

# SPOTLIGHT ON:

## Is decentralisation good for economic growth?

*Dejan Molnar* \*

In the last few years, there has been an increased interest from the creators of economic policy for economic and especially fiscal performances of sub-national entities/levels of government (provinces, regions, sub-regions, local self-governments), since the realisation of planned goals of fiscal policy, as well as economic growth at the national level, depends on them as well. This issue additionally gains importance in conditions when most of the countries are promoting decentralisation as a preferable organisation model for public administration, with the aim of ensuring higher democracy and motivating economic activity. This paper is dedicated to the analysis of the degree of fiscal decentralisation in EU member states, as well as to the analysis of influences that decentralisation, primarily fiscal one, has on economic performance (economic growth) of certain countries (EU, OECD, Central and Eastern Europe). The goal of the paper is also to review in more detail the degree of fiscal decentralisation in Serbia, and to determine where our country ranks according to this indicator compared to other countries, as well as draw certain lessons from managing public policy in this area. The paper will also focus on a dynamic analysis of revenues and expenditure at the sub-national levels of government in EU member states in the period 1995–2010.

### 1. Review of basic characteristics of fiscal decentralisation in EU countries

In many developed countries (including those that are members of the EU), there is a trend of delegating responsibility for basic functions of the public sector from the central (national) level to lower levels of territorial organisation (regions, sub-regions, local self-governments). The mentioned decentralisation could be reflected in transferring responsibility for raising financial funds (revenue side), but also in performing and self-financing certain activities of the public sector (expenditure side). Based on the results of relevant research and studies<sup>1</sup>, and on Eurostat data, we will review in more detail the degree of decentralising spending by analysing share of revenue and expenditure of sub-national territorial entities/authorities in total revenue and expenditure of the central budget of EU member states.

#### 1.1. Revenue decentralisation

Degree of revenue decentralisation can be measured by share of revenue at the sub-national level in total state budget revenue. There are two basic sources of revenue at the sub-national level<sup>2</sup>: (a) source revenue (primarily taxes) independently collected by the sub-national level, and (b) transfers from the central level.

As can be seen in Table 1, in 2010 Denmark had the highest degree of revenue decentralisation (around 2/3 of total budget revenue were collected at the sub-national level or transferred from the national/central level). The same year, Spain and Sweden collected or transferred around half of total revenues to the sub-national level, while in many countries (10 of them) this percentage was around one third. On the other hand, in small countries (Cyprus, Malta), the sub-national level has a very small percentage of total budget revenues (only 5%). During the observed fifteen-year period (1995–2010), the share of sub-national level in total budget revenues has increased in most of the EU member states (in 20 out of 27 countries).

When it comes to revenue structure at the sub-national level in EU member states, the situation is as follows<sup>3</sup>: own revenues account for about 50% of revenue at the sub-national level in Sweden, Germany, Austria and Latvia, while in Finland, Spain, Estonia, Slovakia, the Czech Republic, Slovenia and Italy, own revenues (taxes, etc.) account for

\* Economic Faculty of the University of Belgrade

<sup>1</sup> See: European Commission (2012), Report on Public finances in EMU 2012, European Economy 4|2012, Economic and Financial Affairs.

<sup>2</sup> Here, source revenues and transferred funds are observed together as sub-national budget revenues.

<sup>3</sup> According to: European Commission (2012), Report on Public Finances in EMU 2012, European Economy 4|2012, Economic and Financial Affairs, p.178.

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40-50% of total revenues at the sub-national level. On the other side are countries where share of own revenue in total revenues is far lower: 0% (Malta), less than 10% (Greece, the Netherlands, Bulgaria), 10-20% (Romania, Great Britain, Ireland, Hungary and Belgium). In 14 EU member states, the transfers from the central level “fill up” the sub-national budgets by more than 50%. It should also be mentioned that in 13 states, including those that are more decentralised (Sweden, Finland, Denmark, Germany), around 70% of total tax revenue collected at the sub-national level comes from income tax and wealth tax, including property tax.

