

DEALING WITH FISCAL VULNERABILITIES AT LOCAL LEVEL: GOOD PRACTICE AND LESSONS FROM RECENT CRISIS

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ABSTRACT

Considering that public administration is often characterized by rigidity and has shown over time that it is capable of developing resistance to change, it is all the more important to research today the issue of resilience in the public sector, with an emphasis on public administration at the local level. While crises and shocks are often described as single events, they have been observed to take on a certain pattern, requiring public authorities to be constantly prepared. As a result, there is a need to study how public authorities deal with crises and, at the same time, learn from them for the future. The recent economic crises and the context of austerity that followed, which some authors describe it as the “new normality” may provide opportunities for research on how public authorities deal with unexpected events. In this paper we will analyze the behavior of a selection of local public authorities from Romania after the economic shock caused by the pandemic crisis, based on some assessment tools. Furthermore, we will look to point out local, national or international good practices to prevent crisis impact on local finances or improve it ex-post.

Keywords: Local governments, public authorities, pandemic crisis, finances, new normality

JEL Classification: according to the JEL Classification System

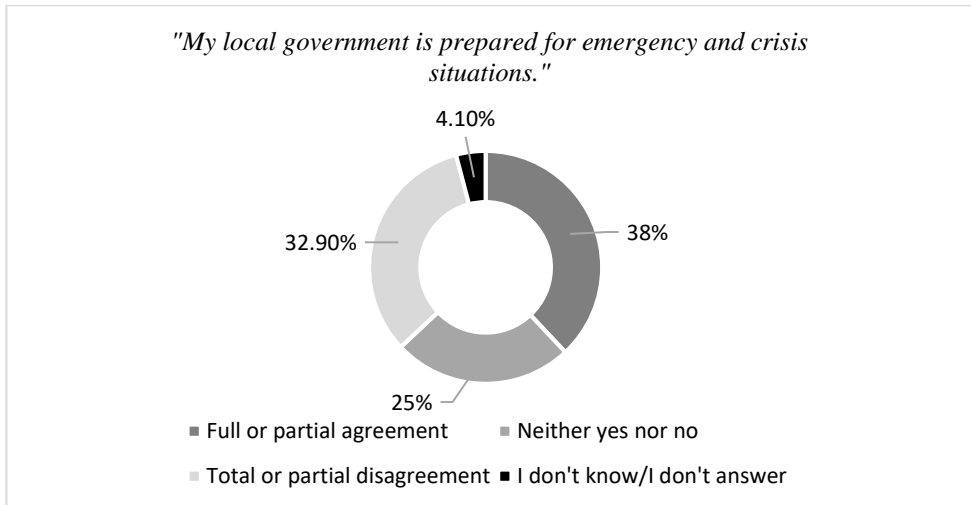
SECTION 1. THE PERCEPTION FOR LOCAL PUBLIC RESILIENCE IN ROMANIA

The importance of the financial resilience of local public administrations is related to regional or global shocks and crises that have become increasingly frequent, recalling the 2008 recession followed in 2020 by the COVID19 pandemic and which implicitly generates a new economic crisis on international scale. Together with the evolution of climate and technological changes, geopolitical instability, migration crises or demographic problems, it puts the issue of resilience at the center of the scientific debate held at international and national level.

The concept of (financial) resilience in public administration began to be addressed for the first time in Romanian legislation only from 2021, as a result of the need to implement the Recovery and Resilience Plan for Romania, a European economic mechanism thought to combat post-pandemic shock. Unlike Romania, the UK has taken a firm stance on local government financial resilience policies since 2010, shortly after the Recession, showing concern for shocks felt down to the lowest administrative level, as shown by a study published recently by the House Of Commons Library (Sandford, 2023), which emphasizes that local public authorities are independent bodies with legal responsibility for their own finances, own assets, can borrow and invest money and have financial reserves to enable them to plan and manage financial risk.

A survey conducted by INSCOP Research in 2022, at the request of the University of Bucharest, shows that only 38% of those interviewed believed that their locality is prepared for emergency and crisis situations, 52.6% believed that political parties are not doing their duty in crisis situations (therefore neither the local public administration, as a result of the political vote) and only 32% were of the opinion that in case of a national crisis the country's leadership will make the right decisions.

Chart 1. The perception of Romanian citizens regarding the resilience and preparation of local public authorities in crisis situations.

