

# MACROECONOMIC IMPACT OF DECENTRALIZATION

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## **Abstract**

*The concept of decentralization has a variety of expressions, but the meaning generally accepted refers to the transfer of authority and responsibility of the public functions from central government to sub-national public entities or even to the private sector. Decentralization process is complex, affecting many aspects of social and economic life and public management, and its design and implementation cover several stages, depending on the cyclical and structural developments of the country. From an economic perspective, decentralization is seen as a means of primary importance in terms of improving the effectiveness and efficiency of public services and macroeconomic stability due to the redistribution of public finances while in a much closer logic of the government policy objectives. But the decentralization process behaves as well some risks, because it involves the implementation of appropriate mechanisms for the establishment of income and expenditure programming at the subnational level, which, if is not correlated with macroeconomic policy imperatives can lead to major imbalances, both financially as in termes of economic and social life. Equally, ensuring the balance of the budget at the local level is imperative to fulfill, this goal imposing a legal framework and specific procedures to size transfers of public funds, targeted or untargeted. Also, public and local authorities have to adopt appropriate laws and regulations such that sub-national public entities can access loans - such as bank loans or debentures from domestic or external market - in terms of a strict monitoring national financial stability.*

*In all aspects of decentralization - political, administrative, financial -, public authorities should develop and implement the most effective mechanisms to coordinate macroeconomic objectives and both sectoral and local interests and establish clear responsibilities - exclusive or shared - for all parties involved in the modernization process of the state.*

**Keywords:** *decentralization, sub-national government, efficiency, impact, imbalances.*

## **1. Introduction**

### **Reasons for decentralization**

Reasons to brows an extensive decentralization process are multiple and concern the characteristics of countries that implement it. So, in the developing countries from Central and Eastern Europe, the former socialist countries, decentralization has proved necessary to modernize centralized administrative structure of the state and to provide adequate public services the entire population of civilized life, under the conditions of effectiveness and efficiency. Also, for a good public management it have to be applied the principle of subsidiarity, which is the passing of the responsibility to achieve and/or to monitor of some public services from the central level to the sub-national levels in terms of efficiency - ie with the lowest costs - and effectiveness - ie achieving objectives of meeting community needs în quantity and quality required.

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Decentralization is a vital part of the democratization process, because the autocratic regimes required especially by centralizing power, not only the political but also the economic and obviously administrative. Therefore, in countries such as Latin American countries, the decentralization is an accelerated process of modernization after removal of the military regimes, in terms of adoption of new and democratic constitution.

In other countries, the trend of decentralization - local municipalities or regional - is intended to maintain state unity, in terms of the existence of hard disparities between different geographical areas of the country. In this situation are many African countries, where economic and social balance between communities can be maintained only through intense concerted actions to avoid, thus, dismantling the country.

Although the situations are far from being similar, extending some form of regionalization in some developed European countries - such as Italy, with disputes between North and South; Great Britain, tensions often arise between its historic regions; Belgium, with the trends of separation between Walloons and Flemish etc. - has the same purpose, namely balancing the communities in terms of lifestyle, including economic development.

## **2. The economic logic of decentralization**

The variety of forms that shows the decentralization covers a multitude of issues, presenting a significant impact on business efficiency, equity in the social field and macroeconomic stability.

The literature in this field, particularly rich and varied in the last decades, presents several approaches about the role of decentralization to modernize the civil society. The economists believe that decentralization allows redistribution of national resources - something that is one of the main functions of public finance - much more efficient and effective because decisions on public expenditure taken at subnational administrative levels reflect more accurately the necessary public services, thus avoiding the waste. In addition to that, due to better information for taking part in making decisions, people can better realize the priorities, therefore being willing to pay a fair price for the services managed by local authorities.

From the economic perspective, decentralization, which involves training local authorities in most problems lead to competitive between communities, but also to mutual aid of collectivities, with beneficial impact on the quality of governance at local and national level.

From this point of view, in the Act no.273/2006 on local public finances, with subsequently additions and modifications, are provided four new principles as follows:

- the principle of solidarity, whereby local authorities can help distressed municipalities or individuals by providing amounts from the reserve fund which was established in the local budget;
- the principle of local financial autonomy, under which local authorities are entitled to sufficient financial resources consisting of local taxes and the amounts and rates deducted from certain revenues of the state budget and general or targeted subsidies and transfers;
- the principle of proportionality, according to which local public resources must be consistent with the responsibilities of local authorities;
- the principle of consultation, which impose involving associative structures of local government - villages, towns, municipalities, county councils - the legal and regulatory framework on the allocation of financial resources from the state budget to local budgets.