**Table 1. Share of revenue at the sub-national level in EU**

Country	The share of revenues on the subnational level in total government revenues				The share of revenues on the subnational level in GDP (%)			
	1995	2010	relative change (%)	absolute change (pp)	1995	2010	relative change (%)	absolute change (pp)
Austria	34.1	31.6	-7.33	-2.50	17.2	15.2	-11.63	-2
Belgium	34.9	38.5	10.32	3.60	16.6	18.8	13.25	2.2
Bulgaria	22.4	19.8	-11.61	-2.60	8.4	6.9	-17.86	-1.5
Cyprus	3.7	5.4	45.95	1.70	1.2	2.2	83.33	1
Czech Republic	30.3	29	-4.29	-1.30	12.2	11.4	-6.56	-0.8
Germany	36.8	38.8	5.43	2.00	16.7	16.9	1.20	0.2
Denmark	57.8	66.3	14.71	8.50	32.6	36.8	12.88	4.2
Estonia	24.8	25.2	1.61	0.40	10.5	10.3	-1.90	-0.2
Greece	5.2	6.6	26.92	1.40	1.9	2.6	36.84	0.7
Spain	37.6	49	30.32	11.40	14	17.8	27.14	3.8
Finland	36.1	41.7	15.51	5.60	20	21.9	9.50	1.9
France	18.8	23.2	23.40	4.40	9.2	11.5	25.00	2.3
Hungary	28.2	25.9	-8.16	-2.30	13.3	11.7	-12.03	-1.6
Ireland	33.2	19.2	-42.17	-14.00	12.9	6.8	-47.29	-6.1
Italy	28.3	32.5	14.84	4.20	12.7	14.9	17.32	2.2
Lithuania	24.3	33.7	38.68	9.40	8	11.4	42.50	3.4
Luxembourg	13.5	11.8	-12.59	-1.70	5.7	4.9	-14.04	-0.8
Latvia	19.7	31.3	58.88	11.60	7.3	11.3	54.79	4
Malta	1.7	1.8	5.88	0.10	0.6	0.7	16.67	0.1
Netherlands	48.3	35.3	-26.92	-13.00	22.8	16.3	-28.51	-6.5
Poland	23.1	36.3	57.14	13.20	10	13.6	36.00	3.6
Portugal	13.4	15.1	12.69	1.70	4.9	6.3	28.57	1.4
Romania	13.1	28.5	117.56	15.40	4.2	9.7	130.95	5.5
Sweden	42.2	48	13.74	5.80	24.3	25.3	4.12	1
Slovenia	17.7	22.1	24.86	4.40	7.8	9.8	25.64	2
Slovakia	6.9	17	146.38	10.10	3.1	5.5	77.42	2.4
Great Britain	28.9	34.2	18.34	5.30	11	13.8	25.45	2.8
EU-27 (average)	25.37	28.44	12.10	3.07	11.49	12.38	7.75	0.89

Source: European Commission (2012), *Report on Public Finances in EMU 2012*, European Economy 4|2012, Economic and Financial Affairs, p.175 (with changes by Author).

Trends in share of source and shared revenues of local self-governments in consolidated state budget were between 12.5% in 2002 and 20.9% in 2011. Having in mind that share of transfers in total revenue of local self-governments in the period between 2002 and 2011 was on average around 19%<sup>4</sup>, it can be concluded that share of revenue from the local level in total state revenue has been constantly growing, reaching up to 25% in the observed interval.

In that context, it can be concluded that there is a high degree of fiscal decentralisation in our country in the sense of decentralised revenue (compare data in Table 1). During the period 2002-2011, source revenue in Serbia was around 38% of total revenue of local self-governments. Source revenue began to increase its share in the structure of local revenues after the adoption of the Law on Financing Local Self-Governments in 2006, and mostly due to the change in treatment of property tax (it became source instead of shared revenue), as well as to increased land usage fees. However, the aforementioned share of source revenue in total revenues of local self-governments began to decline after 2011, after the Law on Changes and Amendments to the Law on Financing Local Self-Governments (2011) was adopted, due to the increase in income tax that belongs to the local level (from 40% to 80%; this tax is characterised as shared revenue). This change caused a reduction in the share of source revenues in total revenues of cities and municipalities.

<sup>4</sup> See: Bisić, M. and G. Radosavljević (2012), “Degree of Fiscal Decentralisation in the Republic of Serbia: Indicators and Comparisons”, *FINANSIJE Magazine for finance theory and practice*, year 67, no. 1–6/2012, p.53. Average share of source revenue of local self-governments in their total revenues in the same period was around 38%, so it can be concluded that shared revenue on average (2002-2011) had a share of around 43%, *ibid*, p.50.

## 1.2. Expenditure decentralisation

Degree of decentralisation of public expenditures can be measured as share of expenditures that exist in sub-national<sup>5</sup> budgets in the total expenditures of the central (state) budget. Table 2 shows the aforementioned share of budget expenditures of sub-national territorial entities in total state budget expenditures and total GDP during the period 1995–2010, as well as relevant changes during the observed period.

