Central Legislation Regarding Romanian Local Budgeting

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ABSTRACT

Romanian financial legislation establishes the main budgetary rules regarding local public resources. These resources are based on taxes collected and transferred by central fiscal authorities to local budgets. The rules of transferring and the exact amounts are established by laws and decisions taken at the central level. Using an evaluative L&E approach, we propose to analyze the criteria used by central legislative and executive bodies in distributing amounts for local authorities (separately for each local revenue type) and to compare the central and local resource ratios. The conclusions will present the vulnerabilities of the Local Public Finance Law, the annual State Budget Laws and Government Decisions’ repartition criteria of the public fund between central and local administrations in Romania.

Key words: local finance; local revenues; Local Public Finance Law; State Budget Law; Romania

1. Introduction

Romanian public finances are ruled by normative acts which establish the revenues separately for each component of the unitary public budgetary system (Verboncu et al. 2008), although transfers between them are encouraged. The relevant financial laws which rule in Romania are: (i) the Local Public Finance Law (LPFL), which establishes the principles, framework and procedures for managing local public funds and the responsibilities of local authorities/institutions involved in local public finance; (ii) the State Budget Law (SBL), providing and authorizing each year’s specific financial rules for the state budget, local budgets, social assurance funds, EU projects; (iii) the Public Finance Law (PFL), which establishes the general budgetary and public financial rules, especially those applicable to central administration. These laws were proposed by the Government to be discussed by Parliament, motivated by the need of the moment and pointing out the novelty. Periodically, changes proposed by the Government are analyzed by Parliament and approved if they are considered appropriate.
As a measure for improving public finances, the first LPFL was adopted in 1998 by extracting specific provisions from PFL. By 2006, this law had been amended several times, when the Government asked Parliament to change it completely, justifying this action, among others, by the need for more transparency in fund allotment, the elimination of arbitrariness and the removal of the county councils’ political interference. The proposed repartition criteria should target only those administrative-territorial units (ATUs) which are “in real financial difficulty” by excluding ATUs above average.

Local budgets are dependent on financial resources collected and transferred to them by central fiscal authorities. For this reason, it is vital to carry out this repartition as fairly as possible from two points of view: (i) between levels of administration or, respectively, between central and local budgets and (ii) between ATUs using the repartition criteria established by LPFL.

In our paper, we propose an analysis of legal provisions and their effect on Romanian local budgets, taking into account the criteria used for repartition. Central vs. local repartition is more often presented (especially in papers dealing with decentralization); the repartition between ATUs and the effect in time of these repartitions was not the subject of a paper to our knowledge. In the first chapter, we present the local revenues collected by central fiscal authorities, in the second chapter, the legal criteria of the repartition of these local revenues for each local budget, and in the third chapter, we present the role of SBL in this process. The fourth chapter contains a few case studies that quantify the impact of the repartition criteria on local budgets (using an evaluative approach to Law and Economics). The conclusions synthesize the vulnerabilities of LPFL, annual SBLs and Government Decisions’ repartition criteria of the public fund between central and local administrations in Romania.

2. Local budgetary revenues collected at the central level and transferred to local authorities

Local financial autonomy is a current debate subject all over Europe. The challenge consists of achieving an equitable distribution of financial resources among the different levels of government in the context of budgetary cutbacks at every level of public administration (Rusu 2008) and a correct distribution of funds between ATUs. Decentralization in Romania began in 1991, with the reform of local and intergovernmental finance taking place in the context of political decentralization and in particular showing a strong commitment to the decentralization of certain responsibilities and revenue to self-governing local administrations (Campeanu and György 2009).

The Romanian administrative model is similar to the situation of other EU countries, although there are no standards of horizontal systems of governance at the EU level (Graver 2007). Financial decentralization consists in transferring money to local budgets. Every ATU (corresponding to localities and counties) has its own local budget. There are 3,000 local budgets, which are administrated by different-sized local authorities. Large localities are declared municipalities based on a special law, after fulfilling some criteria proving that their infrastructure is able to provide public services in neighboring localities. Other urban localities are considered towns and
offer a smaller range of public services to citizens. Rural localities are organized as communes and offer only basic public services, first and foremost to their own citizens. Counties are organized as sub-national entities which geographically cover tens of municipalities, towns and communes. From an administrative point of view, the county’s responsibilities are separated from the component ATUs’ responsibilities.