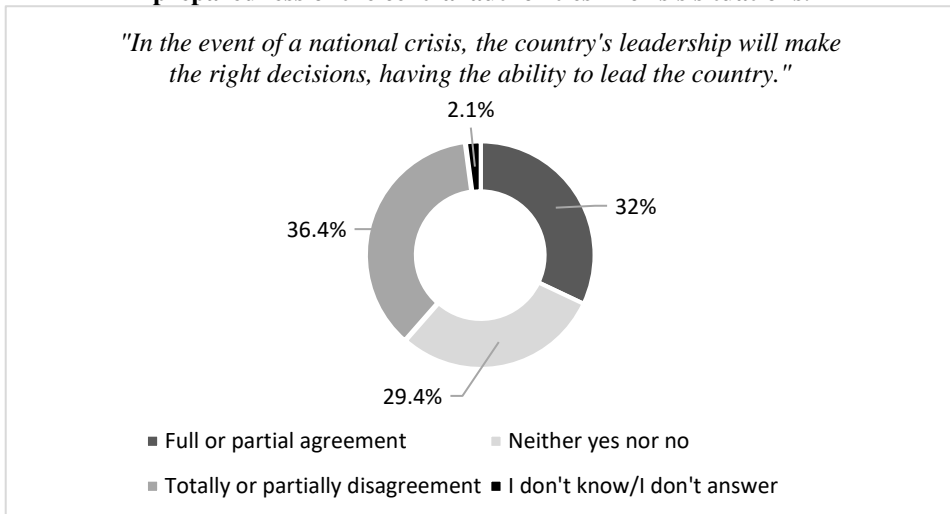


Source: Author's processing after INSCOP Research Romania, 2022

Based on Chart 1 numbers, the differences between agreement and disagreement are relatively small to tip the balance of public perception in the ability of local authorities to cope with crises or shocks, if we also take into account the weight of the undecided. It should be taken into account that the survey recognizes that those who answered affirmatively to this question represent the group made up of people with high financial possibilities, employees in the public sector (therefore with a stable income), residents of the urban environment (more developed areas), so that in this case personal factors make their presence felt, which often act independently of public behavior as a whole.

The figures of this survey carried out two years after the start of the pandemic show that the effects of the crisis caused by it were strongly felt in Romania, as a result of some policies and measures with a short-term impact, namely the encouragement of an economy based on consumption at the expense of investments and long-term strategies for the national and local economy. The shock also had a strong impact among local public administrations due to fragile budgets, lack of infrastructure, human resources and forecasting capacity.

Chart 2. The perception of Romanian citizens regarding the resilience and preparedness of the central authorities in crisis situations.



Source: Author's processing after INSCOP Research Romania, 2022

The importance of the data in Chart 2 is given by the close connection between central government and local government policies in overcoming the effects caused by crises. That is because after the Covid19 pandemic, most European governments have provided financial support to local communities, mostly due to specific local issues. This time, the results from Chart 2 look different from the perception of resilience at the local level, in the way that several Romanian citizens disagree with the statement that "In case of a national crisis, the country's leadership will make the right decisions, having the ability to lead the country.", but the percentage differences are small and do not lead to a clear picture of the national capacity in the face of crises. However, we notice that respondents have more trust in local public governments, since they are the closest entities to any individual needs and have a better knowledge and understanding of local problems and shortcomings, an aspect that makes it more convenient to study. For example, studies published by the Council of Europe in 2021 show that local and regional authorities were at the forefront of the response to the crisis in the EU and therefore among the most affected by its effects. In their case, the crisis had a strong territorial dimension, with a significant impact on local economies taking into account the differences between the local communities regarding financial situations, sources of income, requirements and responsibilities regarding public spending.

On the negative side, we couldn't find any survey carried out at the level of the Romanian local or central public authorities regarding their capacity for resilience in the face of crises, which makes it more difficult to assemble a

complete picture for the present study and to fully understand their readiness levels in the “new normality” era.

SECTION 2. CASE STUDY REGARDING THE FINANCIAL BEHAVIOR OF CITIES IN ROMANIA BEFORE AND AFTER THE PANDEMIC CRISIS

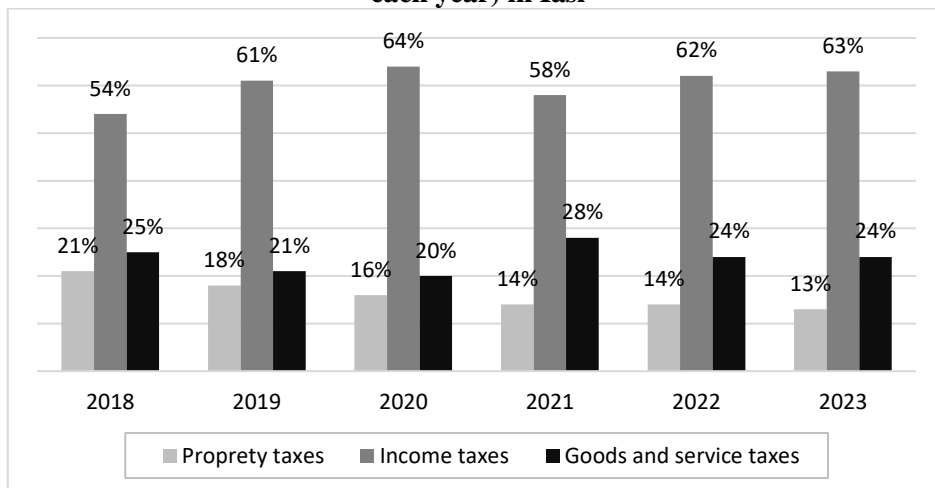
In a recent study (OECD, 2022) regarding the improvement of local governments' resilience in the wake of the COVID-19 pandemic, it is underlined that the improvement in budget outcomes is stronger for national governments than for local governments during upswings but in return, the deterioration of the budget balance is sharper for national governments than for local governments during downturns.