Based on data presented (see Table 2), it is evident that according to this indicator, EU member states significantly differ. In 2010, Denmark was ranked first on the list, considering that 63.4% of total expenditure in this country was decentralised. It was followed by Spain and Sweden with the percentage of expenditure decentralisation of around 47–48%. These were followed by a group of countries where this indicator was around 30–40% (Finland, Germany, Belgium, the Netherlands, Poland, Austria, Italy). On the other side are countries where the degree of expenditure decentralisation was at a very low level: Malta (1.6%), Cyprus (4.8%), Greece (5.6%), Luxembourg (11.5%), Portugal (13.8%), Slovakia (16%), and Bulgaria (18.2%). The data leads to a conclusion that the degree of expenditure decentralisation doesn't only depend on the institutional framework in the country, but also on geographic (size) and demographic (population) characteristics. It is interesting to note that degree of expenditure decentralisation is not relatively higher only in federally organised states (Austria, Belgium, Germany, Spain), but also in those that can be classified as unitary (Scandinavian countries, the Netherlands, Poland). Observed dynamically, it is evident that in most of the EU member states (as many as 22 countries), during the observed time interval (1995–2010), there has been an increase in the degree of expenditure decentralisation.

**Table 2. Share of expenditures at the sub-national level in EU**

Country	The share of expenditures on the subnational level in total government expenditures				The share of expenditures on the subnational level in GDP (%)			
	1995	2010	relative change (%)	absolute change (pp)	1995	2010	relative change (%)	absolute change (pp)
Austria	31.4	34.5	9.87	3.10	17.7	18.1	0.02	0.4
Belgium	33	37	12.12	4.00	17.2	19.7	0.15	2.5
Bulgaria	23.7	18.2	-23.21	-5.50	10.8	6.9	-0.36	-3.9
Cyprus	4.2	4.8	14.29	0.60	1.4	2.2	0.57	0.8
Czech Republic	19.2	27	40.63	7.80	10.2	11.9	0.17	1.7
Germany	33.2	37.5	12.95	4.30	18.2	18	-0.01	-0.2
Denmark	53.7	63.4	18.06	9.70	31.8	36.9	0.16	5.1
Estonia	26.7	24.6	-7.87	-2.10	11	10	-0.09	-1
Greece	4.2	5.6	33.33	1.40	1.9	2.8	0.47	0.9
Spain	33.1	47.9	44.71	14.80	14.7	22	0.50	7.3
Finland	30.5	39.9	30.82	9.40	18.7	22.1	0.18	3.4
France	17.6	20.5	16.48	2.90	9.6	11.6	0.21	2
Hungary	23.5	25.4	8.09	1.90	13.1	12.6	-0.04	-0.5
Ireland	31.1	10.2	-67.20	-20.90	12.7	6.8	-0.46	-5.9
Italy	24.1	30.7	27.39	6.60	12.6	15.4	0.22	2.8
Lithuania	24.1	27.6	14.52	3.50	8.3	11.3	0.36	3
Luxembourg	13.4	11.5	-14.18	-1.90	5.3	4.9	-0.08	-0.4
Latvia	19.2	26.6	38.54	7.40	7.4	11.8	0.59	4.4
Malta	1.5	1.6	6.67	0.10	0.6	0.7	0.17	0.1
Netherlands	40.2	33.3	-17.16	-6.90	22.7	17.1	-0.25	-5.6
Poland	18.9	32.5	71.96	13.60	11	14.8	0.35	3.8
Portugal	11.6	13.8	18.97	2.20	4.8	7.1	0.48	2.3
Romania	12	23.9	99.17	11.90	4.1	9.8	1.39	5.7
Sweden	37.8	47.5	25.66	9.70	24.6	25.1	0.02	0.5
Slovenia	14.5	20.4	40.69	5.90	7.6	10.2	0.34	2.6
Slovakia	13.1	16	22.14	2.90	6.4	6.4	0.00	0
Great Britain	25.8	27.4	6.20	1.60	11.3	13.8	0.22	2.5
EU-27 (average)	23.01	26.27	14.17	3.26	11.69	12.96	0.11	1.27

Source: European Commission (2012), *Report on Public Finances in EMU 2012*, European Economy 4|2012, Economic and Financial Affairs, p.168 (with changes by Author).

<sup>5</sup> In this paper, sub-national territorial entities are considered all forms of territorial organisation "below" the national level (i.e. regions, sub-regions and local self-governments). This approach can be found in many relevant studies and scientific articles dealing with this topic.

