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**EFFECTS OF FINANCIAL DECENTRALIZATION IN THE CONTEXT  
OF TERRITORIES’ ECONOMIC GROWTH**

**Abstract:** The paper provides the peculiarities of financial decentralization. Its effects in the context of economic growth of territories are systematized. Positive and negative consequences of financial decentralization from the viewpoint of macroeconomic regulation of socio-economic processes are outlined.

The research provides suggestions regarding the conducting of local governance and authorities’ territorial organization reform in terms of expansion of local governments’ competences in forming and use of financial resources based on positive/negative effects of financial decentralization and regarding the defining of the necessary and sufficient level of its implementation and level of central authorities’ and society’s readiness for changes. The paper proves that there isn’t an optimal level of financial decentralization same as there aren’t any ideal solutions in the process of implementation of financial decentralization reform. What spheres should be more or less centralized depends on the capacity of local authorities.

**Keywords:** financial decentralization, economic growth, territories, effects.

**JEL classification:** H77, 043

**Introduction**

Financial decentralization is the key to decentralization of authorities and establishment of efficient system of local finances. What is most important, it is the instrument of regulation of territories’ development. Financial decentralization encourages the regions to financial autonomy, search for additional own resources and boosting of internal development capacity. It allows for balanc-

ing of the territories' needs and opportunities. Practical demand for the research of this subject is caused by low efficiency of the use of budget funds, which is the barrier for efficient management of budget expenditures at regional and local levels.

Therefore, the list of issues that require additional research and discussion in conditions of existing social and political challenges and processes in the sphere of public finances in Ukraine includes the impact of financial decentralization on socio-economic processes in the regions, their level, reasons of activation, models of financial decentralization and, just as important, conditions and readiness of society to implement it.

Insufficient theoretical elaboration of these issues testifies to incomplete nature of forming of efficient mechanisms to maintain the competences regarding expenditures by local governments, especially taking into account the effects of financial decentralization. It requires additional scientific development.

The research **aims to** outline the peculiarities of financial decentralization and systematize the effects of its impact on economic growth of territories.

### **Research results**

Financial decentralization is the complex process of distribution of functions, competences, financial resources and responsibilities for their use. Start of decentralization is always preceded by initial conditions. Based on them, various goals and ways of their achievement are defined, whether it is the expansion of financial capabilities of local governments to improve the efficiency of public services (e.g. Denmark, Sweden, Finland) or strengthening of local democracy (the countries of the Eastern Europe). As the result of these changes, administrative and territorial units gain a “new” status in making managerial decisions. The forms of financial decentralization manifestation will have their advantages over centralization depending on the nature of interaction between public authorities, at least given the fact that local autonomies enable solution of social problems due to transparent living activity spheres as close to the interests of residents as possible. Moreover, global experience shows, on one hand, that financial decentralization is the complex and ambiguous process that strengthens the ground for sustainable growth in the long-term period. On the other hand, the deepening of the processes of financial decentralization stipulate the contradictions and risks for the development of a country in general and its regions in particular, preventing the achievement of desired goals.

Effects of financial decentralization and its impact on the development of regions is systematized in Figure 1. An opportunity to increase the allocative efficiency of public services is the dominating advantage of financial decentralization (Martinez-Vazquez, 2003). The point is that local governments can improve the wellbeing of population through meeting its individual preferences. Moreover, public services can be provided in the way that they correspond to the interests of population as much as possible, are of good quality and have minimal expenditures for their production.

Ability of financial decentralization to boost horizontal and vertical budget competition is another instrument in its favour, which, in its turn, promotes the minimization of public sector and improvement of services quality (Davoodi, Zou, 1998). Financial decentralization is intended to improve the efficiency of functioning of the budget system. Transfer of competences to the local level and independence in making decisions in forming of revenues and use of budget funds is another prerogative of financial decentralization. Territorial proximity of authorities and residents promotes civic activity and accountability to community. Awareness about the problems contributes to their more efficient solution compared to centralization. Successful financial decentralization increases financial capacity of a territory, boosts investment activity, stimulates entrepreneurship activity and further strengthens economic capacity and provides the