It has to be pointed out that Romanian local authorities had to depend a lot on government transfers which ultimately triggered the dimension of the political factor. In the case of Romania, a report from the European Commission (2021) on local and regional finances after the crisis caused by the Covid19 pandemic shows that despite increasing decentralization, local public authorities were still very dependent on government transfers, with a proportion of 81.2%. This high proportion of dependency also shows that Romanian local authorities did not adopt a preventive behavior since the 2008 recession and did not learn any lessons from the past crisis, unlike the British model where some authors (Arhens & Ferry, 2018) proposed preventive behavior and recommendations for local public authorities to consider how they can strengthen institutions and financial resilience to be prepared for a crisis or the report published by the British Parliament in 2020 named „Lessons learned” on how four local communities managed their finances after the 2008 recession and then into the pandemic crisis, identifying multiple major issues and possible solutions.

For this section of our study, we will look into the local public budgets of some Romanian cities, analyzing their financial behavior prior and after the impact of the pandemic crisis and finding patterns in their capacity to overcome negative effects. For this, we will take a detailed overview of main instruments regarding revenues that affects the strength of local government's finances: income taxes, property taxes, goods and service taxes (from the perspective of VAT allocations). It is worth pointing out that the main source of local budgets is the income tax, since 80% of collected income tax returns to local government's budgets. The second most important source of income is goods and service taxes, also known as a complex VAT allocation system that mixes the size, population and financial capacity of the territorial administrative unit. Thirdly comes property taxes, mostly because the amount of this type of tax is usually smaller and while income taxes, respectively goods and service taxes are processed through

governmental instruments, property taxes depend on citizen's ability and willingness to pay.

Chart 3. The fiscal revenue by instruments (% of total fiscal revenues for each year) in Iasi



Source: Author's processing after financial documents regarding local budgets

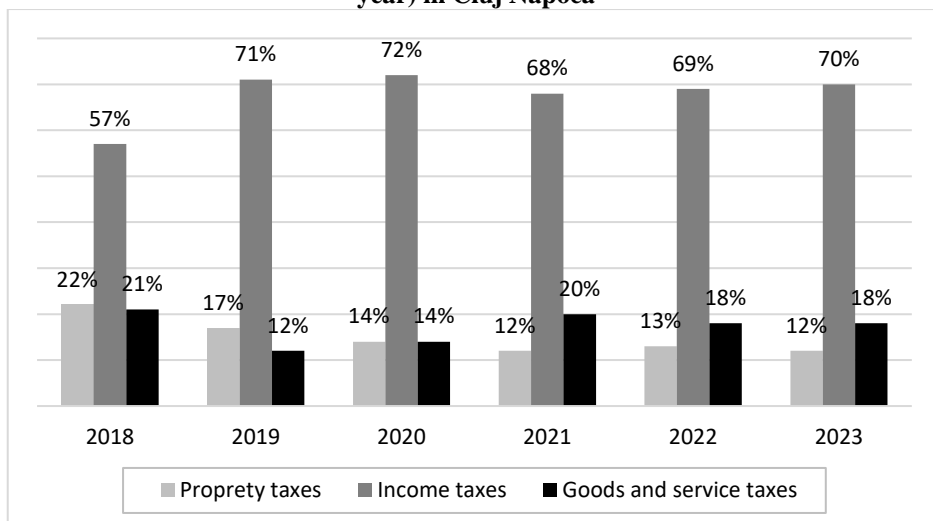
In Chart 3 we observe the fiscal behavior of the municipality of Iasi, in the period of 2018 – 2023, on three main fiscal instruments. As seen above, there is a steady decrease in property tax proportion from 21% in 2018 to only 13% in 2023. This is nothing short of a paradox if we admit that the phenomenon of real estate development in the municipality of Iasi has taken on an ever-increasing scope in the last six years. For example, data from the Romanian National Institute of Statistics shows that in 2018, the city of Iasi had 150.820 existing private homes while in 2022 the number increased to 176.428. In general, this situation can be put on several dimensions: a political dimension, where taxes are unpopular by nature and authorities often neglect them for political reasons; lack of the institutional capacity of the authorities to collect taxes; and unlike income taxes, where the amount is stopped and paid automatically by the employer, property taxes are left to be paid to the discretion of the owner.

