

LOCAL GOVERNMENT

FOCUS: FINANCING DEMOCRACY AT ITS GRASSROOTS: BUDGETARY CHALLENGES IN LOCAL GOVERNMENT

Since the introduction, in 1998-99, of the new decentralized system ~~was introduced in 1998-99~~ for public finance, ~~the~~ Romanian's public finance at the sub-national finance level has evolved towards more transparency and predictability. Both conditions are a must if the local gGovernments are to enjoy real autonomy in developing their own budgets and policies. However, there are still shortcomings that undermine the functioning of the new mechanisms. Moreover, important pieces of legislation adopted this year (local taxes) or currently discussed (local finance) may threaten the positive developments achieved/achievements realized so far.

By tradition, the blueprint structure of the modern Romanian state ~~born in the second half of the 19th century~~ was modeled influenced by after the centralized, uniform structure of the French state. For Mmost of the time period since its inception establishment, the local Government (LG) was organized eninto two tiers (though there were several attempts to create a third tier). But However, whilst if the details of the administrative structure have changed several times inover the last century and a half, the institutional culture in ~~the~~ local Government has stayed more or less by and large the same in one important respect: central Government's intervention in ~~the~~ local affairs is tacitly accepted, or at least

tolerated, especially when it comes from the Prefect's office. Local autonomy in Romania has never been as strong as in the Central Europe, which was exposed more to the German influence. Moreover, since nation- and state-building were top priorities in the 19th century, all the other political goals had to be subordinated to the ~~urge to objective of~~ creating a modern and functional national ~~body~~ ~~politiestate, and with its central~~ bureaucracy. ~~The~~ local needs and agendas were seen as secondary and accepted only as long as they did not threaten the interests of the broader, national community.

Therefore, an uniform pattern of the local units ~~were~~ created, which, though not totally independent of the regional traditions, was meant to serve first of all the functional ~~necessitiimperatives~~ of the young state. Grassroots democracy ~~was~~ ~~traditionally rather weak~~ ~~has been by tradition not very strong~~, and all the attributions of ~~the~~ local ~~g~~Governments, irrespective of the formal constitutional setting, were perceived as mandates or liberties delegated or created by the national state.

The Communist regime, ~~which that~~ took over Romania in 1948, operated many changes in the local ~~G~~g government framework, but found the bases of the old arrangements ~~as being~~ fundamentally convenient for its own purposes. Since the local communities were generally accustomed to being patronized – and sometime abused – by the central Government, they did not represent a real obstacle for the new ~~authorities~~ regime. As a result, when ~~a~~ decentralization ~~process~~ was ~~initiated embarked upon~~ immediately after 1989, being ~~regarded~~ ~~seen~~ as a mandatory ~~stage~~ ~~ep~~ on the 'road towards Europe', the historical experience of local self-~~G~~g government was ~~neither rich~~ ~~limited~~, ~~and seldom relevant~~ ~~not very useful~~ in the new context. Creating a functional network of local ~~g~~Governments turned out to be both a challenge, because of the difficulties, ~~as well as~~ ~~and~~ an opportunity, since a new system could be ~~built~~ up from scratch in a coherent manner.

As it happens in real life, ~~however~~, a complex system such as this could not be organized ~~in a fully entirely~~ ~~rational~~ ~~ly~~ manner. Many decisions that affected the process of decentralization were taken by default rather than deliberately, and the ~~final~~ ~~end~~ result is sub-optimal¹². ~~This is the case, for example, with the allocation of~~

¹² ~~This is the case, for example, of the allocation of transfers and of the equalization grants system.~~

~~transfers and the equalization grants system.~~ But eventually a system did emerge that relies on four main building blocks:-