Local financial resource problems were treated differently with time. The decentralization process imposed a better regulation of local budgets’ revenues in order to cover all expenses made by local authorities in connection to their new responsibilities. In 1997, Parliament passed a law proposal which split the Public Finance Law and approved a new normative act dealing exclusively with local financial issues. In 1999, the new law came into force and was improved several times. In 2003, a new legal act replaced the existing law as a consequence of reforming the Public Finance Law the previous year.

In 2007, a new LPFL (Law no. 273/2006) came into force, initiated by the Government. The initiator synthesized the main novelties of their proposal as:

- introducing new concepts (local budgetary rectification, financial crisis, municipal bonds etc.);
- introducing four supplementary budgetary rules;
- repartition of amounts to local budgets being made in a transparent way, significantly reducing arbitrary allotments and county-level political interferences;
- introducing limitation criteria for rich local communities;
- regulation of local insolvency.

The representative associations of local authorities (National Union of Romanian County Councils, Romanian Municipalities Association, Association of Romanian Towns and Association of Communes from Romania) argued that the repartition criteria should be revised in order to assure enough financial resources to each local budget, not only a few of them.

In order to assure local financial resources, LPFL establishes the general categories of local revenues that can be collected by every locality’s and county’s budget. The main categories established by the law are:

- own revenues which include local taxes (especially different types of property taxes) and quotas from the income tax;
- revenues from VAT;
- transfers with special destinations from the state budget;
- donations and sponsorships.

Every year, SBL details the main revenue categories presented in LPFL (György and Campeanu 2009). Most of these resources are collected by central fiscal authorities and redirected monthly to local budgets in order to assure local interest expenditures. These procedures are widespread in different countries, without a uniform
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pattern of dividing collection responsibilities between central and local fiscal authorities (Davey 2004).

These revenues collected by central fiscal authorities and transferred to local budgets can be grouped as follows: quotas from the income tax, revenues from VAT, transfers with special destinations and allocations from the budgetary reserve fund. These revenues have particular characteristics, the way of transferring them to local budgets being legally provided, separately in each case.

*Quotas from income tax* are distributed to each local budget based on two different methodologies: a 47% quota of income tax collected in that locality (respectively for county budgets a 13% quota of income tax collected in that county) and a 22% quota established in each county to balance local budgets.

*Revenues from VAT* are allocated for funding certain expenses that were decentralized to local authorities. The level of VAT revenues is determined on different factors based on legally established indicators such as local road length in the case of financing road rehabilitation, number of sport halls approved to be built in rural areas, number of pupils for honey acquisition and so on.

*Transfers with special destinations* from the state budget are assured by line ministries for those domains which should be implemented by local authorities, but financial aids are necessary in order for them to be financed and implemented. The list of domains which benefit from these transfers are established by annual laws, every line ministry establishing what category of expenditures will be made throughout the local budgets and in what amount. This financing way is a more discretionary tool in order to help only those local communities which have backlogs in a certain field of activity.

*Allocations from the budgetary reserve fund* should be extraordinary resources that are allocated in special cases, usually when natural disasters affect localities. In practice, this resource is used to supplement local budgets in order to front expenditures which cannot be delayed, and although they were known when the budget was prepared, the amounts were underestimated.

3. Repartition criteria from the Local Public Finance Law and other special laws

LPFL presents the categories of revenues for local budgets (as presented above), leaving the allocation criteria to be established in most cases by special laws or by the state-budget law. The exceptions are quotas from income tax (47% quota and 13% quota) and amounts destined to balance the local budgets. Representing almost half of the income tax collected in the state budget, the 47% quota represents the principal revenue of local budgets (Matiuta 2007) next to balancing the funds from the income tax.

Funds balancing local budgets refer to multiple destinations established by each local authority because budget imbalances are effects of expenditures that are higher than the revenues. Balancing funds are important for local budgets because LPFL imposes for all local budgets to be in balance or to have a surplus.