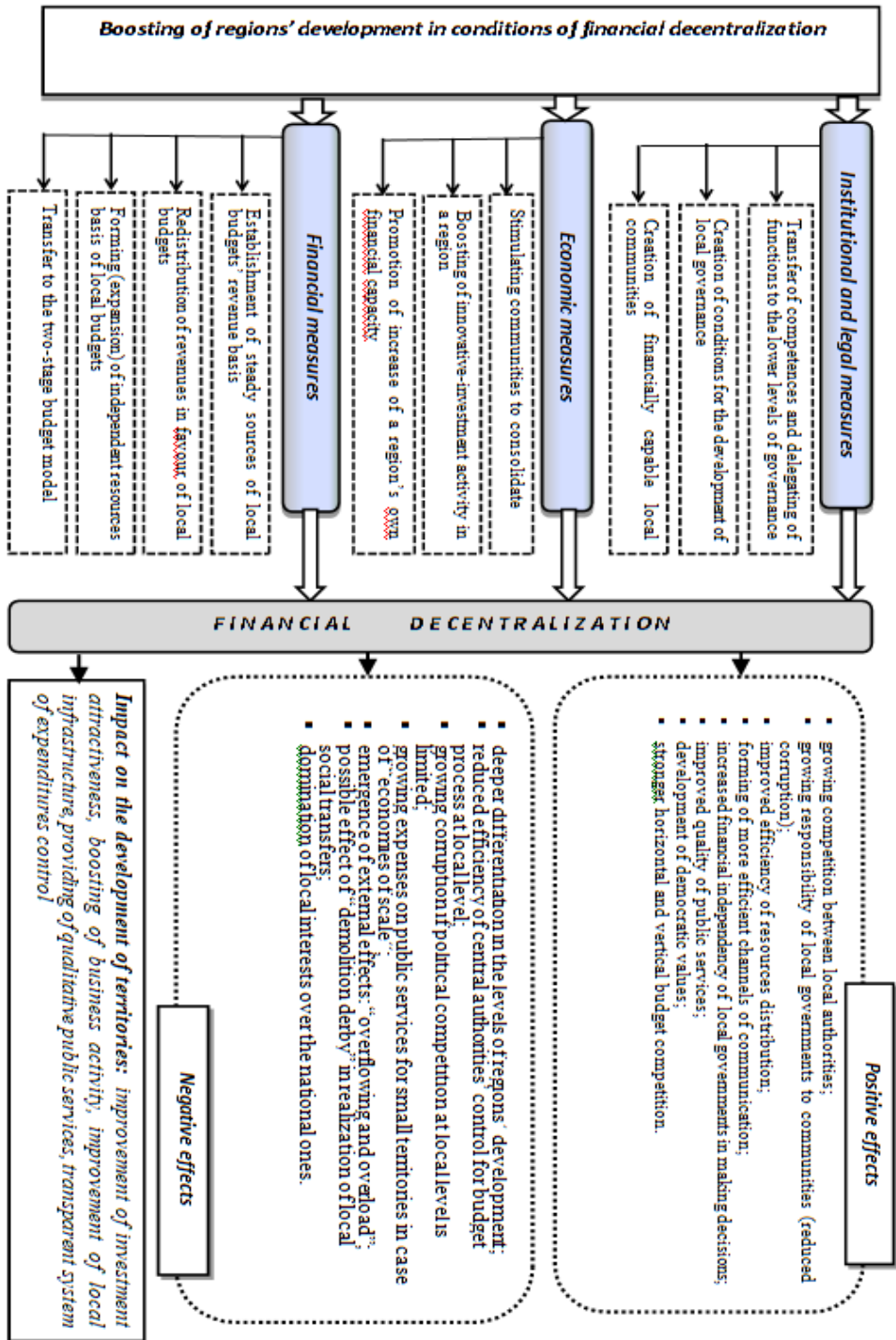


Figure 1: Effects of financial decentralization in the context of its impact on the development of regions

Source: Author's work.

ground for growth and development. The right of local authorities to define the forms of public services is among the most important aspects of financial decentralization.

