Municipal Debt and Its Economic Effects – The Romanian Case

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Abstract

The paper analyzes the municipal debt of Romanian subnational governments and its effects on the economic development of local communities, especially focusing on the particularities of local indebtedness in the context of the recent economic and financial crisis. By combining qualitative and quantitative analysis (based on indicators of the level, structure and dynamics of local debt) we seek to identify the sources of malfunction or inconsistencies in public policy making and further provide alternative solutions to eliminate them.

Taking into account the particularities of the socio-economic environment and the current socio-political realities of Romania, as a European Union Member State, our assessments are carried out by reference to the developments in the municipal indebtedness of other European countries, developed but also developing ones. The quantitative analysis is based on both national and European regulations and incident databases of national authorities and Eurostat.

Key words: municipal indebtedness, local guarantees, subnational governments, economic growth and development
J.E.L. classification: H50, H75, H76

1. Introduction

Self-financing should generally be the key word when it comes to supporting the expenditures of local governments, granted with local (administrative and financial) autonomy. Throughout the modern world, however, the existence of vertical and horizontal fiscal imbalances, dictated essentially by the heterogeneity of local fiscal potential, combined with some equivalence of local public needs, causes a permanent search of local authorities for additional resources to fully cover local expenses. Under these circumstances, central public authorities resort to different solutions for restoring fiscal equilibrium (operating endowments, grants, subsidies, transfers, amounts and quotas deducted from some taxes to central budgets, etc.), while also recognizing the right of local authorities to borrow money or guarantee the loans of other local entities.

Resorting to extraordinary resources (in particular, borrowing) to cover local budgetary imbalances is not, however, a viable solution in all circumstances (depending, for example, on the conditions on financial markets, the existing legal debt ceilings, the rating or creditworthiness of local authorities, etc.) and practicing it basically means the postponement of raising taxes to finance public expenditures, as the former are the main source of public resources used to repay debts and pay the additional costs resulting from borrowing (with interest, fees, etc.). For these reasons, the regulation of local indebtedness should be closely connected with the socio-economic realities of local communities, avoiding both the creation of an illusory, unrealistic (legal) indebtedness potential and the eventual over-indebtedness of local authorities. From this point of view, the existence of local debt limits, the prior authorization of local loans, the imposition of guarantee funds or the restricting of destinations of borrowed resources are essential issues that the regulator should consider.

Although the need to borrow is sometimes associated with local authorities in difficulty or with a lower economic and fiscal potential, we should say that precisely in these cases borrowing is a less viable solution, as these communities have lower financial credibility and possibility to guarantee new debt. So public loans are not necessarily a solution reserved only for situations of crisis, but can be used as a tool to influence local economic development, provided that borrowed resources are directed to investments of economic nature or to support private economic activities, thus entailing the future growth of local tax base and generating (even at unchanged tax rates) higher fiscal receipts to cover the additional public expenditures driven by loans. This reasoning, together with the recognition of local administrative autonomy, lay behind the regulation of Romanian local governments' indebtedness, through the law on local public finance: *"Local councils, the councils of counties and the General Council of Bucuresti, respectively, may approve the contracting or guaranteeing of internal or external loans over the short-, medium- and long-term, for local public investments as well as to refinance local government debt."* Administrative-territorial units may also benefit from external loans contracted or guaranteed by the central government.

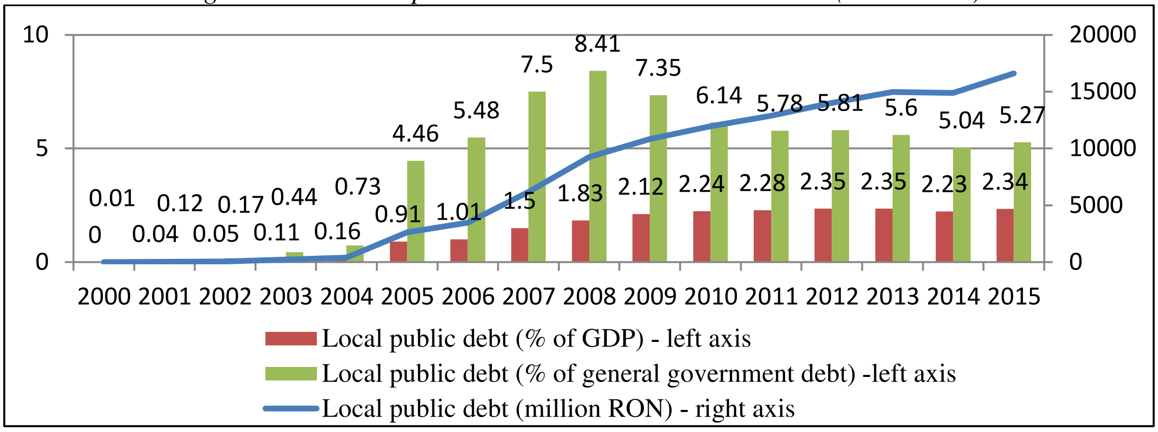
2. Municipal indebtedness in Romania – some stylized facts