- The Law of Local Public Administration (LLPA), adopted in 1991 and amended many times after that ~~date~~, until ~~its was replaced~~ ~~ment by~~ ~~with~~ a new LLPA in 2001. This piece of legislation defines the structure and attributions of the local ~~G~~governments in Romania, at both the ~~local commune/municipality~~ and county level. It actually formalizes the return to the ~~Romanian~~ sub-national administrative structure ~~from of~~ the interwar ~~years period~~ (but with fewer and larger counties). The language is rather general as far as the functions are concerned, enumerating a long list of attributions and making very few distinctions between the two levels of local Government (counties and municipalities).
- The Law of Local Taxes (LLT), adopted in 1993, is likely to be replaced in 2002. This act established in law the notion of ~~own-ocal~~ taxes, controlled and levied by ~~the local G~~governments (though the control has never been total). Thus, the property tax became the main source of ~~own-locally generated~~ revenues for the sub-national ~~g~~Government in Romania.
- The Law of Local Public Finance (LLPF), adopted in 1998, is also likely to be replaced in 2002. This act governs the system of transfers among ~~st~~ tiers of Government, the shared taxes, the equalization grants and ~~the~~ municipal borrowing ~~issues~~. In its current form, it represents an attempt to codify ~~the revenue-sharing system in Romania~~, and ~~to~~ make ~~it~~ more transparent ~~the revenue-sharing system in Romania~~. The Annex of ~~the is~~ law contains the ~~chart of~~ accounts ~~that~~ ~~o~~ ~~must~~ be used by local ~~G~~governments in managing their own revenues and expenditures.
- The Annual National Budget Laws (ANBL), which governs one budgetary cycle (January ~~—~~ December) and must be ~~passed~~ ~~passed~~ by the Parliament before the end of the previous year. These annual ~~bills~~ ~~budgets~~ specify the total amount of funds that is transferred from the central budget to local ~~G~~governments, in the form of equalization ~~funds~~ ~~money~~ or conditional grants. ~~#~~ ~~They~~ also ~~spell out~~ ~~gives~~ the criteria to be used by the Ministry of Finance and counties in the process of equalization.

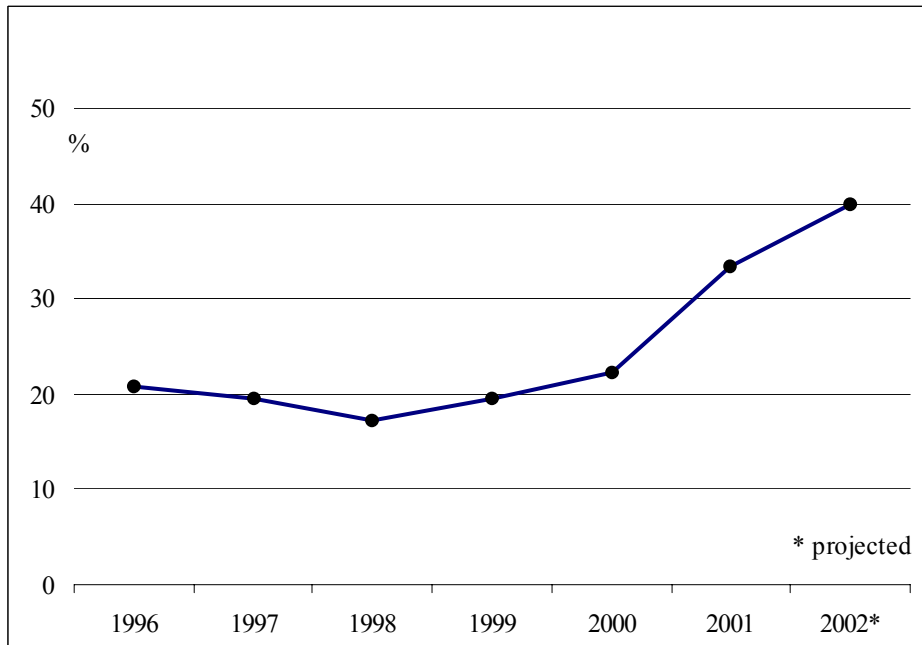
Whilste in the early '90s the ANBL was the main basis ~~e~~for local ~~G~~government policy, reflecting a high degree of centralization in decision-making ~~—~~and

~~decreasing predictability at the local level~~, the situation has gradually changed ~~in over~~ time. LLPA and LLT extended substantially the local administrative autonomy and created own sources of revenue for the local ~~G~~governments. However, many fiscal issues had not been sorted out and the ~~allocation process remained highly un~~predictability ~~of the allocation process was low~~.