Despite obvious advantages of financial decentralization, there are significant risks accompanied by the range of problems. Domination of local interests over the regional or even national ones is among them. Experts argue that excessive decentralization of budget system complicates the implementation of such function as stabilization and redistribution of income for the state (Prudhomme, 1995). Under the conditions of financial and economic instability (crisis), the goals of state and regional (let alone local) authorities in terms of budget policy implementation can have various priorities. It means that the policy of budget provision alignment is inefficient and therefore it increases the differentiation of territories' development.

Depending on the methods of implementation of inter-budget relations reform, the effect of financial decentralization can be ambiguous: the same level of decentralization in terms of expenditures in two countries with similar levels of economic development can be accompanied by various levels of decentralization in terms of revenues, producing various incentives for regional and local authorities.

The discord between the redistribution of revenues and establishment of macroeconomic stabilization can be an essential risk of inefficient financial decentralization. In majority of cases, financial decentralization is accompanied by difficult managerial decision-making: which national goals should be granted the priority – achievement of economic efficiency, social justice or macroeconomic stability?

Ratio of local effects from public services and efficiency of their creation is another perspective “stumbling block” in the course of implementation of financial decentralization. We shall speak about the so called risks stipulated by “the economy of scales”: reduced expenses per one unit of provided service with the increasing volumes of provided services (the cost of a service reduces with the growth of the number of those desiring to receive it). The argument is often used by experts for explaining the reasonability of consolidation of administrative-territorial units. When analyzing the risks of financial decentralization in this vein it is necessary to clearly understand what should the minimum size of administrative-

territorial unit be that the price/quality ratio for public service is optimal and socio-economic effect is maximized.

Special attention should be paid to strengthening of financial decentralization that can be accompanied by “external” effects\* - “overflowing and overload”. The nature of this phenomenon is that if one cannot receive appropriate payment for the provided public service, the latter should not be fully provided. It results in irrational use of funds (emerging misbalance between those who pay and the recipients of a service) (Zanadvorov, Iina. Available from: [http://ecsocman.hse.ru/data/540/645/1219/Glava\\_2.pdf](http://ecsocman.hse.ru/data/540/645/1219/Glava_2.pdf)).

The range of authors explains the inefficient consequences of financial decentralization by the effect of “soft budget constraints” (Weingast, Shepsle, Johnsen, 1981). The phenomenon stipulates that local governments of lower governance levels can count on assistance of central authorities. Therefore, they are not “punished” for their incompetence in local finances management. The situation is especially relevant when local budgets are formed by transfers from the budgets of higher levels. Moreover, local authorities do not have any commitments to the residents of the region if tax burden increases, however they will use the advantages from additional financial assistance. Fiscal decentralization in Germany and Italy is the example of “soft budget constraints”, where the vertical misbalance of budget system caused by fast decentralization of social expenditures led to opportunistic expenditures policy of local governments of lower levels. Therefore, central authorities had to grant additional financial assistance (Bordignon, Available from: <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.200.7931&rep=rep1&type=pdf>).

Despite the range of financial risks of decentralization, the experts mention another group of risks – the managerial ones. Such risks are often attributed to poor qualification of managerial apparatus of local governments, domination of personal interests over the public ones, non-compliance of forming of local budgets with the goals and tasks of socio-

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\* Classic understanding of “external effect” (externalities) was suggested by Arthur Pigou in his theory of welfare.

economic development of territories. Eventually, it will eliminate the use of financial decentralization capacity and lead to reduction of public sector functioning efficiency.

Speaking about financial decentralization in the context of its impact on the development of territories, it is important to emphasize another perspective problem related to financial maintenance of delegated and formalized in legislation competences and functions and financial independence of local governments. In this context, it is reasonable to agree with the researcher, who deems inappropriate to introduce full independence of local governments and outlines the following problems related to decentralization: limited administrative capacities of local governments, lack of the mechanisms to secure responsibility of local governments and substantial regional misbalances [Ma J., Available from: [www.worldbank.org/mdf/mdfl/topdown.htm](http://www.worldbank.org/mdf/mdfl/topdown.htm)]. The boundaries of financial independence should be legally formalized and regulated.