### 3. Controversial aspects of decentralization

Decentralization can not be regarded as an universal panacea. There are a number of problems, both theoretical and practical, showing controversial economic decentralization as a strategy that can have negative effects regarding macroeconomic stabilization policy. In this respect, it is noted that the transition of power from the central decision by some subnational levels can produce local financial imbalances, if is not implemented a legal and consistent framework, unique for the whole country, mainly the rights to make decisions regarding public spending and the possibility of contracting public debt.

Regarding the right of the local authorities to contract local government debt - direct or guaranteed -, they can access borrowed funds, as long as the service of the local public debt of the community - reimbursements plus costs of direct and guaranteed debt - not exceed 30% of the own revenues of the budget of the administrative-territorial unit (Article 63 paragraph (4) of the Act no.273/2006).

Also, issues of equity – both between communities and people - must be viewed carefully during the decentralization process as their resources, especially financial ones, differ considerably multiple reasons: geographic location, previous social and economic development, historical evolution, etc.. These disparities can be resolved only through appropriate mechanisms concrete situations, that ensure all citizens access to a minimum of public services that is done a decent level of living. Those mechanisms can be formed from a range of financial transfers between levels of government, their planning and implementation in a total transparency being a prerequisite for macroeconomic stability and equity between the citizens of the same country.

In this context, ensuring fairness and supervising the balance between administrative units shall be the responsibility of the central government, but it will have to involve all sub-national authorities on decision-making and/or the management of public affairs affecting local life: determination local taxes, redistribution expenditures to financial coverage of public services shared between central and sub-national levels or the public services under the sole responsibility of local authorities, etc.

In this respect, in Romania, in the Act no.195/2006 framework law on decentralization, it is stipulated that to provide necessary public services, local authorities exercised - under the law mentioned above, under the Act no.215/2001 local government and the Act no.273/2006 local public finance law, to remember only organic laws in the area - exclusive competences, shared and delegated as follows:

- according to exclusive powers, local authorities have the right of decisions and have the resources and means to achieve them, in compliance with legal requirements - for example, public and private administration of the village, town, county; transport infrastructure; local and county cultural institutions; public health units; social services with the primary purpose to protect children and for the elderly; for victims of domestic violence; and so on;

- according to shared competences, local authorities - villages, towns, cities - share their responsibilities of public authorities at central and county, and the county with the local and central level. Few examples of this: thermal power produced in a centralized system; the construction of social housing and youth pre-university education; public order and safety; social benefits for people in need; prevention and emergency management at the local level; medical and social assistance; social primary character, population registrar; road transport infrastructure of local interest, etc..

- delegated powers which local authorities exercise on behalf of the central government authorities regarding the pay of some allowances for children and adults with disabilities.

The responsibility of the central authorities result not only from the need to ensure fairness, but also the conduct monitoring of the decentralization process while in town a unified framework. So, as local economies are intrinsically open economy, where the resources, especially human ones can be very mobile, redistribution programs targeted to specific communities become ineffective, requiring correction mechanisms applied ad-hoc, but also placing a legal and regulatory general framework of the balancing mechanisms combined with specific situations of administrative units.

In Romania, balancing mechanism of local public finances is based on the establishment of a fund balance consisting of odds shared deducted from income tax – at present 7% the income tax collected from that community - and the amounts deducted from VAT. Accumulated amount in that account, which is located in the county treasury of the County General public finances is designed to balance local budgets in the county area, including the local budget of the county, and will be distributed first horizontally and then vertically.

From the vast range of public services, those to be decentralized, and the type of decentralization that will be implemented depend on expected economies of scale, mainly in terms of technical effectiveness and of the benefits which can be obtained outside the communities where products. Thus, the type and degree of decentralization does not have to be the same for all the decentralized services, the most advanced form of decentralization from the economic point of view being considered privatization, which allows the consumer to choose their supplier and the product wants it. Nevertheless, because the nature of local public services, people see their option limited, and the best efficiency is obtained when there is the possibility of introducing competition between providers/operators of public services. Given the wide variety of public services placed in the responsibility of local public services and also of economic circumstances in which local communities are, decentralization takes various forms, from devolution to regulated competition and even privatization.