In 1997-98, key legislative reforms were implemented, ~~with a view to~~ ~~aimed at~~ fundamentally changing ~~interGovernmental fiscal relations and~~ the structure of the finances of the county and local councils. In particular, the LLPF, enacted in 1998, ~~put~~laced local finances and the local budget process on an equal legislative basis with those of the national Government. The law also introduced tax revenue sharing in Romania. Under the new arrangement, the county and local councils receive a share of the income taxes collected from taxpayers in their ~~geographic area of jurisdiction~~, and ~~the discretionary power of the~~ central Government ~~discretion into~~ earmarking ~~sum~~fundss has ~~decreased~~been reduced.

The new legislation also greatly simplified the transfer system. All dedicated transfers for ~~operating~~ subsidies ~~of~~to public service companies and investment subsidies to the local and county councils from the state budget were eliminated. The general transfer was replaced with a 'equalization grant', ~~that~~which aims to ~~correct~~mpensate for differences in expenditure responsibilities and fiscal capacity amongst the county and local councils. ~~Equally, The the authority of the national Government to approve local investment projects reforms also reduced~~was ~~restricted the authority of the national Government to approve local investment projects to larger~~ projects above a certain ~~minimum cost levels~~financial threshold, and to those ~~fully or partially~~ funded ~~partially or fully by~~from the ~~state~~central budget. A vigorous policy of ~~reallocate~~delegating attributions and sources of revenue to sub-national levels of ~~G~~governments ~~was~~ pursued, ~~that~~which ~~substantially~~ increased ~~substantially~~their share ~~of local public finance~~ in the total public expenditure in Romania (Fig. 1).

Fig. 1. Local ~~g~~Government, % total public expenditure



~~As a matter of fact,~~ ~~The~~ central Government has even been criticized for decentralizing too fast and too much, ~~thus~~ overburdening ~~the~~ local ~~G~~Governments. ~~The truth is that~~ ~~Moreover,~~ many new functions are in fact just ~~mandates~~—tasks that are passed ~~delegated~~ down to ~~LGs~~local governments for execution, with ~~some~~ ~~money~~ ~~yearmarked~~ funding, ~~attached~~ but without any decision-making power.

~~On the other hand~~ ~~However,~~ the central Government has a point ~~when they~~ ~~when~~ arguing ~~ge~~ that many ~~of the~~ newly transferred functions start as ~~just a mandate~~ ~~tasks~~ ~~delegated for execution, as a transitory situation~~ ~~for the first one or two years, just in order to preserve flexibility in conditions of extreme uncertainty,~~ but that ~~A~~ after ~~the situation stabilizes and local governments accumulate more~~ ~~experience~~ ~~accumulates in LGs,~~ the conditionalities will be relaxed and ~~the~~ local authorities will be free to take over the services. This is ~~in particular~~ the case ~~withof~~ primary and secondary education, ~~orand of~~ welfare support ~~policies~~ ~~services,~~ reassigned to local ~~G~~Governments in 2001. ~~It should be highlighted, in this context, that~~ ~~In fact,~~ it is not the central Government, but ~~the~~ ~~other~~ stakeholders ~~involved~~—(for example, ~~e.g.~~ the trade unions in ~~the~~ education sector) who are the main opponents of real decentralization.

Sources of uncertainty in the local decision-making process

~~In fact, the~~ on-going reallocation of substantial attributions from the central Government to local governments unavoidably creates uncertainty for the near future couple of years. ~~The trend is clear — Tab. 1 shows that the proportion of sums spent for covering the cost of mandates has risen, at the expense of the non-mandated functions — but the details (calendar, costs) are hard to anticipate. As a result, the unstable policy environment is unlikely to change much on the short term.~~ The Government has an ambitious agenda for the next one ~~or~~ two years, when more attributions will be reassigned to LGs local governments. ~~These~~ list will include ~~s~~ police, disaster relief, emergency services, and local power plants. The exact impact on ~~the~~ local budgets is hard to ~~estimate~~ anticipate at this stage, ~~but the direction of change will be the same — more mandatory spending, and probably more dedicated transfers paid from the VAT revenues collected at the national level.~~

