

TAX FEDERALIZATION – AN IMPORTANT STEP IN THE PROCESS OF DECENTRALIZATION

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1. Introduction

Improving efficiency and modernizing the public administration was and still is a major requirement of the Romanian society's reform.

One of the essential principles which form the basis of the functioning of the local administration – principle stipulated in the European Charter of Local Self-Government – is, without doubt, the principle of subsidiary, principle that governs all civilized countries and which states that adopting decisions is done by the authority that is closest to the citizen. Therefore, the financial decentralization represents one of the major priorities of the Romanian administration reform.

In accordance with art. 120 paragraph 1 of the Romanian Constitution, republished: "The public administration from the administrative-territorial units is based on the principles of decentralization, of self-government and of the deconcentration of public services". The public administration authorities, by means of which local autonomy is achieved in communes and towns, are the local councils and town halls chosen within the provisions of the law (art. 121, paragraph 1). At the same time, the fundamental law acknowledges the Council as being "the public administration authority that co-ordinates the activities of all commune and town councils" (art. 122, paragraph 1)

Therefore, decentralization in public administration is a legal system

where the local problem solving is no longer done by clerks named by the centre, but by the ones chosen by the electorate.

In case of decentralization, the state does not assume all alone the burden of administrating, but it shares it, in certain proportions, with other categories of persons such as local authorities. The decentralized system replaces the hierarchical power – proper to centralization – with a legal administrative control.

As a consequence, the concept of decentralization has a broad and a narrow acceptance. In its broader acceptance, decentralization represents any transfer of power from a central to a local level. In its narrow acceptance, decentralization is linked to the process of achieving it, i.e. territorial decentralization – by transfer of power to the administrative-territorial units, and services decentralization – by separating some public services from central or local jurisdiction and offering them an autonomous organization.

The blueprint act of decentralization no. 195/22 May¹, defines decentralization as: the process of dispersing administrative and financial competences from the central public administration level to the local public administration or the private sector levels.

¹ Appeared in the Official Journal, no. 453/25 May. 2006.

2. Faces of the decentralization

After responsibility transfer, decentralization is divided into three categories: political, administrative and fiscal.

Political Decentralization implies offering to the citizens a greater power in which concerns the decision making, especially by using democratic processes.

The success of the Political Decentralization depends on a series of key components such as: constitutional or statutory reforms, the existence of the political pluralism, the enforcement of the legislative bodies and the local political units. Usually, political decentralization determines the emergence and development of many administrative tasks in the public sector.

Administrative Decentralization is recognizing the legal personality of the administrative-territorial units, the existence of public authorities that represent them and that are not part of an hierarchical system subordinated to the centre, as well as the dispersal of some of the public services from the central authorities to the local ones.

The different sub-categories of the administrative decentralization are frequently defined according to the types of institutions or agencies to which the responsibilities are transferred.

- *Deconcentration* represents the weakest form of decentralization that implies the transfer of authority and responsibilities from the Ministry and Agencies to their corresponding territorial structures.

- *Devolution* generates a higher autonomy level and implies the transfer of responsibilities from the central government level to inferior levels that have been empowered by means of constitutional or statutory provisions.

- *Delegation* implies the responsibilities transfer from the central agencies to quasi-autonomous entities,

working independently or semi-independently from the government.

- *Privatization* sometimes is seen as a form of decentralization (one projected in such a way that higher performances regarding the efficiency of the market style could be generated by higher levels of autonomy and higher flexibility in decision making) and implies the transfer of responsibilities from the government to private entities. In what concerns privatization, responsibilities can be transferred even to the services suppliers themselves.

The degree of administrative decentralization depends on the number of public services given to the local jurisdiction. The greater their number, the higher will be the degree of decentralization.

The national economic policy should provide that the local authorities should have their own adequate financial resources of which they could dispose freely within their competences. A real reform of the local administration cannot be resumed just at dispersing responsibilities to the local authorities. The transfer of tasks to local authorities without providing the necessary funds can affect directly the process of decentralization. The local authorities' financial resources must be proportionate to the competences under the Constitution or under other laws.

We cannot speak about a true decentralization without a more serious approach of the fiscal (federalization) decentralizing segment that has to ensure the necessary financial resources for the performance of the administrative decisions of the administration.

3. Fiscal Federalism

Fiscal Federalism refers to the structure of the financial-tax relations existing in a country between the central administration level and the one of local administration.

Many of the scholars' studies focus on the nature of the inter-governmental transfers and on the differences concerning the capacity of generating revenues of the different types of authorities.

This way, fiscal federalization refers to the power transfer for mobilizing and attracting monetary resources, and spending public money from the central governmental authorities to the local, provincial, regional, county, municipal or parochial (parish) governmental authorities etc.²

As originally developed by Musgrave (1959)³ and Oates (1972)⁴, the "theory of fiscal federalism" concerns the division of public-sector functions and finances in a logical way among multiple layers of government.

Fiscal federalism is concerned with "understanding which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government"⁵

An important aspect in analyzing the fiscal federalism is represented by a corresponding balance between the authority and the necessary financial resources in order to exercise that authority.

The vast literature also raises aspects concerning about "decentralization theorem" (Oates 1991)⁶, models for the assignment of

powers (McLure 1993)⁷, discussions of intergovernmental spillovers⁸ and intergovernmental grants (Break 1980)⁹, fiscal mobility and migration (Wildasin 1991)¹⁰, and vertical fiscal imbalance and dependence¹¹ (Hunter 1977)¹².