Decentralization is a deeply political action aiming to attract voters and citizens' participation in political actions of elected representatives of the community and its economic side acts in the same sense, its main purpose consisting efficient use of the public funds and increased tendency to pay for services provided. In this respect, at present is considered a successful program to achieve/extension decentraliz must fulfill several conditions:

- for decentralization to be effective and achieve their goals, public authorities decision makers on local public finance area must comply with commitments to service operators that have trained în development/distribution of public services for which they had been designated by law to take responsibility - by any of the legal forms in force of local public service management: delegation concession, Public Private Partnership (PPP) etc. - and local officials to bear the consequences of their decisions and to pay the costs to operators in accordance with contractual obligations which it assumed.

In this context, the local community should be informed about the expected costs and/or contracted public service managed directly or by delegation, as well as the financial resources available or accessible as possible - from grants or repayable sources and in this situation, about the costs of those financial sources - so the projection and multi-annual budget to be performed in compliance with the budgetary principles of organic law;

- in the framework legislation on local public finances must be provisions that subnational authorities are obliged to consult communities, their populations being stimulated to actively participate in decisions concerning the construction of the local budget;

- the responsibility of local authorities should be clearly defined by law - obligations, penalties - so that local government performance can be analyzed, compared with the provisions stipulated by law and with the policies and strategies that local officials have captured the electorate;

- for decentralization to be implemented it is necessary that the use of instruments, primarily financial ones, suitable for local public policy objectives to be met, which requires fair contractual relationships with operators providing local public services, generally by delegation mechanisms used by administrative units responsible leaders. A correct behavior, the spirit of the law, which is adopted by the local authorities is essential to achieve effective decentralization, targeted local benefits and also macroeconomic ones being a logical and predictable consequence.

#### **4. The macroeconomic impact of decentralization**

The implementation of decentralization - a concept that refers to a new approach to administrative decision-making power at all levels of government - can produce significant effects on the economic situation of a country, whether federal or unitary. Framework applied, also the cyclical conditions in that apply decentralization must be well researched, so that the process that takes several aspects that interact and can not be ignored, as: administrative, economic, social and so on, to be on line with the economic development, consumer inclination manifested by population, organization of local authorities and local public finance etc. However, the shift of responsibility of some public services from central to sub-national levels must be accompanied by providing the resources of any kind: material, human, financial, allowing continuation of services, in good condition of the services concerned. Otherwise, or those services are not provided to persons eligible to accepted standards or imbalances will occur, which can become major from the financial point of view, where territorial administrative units who took responsibility for carrying/distribution of the public service. Moreover, expanding the scope of analysis, the impact of inappropriate decentralization will propagate inappropriate macroeconomic, imbalances of the subnational budgets causing a general government deficit, which can be managed with significant costs for the entire national economy.

#### **5. Causes of macroeconomic imbalances generated by sub-national**

Unlike central government, subnational governments are not interested in the macroeconomic implications of the evolution of communities over which they preside, monitoring national central government is of concern that can be used for this purpose tools that can be used for this purpose tools and that are exclusively competent to, for example, the monetary policy. Through this policy, the government can influence - indirectly while in town a democratic state - the global demand on the domestic market and thereby national production, but things get complicated depending the socio-political context that is in the country.

If, according to the national legal framework, sub-national authorities can borrow unrestricted on domestic and/or international financial markets, local government debt may create significant negative issues to the financial stability of the entire state. Similarly, aggregate expenditure on all levels of government while in town a consolidated budget requires strict control of both current expenditures and those of capital for investment, as can be observed to macroeconomic stability criterion - expressed, at least in European Union member states as subnational balance (lower budget costs at most equal to the budget revenues) and at macroeconomic level, the negative balance of the central budget must fall within the limits of 3% of GDP.

Also, if the country is part of year association of states while in a common regional context, as countries joined the European Union Eurozone, the possibility of the central public

authorities to use monetary policy to influence stability and/or national macroeconomic development is limited because this policy is the responsibility of the supranational authority, that does not take into account the needs of each member state, but the whole community area.

## **6. Determinants of macroeconomic financial stability**

### *Distribution function of public finance and tax sharing*

The financial balance of administrative territorial units depends largely on stability of different categories of their income, according to the structure of subnational government budgets. This structure is fixed by national law on local public finances, which in the European Union Member States comply with the provisions of the European Charter of Local Autonomy. In accordance with the Charter, specific local government revenues - local taxes, prices and charges for certain public services produced and distributed by those authorities and residents enjoyed its etc. - represent about 20% of total local revenues, the rest being provided by a range of transfers and taxes shared between central authorities and the sub-central administrative level.