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The following criteria can be found in literature for the classification of countries according to the level of (de)centralisation<sup>6</sup>, thus grouping the EU member states (in 2010):

- very decentralised: if over 50% of public spending is realised at the levels below the central one (Denmark);
- decentralised: if 40-50% of public spending is realised at the levels below the central one (Spain, Finland, Sweden);
- semi-centralised: if more than 30% and less than 40% of public spending is realised at the levels below the central one (Austria, Belgium, Germany, Italy, the Netherlands, Poland);
- centralised: if 20-30% of public spending is realised at the levels below the central one (the Czech Republic, Estonia, France, Hungary, Lithuania, Latvia, Romania, Great Britain, Slovenia);
- very centralised: if less than 20% of public spending is realised at the levels below the central one (Slovakia, Portugal, Malta, Luxembourg, Ireland, Greece, Cyprus, Bulgaria).

Share of expenditure of local self-government units in total consolidated expenditure of the state, in the period 2005-2011 in Serbia was on average around 14.5%<sup>7</sup>. Compared to other countries, the share of expenditures of the local level in total expenditure of the state in Serbia is among the lowest and our country can be grouped together with Slovakia, Portugal and Ireland. In our country, this share is far smaller than in Denmark, Germany, Austria, Spain, etc. The conclusion is that according to this indicator of the degree of fiscal decentralisation, Serbia cannot be grouped with countries with a high degree of fiscal decentralisation. Comparing this conclusion with the one referred to by indicators that measure the relative importance of revenues, it can be observed that the scope of real responsibilities of the local self-governments is at odds with their scope of revenue.

### 1.3. Coverage of expenditures by source revenue at the sub-national level – Vertical fiscal (im)balance

The prevailing opinion in the relevant literature dealing with the study of fiscal decentralisation is that own revenues at the sub-national level (primarily taxes collected at the sub-national level) are a much more efficient form of financing sub-national expenditures than transfers from the central level. If the majority of expenditure of the lower level of government is financed through own (source) revenue, then the production of goods and services of the public sector at the sub-national level is financed by those who have direct benefit from their use. Contrary to that, in a situation when public goods and services that are needed at the sub-national level are financed by funds transferred from the central level, an irrational spending of limited resources occurs and for at least two reasons. First, the expenditures are not completely internalised at the sub-national level, because expenses are partly born by those who are “outside” of the particular region. Second, the responsible people at the sub-national level, as a rule, expect that, in the cases when the expenditures at the sub-national level exceed revenues, the difference, i.e. the deficit will be covered by the central government, which then results in the so-called “soft budgetary limitations” at the sub-national level, which could have negative effect on the fiscal balance of the national (central) budget.

However, there are numerous arguments in favour of the claim that not all expenditures at the sub-national level should be financed by own revenues of the sub-national level. Some of them being: (a) economy of scale and complexity of administrating certain taxes, (b) spatial mobility of the tax base, e.g. capital and investments, and the consequent possibility of “tax wars” between sub-national entities trying to attract them, (c) reduced stability of tax revenue at the sub-national level, (d) the need at the central level to lead a policy of equal territorial development, which includes redistribution of funds from richer to poorer sub-national areas, etc. Naturally, the strength of these arguments is relative and depends on form of tax. In literature there can be found a high degree of consensus regarding the taxing of personal and corporate revenues being centralised, as well as administrating the Value Added Tax, while immovable taxes (such as property tax, etc.) can be collected at the sub-national level.

Having this in mind, the following Table 3 shows the degree of expenditures at the sub-national level in EU countries being covered by their own (source) revenues. The assumption is that the smaller the difference between sub-national expenditures and revenues, i.e. the smaller the dependency of the sub-national level on the transfers from the central level, the more efficient the relationship between the various levels of the state administration regarding

<sup>6</sup> See: Miñana Simó, J.S. (1999), “Fiscal Decentralisation in Europe”, *Departamento de Economía Aplicada*, Univerzitat de Valencia, p.11

<sup>7</sup> According to: Bisić, M. and G. Radosavljević (2012), “Degree of Fiscal Decentralisation in the Republic of Serbia: Indicators and Comparisons”, *FINANSIJE Magazine for finance theory and practice*, year 67, no. 1–6/2012, p.59.

the fiscal discipline, i.e. responsible and rational spending of scarce resources. The basic conclusion that can be drawn based on the available data is that there is not a pronounced high degree of coverage of expenditures by revenues at the sub-national level – only in two countries this coverage was above 50% in 2010 (Sweden and Germany)<sup>8</sup>. Observed dynamically, in the period 1995–2010, even though there was no rule among EU member states, there was a notable decrease of the aforementioned coverage in as many as 13 states (it was pronounced the most in Romania, Lithuania, Latvia, Bulgaria) and it was higher than the increase in the other group of countries where the coverage of expenditures had increased as well (Spain, Italy, Slovakia, see Table 3).