Next, the income tax percentage in the total fiscal revenues has a circular trajectory every three years, with its lowest level in 2018 and then in 2021, one year after the start of Covid19 pandemic. It is important to point out that, in 2018, the income tax dropped from 16 to 10%, which affected the revenues of local public administrations. On first glance, this is mainly due to the national problem of unemployment among the population as a result of the difficulties faced by companies during the pandemic. But in the case of Iasi this is also a paradox because the highest unemployment numbers in the studied period was in 2020

(9.356), where we can see in the chart above that income taxes were at their highest peak (64%), while 2021 had the lowest unemployment rate (7.987) and also the lowest income tax collection rate (58%). In addition to this, the average number of employees in Iasi was higher in 2021 (169.215) than 2020 (164.684) and also the average monthly net nominal salary gain was higher in 2021 (3.416 lei) than the year before (3.217 lei), thus there was more taxable base. So what went wrong? A plausible answer is that, in 2020, Romania's government had issued an act to extend the application of fiscal measures beneficial to the business environment in the context of combating the financial difficulties faced by most businesses in the light of COVID-19 epidemic. There was a change in government strategy in 2021 with compensations through taxes on goods and services, especially from the perspective of territorial VAT allocations. In other words, this is where intergovernmental grants and transfers intervene to balance the losses in the local authorities' budgets, to the highest level (28%), while income taxes decreased.

Considering that income taxes and goods and service taxes are under strict regulations, we point out that the municipality of Iasi could improve property taxes collection rate through digitization services, digital and financial education campaigns or offering bonuses to good payers.

Chart 4. The fiscal revenue by instruments (% of total fiscal revenues for each year) in Cluj Napoca



Source: Author's processing after financial documents regarding local budgets

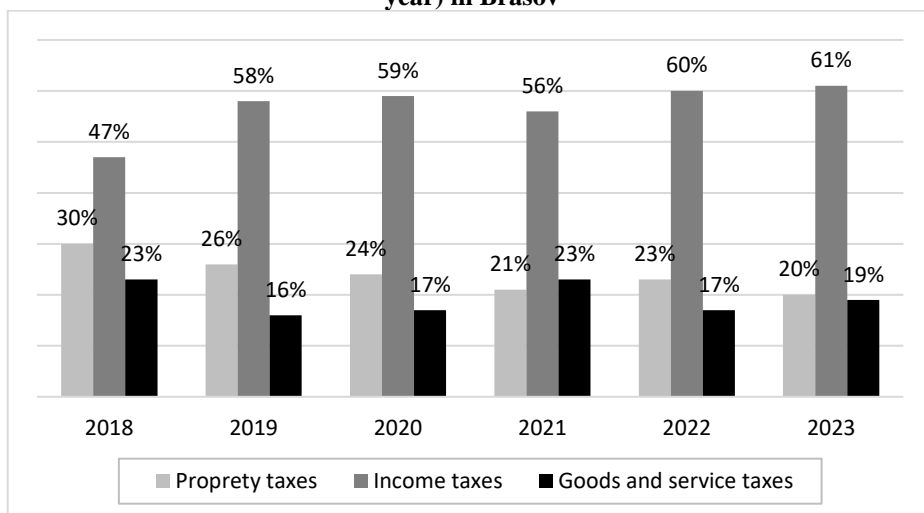
Although both cities like Iasi and Cluj Napoca are often compared, the regional position and access to critical infrastructure cannot allow a fair parallel between the two. Both considered economic and university poles in their region,

the city of Cluj Napoca thrives more as a result of the connection to highways network and a good economic partnership with regional neighbors, having a larger GDP than Iasi. As a result, Cluj Napoca is attracting more workforce and has a larger income tax rate in total fiscal revenues, as seen in Chart 4.

Still, similar to Iasi, Cluj Napoca has the same evolution pattern for income tax in the studied period. Even more, the same can be said about property tax collection rate, which has diminished gradually over the last six years, taking into consideration that the city is also known for its vastly real estate development and high prices for purchasing and renting homes (from 7.582.643 square feet of living area in 2018 to 8.063.815 square feet in 2022).

Cluj Napoca also registered a negative spike in 2021 for income taxes while goods and service taxes have come into compensation, but to a smaller percent in total fiscal revenue.