In this respect there are relevant amounts and odds shared in some central budget revenues, in most states that practice the income tax system - irrespective of the tax rate: flat rate or proportionality in installments - and value added tax (VAT), as main neutral tax on consumption, which constitutes for most developing countries the dominant source of revenues. Due to this situation, if the tax base of the shared taxes fluctuates from various causes, such as important changes in tax laws, significant change of macroeconomic indicators, such as gross domestic product, domestic consumption, etc., that underpin these taxes, the possibility of financial coverage of decentralized public services degrades, requiring the intervention of the central government to balance the financial deficit.

## **7. Responsibility for public spending**

Responsibility for the financing of decentralized public services are moving from central to local authorities when it is decided, by law, to pass their administrative and financial management from the central to the subnational level, on compliance with legal requirements.

Decentralization of subnational public spending is the crucial issue of administrative reform of the state, since designated administrative level responsible for the established political and/or distributing a public service are the prerogative of a state policy. The general approach of this action seeks the democratic states that decentralized services require relatively stable public spending - such as budget expenditures financing expenditures for school education, compulsory while in town a modern state. Also, social services are influenced by macroeconomic developments that can be expected and consequently, sizing requirements are more predictable funded.

## **8. Subsidies and transfers from the central to the subnational**

Although a share increasingly lower of the public spending falls under central government responsibility, for reasons of fairness and national tax administration, and having in mind the macroeconomic development, most public revenue is central. In this situation, to maintain and even improve the stability of the entire financial public sector, in any state

addressing decentralization as one of the main tools of public modernization management should be designed and implemented various forms of subsidies and transfers, aiming, however, the principles fairness and effectiveness of the approach to local public authorities about the services they are responsible.

For revenue administration and public expenditure management to achieve the lowest costs, subsidies and transfers should be provided in the draft budget before the start of that year before, as necessary allocation after the imbalances may be more expensive. Obviously, in this situation, the central authorities will be given some discretion to allow adjustment of amounts transferred, which means that in addition to transfers expressly provided in organic law of public finances, they can decide transfers and subsidies for specific projects and/or administrative units that provide such necessity.

In most cases, own revenues and transfers and subsidies from other budgets are not sufficient for local governments to finance all their respective services in responsibility, legal and administrative framework suitable to be applied while in town some time. To overcome this drawback, the law enables authorities administrative units to borrow, framing loan, establishing it between national boundaries, also the concrete form of achievement depending on specific conditions imposed by the local financial market. The developed countries that have the financial markets in which regulators have imposed a strict discipline – for example Germany, Switzerland, France, UK etc. - although allow a significant amount of municipal credit, its values capped at values that must enroll in general macroeconomic equilibrium, according to the Stability and Growth Pact.

Although the decentralization process is a variable percentage in sizing the entire public sector in each country, the financial stability of local governments is one of the major concerns of the national governments that adopt their methods of balancing it deems most appropriate from the point of view of the funds transferred from the central to sub-national levels, also regarding the management system best suited to local tax revenues and local loan.

Closely following the implementation of the decentralization process, central authorities try to limit and discourage local public finance imbalances, for the general government balance to be maintained. For this purpose, transparency is a key intergovernmental factor to determine the transfers, especially since the financial crisis - and its envelope, the economic crisis - primarily affects vulnerable collectives. For example, in Romania, the most affected communities, medium and long term, are the former monoindustrial ones, where public intervention is required to stimulate recovery, both economic, but especially on social issues, involving, alongside targeted transfers, the use of balancing mechanisms according to the needs communities - so-called vertical balancing mechanisms - financially covered by earnings and allowances deducted from certain revenues of the central budget.

## **9. Conclusions**

### **Foreseeable effects of financial relations between levels of government**

Financial relations between central and sub-national administrations occurs both at the macroeconomic and local level. If the financial relations produce significant imbalances to the good of the central authority, the negative effects can be subsequently repaid even if it will be neglected the funding of local public services through taxation and/or local indebtedness. Conversely, if relationships between public administration steps positive effect in favor of administrative units, it can create conditions conducive to poor financial discipline at the sub-national level, with serious consequences for countrywide.

In **conclusion**, each administrative level should have well-defined responsibilities, predictable funding sources and related responsibilities, and autonomy of each step of the

government has to be reflected only in a good management of resources, consistent with the needs of the community, also with the public policies promoted and approved at national level.

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