The evolution of municipal debt in Romania is the combined reflection of the characteristics of local social needs and the developments in the legislative framework, filtered through local public decision making. In other words, in some cases, although the legislative framework allowed for local indebtedness, and local social needs were urgent, local decision makers have shown excessive caution with regard to borrowing, especially prior to 2000.

Looking at the dynamics of local public debt in Romania, we can see that its accumulation occurred mostly after 2004, against the background of the development of local authorities' capacity to use public loans to finance local investment projects, as a result of the comprehensive reform program initiated at the level of local governments starting with 1998, with the aim to enhance the financial autonomy of administrative-territorial units.

From this perspective, the trends registered in Romania apparently were contradictory as, while the own revenues of local authorities increased, due to the legislative reforms of local public finances, local public debt also increased, on the background of recognizing the right of local authorities to contract and guarantee loans, since 1998. Growing own resources, but still well below local expenditures and real local development needs (particularly with regard to infrastructure), encouraged local authorities to borrow or guarantee local loans, as the aggregated data in fig.1 regarding the size and dynamics of overall local public debt prove.

Figure no. 1. Local public debt indicators in Romania (2000-2015)*

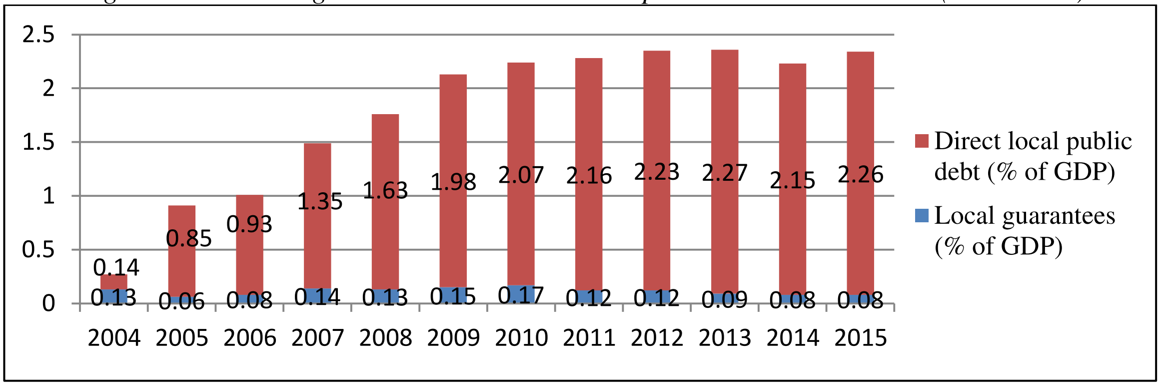


*local public debt is defined according to Government Emergency Ordinance no. 64/2007

Source: the authors, data from the Romanian Ministry of Public Finance (2016)

The synthetic data in fig. 1 also reveal the fragility of Romanian local authorities' indebtedness potential, as it can be seen that during the years of crisis (since 2009) municipal debt grew at a slower pace, on the background of the contraction of local governments' own revenues. Compared to the real needs of local sustainable development in Romania, these extraordinary revenues can not be considered as sufficient, even though they have been consistently completed in some specific cases with financial resources drawn from the EU funds.

