

# DECENTRALIZATION AS A PREREQUISITE FOR ENHANCING FUNCTIONING OF MUNICIPALITIES

Srećko M. RADOJČIĆ, Jasminka M. DJUROVIĆ, Miloje A. JELIĆ  
High Business School, Blace, Serbia

**Abstract**—The importance of fiscal decentralization (as part of a larger system of fiscal federalism) can be completely perceived only through studying and from the viewpoint of both theory and practice. Comparison between theory and practice leads to a conclusion that the observed phenomenon is complex and that special attention should be paid to it.

**Keywords**—decentralization, fiscal decentralization, public property, municipality, financing outgoings.

## I. INTRODUCTION

THE problem of fiscal decentralization emerges in conditions of decentralization of various areas of social life, but in the first place when decentralization of public property has already been done in sense of its organising at various levels of authorities. In such situations it is essential to answer several questions – in what way should public functions and expenses (outgoings) appearing in the course of their operation be allocated; what are the sources which are to be used for financing particular levels of authorities, etc.

Every country has its own characteristic system and each aspires to maintain the system and its stability. Bearing in mind the important role the public property has in functioning and existence of a country as a whole, there is a tendency towards organizing their production sector so that the needs of the citizens are satisfied at the utmost degree. And this should be taken care of especially in conditions when the public sector is decentralized.

Theoretically, when relations between political and territorial units have been decentralized, meaning that lower levels of authorities have to a certain extent some independency when making decisions in comparison to the central authorities, public production should be organized with taking care of the character of the property. If it is a property needed by all citizens of a country, its production should be organized in a uniform and unique way, which can be achieved best at a central level of authority. The property needed by the citizens of a territorial unit and whose production demands more information concerning the needs and priorities that the citizens have, should be provided at a lower level of authority, as a rule at a local level.

The property needed by the citizens of a larger number of

local units, but not necessarily by all citizens of a country, or the goods provided at a local level, whose production implies appearance of certain externalia, it is believed that their production should be a function of a medium level of authority (if such a level of authority has been established). Practical experience of modern countries with decentralized relations between authority levels also shows that production of public property (allocation of public functions) is mostly thus organized. This is why the central authorities, as suggested by theory, are obliged to secure:

National defence and security; monetary policy; foreign affairs, etc;

Local authorities are obliged to secure communal public property, and subcentral authorities are obliged to secure property accompanied by externalia (e.g. culture) and other property with importance at a regional level.

However, some public property requires to be secured at each level of authority (health care; education; social security; roads and traffic; environmental protection, etc.), because some production aspects require uniformity, while others require being closely informed about the needs and priorities of the citizens. According to the above mentioned theoretical standpoint, the production of this property has been organized in almost all modern countries with decentralized structure.

Yet, decentralization of the public sector does not solely require organizing the production of public property in a specific way, concerning the way the public functions have been allocated at different levels of authority, but it is also necessary to determine precisely which level of authority bears the production expenses, i.e. to establish if the production of a specific public property is financed by one political and territorial unit which secures it at the same time or by another unit. According to theory, when securing a public property represents an authentic function of an authority level, expenses arising in the course of production should be outgoings of that authority level.

In situations when a specific function is transferred by means of delegation by central authorities to a lower level of authorities, then production expenses should represent outgoings of central authorities, while in case a function has been transferred by means of devolution, production expenses should be financed by a lower territorial unit,

since it is completely free to organize production. However, these theoretical standpoints have not entirely been applied in practice. As a rule, the most serious problem arises in situations when authorization for securing common public property – in cases when it has not been, for example, established which level of authority finances securing a certain aspect of medical or social security, it is possible that serious disorder can appear in production of this important property, which makes way for discretion and various forms of abuse. In such situations, production would not be suspended, as a rule the central authorities finance the biggest part of expenses from their budget. This underlines the fact that in order to preserve a stable system there has to be a clear and precise allocation of public functions and responsibilities for their performance and financing. Only if we know in every moment who is responsible for production of a specific property and who bears the production expenses, public property will be secured in an efficient way and appearance of unnecessary expenses will be avoided.

Allocation of public functions dictates to the level of authority which bears the expenses to handle the appropriate (substantial) income sources which are used for financing. Theory suggests derivative public revenue (taxes, duties and compensations) which regularly flows into the budget of a political and territorial unit to which certain outgoings have been allocated. But, the lower levels of authorities have been entrusted with functions whose performance produces outgoings which cannot be entirely covered by their regular public income, in order to enable the continuance of production of public property, central authorities transfer the necessary funds to them.