Fig. 2. Categories of expenditure in the LG local governments' budget

			Before 2000	2001-2002
Not mandated	General	local	40%	25%
	services			
	Public		20%	8-9%
	transportation			
Mandated	Education		10-12%	35%
	Welfare policy		5-6%	15%

In the long run, the Government will ~~be~~ probably be able to ~~transform~~ replace some of the earmarked ~~sum~~ transfers and subsidies to local governments ~~into~~ with own sources of revenue for the latter (or at least with general purpose transfers with stable allocation formulas, such as shared taxes), ~~and which will make~~ the local budgetary process ~~will become~~ more predictable and stable. Until then, however, the attempts to ~~do~~ fine-tuning in revenue allocation are probably useless, and the attention should focus on the few big important issues that can make a difference irrespective of what exactly will be how the final list of final functions ~~assigned~~ of functions ~~look like~~ to local governments.

The de-centralization process ~~of transfer~~ is complex and unpredictable, and sometimes even the central Government cannot control it fully. For ~~example instance~~, ~~some certain~~ services that will be transferred to LG local governments must ~~be~~ first be demilitarized (e.g. police, firefighters). This is a sensitive ~~and visible~~ issue and, as it happened with education, is likely to meet fierce opposition ~~will be fiercely opposed by from the stakeholders involved~~ the staff concerned, who will not like to see their special military status abolished and, ~~moreover~~, themselves ~~become~~ local civil servants instead of employees of a central ministry. ~~This~~ Such factors creates uncertainty and political risks until the reassignment of functions is completed. Moreover, it is difficult to ~~make~~ an accurately estimate ~~of~~ the real costs of these services, as long as they are part ~~of~~ central ministries, because many auxiliary operations and overheads are shared with other departments. The only realistic option in this respect is learning by doing – ~~and~~ hence the central Government has one more reason to continue for some time ~~to use~~ ing earmarked sum funds.

On the revenue side, the purpose intent of the current legislation ~~was~~ has been to strengthen local fiscal autonomy by clarifying and expanding local control over the budget process. However, progress in meeting this objective has been partial at best. The rules ~~on for~~ revenue sharing have gone through two amendments. Equally, ~~the~~ simplification of the system of transfers ~~also~~ did not last ~~very~~ long. The national budgets laws of in 1999 and 2000 reintroduced dedicated transfers for roads, housing and child protection, and divided the equalization grant into two parts, one general and one solely to compensate for the cost of residential heating subsidies. The rate of the shared taxes has also been modified each year.

At the same time ~~in parallel~~, there are still ~~some certain~~ special funds, typically dedicated to investments, that are allocated to LGs local governments in a way that is neither transparent nor ~~very~~ accountable. Some matching grants for investments are included in the national budget with a known clearly specified destination, ~~but~~ ~~some of them others~~ are simply allocated given to the relevant line ministries, who are responsible for administering them (most often Public Works ~~or~~ and Industries, since ~~the typical~~ investments are in mostly concern roads, social housing, water ~~systems~~, and gas pipes).

Apart from these shortcomings, the local budget process remains the main source of 'institutional noise' for local and county councils. This is an important point, which is and often overlooked in many assessments of the decentralization that rely solely on quantitative data and spending indicators.

With the approval of the State budget, often occurring as late as February of March of a fiscal year that runs from January to December (the 2002 budget has been the first exception to this rule), each local ~~G~~government has to wait for the adoption of the State budget before can adopting its own budget for the year. First, however, local governments~~they~~ must adjust their draft budget in accordance with the rules set forth in the ~~current~~ State budget law. ~~In each~~Every year since 1991, ~~thisese~~ hasve included changes in the expenditure responsibilities of both local and county councils, ~~and it also has included~~ variations in the volume and type of transfers, (for both general and earmarked transfers). ~~In addition~~Additionally, ~~the~~ local councils must wait for the county council to allocate to each one of them their ~~respective~~corresponding share of the equalization grants received by the county council from the State budget.