Balancing funds come from two main resources: income tax (the 22% quota established automatically for every amount collected as income tax) and VAT (in this
case, the amounts can vary). Revenues from VAT for balancing local budgets are established every year by the SBL depending on objectives.

The 47% quota is distributed in accordance with the tax amounts collected from taxpayers that operate in that locality. This means that localities with strong economic activity will have considerable resources in their local budget in comparison with localities with low economic development. These repartition criteria from LFPL do not take into account the origin of the employees, the quota being directed to the local budget of their workplace regardless of their locality of residence. In this way, the allotment of the 47% quota from the income tax takes into account the fiscal domicile of the employer and not the fiscal domicile of the taxpayer (Dinca and Dinca 2009). The implementation of the 47% quota mechanism encountered some difficulties because the companies had to conduct separate income tax evidence for each local division and pay these taxes separately in order to permit fiscal authorities to redirect the correct amounts to local budgets.

The repartition of the 22% quota begins with a separate allocation for the county budget (27% of the total balancing amount); the rest is designated to go to each local authority. The first allocated amounts are exclusively for those localities that collected less per-capita income tax than the county average in the previous year (“below-county-average localities”). The financial repartition helps targeted localities to supplement their revenues to the county-average level. The repartition key is the surface of the built-up area for one quarter of the amount and the number of inhabitants for the other three quarters. In the second stage, all localities receive budget allocations indirectly proportional to their financial capacity and directly proportional to their number of inhabitants. At the end, all calculated amounts are reduced with the own-revenue-collection rate in order to encourage a better collecting rate at local taxes although these represent less than a fifth of the total revenues (the restraint amounts are redirected to local budgets on the County Council’s Decision without taking into account the presented criteria).

In most cases, the repartition criteria are based on statistical data supplied by central institutions (State Treasury, National Institute of Statistics, National Agency for Cadastre and Land Registration), thus avoiding appealing to local information, which could be denatured in order to assure a higher financing level. The single information obtained from local authorities is related to the own-revenue-collection rate, but also in this case, the Treasury can verify whether the data are correct.

If SBL establishes revenues from VAT for balancing local budgets, the repartition criteria remain identical with those used to distribute the 22% quota from the income tax. In practice, the repartition is made simultaneously for these two balancing resources.

The repartition criteria for certain objectives or activities are provided by special normative acts. One category of these special acts is represented by Government Decisions, which present the cost standards which are used in different cases. Social services (services for children with disabilities, services for children with AIDS, services for elderly persons and so on) and pre-university education are in this situation.

A simple calculation shows that 82% of the income tax is transferred to local budgets (47% quota to localities, 13% quota to counties and 22% quota to balancing
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local budgets). These amounts, resulting from the application of the 82% quota, are allocated to local budgets according to different criteria, especially financial capacity. This indicator is based exclusively on the income tax per capita collected in a locality during the previous financial year. Financial capacity cannot accurately reflect the needs of a locality, and the ranking made using this indicator is not correct because it does not reflect the local financial management’s quality. Financial capacity is based exclusively on incomes transferred in the previous year and not incomes collected directly by local authorities.

4. State Budget Laws and local budgets

Annual SBLs have a major role in establishing the amounts that will be allocated to local budgets and the repartition on the county level. Supplementarily, SBL establishes some general financial rules that should be respected by local authorities.

For 2010, the destinations established for income tax and VAT transferred to local budgets were the following:

- wages for teachers in pre-university schools;
- inventory items for pre-university schools;
- child-protection system and social-welfare centers for persons with disabilities;
- providing milk and bread for pupils and children in kindergartens;
- providing honey as a nutritional supplement for preschoolers and pupils;
- expenditure related to special education and county resource centers and educational assistance;
- decentralized cultural institutions;
- payment for non-clerical staff;
- public services dealing with persons’ records;
- providing personal assistants to people with severe disabilities;
- social assistance and support for residential heating with wood, coal and petroleum fuels;
- regional state aids;
- expenditures of nurseries.

Annual SBLs establish the exact amounts allocated to local budgets. Yearly evolutions depend on the economy’s situation in that year and the degree of decentralization. These criteria are in consonance with the fiscal policy promoted in Romania (Campeanu et al. 2008).