In other words, it is the study of how competencies (expenditure side) and fiscal instruments (revenue side) are allocated across different (vertical) layers of the administration.

To summarize, the basic elements of the fiscal federalism are:

- Dispersing the public services responsibilities from the central administration to towards the local public authorities;

- Empowering the local government to collect revenues from its own resources to finance these services.

In some countries, financial decentralization is motivated by the desire for a macro-economical stability and economic growth. In the case of the countries members of the OCDE, the financial federalism is sustained by arguing based on the practical reality according to which central governments are not able to properly respond to an increasing requirement for goods and public services. This argument is also sustained by Oates'¹³ optimal decentralization theorem that grounds that a public good whose consumption

² Gallagher, Mark. 1998 – *Choices in Fiscal Federalism*, Center for Applied Studies in Economics, CASE STUDY NO. 98/1, September.

³ Musgrave, Richard A. 1959 - *The Theory of Public Finance*. New York: McGraw Hill.

⁴ Oates, Wallace E. 1972 - *Fiscal Federalism*. New York: Harcourt Brace Jovanovich.

⁵ Oates, Wallace E. 1999 – *An Essay on Fiscal federalism*, Journal of economic Literature, 37(3):1120-49

⁶ Oates, Wallace E. 1991 - *The Theory of Fiscal Federalism: Revenue and Expenditure Issues—A Survey of Recent Theoretical and Empirical Research, Public Finance with Several Levels of Government*, edited by Remy Prud'homme. The Hague/Koeningstein: Foundation Journal of Public Finance.

⁷ McLure, Charles E., Jr. 1993 - *Vertical Fiscal Imbalance and the Assignment of Taxing Powers in Australia*. Stanford: Hoover Institution.

⁸ *The spillover effect* supposes almost automatic transition from one state of integration to another, the sectorial integration aiming for a general integration.

⁹ Break, George F. 1980 - *Financing Government in a Federal System*. Washington, D.C.: The Brookings Institution.

¹⁰ Wildasin, David E. 1991 - *Income Redistribution in a Common Labor Market*, American Economic Review 81/1991: 757-74.

¹¹ *The process of deepening*, vertical development (institutional).

¹² Hunter, J.S.H. 1977 - *Federalism and Fiscal Balance*. Canberra: Australian National University Press.

¹³ Oates, Wallace E. 1972 - *Fiscal Federalism*. New York: Harcourt Brace Jovanovich.

spreads in areas of several local communities and whose production cost is the same both at central and local levels will always be easier to be produced in optimal amounts, in a parentian sense, locally than centrally.

Both responsibility and allocative efficiency can be improved by transferring the distribution of costs closer to the income sources and therefore closer to the taxpayer.

Until now, in Romania, three stages¹⁴ can be identified within the process of implementation of the fiscal federalization (decentralization). The first stage (1991-1994) is characterized by important changes in the structure and financing of the local authorities, which also included the introduction of the local tax and contributions system. During the second stage (1998 – 2001) new steps were made in order to achieve administrative and financial decentralization. This way, on the grounds of the new legal provisions concerning the finances of the local authorities, not only the GDP on local budgets, but also the corresponding proportion of local expenditure in total public expenditure has increased (for example, between 1998-2001, the GDP percentage increased from 3.6 to 6.5% and the local expenditure increased from 14.4 to 26.6%). During the third cycle (2001 – present), the normative acts adopted established new rules for certain functions of the local authorities, especially concerning the services and utilities in the local sub-ordination.

The process of fiscal federalization is still ongoing, some of its “failures” being demanded by the local communities and, at this time, they should be solved as urgent as possible. Among these, we can identify mainly:

- Lack of predictability of the revenues of the local communities;
- Modifications of some categories of costs of the local administration, without a proper insurance of the resources (the social protection issue, investments in education and public health, ensuring public order) ;
- A high degree of dependence on the annual laws of the state budget
- The impossibility to control certain local taxes or contributions which are very important for the local budget, shares of the income tax included;
- The incapacity of the local economies to generate tax revenues sufficient enough as to cover the public necessities. Most taxes with an increased rate of collection are taken to the state budget, and local communities are set taxes and contributions that presuppose relatively small tax returns;
- Although they finance certain activities, the local public authorities do not have competences regarding the naming or the dismissal of the leaders of these institutions;

Local governments have no real leverage to influence taxpayers to ensure the opportunity and the complete payment of local taxes etc.

4. Conclusions

A developing community is a community that relies more and more on its own decisions and resources that it manages, and less and less on the outside help.

If the decisions and the managing of the resources are not done within the community, the latter will become dependent. It will depend on institutions and organisms which it, the community, controls more or less directly.

Institutions that are not directly controlled by the citizen are less transparent institutions, thus less efficient. Therefore, expressions like “the government’s money...”, “the district’s money...” or “the money from the city

¹⁴ Profiroiu, Alina; Profiroiu, Marius și Pradelles, Ane-Azam, 2006, *Considerații privind procesul de descentralizare în România*, Revista Administrație și Management public, nr. 7, pg. 34.

hall...” are easily and often used. But one essential thing has been forgotten. This money belongs to the citizen; he is the one who finances the budgets of the administrative institutions, he is the one who generates the resources of the community. Unfortunately, at this time, only a small amount of this money

remains within the community from where it left.

Hence, we embrace the opinion according to which the local community itself must manage the resources, the values and the mechanisms of a good functioning. That is why there is a need for a tax federalization.

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