**Table 3. Coverage of sub-national expenditure by own revenue**

Country	1995	2010	absolute change (pp)
Austria	42.2	48.6	6.4
Belgium	15.1	19.9	4.8
Bulgaria	32.4	8.7	-23.7
Cyprus	28.6	22.7	-5.9
Czech Republic	41.2	40.3	-0.9
Germany	50.9	51.7	0.8
Denmark	48.6	34.1	-14.5
Estonia	43.5	46	2.5
Greece	10	7.1	-2.9
Spain	26.9	37	10.1
Finland	49.8	45.8	-4
France	45.5	36.4	-9.1
Hungary	20.6	18.9	-1.7
Ireland	6.3	13	6.7
Italy	24	38.9	14.9
Lithuania	61.4	28.3	-33.1
Luxembourg	39	30.2	-8.8
Latvia	75.6	47.5	-28.1
Malta	0	0	0
Netherlands	5.2	8.1	2.9
Poland	42.7	26.7	-16
Portugal	33.3	30.6	-2.7
Romania	59.5	11.2	-48.3
Sweden	57.5	62.5	5
Slovenia	31.2	39.2	8
Slovakia	25	37	12
Great Britain	11	12.9	1.9
EU-27 (average)	34.33	29.75	-4.58

Source: European Commission (2012), *Report on Public Finances in EMU 2012*, European Economy 4|2012, Economic and Financial Affairs, p.179.

The review showed that there is a trend in EU of increased fiscal decentralisation in most of the countries, when it comes to observing both expenditures and revenues, although solutions by individual countries are not unified.

<sup>8</sup> The mentioned state was to be expected, having in mind that it is not economically efficient to administrate the most important forms of tax (VAT, income tax, social contributions, tax on profit, excise) at the sub-national level. Lower territorial entities/regions, as forms of own revenue, are left with tax on income, various fees, etc. (and they don't yield generous contributions to the balance sheet).



## 2. Effects of fiscal decentralisation on economic growth

The aim of this part of the paper is to clarify more closely the relationship between the degree of fiscal decentralisation and economic growth. This issue deserves appropriate attention for at least two reasons<sup>9</sup>. First, stimulating economic growth is one of the most common arguments presented by the proponents of decentralisation. Second, one of the most important functions of the creators of economic policy and holders of power is to create an institutional framework and adopt policies that will stimulate economic progress. Based on the analysis of relevant literature, we will try to answer the question whether a higher degree of fiscal decentralisation contributes to an increase in gross domestic product at the national level. First, we will review the mentioned inter-dependency from a theoretic aspect, and then we will present the results of relevant empirical research (conducted on samples of various countries/groups of countries over the last decade) with the aim of systematising possible answers.

The main argument cited in favour of fiscal decentralisation is that it improves efficiency of public sector and thus contributes to the economic growth in the long term. Economic efficiency is higher, because the local level of government (local authorities) know better the business conditions, specific circumstances and preferences of the local population and economy than some distant central authority does, primarily due to physical and institutional proximity<sup>10</sup>. This argument is especially important in less developed countries where, due to lack of market possibilities, the population is “condemned” to getting aid from central level government, which is not very familiar with the local needs. Therefore, one of the initial premises is that decentralisation contributes to the mobilisation of local resources<sup>11</sup>. This fact allows the local level to secure better and higher quality goods and service of the public sector at lower prices. The aforementioned allocative efficiency is particularly evident, as Oates noticed back in 1972, in conditions of high degree of concord between decentralisation of expenditure and revenue. Likewise, in a situation when government expenditure is decentralised and in line with preferences of the local levels, there is a higher degree of social welfare, which in turn has a positive impact on economic performance<sup>12</sup>. Because, when preferences for public goods and services vary across regions and local communities, centrally governed public policies, which are usually unified, lead to suboptimal solutions (*consumer inefficiency*)<sup>13</sup>. In a situation when lower levels have an opportunity to independently reach decisions (when there is a fiscal decentralisation), there is competition between various levels of government which contributes to more efficient production of public goods and services. Finally, the literature points out one more important argument in favour of (fiscal) decentralisation – a process that stimulates democracy, citizen participation and thus contributes to transparency and responsibility of public authorities. Excessive centralisation reduces what is most important and valuable in any society and a system of decision making, and that is the ability to reach decisions that are in the interest of the majority of citizens and on the level that is “closest” to the citizens (this is the principle of democracy). When a large percentage of decisions is being made at the central level, it poses a risk of creating a “bottleneck”. And the results are misadjusted decisions, whose consequences are numerous missed economic opportunities and therefore reduced efficiency. In addition, excessive centralisation causes a whole range of other non-economic (social) negativities (excessive centralisation of the fiscal system is material basis for a concentration of social power).