Chart 5. The fiscal revenue by instruments (% of total fiscal revenues for each year) in Brasov



Source: Author's processing after financial documents regarding local budgets

The fiscal revenue by instruments in Brasov follows a similar path regarding property taxes, income taxes and goods and service taxes. Firstly, the image shows that property taxes proportion in fiscal income registers a gradual decrease from 2018, at its peak, to 2023, to its lowest. Despite some financial advantages granted to citizens (taxpayers who pay fees and taxes by March 31 benefit from a 5% bonus offered by the municipality), or financial constrains (1% penalty for each month late after September 30), the public behavior was not influenced by these decisions. Similar to Iasi and Cluj Napoca, the city of Brasov registered an increased number of properties in the past years, while property taxes constantly

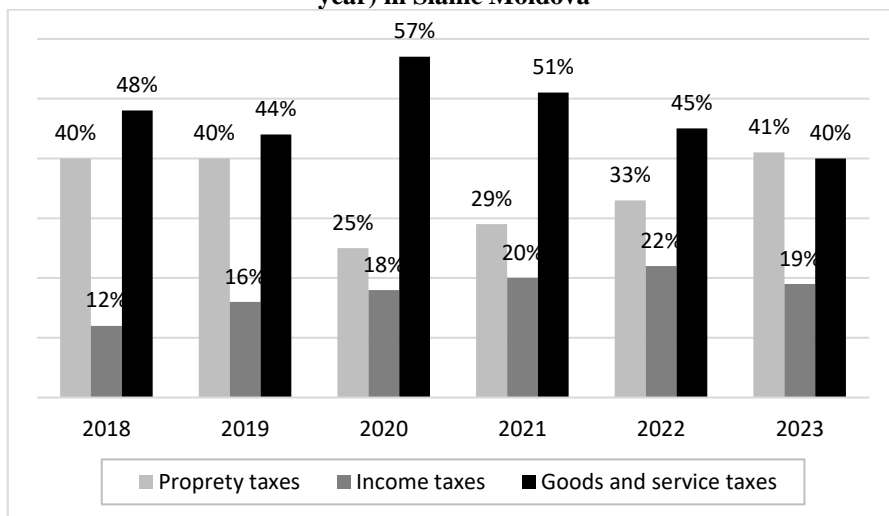
decreased. Data from the Romanian National Institute of Statistics shows that in 2018, the city of Brasov had 122.596 existing private homes while in 2022 the number increased to 141.861.

Income tax evolution follows the same pattern as other studied cities but our focus remains in the period most affected by COVID19. In 2020 – 2021, the amount of income taxes registered a 3% decrease in total fiscal revenues, sign of labor-related vulnerabilities. While central government offered social and job protection measures, the private sector (some areas of activity more than others) was greatly affected by the COVID19 pandemic, which led to a higher unemployment rate, respectively to a lower income base.

In 2021, losses from income taxes were covered by the increased amount of goods and service taxes, as a policy for VAT allocation to better conserve the local budget, similar to other big cities like Iasi and Cluj Napoca.

Finally, by overlaying Chart 3, 4 and 5 we can conclude that fiscal instruments as property taxes, income taxes, goods and service taxes have all similar patters before and after the peak of Covid19 pandemic, which cannot be said about our next city in focus.

Chart 6. The fiscal revenue by instruments (% of total fiscal revenues for each year) in Slanic Moldova



Source: Author's processing after financial documents regarding local budgets

The focus on a smaller city like Slanic Moldova is due to its touristic resort particularity and its dependence for intergovernmental grants and transfers. Firstly, let's look at the evolution pattern for property taxes, notably in 2018 and 2019, followed by a negative spike in 2020 – 2021, when the tourism sector was gravely affected by the pandemic restrictions. This phenomenon can be explained

through the prism of the fact that Slanic Moldova is a touristic resort and the restrictions have completely affected its taxable base. Still, income taxes are growing steady until 2022, even if most of the labor is tied to tourism and hotel business.

Unlike Iasi, Brasov and Cluj Napoca, which have a diverse labor activity, Slanic Moldova's finances almost completely depend on tourism activity. As a result of a specific government act, certain domains like tourism have received an influx of advantages and grants to keep their workforce in place. This explains the increasing evolution in income tax rate.

To balance the losses in the face of COVID-19 crisis, and even before due to its touristic feature, a city like Slanic Moldova with not more than 4.000 inhabitants, cannot sustain itself without a helping hand from the central government. For this reason, goods and service taxes have the highest proportions in total fiscal revenue, notably in 2020 and 2021, when the pandemic immediate effects were felt the most.

As a conclusion to this, cities like Slanic Moldova are the most vulnerable in the face of sanitary or economic shocks, due to the workforce ties to specific activities and the lack of investment diversity to make up for losses in other sectors of activity. More notably, we are of the opinion that any community that is dependable on governmental grants and transfers cannot find the strength and resources to further develop than its current status-quo, accepting that whenever it comes into trouble, the state will step in to the rescue.