In this way, theory shows that in conditions of decentralized public functions, it is always necessary to allocate public outgoings first, which leads to formation of a specific pattern of allocating public revenue, and then to an appropriate system of transfer (and a system of indebtedness). All these questions are connected and answering the previous question requires answering the next one.

For the purpose of regular production of public property and providing sufficient assets for financing expenses, theory suggests that a specific public revenue should be subject to a specific level of authority. Lavish sources of revenue and those with mobile basis, and especially those ones which are important for the achievement of a stabilization and redistributive functions, should be subject to central authorities.

This is how central revenues should be determined: general sales tax; citizens' income tax; corporation tax; excise taxes; natural resources tax and customs tax. Less lavish revenues with an immobile basis should be subject to local authorities – tax on property and probably taxes for other resources with a local character. Concerning subcentral revenues, theory maintains that in countries with a big enough territory, this level of authority should

be in charge of some revenues which should otherwise be subject to central authorities (citizens; income tax or sales tax in the retail phase, etc.).

However, disregarding the size of national territory, theory has a clear attitude towards revenues obtained from customs taxes and Value Added Tax – these revenues are always subject to central authorities, since leaving them to subcentral units would be inefficient and would lead to unnecessary increase in expenses.

In compliance with such an allocation of jurisdiction for introduction of public revenues,

theory proposes a convenient model for allocating resources obtained by collecting particular revenues. Allocation should always be carried out by applying some of the following systems: a system of proper revenues, a system of common revenues or a system of tax overlapping, or best by combining all of them. Based on such standpoints, in the practice of modern countries, allocation of public revenues is carried out, as a rule, by combining two or three of the above mentioned systems. Most frequently, Value Added Tax and citizens' income tax, or in other words those sustained by theory, are regarded as common revenues. As a rule, these revenues are introduced by central authorities, which assign part of the obtained resources to lower political and territorial units. However, in practice, some examples which are exception to the rule, can be found, and this happens most frequently with allocating VAT.

Although, as a rule, departure from theoretical views can cause numerous problems, sometimes it can be successful. In comparison to a theoretical view saying that VAT shall be most efficiently implemented in a system of a country when introduced at a central level of authority, different solutions can be found in some countries. The most impressive example is Canada where VAT was introduced not only at the central level of authorities but also in the province of Quebec, so that it is implemented parallelly on both central and subcentral level. Although theory emphasizes numerous deficiencies and consequences which could result from applying this tax at higher authority levels, VAT system in Quebec is a good example of its implementation at a subcentral authority level. However, this is not in contradiction with the theoretical standpoint, but certain factors (in this case territorial and, first of all, political) conditioned deviation from theoretical principles.

Allocation of public revenues should be organized so that central authorities get the most lavish revenues, or in other words, the largest funds since the expenditure arising from public production at this authority level is the largest; while the lower authority levels should handle a narrower range of assets since their expenditure is smaller. However, in decentralization, when public functions whose performance produces expenditure which is larger than their public revenues, are transferred to lower political and territorial units, using transfer is suggested by other political and territorial units.

While theory, on the one hand, justifies their usage in case when general (unconditioned) transfers are used,

when fiscal disbalance (primarily, the vertical one) has to be removed, on the other hand is quite “reserved” in reference to their usage in conditioned transfers. By conditioning the usage of the carried forward assets for a specific purpose, we produce space for discretion of central authorities and political control and pressure on lower political and territorial units. This is why theory presumes that transfers are influenced by political factors and the relation between political forces in a society, because of which a transfer system applied in one country sustains the character of its political system.

There are also some discrepancies in theory in reference to transfer classification – while one group of authors presumes that besides dotations, common revenues as well represent transfers, the other group of authors advocates transfers in the form of donations. We are of the opinion that the first solution is more acceptable, since in certain cases the transfer of common revenues by one political and territorial unit to the other one has such characteristics that it could be considered as a genuine inter-budgetary transfer. It is confirmed in practice as well. In most modern countries, transfer of assets is carried out not only by applying donations, but also by conceding revenues by central authorities to lower political and territorial units, and often with the purpose of achieving uniformity. As a rule, uniformity transfers have the priority in all countries (because they are used in order to remove fiscal disbalance), and at the same time, thus most revenues are transferred to lower authority levels.