Still, it should also be stressed that decentralisation (autonomy) is not necessarily a guarantee of economic development of the local community and national economy. The success is predominantly determined by institutional development, as well as the capacity of local communities (local leaders and their administration) to take over certain activities, but also responsibilities for results achieved. Before taking any concrete steps, potential risks should be considered that are related to the process of decentralisation. If basic conditions for its implementation haven't been fulfilled, decentralisation could cause more damage than good. Unprepared local communities could face: reduction in quality and efficiency in performing public work, too great demands placed before unqualified government representatives, conflict of priorities at the local level, nepotism and increased corruption, unnecessary enlargement of local administration, etc. When creating a decentralisation strategy, one has to take into account the capabilities of

9 Asatryan, Z. (2010), “Fiscal Decentralisation and Economic Growth in OECD Countries: A Bayesian Model Averaging Approach”, Humboldt-Universität zu Berlin, p.7

10 See: Gemell, N Rich at all. (2009), “Fiscal Decentralisation and Economic Growth in OECD Countries: Matching Spending with Revenue Decentralisation”, P. T. N.º 6/09, p.8; Rodrigues-Pose, A. and A. Krøijer (2009), “Fiscal Decentralisation and Economic Growth in Central and Eastern Europe” LSE ‘Europe in Question’ Discussion Paper Series, Paper No. 12/2009, p.1

11 Rodrigues-Pose, A. and R. Ezcurra (2010). “Is Fiscal Decentralisation Harmful for Economic Growth? Evidence from the OECD Countries”, *Imdea Working Papers Series in Economics and Social Sciences 2010/09*, Madrid, p.6

12 According to: Oates, W.E. (1999) “An Essay on Fiscal Federalism”, *Journal of Economic Literature*, n.º 37(2).

13 See: Rodrigues-Pose, A. and A. Krøijer (2009), “Fiscal Decentralisation and Economic Growth in Central and Eastern Europe”, LSE ‘Europe in Question’ Discussion Paper Series, Paper No. 12/2009, p.4

individuals, local organisations and institutions to perform transferred/assumed jobs and responsibilities. Success in the implementation of decentralisation depends on many factors. Certain analyses show that decentralisation could have positive effects only if the state has previously reached a certain level of development. Concerning potential risks (negativities) of decentralisation, it should be stressed that its quality fully depends on the critical mass of the population, the size of the territory, scope of economic activities, realised revenues, etc. Decentralisation will be more successful in populated countries where sub-national territorial units have bigger population.

Theoretic opinions are not fully in favour of the higher degree of decentralisation either. First, increased fiscal decentralisation and competition between sub-national entities could lead to pronounced mobility of individuals, households and companies (which are the tax basis) in an attempt to secure a better treatment for themselves, which negatively affects territorial distribution of public resources (certain areas could be left without budget revenue, so they won't be able to finance spending on public goods and services). This could have very negative implications on the dynamic of the economic growth, because expressed regional inequalities (in income, infrastructure, level of education of the population, level of healthcare, etc.) that occur as a result of fiscal capacity of different areas, have a negative impact on the growth rate of national economy. In less developed sub-national entities, there are no quality institutional or human capacities necessary for making quality developmental decisions and their implementation. In this context, public policies and public sectors that are more centralised could secure a higher territorial equality in the distribution of production (economic and non-economic) factors. Fiscal decentralisation could have negative effects on the economic growth due to the impossibility of adequate coordination in a situation when there are a lot of different entities making independent decisions on borrowing and spending and thus affect the state public finances. Likewise, the sub-national levels are often not big enough to use the economies of scale in the production of public goods and services, which leads to irrational spending, doubling of capacities, etc.<sup>14</sup> The familiarity that exists on the lower levels between the government representatives and the private sector could be a fertile ground for corruption, nepotism, clientelism and thus hinder economic growth. Irresponsible and insufficiently cautious political elite at the sub-national level could create huge fiscal deficits that are then transferred to the national level, because their excessive borrowing, beyond the possibilities of repayment, burden the national budget that acts as a "saviour" (the national budget covers the debts of the sub-national one). Taking over responsibilities of certain sub-national authorities creates, on the one hand, a deficit at the central level, which is, on the other hand, contrary to the principle of fairness (socialisation of expenses/losses). Increase of expenditure of the central budget causes additional borrowing of the central government, which leads to increased inflation and macroeconomic instability, causing a decline of economic activity.