Figure no. 2. Local guarantees and direct local public debt in Romania (2004-2015)*

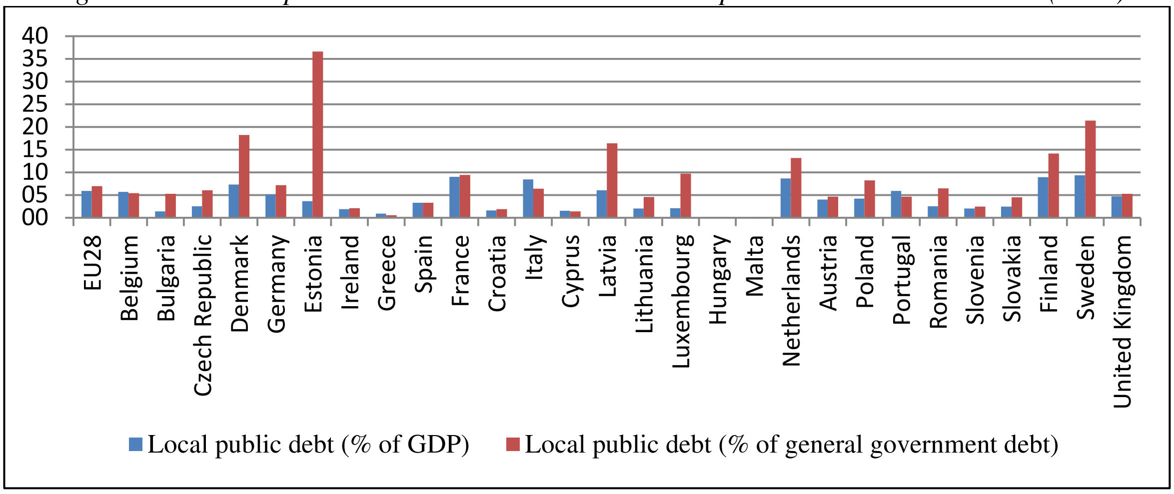


*local public debt is defined according to Government Emergency Ordinance no. 64/2007

Source: the authors, data from the Romanian Ministry of Public Finance (2016)

Structurally, local public debt resulted mainly from direct loans, as local authorities proved to be quite cautious in providing guarantees for the loans of economic operators (fig. 2). This is quite reprehensible, since it is usually accepted that the guarantees granted to local agents could be connected more directly to local development, given that the resources coming from the direct loans of local authorities were in many cases used to finance projects with low economic rentability, mainly social and cultural ones. However, this caution could be justified by the features of an unstable business environment, in which economic agents rarely show the credibility required for local authorities to guarantee their loans. On the other hand, the legal debt limits established by central authorities denote constaints on the freedom of local decision-making to the extent that the local portfolio of public development projects is more consistent.

Figure no. 3. Local public debt indicators in some European Union Member States (2015)*



*local public debt is defined according to ESA 2010

Source: the authors, data from the European Commission (2016)

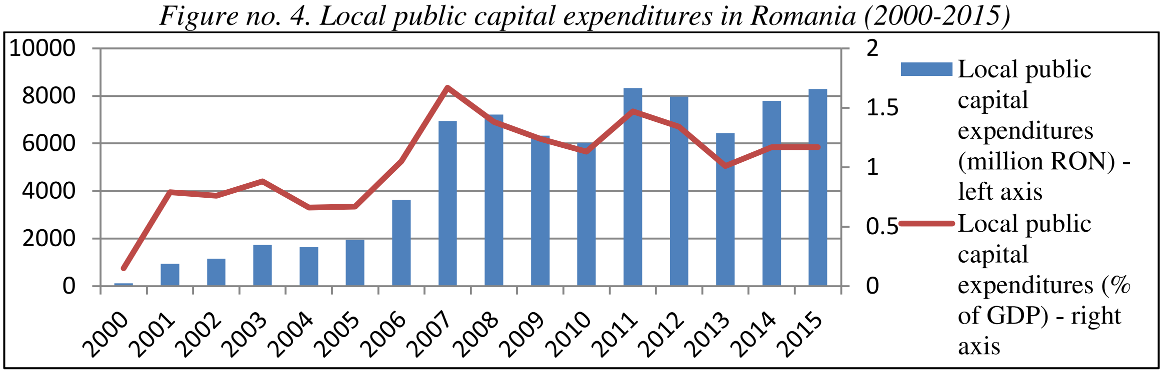
By comparison to other EU Member States, the public debt of Romanian local governments, of only 2.5% of GDP, is well below the European average of 5.9% (fig. 3). Among the most indebted local governments are those of EU15 Member States, namely France (9.0% of GDP), Italy (8.4%), the Netherlands (8.6%), Finland (8.9%) and Sweden (9.3%). Romania's situation proves to be similar to that of the new Member States which joined EU in 2004, 2007 and 2013, most of them from Central and Eastern Europe. At the end of 2015, local public debt represented 1.4% in Bulgaria, 4.2% in Poland, 2.4% in Slovakia, 2.5% in the Czech Republic, 0.2% in Hungary and 1.6% in Croatia, a much lower level than the one registered in EU15 developed Member States.