What will the transfer system be like; what form of assets shall be transferred; what will the function be, etc. - these are the questions answered differently in the practice of different countries.

Numerous factors which influence socio-political system influence how a system of transfer shall be organized in one country. There is no doubt that transfer is necessary in conditions of decentralized public outgoings and fiscal decentralization, if the right measure has always to be found, otherwise transparency, neutrality, flexibility and righteousness of a system shall be violated, as well as the efficiency itself. This is the reason why a complex system of transfer with a large number of forms for transferring assets is introduced in the countries with a long tradition of fiscal federalism, while the countries in which fiscal federalism has just been started, decide to use smaller number of transfers, mostly in the form of conceding common revenues (with the purpose of uniformity) and various forms of restrictive donations. If the economy of a country is developed, it guarantees a sufficient financial basis for stable functioning of the transfer system. This is the reason why the most successful and the most developed transfer systems are those being implemented in economically most developed countries.

However, although lower political and territorial units can obtain additional assets for financing their outgoings by transfers made by central authorities (or by wealthier units at the same level of authority), theory is committed to allowing, in certain cases, the funds to be obtained

through taking loans and credits. Since the usage of transfers is always connected with the possibility to control, reducing the autonomy of lower authority levels and becoming financially dependent on central authorities, lower levels of authority should be given the opportunity to obtain the funds by going to the bond market, taking bank credits, loans from the budget of central authorities and abroad.

Theory also justifies becoming indebted for the purpose of financing capital needs, while becoming indebted for the purpose of financing budgetary deficiency is allowed only in special cases, solely in the form of short-term debts. Apart from the purpose of the borrowed funds, in order to avoid excessive indebtedness, it is necessary to control taking credits (through market, by determining appropriate legal rules, through cooperation of different authority levels, directly by central authorities or in the form of selfcontrol), while in most cases it is justifiable to perform control by setting restrictions concerning indebtedness in legal regulations, or by “strict budgetary restrictions” – it is allowed to become indebted up to a certain amount of regular public revenues and with obligation to pay off the borrowed funds within the agreed period.

In the practice of modern countries these theoretical attitudes have been more or less respected. In all countries where indebtedness of lower levels of authority are allowed, it is anticipated that this is possible only for capital needs, with setting strict budgetary limitations and without guarantees given by central authorities for the borrowed funds. This is why lower political and territorial units do not rely on this form of obtaining funds as much as they rely on transfers provided by central authorities: funds obtained by transfers do not have to be returned, the situation is the reverse with credits and loans (not only does the borrowed amount have to be returned, but the interest has to be paid as well).

In comparison to modern countries with developed market economy and a fairly developed fiscal federalism, in countries undergoing transition with a prominent tendency to decentralized public sector as much as possible, the situation is quite the reverse. In those countries, fiscal federalism is, as a rule, undeveloped or developed partly, which is a cause of numerous problems. There is a similar situation in Serbia and Montenegro. In these countries, both of them having a very long mutual heritage, fiscal federalism can be discussed taking into account the existing decentralization of public revenues, while the others have been managed quite unclearly or are undeveloped. In the process of allocating public outgoings there are numerous deficiencies which should be eliminated; the system of interbudgetary transfers is very undeveloped, and local communities have the possibility of becoming indebted, although regulated in a general way, it is mostly unemployed (Serbia) i.e. it has led to excessive indebtedness of municipalities (Montenegro).

The method used in the process of decentralization of

public functions in Serbia and Montenegro has produced numerous doubts, because it often cannot be determined if carrying out a specific job presents outgoings of the republic or a municipality, i.e. if the specific situation is an example of decentralization, delegation or devolution of jurisdiction.

Legal limits of both countries which have been the subject of our analysis and research, determine existence of executive local affairs and the possibility of entrusting certain operations by central authorities, but the category of entrusted operations has not been specified at all, nor it has been determined the budget of which political and territorial unit will be used for financing.

There is even greater inaccuracy when it comes to defining regional structures of authority. For example, in Serbia, by the so called „omnibus“ law, jurisdiction for performing a large number of operations from the domain of republic functions has been transferred to the province, without stating the exact form of decentralization (except for the social security) and who shall finance securing specific public property. Such inaccuracy produces a large number of doubts, because it is often not clear which political and territorial unit should finance performance of a specific job, which can result in not providing the necessary funds, and thus in inability of the citizens to satisfy their consumption of a specific (usually very important) public property. Montenegro has recently adopted the Law on regional development, but it is still questionable how this Law should be put into effect, namely, how the regions and the management system at this level shall be organized.