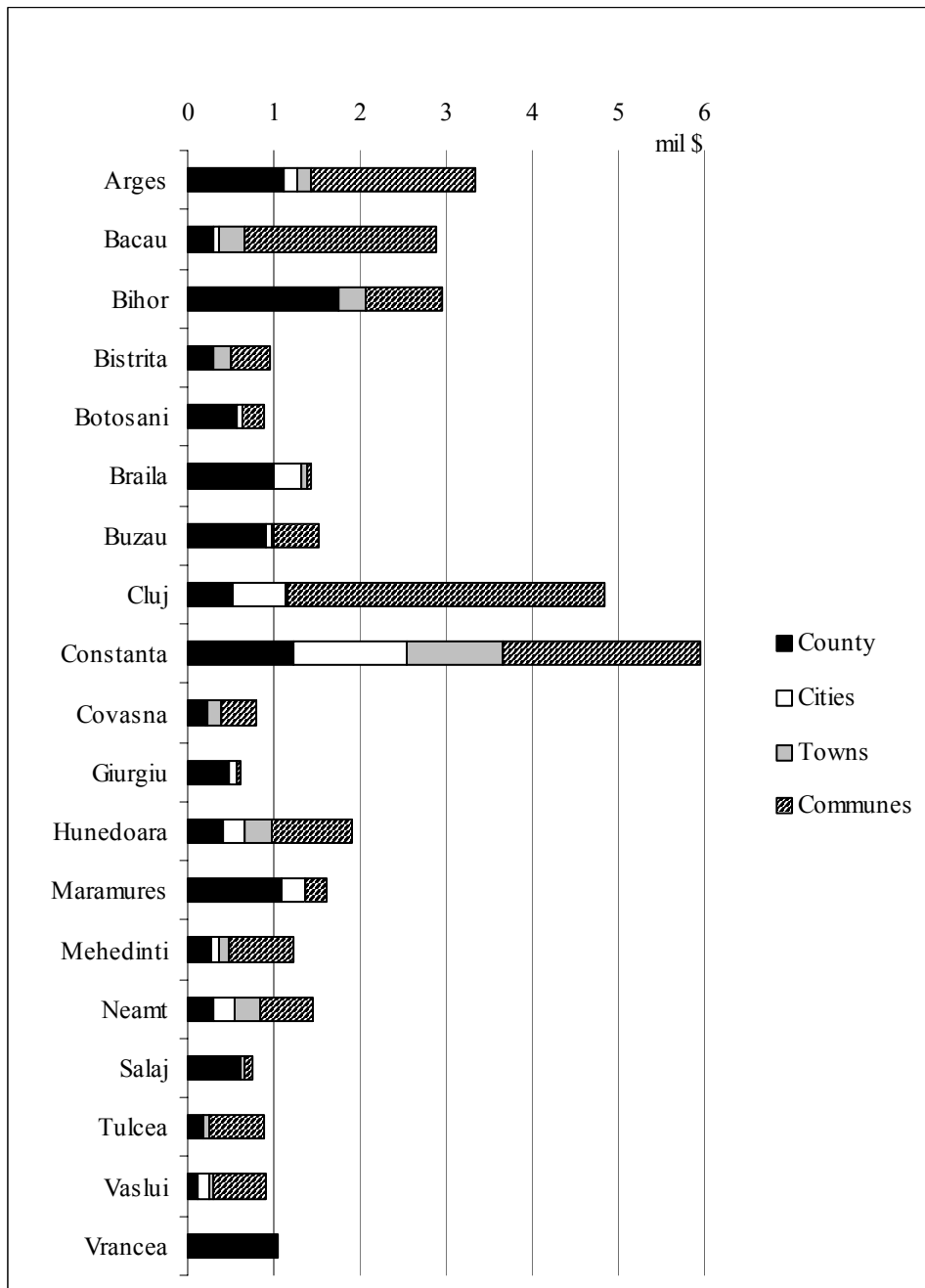
This allocation process has followed different rules in each of the 41 counties—, which is clearly against thea departure from the provisions of the Annual National Budget ~~l~~aws. Even tough, according to the text of ANBL, the counties should strictly apply the fiscal capacity formula, deviations from this standard are tolerated on a large scale. The usual practice involves ~~some~~certain quantitative criteria, but the process if far from being strictly based ~~purely~~ on a formula. No local council knows for sure what amount ~~they it~~ will receive from the county council. The process typically involves significant individual ‘negotiation’ between the local councils and the county council, ~~and it is~~ rural communes ~~who~~ are mostly at the mercy of county councils, since for many of them the equalization funds are the main source of revenues.