Finally, if we sum up positive and negative effects of fiscal decentralisation on the economic growth, we can see that there are valuable arguments for both alternatives. That is why it shouldn't be surprising that the results of empirical research didn't contribute to a more decisive commitment to either one of them. On the contrary, the empirical literature stresses the difference regarding the conclusions on the effects of decentralisation on economic growth, since the mentioned inter-dependency is predominantly determined by the context in which it is analysed. In that sense, there are opinions that fiscal decentralisation is a more adequate and a more desirable alternative in developed countries, and that it is more probable that in less developed and developing countries its influence on the economic growth would be negative. Hence, in territorial and geographically differentiated decentralisation, the key is the *critical mass concept*. In order for decentralised units to be efficient and make positive contribution to economic prosperity, they have to be large enough in the sense of population, as well as level of economic activities and their realised revenue.

Theoretical considerations are clearly not sufficient to give a unified and unambiguous answer to the question: what is the relationship between the degree of fiscal decentralisation and the rate of economic growth? But, while theory is pointing to a possible positive relationship, the empirical research and literature do not offer any convincing arguments to this effect<sup>15</sup>. Below (in Table 4), we give a tabular presentation of empirical research and their basic findings.

14 Some authors, still, relativise this argument stating that if the fiscal decentralisation is adequately implemented/designed in the sense of control of borrowing of the lower levels of the government and stimulating cooperation of the lower levels on larger and more expensive infrastructure projects/capacities (functional regions; association by the function principle), then the stated negative aspects of fiscal decentralisation could be substantially avoided.

15 First empirical papers examining directly the influence of fiscal decentralisation on economic growth, appeared at the end of 1990s. See: Asatryan, Z. (2010), "Fiscal Decentralisation and Economic Growth in OECD Countries: A Bayesian Model Averaging Approach", Humboldt-Universität zu Berlin, p.8.

## Is Decentralisation Good for Economic Growth?

**Table 4. Correlation between the degree of decentralisation and economic growth**

Author (year)	The sample on which the test was performed	Time period	Main findings / results
Akai i Sakata (2002)	U.S.	1988-1996	Positive and statistically significant relationship.
Baskaran i Feld (2009)	23 OECD countries	1975-2001	Negative, but not strong (expressed) relationship.
Davoodi i Zou (1998)	46 countries	1970-1989	developing countries: negative but insignificant relationship; OECD countries: existence of a relationship not determined.
Limi (2005)	51 countries	1997-2001	Positive and statistically significant relationship.
Lin i Liu (2000)	China	1970-1993	Positive and statistically significant relationship.
Rodrigues-Pose i Bwire (2004)	Germany, India, Italy, Mexico, Spain, United States	Different periods up to 2001	Mostly statistically insignificant relationship, with the exception of Mexico, the U.S. and partly India, where the existence of a negative relationship was found.
Stansel (2005)	SAD	1960-1990	Positive and statistically significant relationship.
Thießen (2003)	26 countries	1973-1998	Connection type conversely "U".
Thornton (2007)	19 OECD countries	1980-2000	Statistically insignificant relationship.
Woller i Phillips (1998)	23 less developed countries	1974-1991	The existence of any relationship non found.
Zhang i Zou (2001)	China	1980-1992	Negative and statistically significant relationship.
Zhang i Zou (1998)	China	1987-1993	Negative and statistically significant relationship.
Rodrigues-Pose i Ezcurra (2010)	21 OECD countries	1990-2005	Negative and statistically significant relationship.
Gemmell, Kneller i Sanz (2009)	23 OECD countries	1972-2005	Decentralization of expenditures has negative and decentralization of revenues positive impact on economic growth, convergence in the degree of decentralization of expenditures and revenues positively influences the economic growth.
Zhang i Zou (1998)	China	1986-1992	If sub national expenditures are highly decentralized additional decentralization stunts growth. The existence of a negative relationship between: (a) the degree of decentralization of expenditures and economic growth, and (b) the share of transfers from the central level and economic growth.
Rodrigues-Pose i Krøijer (2009)	16 Central and Eastern Europe countries	1990-2004	A positive relationship exists between the volume of the original sub national income levels and economic growth.
Enikolopov i Zhuravskaya (2003)	21 developed and 70 developing countries	1975-2000	Positive relationship for less developed countries.