This situation can have many explanations, being the result of both the lack of experience and unwillingness of local authorities in these countries to use debt resources and the underdeveloped legal framework (Dafflon *et al.,* 2009; Freire *et al.,* 2004). From another perspective, one can admit that, given the smaller amount of financial resources collected to local budgets, including as a result of the lower economic development, the level of public debt that local governments in these countries can sustain is generally lower. One of the conclusions highlighted in the literature on government debt, which we consider to be perfectly applicable to the subnational level, is that less developed countries record lower affordability thresholds and may encounter problems in honoring their financial obligations at much lower public debt levels compared to the developed ones (Callen *et al.,* 2003, p. 120). Last but not least, the specific characteristics of the Romanian capital market may justify the quite modest use of municipal borrowing, as there were cases where some local authorities have issued prospectuses for bond issuance that lead to no concrete results. From this perspective, one significant adverse effect (even if its impact over the long-term is debatable) refers to the widening of the economic and social development gap between the "richest" communities, which benefited of more favorable conditions for borrowing, and the "poorest" ones. In this regard, it is to be criticized that neither the Romanian regulations on public finance nor the promoted governmental financial policies took into account specific measures aimed at encouraging the poorest communities to borrow, in order to support the „catching-up" in local development, at least by providing a separate guarantees ceiling for the loans of such local collectivities.

3. Some economic effects of local public debt

The Romanian legislative framework imposes conditions on the destinations that local governments can give to borrowed resources, restricting them to investment projects or local debt refinancing, so municipal indebtedness should be reflected, to some extent, into the evolution of public capital expenditures and, in this way, into local economic development. However, the synthetic data in fig. 4 show that, in recent years, these capital expenditures recorded quite small sizes, in nominal figures and as a share of GDP, against the background of a financial administrative autonomy more clearly regulated only after 1998. Basically, the low economic potential of local communities and fragile local tax base reflected themselves in low budgetary revenues, often insufficient even to cover the operational expenditures of local governments (which have constantly grown), so capital expenditures had to be sacrificed.

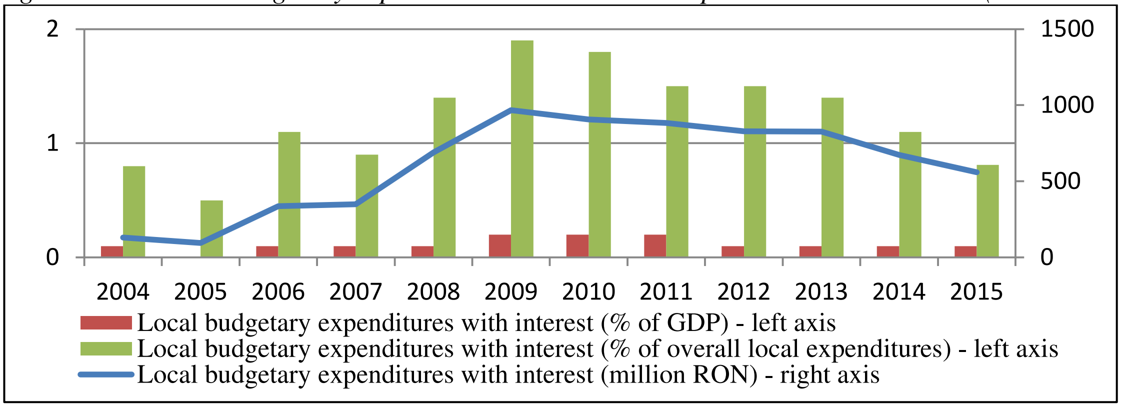
Figure no. 4. Local public capital expenditures in Romania (2000-2015)



Source: authors' calculations, data from the Romanian Ministry of Regional Development and Public Administration (2016) and the Romanian Ministry of Public Finance (2016)

The short period of high economic growth registered after 2004 enabled, by higher budgetary revenues, to put a greater emphasis on infrastructure, housing and environmental needs, so local capital expenditures became more and more important, exceeding 1% of GDP since 2006. However, many of the expenditures in question were represented by repairing costs of various public institutions (schools, hospitals, social homes), with a significantly lower impact on local economic development. Also, they are notorious the issues regarding the efficiency of the use of these funds, namely that of fraudulent public procurement and corruption. Another important aspect to be noted refers to the evolution of these expenditures during the financial and economic crisis (2009-2010), when their role noticeably became less important, as they have been sacrificed in favor of transfer expenditures (especially with the remuneration of public employees and social security).