The reforms of financial decentralization that began in the late 1980s in the post-Soviet space, in the countries of Eastern Europe and China have updated the interrelations between financial decentralization and economic growth (of countries, regions) due to discrepancy in evaluation of its advantages and risks. Ideologues of the reform tried to find the answers to the questions if there is the connection between the level of budget independence of regional authorities and inflation, public debt, level of balance of budget system; if financial decentralization in fact contributes to reduction of taxes at national level with their parallel growth at lower levels; if internal regional competition caused by financial decentralization increases the revenues, etc. Moreover, to substantiate (or refute) the hypotheses the researchers analyzed and adapted various models of economic growth and used all the possible empirical methods and econometric specifications. Theoretical and empirical research of this subject caused by decentralization phenomenon (which has been retaining its relevance to date) turned out to be ambiguous and not obvious. For example, trying to establish the possible interrelation between the financial decentralization and economic growth in the USA (Akai, Sakata, 2002), the authors argue in their empirical research conducted for

50 states in 1992 -1996 that decentralization of revenues by 10% increases the real GDP per capita by 1.6-3.2 p. p. (significance value 10%), i.e. promotes the regions' economic growth. Trying to substantiate the reasonability of orientation on increase of revenues of the budgets of lower levels, the authors conclude that the revenues of budgets of lower levels can grow due to subsidies. Hence, it is not always the decentralization measure. Another conclusion they come to is that in case of sufficient autonomy the authorities can be decentralized even with insignificant growth of revenues. However, unfortunately, the question of how to measure quantitatively the distribution of liabilities remains open.

According to (Lin, Liu, 2000), economic growth in China is negatively associated with growing decentralization of expenditures. However, transition to new system of revenues distribution between the levels of budget system (which stipulates the growing budget autonomy of provinces) leads to positive changes in economic system.

Analyzing the conducting of decentralization reform in Spain (Cantarero, Perez Gonzalez, 2009), the authors also managed to substantiate the statement regarding the strong positive connection between the decentralization of revenues and economic growth, while decentralization of expenditures has negative impact.

The research conducted for OECD countries testify to the fact that decentralization has the broad scope of impact (Blöchliger, Égert, Fredriksen, 2013). The authors experimentally showed that investment in human capital is much more efficient in more decentralized countries; decentralized budget policy positively impacts the growth of economic capacity not only through investment in technology, but also due to the growth of human capital; decentralization of revenues is also stronger than decentralization of expenditures. Fiscal decentralization is a positive incentive of territories' development as far as it provides local governments with an opportunity to increase capital investment, adjust the composition of expenditures and increase investment in socially oriented sectors, etc. With regard to education services, decentralized authorities provide them more efficiently. Most of empirical surveys show that decentralization in education positively influences the success (of pupils/students), although



such consequences are rather uneven for primary education.

## Conclusions

Financial decentralization is a complex process of distribution of functions, competences, financial resources and responsibilities for their use. Therefore, when expanding the competences of local authorities in terms of making managerial decisions regarding forming and use of budget resources (budget autonomy), it is essential to clearly understand positive and negative effects of implementation of such budget policy and define the necessary and sufficient level of its implementation. Since we are talking about the efficient management (distribution) of budget funds, deepening of budget decentralization can cause the horizontal budget competition between regions and lead to horizontal budget misbalance in the future. The readiness of central authorities in the country and society in general for changes is of utmost importance. Certainly, implementation of budget decentralization principles has its positive points and risks at a certain development stage. One of the most essential problems of evaluating the advantages/flaws of decentralization/centralization processes is to find the balance between these competing approaches to budget policy implementation. There seems to be an optimal set of parameters for each development stage of any territory, which shows the continuity of functioning (Voznyak, 2015).

Examining of global practices of financial decentralization reform and peculiarities of its impact on the processes of territories' development shows various degrees of its manifestation. Financial decentralization reform continues in most European countries and is characterized by gradual transfer of competences in expenditures to local authorities with simultaneous reduction of their funding by central authorities.

Another conclusion made in the course of this research is that there isn't the optimal level of financial decentralization same as there aren't any ideal solutions in the process of implementation of financial decentralization reform as far as each country goes its own development way. However, each country should aim for the balance in decentralization by

various directions: education, healthcare, land relations, energy efficiency. Moreover, what spheres should be more or less centralized depends on the capacity of local authorities.

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