Although we recognize that these studied examples do not represent the overall picture of the financial behavior of local public authorities in Romania, with sufficient space for future research, it shows us that larger cities have a greater capacity for financial resilience compared to smaller communities, exclusively dependent of certain sectors that can be completely paralyzed by a crisis. Still, a more advanced study for local and regional finances in the aftermath of COVID-19 (EU Commission for Economic Policy, 2021), notes that despite more decentralized local financing over the years, Romanian local public authorities are highly dependent of transfers from central government (81.2% of public local governments).

SECTION III. GOOD PRACTICE AND LESSONS FROM RECENT CRISIS

The preparation and overcoming of the negative effects cause by the COVID-19 crisis is based on a few key elements: public financial education, institutional digitalization, flexibility of tax collection instruments and public investment funding.

The problem of financial education in Romania has been little studied after the economic crisis of 2008, with the appearance of the new package of education

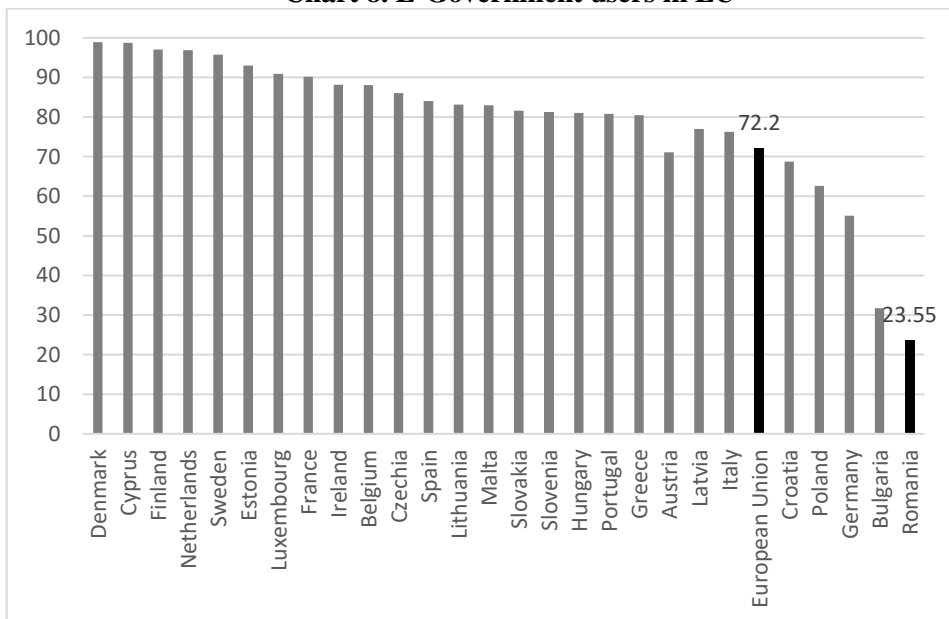
laws in 2011, promising to make the Romanian education system more adaptable to labor market conditions and more consistent with EU educational standards and requirements (Lacatus, 2016). While Government policy was to improve financial understanding as part of school-based curriculum, there is not much evidence of effort regarding adult population and public institutions financial education. This led to worrying statistics placing Romania at the bottom of the EU rankings for financial knowledge, as shown by the Eurobarometer on Monitoring the level of financial literacy in the EU, published in 2023.

The Eurobarometer is placing Romania on the bottom end of the EU countries for financial knowledge score, with only 13% of the participants correctly answering questions on financial knowledge, registering the lowest score among European countries. On the other hand, 30% could not answer any questions correctly or managed to answer only one out of five, making Romania have the highest negative score for financial knowledge. Studies earlier conducted by OECD in 2020 for adult financial literacy using criteria such as financial knowledge, financial behavior and financial attitude from 26 countries, placed Romania at the bottom end of the ranking. This was a wakeup call for national authorities and with the help of Romanian Association of Banks, Romanian Government developed the National Financial Education Strategy 2022 – 2026, as a response to increase public financial knowledge. Seen as a post-pandemic instrument in Romania, such strategies initially appeared on the public agenda of developed countries in the early 2000s, like Japan, Great Britain, the Netherlands, Spain or United States of America (OECD, 2013). Developed early, these financial education tools helped countries to more easily overcome the effects of the pandemic and released the financial pressure on public funds. Although these strategies are the responsibility of central governments, local public administrations should play an important role, because only in an integrated educational system applied to the lowest administrative level can the effects be maximized. In Section II we outlined that local government's budgets mostly depend on income taxes. To improve this fiscal instrument, vital to the financial resilience of local budgets, local governments need to engage into promoting strategies of financial education for inhabitants to adapt and prepare for certain situations. For example, local governments could collaborate with local financial institutions, nonprofit organizations, and educational institutions to create comprehensive financial education programs, tailored to the specific needs of the community. Having a better financial education raises the awareness of the importance of correct and responsible fiscal behavior among taxpayers, contributing to local financial resources.