Local authorities are obliged to secure communal public property, and subcentral authorities are obliged to secure property accompanied by extranals (e.g. culture) and other property with importance at a regional level.

However, some public property requires to be secured at each level of authority (health care; education; social security; roads and traffic; environmental protection, etc.), because some production aspects require uniformity, while others require being closely informed about the needs and priorities of the citizens. According to the above mentioned theoretical standpoint, the production of this property has been organized in almost all modern countries with decentralized structure.

Yet, decentralization of the public sector does not solely require organizing the production of public property in a specific way, concerning the way the public functions have been allocated at different levels of authority, but it is also necessary to determine precisely which level of authority bears the production expenses, i.e. to establish if the production of a specific public property is financed by one political and territorial unit which secures it at the same time or by another unit. According to theory, when securing a public property represents an authentic function of an authority level, expenses arising in the course of production should be outgoings of that authority level.

In situations when a specific function is transferred by

means of delegation by central authorities to a lower level of authorities, then production expenses should represent outgoings of central authorities, while in case a function has been transferred by means of devolution, production expenses should be financed by a lower territorial unit, since it is completely free to organize production.

However, these theoretical standpoints have not entirely been applied in practice. As a rule, the most serious problem arises in situations when authorization for securing common public property – in cases when it has not been, for example, established which level of authority finances securing a certain aspect of medical or social security,

it is possible that serious disorder can appear in production of this important property, which makes way for discretion and various forms of abuse. In such situations, production would not be suspended, as a rule the central authorities finance the biggest part of expenses from their budget. This underlines the fact that in order to preserve a stable system there has to be a clear and precise allocation of public functions and responsibilities for their performance and financing. Only if we know in every moment who is responsible for production of a specific property and who bears the production expenses, public property will be secured in an efficient way and appearance of unnecessary expenses will be avoided.

Allocation of public functions dictates to the level of authority which bears the expenses to handle the appropriate (substantial) income sources which are used for financing. Theory suggests derivative public revenue (taxes, duties and compensations) which regularly flows into the budget of a political and territorial unit to which certain outgoings have been allocated. But, the lower levels of authorities have been entrusted with functions whose performance produces outgoings which cannot be entirely covered by their regular public income, in order to enable the continuance of production of public property, central authorities transfer the necessary funds to them.

In this way, theory shows that in conditions of decentralized public functions, it is always necessary to allocate public outgoings first, which leads to formation of a specific pattern of allocating public revenue, and then to an appropriate system of transfer (and a system of indebtedness). All these questions are connected and answering the previous question requires answering the next one.

For the purpose of regular production of public property and providing sufficient assets for financing expenses, theory suggests that a specific public revenue should be subject to a specific level of authority. Lavish sources of revenue and those with mobile basis, and especially those ones which are important for the achievement of a stabilization and redistributive functions, should be subject to central authorities.

This is how central revenues should be determined: general sales tax; citizens' income tax; corporation tax; excise taxes; natural resources tax and customs tax. Less

lavish revenues with an immobile basis should be subject to local authorities – tax on property and probably taxes for other resources with a local character. Concerning subcentral revenues, theory maintains that in countries with a big enough territory, this level of authority should be in charge of some revenues which should otherwise be subject to central authorities (citizens; income tax or sales tax in the retail phase, etc.).

However, disregarding the size of national territory, theory has a clear attitude towards revenues obtained from customs taxes and Value Added Tax – these revenues are always subject to central authorities, since leaving them to subcentral units would be inefficient and would lead to unnecessary increase in expenses.

In compliance with such an allocation of jurisdiction for introduction of public revenues,

theory proposes a convenient model for allocating resources obtained by collecting particular revenues. Allocation should always be carried out by applying some of the following systems: a system of proper revenues, a system of common revenues or a system of tax overlapping, or best by combining all of them. Based on such standpoints, in the practice of modern countries, allocation of public revenues is carried out, as a rule, by combining two or three of the above mentioned systems. Most frequently, Value Added Tax and citizens' income tax, or in other words those sustained by theory, are regarded as common revenues. As a rule, these revenues are introduced by central authorities, which assign part of the obtained resources to lower political and territorial units. However, in practice, some examples which are exception to the rule, can be found, and this happens most frequently with allocating VAT.

