level ATU qualifying assignment.  $P_n$  and  $S_n$  are determined by excluding the population, respectively, surface Chisinau and Balti and Gagauzia, as they are not qualified to allocation;

Step 2. Calculate the sum of expressions  $(\frac{PS_p^2 \times P_j}{P_n} + \frac{PS_s^2 \times S_j}{S_n})$  for all second level ATU qualifying assignment;

Step 3. Finally, is determined transfer with general purpose for each ATU second level, qualified at allocation, by multiplying Feb2 with the result obtained in step 2), according to the formula:

$$TE_j = FEB2 \times (\frac{PS_p^2 \times P_j}{P_n} + \frac{PS_s^2 \times S_j}{S_n}).$$

### **C). Special purpose transfers**

Special purpose transfers from the state budget is allocated to ATU budgets for funding:

- a) primary, secondary, general, special and (extracurricular) education;
- b) the power delegated to APL by the Parliament on the Government's proposal.

Information on special purpose transfers from the state budget to local budgets for financing primary, secondary, general, special and (extracurricular) education for 2014 and estimates for the years 2015 to 2016 are presented in Appendix. 2.2. to notes about the development projects of ATU budgets for 2014 and estimates for 2015 and 2016.

At present, establishing relations between the state budget and local budgets, transfers to finance powers delegated to APL are considered:

- a) social transfer payments;
- b) transfers to compensate for the difference in tariffs for electricity and natural gas (used by residents of localities Dubasari and Căușeni and Varna village from Anenii Noi district);
- c) transfers to compensate for lost revenues of ATU budget (... compensation of local budget income, budget of state social insurance and mandatory health insurance funds, missed about exempting landowners located on route Râbnîța - Tiraspol.);
- d) transfers from the republican fund of social support of the population.

In the formulas explained above, may be presented specific calculations to determine general transfers (equalization) for administrative territorial units that have fiscal capacity per capita in different proportions compared to fiscal capacity per capita at the national level. These calculations will highlight the advantages and disadvantages of the new formula of general transfers (equalization) for administrative units with different tax bases. For a summary of the advantages and disadvantages of new ways of funding local authorities, we present a SWOT analysis of this process (figure 1).

Source: based on analysis of the National Decentralization Strategy and the new funding system ATU budgets.

SWOT analysis highlights the range of issues facing local government, but also local authorities have many strong sides which enables them to improve their economic and social situation in the territory. The new system offers these possibilities.

#### **Main findings:**

1. The new funding system provides a real local autonomy which gives the right and effective capacity of local authorities to address and manage, on behalf and in the interest of local communities that they represent, public affairs, according to the law.
2. Moreover, local authorities, according to the principle of local autonomy manage if appropriate, and have financial resources and public or private property of administrative territorial unit.

3. The new system also provides financial decentralization, which aims, in fact, increase of quality of public services provided to citizens, which can be achieved by empowering and improving local government and elected officials receiving authority and resources with which to make decisions concerning the provision public service. Of particular importance in this direction have local authorities, who by the practice, the accumulation of domestic and international experience in the field, the management realized to be the main actor in the process.
4. New system of financing of local government is substantiation for the first time the draft budgets according to the procedures and the independence offered by local public finance law. This creates the possibility for local authorities to organize their tax services and offers the ability to exercise fully and effectively all the components and decentralized responsibilities for the establishment, finding, collecting, controlling and tracking local taxes.

### SWOT Analysis

| <b>Strengths</b>  | <b>Weaknesses</b>  |
|---|--|
| <ul style="list-style-type: none"> <li>- Change the motivation of local government revenue generation;</li> <li>- Delimitation of their income levels of ATU;</li> <li>- Norms breakdown of personal income tax is set by law for each level of APL;</li> <li>- Transfers are performed according to a standard formula, which excludes all possibility to benefit someone in some subjective reasons over others;</li> <li>- General transfers calculation (balancing) are taken into consideration following indicators: fiscal capacity per capita, population and territorial administrative unit surface, which gives the possibility that surplus income collected remain in the local budget;</li> <li>- Excluding financial relations of subordination between ATU first level and second level;</li> <li>- New system of financing local authorities ensure autonomy in allocating money from their own income, deductions from income tax of individuals and transfers from the general state budget prioritization of services to the local community;</li> <li>- Expenditure on education are taken by the state and financed by direct special transfers purpose for each local government in part;</li> </ul> | <ul style="list-style-type: none"> <li>- The economic base and therefore tax and the weak of most local governments;</li> <li>- The level of development of UAT is different. The new system provides immediate increase in fiscal capacity of local governments, this requires time and proper effort;</li> <li>- Most APL leaders are accustomed to be financed from the state budget through transfers and changing attitudes to generate revenue in its territory requires will and interest. The new system creates incentives, but also requires efforts;</li> <li>- Local tax collector lacks fiscal instruments influence upon borrowers with low creditoriness;</li> <li>- Lack of predictability (prediction) of local revenues;</li> <li>- Lack of liquidity (the cash) from the state budget for the full and timely performance of general and special purpose transfers from the budgets of territorial administrative units.</li> </ul> |
| <b>Opportunities</b>  | <b>Threats (risks)</b>   |
| <ul style="list-style-type: none"> <li>- Establishing breakdowns of tax income of individuals will stimulate LPA in creating new jobs based on citizens' contribution to the local budget;</li> <li>- Revenues from local taxes are taken into account in the budget leveling therefore appear more possibilities of financing activities of common interest;</li> <li>- Opportunities appears to allocate general purpose transfers directly from the state budget to each local government, by omitting mixture (intervention) of political factor;</li> <li>- New system of revenue sharing and transfers to general purpose computing provides stability, predictability, predictability over several years in developing strategies and development plans of localities;</li> <li>- Local government will have developed its own tax base will allocate additional funds for local schools.</li> </ul>   | <ul style="list-style-type: none"> <li>- A key risk is hesitation, uncertainty, doubt, leaders of local government to change, fear that they could apply (face) in place incentives offered.</li> <li>- Implementation of the new system of financing local government requires direct involvement of local government leaders, level I, this requires additional effort that many leaders do not wish to proceed, preferring to maintain the present situation;</li> <li>- The influence of weak and local government levers on reducing tax evasion and the shadow economy;</li> <li>- Discrepancies between local public data and official statistics on population and area administrative units complicates the situation by further calls to flesh indicators needs LPA budgeting;</li> <li>- Limited management capacities of local government. Drivers are not trained, do not have accurate information and skills needed;</li> </ul>         |

**Figure 1. SWOT analysis of UAT new funding system**

5. His allows correlation of financial resources attracted heritage items of local communities and the need to reorganize and improve the management and quality of public services provided to

the population. Linking local policies with the regional development and sectoral policies, especially in areas like education, welfare, culture also represents an opportunity for the new system that opens new possibilities for local government.

6. Upside of those mentioned we can conclude that fiscal decentralization gives economic benefits to administrative territorial units by improving resource allocation and efficiency of the administration, through the principle of subsidiarity, by transfer of responsibilities to the most appropriate administrative level to ensure maximum performance. Similarly, a decentralized system is beneficial because it can attract more resources locally. So, decentralization is a process of organizational development, a process of transition from one system to one fundamentally different, all done in order to increase the quality of services provided to the community.
7. Obvious that new system of financing local government provides many more advantages and opportunities than disadvantages. Its implementation is a complicated process and requires additional time and effort, but the benefits they provide is worth the effort.

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