Encouraging financial education is closely related to institutional digitalization in public sector. For example, in Section II we concluded that property taxes gradually decreased in most cases, while we agreed that property taxes depend on citizen's ability and willingness to pay. This means that local

governments need to find new ways to increase revenue using fiscal instruments. For example, local governments could improve property taxes collection rate through digitization services, digital and financial education campaigns or offering bonuses to good payers. In other words, having multiple choices to pay taxes is not enough without digital and financial education campaigns, while adding a bonus for taxpayers that use digital instruments. Romania took some steps in this direction by implementing a national digital instrument called Ghiseul.ro where citizens can pay taxes and fees of any type with multiple benefits like time saving, zero commission, non-stop availability, payment security, payment confirmation and, more importantly, a 10% discount for paying taxes between January 1 and March 31. Moreover, cities like Iasi, Brasov and Cluj Napoca implemented their own digital tax collecting instruments that can be accessed via their official web page. Still, Romania finds itself again at the bottom of European Union rankings when it comes to digitalization of public service, as seen below.

Chart 8. E-Government users in EU

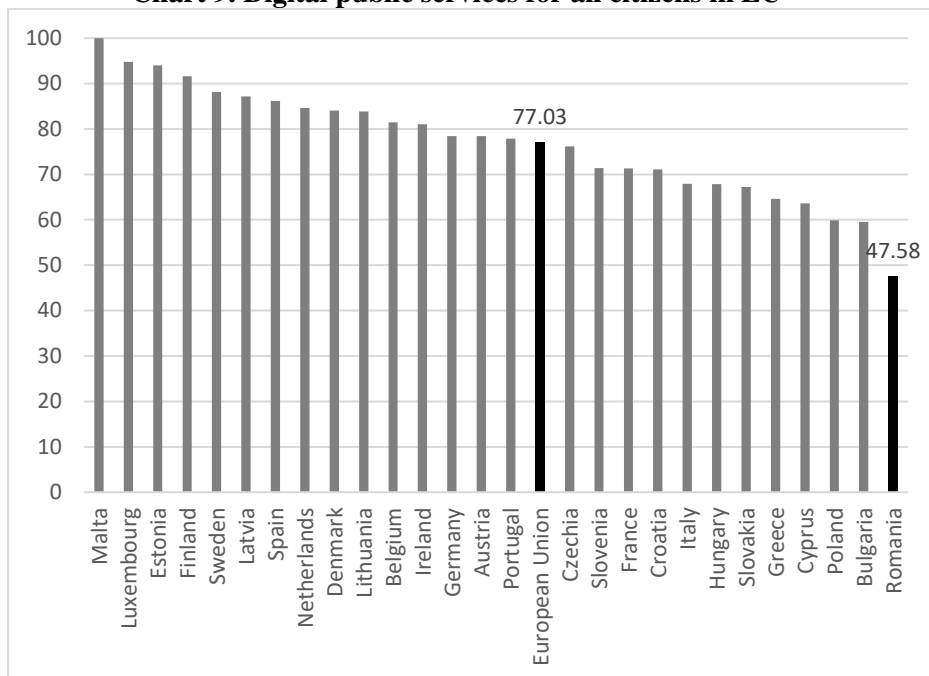


Source: 2023 Report on the state of the Digital Decade, European Commission

The Report on the state of the Digital Decade published by the European Commission in September 2023 outlines that only 24% of Romanian online users actively use e-Government services, compared with an EU average of 73% (Chart 8). The same report shows that Romania performs significantly below the EU

average on the availability of digital public services for citizens, with a score 48 against the EU average of 77 (Chart 9).

Chart 9. Digital public services for all citizens in EU



Source: 2023 Report on the state of the Digital Decade, European Commission

While some countries have higher scores for E-Government users and lower scores for digital public services for all citizens, or vice versa, depending on the implementation level of each country's digitalization strategy, Romania finds itself last in the place in both criteria. The numbers show that there is certainly room to improve in the field of public institutional digitalization but a lot more to work on public financial education, with a score of only 24 for this criteria.

In contrast to this negative side, results of the same study indicates that Romania scores best for connectivity is the area, showing that the first layers of digital infrastructure are already in place, fulfilling one of the preconditions for a successful digital transformation. On the other hand, 5G coverage is at 27% in Romania, well below the EU average of 80%. With the 2022 legislative framework for creating a government cloud, the new 5G network security law and the premise of expanding the 5G coverage, Romania is taking the right steps towards a more comprehensive institutional digitalization in public sector, leaving room for research for future effects.