Fig. 3 illustrates how important the County Council discretion in allocating equalization funds can be. Each month, a share of 15% (16% in 2002) of the personal income tax (PIT) collected locally is given to the county council with the purpose of equilibrating the budgets of localities ~~inunder its—their~~ jurisdiction. ~~But~~However, the law failed to mention the portion that the county can withhold for itself. Therefore, the allocation becomes entirely unpredictable for localities, as the counties can decide to retain most of the revenues for their own budget – or all, as it happened in 2000 (and in 2001 for that matter) in Vrancea county. This legal loophole creates too much autonomy to counties at the expense of localities. A quick analysis ~~of~~ the data presented in Fig. 23 shows that the problem here is indeed the total discretion exercised by counties: the proportion of funds retained by them has nothing to do with the overall regional poverty, since counties with similar revenue-raising capacity display very different distribution patterns.

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Moreover, even when the allocation to localities takes place, sometimes large amounts go to the capital-city-capital (ex-e.g. Braila, Constanta), which runs against the policy objectivegoal of equalization within counties.

Fig. 3. Equalization funds distributed by counties, 2000 (the 15% share of PIT)



Rural communes, who are generally most in need, are the most likely to suffer from this erratic distribution. In this context, it is not surprising that elected officials in many communes – the mayor and the members of the local council – have adopted largely a passive attitude regarding the budget process. Their most ~~critical~~important skill is their ir ability to negotiate with the county council, in order to secure the highest possible equalization grant allocation.

Loopholes and disincentives

~~Altho~~ugh in theory the Government encourages ~~LGs~~local governments to become more self-reliant, this does n~~o~~t always happen in practice. On the one hand, ~~T~~here were instances when county prefects sued local councils in administrative courts when they~~for having~~ tried to introduce new local taxes (as it happened in Bucharest in 2000). Some ministers reprimanded several times local councils ~~that~~for having levied “unreasonable taxes on the already-impooverished population” (e.g. on pets, garbage collection, vehicles pulled by animals, ~~park entrance fees,~~ etc). Equally, ~~T~~he media, ~~more often than not,~~ is also often ready to pour scorn on any such local initiative.

On the other hand, the same Government removed recently from the new Local Taxes Law¹³ the possibility efor the ~~LGs~~local governments to go the other way and lower the taxes. ~~The~~ top officials argued that, because of “populist reasons”, irresponsible mayors were ~~jeopardizing~~threatening the local ~~own r~~ revenues by base by lowering the the property tax rate before local elections. The examples given were several large cities, but no hard data were as produced to back in support of these allegations. ~~This~~ Such a limitation of the local decision-making power, based on the assumption that the central Government is somehow more legitimate and responsible than in the local ~~g~~ Governments, runs against the current trend and the very policy stated objective of ‘~~substantial~~ decentralization’.

However, there are indeed disincentives in the local finance system. A ‘race to the bottom’ seems to be taking place in small towns or rural municipalities~~communes~~: the mayors underestimate their own revenues in the draft budgets in order to get obtain more equalization funds. This is a typical case of the substitution effect

¹³ Through the Ordinance 36/2002, which actually replaces the old Local Taxes Law.

(less effort is put in collecting own revenues when compensation comes from the center) induced by the equalization system. It was confirmed by local financial officers and it becomes apparent when one analyzes the difference between the projected budgets and the execution one year later: the projected own revenues have systematically been lower than what was actually collected ~~realized~~.