Transfers with special destinations are included in every line ministry’s budget and cover a wide range of destinations, such as urban architecture plans, paving communal roads, water supply to villages, reduction of seismic risk, water-management projects, investments in schools and VAT refunds for EU projects.
The budgetary reserve fund shall be distributed to finance urgent or unforeseen expenditure arising during the budget year. When local budgets face financial difficulties, the Government transfers amounts for helping local authorities. The SBL only authorizes the total amount from the reserve fund (this amount is not exclusively for local authorities). The PFL regulates the methodology for the Government to follow in order to use the reserve fund.

Each year, the state budget act has a special annex that presents the revenue and expenditure categories of local budgets. These categories are presented separately for, respectively, county, town and commune budgets.

5. Case studies on applying legally established financial criteria for local budgets

The effective repartition of financing to local budgets is made in accordance with the main legislative acts: LPFL, PFL and SBL. The effects of these laws should be analyzed regarding whether these criteria assure a correct repartition on localities becoming a healthy economic development factor. The Law and Economics analysis involves three different kinds of analysis: an evaluative analysis, a positive analysis of legal structures and a normative economic analysis (Backhaus 2005). In our case, the evaluative analysis was chosen because of aims to measure the effects of the financial legislation on selected UATs.

Our analysis focuses on four case studies which individually emphasize the effects and tendencies on local budgets of allocation criteria from financial legislation: evolution of quotas from income tax and revenues of VAT, repartition of quotas from income tax and revenues from VAT in a county and the allocations from the budgetary reserve fund to local authorities.

5.1 Evolution of quotas from income tax and revenues of VAT

Quotas from income tax are in a strong relation to macroeconomic parameters, especially GDP and unemployment because the quotas are applied to the effective amount of tax collected by central fiscal authorities. The increase of medium wage in economy and the number of employees are the main factors that influence the income tax collected by central fiscal authorities and, indirectly, the amounts transferred to local authorities.

There are also other factors that influence local budgets’ revenues from income tax, especially fiscal policy parameters. Between 2000 and 2010, there were some changes in quotas. Quotas from income tax were introduced in 1999 having the initial value of 40% for local budgets from towns and communes. In 2001, the quota was reduced to 36.5% and in 2003 became 36%. In May 2005, the 36% quota was changed to 47% as a result of a drastic reduction of income collected under the 16% flat tax rate which changed the previous progressive 18-40% quotas. Table 1 presents the evolution of main indicators correlated to quotas from income tax.
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Table 1: Evolution of main indicators correlated to quotas from income tax to local budgets

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<tbody>
<tr>
<td>Quotas from income tax (mil. RON)</td>
<td>1,230.4</td>
<td>3,884.3</td>
<td>6,242.4</td>
<td>6,912.0</td>
<td>13,366.4</td>
<td>13,574.6</td>
</tr>
<tr>
<td>GDP (mil. RON)</td>
<td>80,984.6</td>
<td>152,017.0</td>
<td>247,368.0</td>
<td>344,650.6</td>
<td>514,654.0</td>
<td>511,582.0*</td>
</tr>
<tr>
<td>Share of quotas from income tax in GDP</td>
<td>1.52%</td>
<td>2.56%</td>
<td>2.52%</td>
<td>2.00%</td>
<td>2.60%</td>
<td>2.65%</td>
</tr>
<tr>
<td>Number of employees (thousands)</td>
<td>4,623</td>
<td>4,568</td>
<td>4,469</td>
<td>4,667</td>
<td>4,739</td>
<td>4,665*</td>
</tr>
<tr>
<td>Average wage (RON)</td>
<td>284.05</td>
<td>558.2</td>
<td>768.2</td>
<td>1,077</td>
<td>1,550</td>
<td>1,836</td>
</tr>
<tr>
<td>Quota from income tax for towns and communes</td>
<td>40%</td>
<td>36.5%</td>
<td>36%</td>
<td>47%</td>
<td>47%</td>
<td>47%</td>
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* estimates (autumn 2010)

Revenues from VAT are more sensitive to the decentralization rate because every new competency transferred to local authorities is followed by a rise of amounts to local budgets. Between 2000 and 2009, revenues from VAT increased constantly (2001 was the first year when local budgets received revenues from VAT), first being used to finance the pre-university education system. In time, destinations were diversified by introducing new responsibilities to local authorities. A statistical synopsis of these trends is presented in table 2.