Source: Gemmell, N Rich at all. (2009), p.10-18; Rodrigues-Pose, A. and R. Ezcurra (2010), p.33; Asatryan, Z. (2010), p.17-22 (with modifications from the author – D.M.).

It could be said that the empirical literature in this field is divided: one group of research confirms a positive correlation between the decentralisation and the growth, while another group of papers claims that there is a negative correlation between the observed variables<sup>16</sup>. This is because there is no complete agreement or unified approach in measuring decentralisation and its impact on economic growth, and even when same methodologies are used, there is a difference in samples, approaches, as well as applied analytical methods. The researches were not conducted systematically, samples used to examine the inter-dependency were different, as well as the time intervals. All this leads to different results and warrants caution in drawing conclusions.

Still, certain regularities can be drawn. Fiscal decentralisation gives better results: in developed countries, in conditions when there is a higher coverage of sub-national expenditure by own revenue, in conditions when own revenues have a significant share in the structure of total sub-national expenditures, when the sub-national level has the freedom to independently determine the height of certain tax rates, fees, etc. and not only administrate/collect them, in a situation when there is a clear division of responsibilities when it comes to financing expenditures between various levels of the government, and when the division of responsibilities is done in line with the principle of efficiency in the production of public goods and services. On the other hand, in countries with “younger” democracies (e.g. where there has been a centralised system in managing public sector for a long time), sudden implementation of decentralisation could cause more damage than good. This possibility becomes a probable outcome when the process of fiscal decentralisation starts with a strong delegation of revenue without the transfer of relevant responsibilities (expenses)

16 See: Rodrigues-Pose, A. and A. Krøijer (2009), “Fiscal Decentralisation and Economic Growth in Central and Eastern Europe”, LSE ‘Europe in Question’ Discussion Paper Series, Paper No. 12/2009, p.4.



to the lower territorial units. Sudden transfer of administration (recording, collecting, using, etc.) of certain forms of fiscal revenues to the local levels could cause an economic inefficiency. Professional and technical unpreparedness, lack of a sufficient number of qualified personnel, corruption, and nepotism are just some of the reasons that cause the negative effect of decentralisation on economic growth.

## Conclusion

Regionalisation and decentralisation foresee classification and division of responsibilities, rights and obligations between various levels – local, regional and national. The paper highlighted and analysed in more detail some of the advantages and disadvantages (dangers) of decentralisation, as well as its impact on economic performance. The arguments put forward could be helpful in considering possible alternatives available to the creators of economic policy. It should be clear, though, that the question is not whether there should be a decentralisation, but what is the best way of implementing it. In many cases, the real question is not whether a certain function should be performed by state, regional or local authorities, as the service has to be provided with the participation of all three levels of the government, but the real challenge lies in finding adequate ways of organising the three levels of government to jointly conduct that service.

The paper compared Serbia with EU member states on the degree of fiscal decentralisation. It has been established that Serbia falls into group of countries that are more decentralised when we take as an indicator the share of own revenue of local self-governments in total revenue. According to this indicator, Serbia is ranked together with traditionally highly decentralised countries, which shows that the process of fiscal decentralisation in our country has intensified over the last few years, at least when it comes to the scope and dynamic of revenue of the local self-governments. On the other hand, share of expenditures of local self-governments in the total expenditures of the state is lower than the EU average. This fact relativises the success and quality of the started process of decentralisation in Serbia. The structure of the expenditures of the local self-governments in Serbia (dominated by current expenses – wages and subsidies) supports the conclusion that fiscal decentralisation has not improved efficiency of public spending. Since neither the economic theory nor practice provide unambiguous answers regarding the optimal level of fiscal decentralisation in a country, it remains to be concluded that for our country the alignment in the degree of decentralisation of revenues and expenditures is necessary. In a situation when there is a high degree of fiscal decentralisation of revenue and a low one of expenditures, the efficiency of public spending at the local level is jeopardised, and thus the fiscal balance at the central level as well, which further jeopardises economic growth. It is, therefore, necessary to review the existing system of financing local self-governments (revenue side), as well as consider the possibility of redistribution of responsibilities in order to transfer more power to local self-governments (expenditure side), with the main objective of ensuring the matching of revenues and responsibilities.

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