The formula of PIT sharing introduced in 1999 is simple and straightforward, but it has a downside: it functions as ~~another~~ further generator of horizontal imbalances, especially at the lowest level of LG local governments. Since the tax is collected at the point of origin and then split among st national, county and locality budgets, it benefits those municipalities (usually large cities or towns) who have many official jobs on their territory. In other words, When residents of rural settlements ~~commute to~~ work in the nearby town (which is often the case), the latter collects all the corresponding share of the PIT. ~~Thus, the differences in revenue raising capacity are magnified, both at the local and county levels. Richer counties also benefit, because at the same level of personal income you are more likely to have a formal job here than in a poor county, where a larger part of the real income tends to remain hidden.~~

~~The situation described above creates therefore, the need arises to mitigate the effects of these discrepancies, which make it very difficult for small communities to provide basic public services to their citizens. There are many reasons to do this: it would be politically unacceptable to decrease the provision level under a certain threshold even in the poorest communities. Even if, strictly speaking, not all the local Government functions are national mandates, certain general Government and local services have to be offered to every citizen. Moreover, in ~~the~~ ex-communist statcountries, almost all local communities inherited a network of local services, ~~more or less extended~~, and a strong expectation from the citizens that these services will continue to function, and it is very problematic to ~~Terminate~~ ing this tacit social contract ~~is difficult even in the most dire financial situations~~. Many local Governments are now confronted with the issue of over-extended services and shrinking finances – especially small towns, where the services cannot benefit from economies of scale.~~

Finally, There is one more flaw in the LG local governments' finance system that is shared with almost all of the public sector, namely that: the current cash-based accounting system does not reveal the huge problem extent of unpaid bills (arrears). Local governments are Currently ~~the LGs are~~ constrained by the requirement of having balanced budgets, and, as a ~~result~~ consequence, they tend

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to roll over hidden debts in their books from one year to the next. ~~According to estimates the problem is very serious in itself—and even more so since it cannot be measured with precision.~~ The only way to address ~~it~~this problem would be to start ~~to~~reporting systematically the debts in the local budget execution, ~~preferably~~e.g. by introducing accrual accounting elements.

Recommendations

In this context, it is now possible to outline an agenda for improvement. It must fix the flaws in the system that have become apparent so far – but on the other hand take into account the need for flexibility generated by uncertainties that will continue for a while. The reassignment of functions to LGs local governments is not yet completed and substantial transfers are on the agenda for the next one or two coming years. The calendar – or, indeed, costs – of these new such transfers of functions are difficult to foresee. Therefore, any attempt to fine-tune and write in stone the interGovernmental fiscal rules are premature. One would expect that it is likely that any new major reallocation assignment of attribut functions to local governments by the central Government will be matched with an additional slice of funds taken from the national general budget – most likely, e.g. from the state's residual share of the PIT or from the VAT revenues. Only after several budgetary cycles would have passed with the new arrangements can the policy be stabilized and more automatic transfers set up that will minimize the vertical disbalances imbalances and stabilize in the long run the horizontal equalization mechanisms.

The agenda for reform should has thus to be organized on several steps organized in a sequence and put into the broader policy context.

- A. **In the short run**, several quick fixes are possible that will address some of the problems identified above in the previous section. They se are likely to function no matter what changes will be further operated in the system:-
- The Government must make an explicit commitment regarding the agenda of decentralization until 2004, so that the L G local governments and the public know what functions will be further reassigned, and when. Some of these things are included in other programmatic documents of the Government, but they should be collected into a White Book of fn Decentralization.
 - The Government should refrain from discouraging L G local governments to find their own sources of revenue. If local councils

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decide to create new taxes – so be it. They ~~too~~ are democratically elected bodies that will be held accountable by their constituencies.

- A cap must be imposed on the percentage that can be withheld by counties for their own budget from the second source of equalization (the automatic PIT share). Otherwise, too much freedom of action at the county level will continue to have an adverse impact at the locality level, where the budgetary process becomes unpredictable.
- A reporting system must be introduced at the county level for increasing the transparency of allocation of funds by localities. Each county should prepare a report explaining how much, and why they deviated from the criteria established by the National Budget Law. This is a minimal requirement that will both offer a useful feedback to the Ministry of Finance, and a means to limit ~~the abuses at the local level.~~
- The implicit policy goal of full compensation for lack of fiscal capacity at the county level should be abandoned. ~~The total pool of money earmarked for equalization should attempt to cover only 75-80% of the fall below the average.~~ This would remove the incentive in local Governments to substitute own revenues with equalization grants, ~~and so address a problem that tends to become serious in the years to come.~~
- In case the ideal of full compensation is not abandoned, other simple measuretricks can be applied to remove the disincentive. Instead of using the projected own revenues for the following year in the fiscal capacity formula, the actual figures from the previous year's execution should be used. ~~It is much easier for mayors and CFOs in localities to underestimate projected revenues that appear only on paper, than the realized revenues from the previous budgetary exercise.~~ Or, alternatively, the fiscal capacity formula should be applied only within regards to the PIT shares, ~~without creating disincentives for increasing the own revenues of municipalities.~~