Table 2: Evolution of main indicators correlated to revenues from VAT to local budgets

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<tbody>
<tr>
<td>Revenues from VAT for local budgets (mil. RON)</td>
<td>0.0</td>
<td>3,121.9</td>
<td>4,603.8</td>
<td>9,703.5</td>
<td>15,063.9</td>
<td>14,757.6</td>
</tr>
<tr>
<td>GDP (mil. RON)</td>
<td>80,984.6</td>
<td>152,017.0</td>
<td>247,368.0</td>
<td>344,650.6</td>
<td>514,654.0</td>
<td>511,582.0*</td>
</tr>
<tr>
<td>Share of revenues from VAT for local budgets (mil. RON)</td>
<td>0.00%</td>
<td>2.05%</td>
<td>1.86%</td>
<td>2.82%</td>
<td>2.93%</td>
<td>2.88%</td>
</tr>
<tr>
<td>Number of transfer types to local budgets</td>
<td>0</td>
<td>5</td>
<td>4</td>
<td>13</td>
<td>13</td>
<td>15</td>
</tr>
</tbody>
</table>

* estimates (autumn 2010)

Analyzing the quotas from income tax and the revenues from VAT, we can conclude that local budgets consolidate their financial power by receiving important transfers from centrally collected taxes. These trends should be maintained further, especially after the hospital decentralization made on 1 July 2010. Keeping in mind that almost all income tax and half of VAT are transferred to local authorities, the reparation mechanism should also be extended to other taxes in future decades. From this point of view, LPFL grants the authority to use quotas only for income tax and revenues from any tax collected for the state budget.
5.2 Repartition of quotas from income tax and revenues from VAT in a county

Valcea County is situated in the middle part of Romania and has 89 localities (two municipalities, nine towns and 78 communes). According to the first-stage repartition methodology from LPFL, the localities were grouped in two categories after income-tax-per-capita criteria: below-county-average localities and above-county-average localities. In 2009, the below-county-average category included almost all communes (with one exception) and six towns. As was expected, the large economic centers belong to the above-county-average category because the 47% quota of income tax assure proportional financial resources to their economic power, being calculated on the income tax retained from all persons who work in the locality (regardless whether or not they are living in that locality).

Source: Finance Department of Valcea County

Figure 1: Structure of localities on income-tax-per-capita criteria for every locality type

Below-county-average localities receive financial allocations in both stages of repartition. In the first repartition stage, the amounts were established in such a way that below-county-average localities rise to the county-average level. The second-stage amounts were also indirectly proportional to their financial capacity, so poor localities should receive larger amounts of money in comparison with localities of similar dimension that are richer according to the criterion of financial capacity.

This financial repartition should have propelled below-county-average localities to a higher ranking and reduced the disparities to above-county-average localities. Due to this discretionary help, the difference between below-county-average localities and the county-average value should have reduced or even changed so much that below-county-average localities should have become above-county-average localities the following year.

The 2010 data show us that discretionary help from LPFL regarding below-county-average localities led to an improvement of the position of the majority of below-county-average localities from 2009 as shown in figure 2. Only one locality
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could improve its situation to such an extent than it became an above-county-average locality in 2010. Regarding the above-county-average localities from 2009, half of them saw increases in 2010 and the other half decreases, but only one became a below-county-average locality in 2010.

![Figure 2: Structure of locality numbers which increased/decreased in 2010 vs. 2009](image)

Discretionary distribution (going on the principle of helping more poor localities and less rich localities) should lead to a smaller distribution of prosperity rate. Analyzing the 2010 data, which incorporate 2009 allocation effects, shows us that the expected results were not reached. The average deviation increased from 0.0633 to 0.0661 in Valcea County. This result reflects that amounts provided for a budgetary equilibration of discretionary distribution are insufficient in comparison with amounts allocated directly by the 47% quota from income tax. The explanation seems to be connected to the relation between the two total funds distributed: funds resulting from applying the 47% quota are at least 2.92 times bigger than the income-tax fund for balancing local budgets on discretionary criteria.