Figure no. 5. Local budgetary expenditures with interest on public debt in Romania (2004-2015)



Source: the authors, data from the European Commission (2016)

The revenues raised at the disposal of local authorities through means of borrowing also generate (negative) economic effects resulting from the associated costs, mainly with the interest on local public debt (fig. 5). In Romania, these expenditures increased until 2009, reaching a share of 2% of the total local budgetary expenditures. Although such figures are not alarming, their proportions must be assessed in relation to the overall size of local revenues, the interest expenditures to be paid in the future limiting the room for maneuver of local authorities.

Table no. 1. GDP per capita at national and territorial level in Romania (2004-2014)

Year	GDP/ capita at national level (EUR/ inh)	GDP/capita for NUTS 2 regions				GDP/capita for NUTS 3 regions			
		max. (EUR/ inh)	region	min. (EUR/ inh)	region	max. (EUR/ inh)	county/ Bucuresti	min (EUR/ inh)	county/ Bucuresti
2004	2900	6000	Bucuresti-Ilfov	1900	N-E	6200	Bucuresti	1400	Vaslui
2005	3800	8800	Bucuresti-Ilfov	2400	N-E	9100	Bucuresti	1600	Vaslui
2006	4600	10500	Bucuresti-Ilfov	2900	N-E	10800	Bucuresti	2100	Vaslui
2007	6000	14100	Bucuresti-Ilfov	3800	N-E	14700	Bucuresti	2500	Vaslui
2008	6900	17600	Bucuresti-Ilfov	4200	N-E	18400	Bucuresti	3200	Vaslui
2009	5900	14100	Bucuresti-Ilfov	3700	N-E	14700	Bucuresti	2700	Vaslui
2010	6300	15200	Bucuresti-Ilfov	3800	N-E	16000	Bucuresti	2700	Vaslui
2011	6600	17100	Bucuresti-Ilfov	3900	N-E	18100	Bucuresti	2800	Vaslui
2012	6700	15600	Bucuresti-Ilfov	4200	N-E	16800	Bucuresti	3300	Vaslui/ Botosani
2013	7200	16900	Bucuresti-Ilfov	4500	N-E	18600	Bucuresti	3400	Vaslui
2014	7500	17700	Bucuresti-Ilfov	4700	N-E	...	...	...	...

Source: the authors, data from the European Commission (2016)

The global analysis of the local debt and local economic development of a country should not be sufficient, to have an accurate picture of the phenomena it is also necessary to assess the territorial dispersion of social welfare and indebtedness, as statistical averages can hide very different realities. The data in table 1 show a large discrepancy between different regions and counties with respect to their level of development (expressed by per capita GDP), with the wider difference being registered between Bucuresti-Ilfov region (also the most indebted region of Romania) and the North-East region. Moreover, during 2004-2015 we cannot talk about a real catching up of the regions ranking last. Under these circumstances, it cannot be appreciated that local indebtedness played a role in the equation of harmonious local and regional development in Romania over the past decade, and more attention should be paid to financing local economic development in the future.

4. Conclusions

The balanced economic development of a country depends on how local authorities understand and assume their role of active agents of development, fructifying the legal attribute of administrative and financial autonomy. In Romania's case, the lack of progress in the field has often been motivated by insufficient financial resources, which called for the use of local borrowing as an alternative to finance local development projects. However, based on existing data, it cannot be said that local indebtedness has so far proved to be an important part of the public policy equation on local development financing in Romania, as the results are quite modest. Although some progress has been registered, the recent economic and financial crisis has induced new difficulties, resulting in both a more difficult access of local authorities to borrowed resources and the change of emphasis from local government capital expenditures to current ones, with negative effects on medium and long-term development.

An important issue is that of the real local indebtedness capacity, the local economic potential being, in many cases, a low one. This calls for measures to encourage municipal associations, as means of enhancing local indebtedness capacity and supporting the development of projects of common interest. To do this, a special category of interadministrative transfers from the state budget could be introduced, meant only for financing the common projects of local communities, and matching-grant type conditional transfers should also be more widely used. It is also necessary to rethink the conditions for municipal borrowing, in order to convert them into to active regulatory instruments to encourage and support the more disadvantaged local communities to catch-up with the more developed ones, both by customizing the limits of local indebtedness and by delineating separate guarantees ceilings (at the level of central authorities) for the loans of different types of local communities.

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