B. **On the medium term**, depending on the pace of ~~policy reform in~~ functattributions reassignment, ~~there are some elements~~ the Government

would be well advised to take into consideration the following suggestions:

- A horizontal equalization formula, in whatever form, should be enforced upon counties gradually, but with determination. Eventually, the budgetary policy environment should be made more transparent and predictable at the lowest level of local gGovernment. As the reassignment of functions advances and experience accumulates, the need for flexibility in the distribution of funds will correspondingly decrease. ~~The residual national share of PIT can be then transferred to LGs, either in the form of earmarked sum tied to a mandate (and thus meant for vertical equalization) or as a general purpose equalization grant. Additional funds from the national VAT revenues may be also considered.~~
- It is important that the Government resist the temptation to complicate the horizontal equalization system by factoring in various 'normatives' meant to function as a proxy for local needs. Once wethe Government starts to go down on this road, the proliferation of 'needs' will be unstoppable and the system will become unmanageable (Hungary is sometimes cited as an badunfortunate example in this respect). There is a trade-off ~~here~~ between simplicity and transparency on the one hand, and technical refinement on the other. From the experience available so far with the current Romanian system, which is fairly simple and easy to understand, the biggest-real problem turns out to be not the design, but the implementation. As long as rules are not enforced at the lower levels, so that they create stable expectations and the right incentives, the is design is practically irrelevant. *The more complex the system becomes, the less enforceable it will be.*
- There is some room ~~Somefor~~ experimentation with the current PIT automatic shares ~~are possible~~. For example, instead of fully allocating them fully according to the place of origin, they canould be split into two: e.g. half origin-based, and half transferred according to the number of inhabitants in a local governmentLG unit (county or locality). This would help reducing~~It is likely that~~ the current effect of PIT shares, of magnifying the horizontal disparities, will in funds allocation~~be~~ reduced. Thereforeus, the need for horizontal

equalization ~~will~~ ~~be~~ also ~~reduced~~ decrease, and, as a consequence, with the beneficial effect that less money will go around in discretionary reallocations.

- Alternatively, the central Government may wish to consider the idea of transferring the equalization funds directly to counties and localities, in one step, thus eliminating ~~the~~ interference of counties in the budgetary process of localities ~~would be thus eliminated~~. With the current simple and transparent formula of equalization, this can be done at practically no additional administrative costs. The adoption of this solution is politically difficult, however, because it will be opposed by counties, which have a strong lobby at the central level.
- Since the Government intends to generalize the accrual accounting procedures to the whole public sector from starting with 2003, the huge stock mountain of unpaid bills will suddenly appear in the books of local Governments. It is very likely that some localities are less indebted, other more, and some on the verge of bankruptcy. The Government needs to prepare draft a strategy to for addressing the is problem, ~~and clear procedures for the use of LGs in the passing to accrual accounting.~~

C. **In the long run**, when all the reassignments are completed and the situation is stabilized, ~~the~~ local autonomy can be formally increased by transforming most of the earmarked conditional grants into general purpose transfers, automatic tax shares – or even by creating new own revenues in for the local Governments (for example, by turning some national taxes into local taxes, such as the planned turnover tax on micro-enterprises, ~~a proposal now on the agenda~~). ~~The need for vertical equalization will be thus very much reduced. The horizontal equalization mechanisms can also be stabilized, since the final situation will be much clearer about who needs what. After the experiments run in the previous stage, a final decision can be adopted on the details of the equalization mechanism too.~~