In our studied cases, in Section 2, we noticed patterns for larger cities when it comes to balancing fiscal revenues by taxes (income taxes, property taxes, goods and service taxes). The three larger cities in this study (Iasi, Cluj Napoca and Brasov) had the same behavior before, after and during the pandemic peak. This observations could convince central authorities to issue a behavioral guide for medium and large cities in Romania to help overcome crises. Looking to boost revenues from income and goods and services taxes, governments should focus on certain aspects, like equal access to education and less fiscal pressure on private business, to ensure a better distribution of labor force and better protection of employees. Also, local public authorities can add to this by improving efficiency and quality of the public services offered to citizens and to have a strategy for using public services in case of crisis. Not only in Romania, but also in other countries, the COVID19 pandemic has affected the health system, the transportation system and the education system, all related to governments and public local authorities affairs.

Furthermore, governments and local authorities should improve their tax collection systems since we already outlined in our study that, despite increasing urbanization and real estate, despite maintaining their labor force, as shown by Romanian National Institute of Statistics, the collecting process has been affected during the pandemic climax. International studies show that “resilience of subnational finances to shocks depends, on the one hand, on the sensitivity of subnational government’s revenues and assigned spending responsibilities to the business cycle and to other shocks, and on the other hand on the extent of their fiscal buffers (in terms of budget balances and debt) both at the outset of the shock and in its wake.” (OECD, 2022). This means that local governments need to take preventive and remedial solutions to counter crisis effects on public finances (in our case the instruments of property taxes and income taxes) but also there is a need to improve and strengthen institutional and legislative relations between governments and local authorities to ensure the financial stability of local communities (the example of goods and services taxes). The particular case of a small city like Slanic Moldova, with local finances depending mostly on tourism activity, leaves room for future studies for specific resorts financial behavior. In our paper we outlined that in crisis periods, when it comes to fiscal revenues collection rate, cities like Slanic Moldova suffer more in terms of property and income taxes, while central governments need to compensate the losses in a much greater way than in the case of medium and large cities with an economic diversity. With the normative help of governments, local public authorities must turn their attention more and more to the diversity of tax collection options, improving the collection instruments and methods, opposable to the periodic increase of tax levels.

Public investment funding is another key element to overcome negative crisis effects and one instrument with a predictive role is the local public investment

program. By law, this document is an annex to the local budget in the form of an investment program, which must fulfill the functions of forecasting, evaluation and control. Invoking the need for an investment plan, a number of its particularities are noted that support local public authorities, with immediate and long-lasting impact, as shown in the following table.

Table 1. The impact of the local public investment program

Immediate impact	Medium and long-term impact
It allows the local financial manager a pertinent analysis of the existing correlation between different projects.	It allows a global vision and a pertinent analysis of short, medium and long-term development needs and prospects.
It allows observing the connections that are manifested between the different projects pursued by the local administration and supports the ranking of the objectives of the local administration.	It engages the local financial manager to order the projects in time, ensuring realistic support for the coherent manifestation of the foresight function of the financial management of local communities.
It allows the local financial manager an adequate dimensioning of the projects from the perspective of the requested financial effort.	Through the collaboration of the interested parties of the local administration, the development of the investment plan supports the achievement of a consensus and a harmonization of the vision of all those interested.
Reflecting the financing sources in the investment plan allows the local financial manager to harmonize the usable financing sources.	It allows the local financial manager global and realistic assessments regarding the funding sources that will be considered and the amount of resources required, which guides the local financial managers early on the need to attract additional financial resources in order to be able to support future projects.

Source: Oprea, 2013

From Table 1, it can be seen that the public investment program supports the local financial manager and gives him clarity on the investment prospects in the local community. In addition to the long-term feature of an investment program, it also has an immediate impact on the investment decision. Thus, the current picture of the correlation between projects, the observation of connections between different projects at a given time, the sizing of projects according to the required financial effort or the harmonization of usable funding sources are immediate effects of the local public investment program. On the other hand, perspective analysis regarding development, time ordering of projects, collaboration and institutional consensus, supplementing resources over time to

satisfy planned investment activities, are all attributes of the long-term impact of the public investment program. The multi-annual feature of the investment plan requires a good ordering in time of the projects that the local public authority starts or has in the implementation procedure, respectively of the financial volume related to each project. We can admit that in the first two years the evaluation is simpler, and as the investment projects exceed this threshold, the uncertainty gains intensity. Usually, this uncertainty is based on the unpredictability of certain income categories, natural factors, inflation, etc. On the other hand, if an investment program is projected over a 7-10 years period, the chances for the local financial manager to make realistic assessments regarding the necessity and opportunity of investments would be considerably reduced, as well as regarding the volume of expenses and sources of financing. Under these circumstances, the recommendation is that the investment program falls within a 3-5 year interval, in order to provide the local financial manager with an adequate picture for decisions of an investment nature.

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