The own-revenue-collection rate worsened significantly in 2009 compared to 2008. The collected income-tax amounts increased in a smaller rate. Some centralized information is presented in table 3 and figure 3:
The worsening of the own-revenue-collection rate leads to reduced transfers from the state budget based on local performance. The penalties calculated by applying the own-revenue-collection rate will be redistributed to local budgets, but without taking into account the economic and financial performances of the localities. Supplementary resource attraction is a lottery rather than an economic issue.

### 5.3 Allocations from the budgetary reserve fund to local authorities

Although the budgetary reserve fund should be an extraordinary financing source, many local authorities expect to receive an important amount of money each year in order to complete their budgetary revenues. In this case study, we proposed to analyze the situation in 2009 from two points of view: (i) the relation between amounts allocated to central administration vs. local administration month by month and (ii) the extent to which the allocations to local authorities take into account the size of the locality.

In 2009, the Government issued over 60 Government Decisions, allocating amounts from the budgetary reserve fund totaling over 2 billion lei (0.5 billion euro).
The beneficiaries were line ministries (79% of the amounts) and local authorities (21% of the amounts) as shown in figure 4. During the year, there were no allocations in the first months; beginning in April, allocations were made very prudently, and in the last quarter, allocations were significantly increased, especially to the central administration (the Ministry of Transport being the main beneficiary of these allocations).

![Figure 4: Repartition of amounts from the budgetary reserve fund in 2009 by months](image)

Source: Calculations made on Government Decisions from 2009

Regarding allocations to local budgets, all localities received funds especially to help schools because they were underfunded by local budgetary resources. Although allocations were precise in each case, and only localities in critical condition have received funding, at the national level, the proportion between the main types of localities remained relatively stable, allocations being proportional to population.

![Figure 5: Repartition of amounts to locality types](image)

Source: Calculations made on Government Decisions from 2009

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The repartition of amounts from the budgetary reserve fund was made relatively correctly, by taking into account the exact situation of each beneficiary. The main identified problem concerns the destination. The budgetary reserve fund should be used for unpredictable expenditures, not for predictable and underfinanced expenditures. This fund functions more as a second financing resource which is only sacrificed if not enough revenues have been collected to satisfy the state budget or if enough revenues have been collected in principle but the approved expenditures have increased.

6. Conclusions

Decentralization required supplementary financial resources for local budgets, local authorities having reduced the capacity to collect revenues (with an average collection rate around 80%, less than the central fiscal authorities’ rate). In these conditions, some taxes collected by the central fiscal authorities are transferred to local budgets. The relation between central budget revenues and local budget revenues is changing according to the implementation of decentralization. The financial component of decentralization is provided by special normative acts: LPFL, SBL and PFL.

The real need of financial resources at the local level is estimated and further voted by Parliament in SBL without a clear and transparent base. Repartitions of resources for local budgets are based first on state budget’s availability rather than local budgets’ needs. There are underfunded domains which can count only on financing supplements from the budgetary reserve fund if their situation turns desperate.

LPFL establishes mechanisms of financing local budgets without there being a strong relation between local budgetary revenues and local financial management’s quality. The criteria are based especially on non-economic indicators (population, locality surface) and historic financial indicators (income tax collected in the previous year). The repartition mechanism should be improved by reducing the importance of financial capacity criteria in allocation. Repartition is based too greatly on the income tax transferred to the local budget in the previous year. These criteria are directly linked to the locality’s economic power which cannot be influenced significantly by local financial policies. The single local fiscal management indicator taken into account is the own-revenue-collecting rate, but the effect on repartition is relatively small and is not so much a stimulation criterion as a penalty for those localities which do not organize their local tax offices’ activity correctly.

Gaps between local development rates should be attenuated in a more active way, the actual discretionary repartition criteria from LPFL being insufficient for this purpose. An extension of these mechanisms to more funds is a better solution than trying to reduce gaps in an individual regime by distributing amounts to local authorities using special destination transfers.

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