Although, as a rule, departure from theoretical views can cause numerous problems, sometimes it can be successful. In comparison to a theoretical view saying that VAT shall be most efficiently implemented in a system of a country when introduced at a central level of authority, different solutions can be found in some countries. The most impressive example is Canada where VAT was introduced not only at the central level of authorities but also in the province of Quebec, so that it is implemented parallelly on both central and subcentral level. Although theory emphasizes numerous deficiencies and consequences which could result from applying this tax at higher authority levels, VAT system in Quebec is a good example of its implementation at a subcentral authority level. However, this is not in contradiction with the theoretical standpoint, but certain factors (in this case territorial and, first of all, political) conditioned deviation from theoretical principles.

Allocation of public revenues should be organized so that central authorities get the most lavish revenues, or in other words, the largest funds since the expenditure arising from public production at this authority level is the largest; while the lower authority levels should handle a narrower range of assets since their expenditure is smaller. However, in decentralization, when public functions whose performance produces expenditure

which is larger than their public revenues, are transferred to lower political and territorial units, using transfer is suggested by other political and territorial units.

While theory, on the one hand, justifies their usage in case when general (unconditioned) transfers are used, when fiscal disbalance (primarily, the vertical one) has to be removed, on the other hand is quite "reserved" in reference to their usage in conditioned transfers. By conditioning the usage of the carried forward assets for a specific purpose, we produce space for discretion of central authorities and political control and pressure on lower political and territorial units. This is why theory presumes that transfers are influenced by political factors and the relation between political forces in a society, because of which a transfer system applied in one country sustains the character of its political system.

There are also some discrepancies in theory in reference to transfer classification – while one group of authors presumes that besides dotations, common revenues as well represent transfers, the other group of authors advocates transfers in the form of donations. We are of the opinion that the first solution is more acceptable, since in certain cases the transfer of common revenues by one political and territorial unit to the other one has such characteristics that it could be considered as a genuine inter-budgetary transfer. It is confirmed in practice as well. In most modern countries, transfer of assets is carried out not only by applying donations, but also by conceding revenues by central authorities to lower political and territorial units, and often with the purpose of achieving uniformity. As a rule, uniformity transfers have the priority in all countries (because they are used in order to remove fiscal disbalance), and at the same time, thus most revenues are transferred to lower authority levels.

What will the transfer system be like; what form of assets shall be transferred; what will the function be, etc., - these are the questions answered differently in the practice of different countries.

Numerous factors which influence socio-political system influence how a system of transfer shall be organized in one country. There is no doubt that transfer is necessary in conditions of decentralized public outgoings and fiscal decentralization, if the right measure has always to be found, otherwise transparency, neutrality, flexibility and righteousness of a system shall be violated, as well as the efficiency itself. This is the reason why a complex system of transfer with a large number of forms for transferring assets is introduced in the countries with a long tradition of fiscal federalism, while the countries in which fiscal federalism has just been started, decide to use smaller number of transfers, mostly in the form of conceding common revenues (with the purpose of uniformity) and various forms of restrictive donations. If the economy of a country is developed, it guarantees a sufficient financial basis for stable functioning of the transfer system. This is the reason why the most successful and the most developed transfer systems are those being implemented in economically most developed countries.

However, although lower political and territorial units can obtain additional assets for financing their outgoings by transfers made by central authorities (or by wealthier units at the same level of authority), theory is committed to allowing, in certain cases, the funds to be obtained through taking loans and credits. Since the usage of transfers is always connected with the possibility to control, reducing the autonomy of lower authority levels and becoming financially dependent on central authorities, lower levels of authority should be given the opportunity to obtain the funds by going to the bond market, taking bank credits, loans from the budget of central authorities and abroad.

Theory also justifies becoming indebted for the purpose of financing capital needs, while becoming indebted for the purpose of financing budgetary deficiency is allowed only in special cases, solely in the form of short-term debts. Apart from the purpose of the borrowed funds, in order to avoid excessive indebtedness, it is necessary to control taking credits (through market, by determining appropriate legal rules, through cooperation of different authority levels, directly by central authorities or in the form of selfcontrol), while in most cases it is justifiable to perform control by setting restrictions concerning indebtedness in legal regulations, or by "strict budgetary restrictions" – it is allowed to become indebted up to a certain amount of regular public revenues and with obligation to pay off the borrowed funds within the agreed period.

In the practice of modern countries these theoretical attitudes have been more or less respected. In all countries where indebtedness of lower levels of authority are allowed, it is anticipated that this is possible only for capital needs, with setting strict budgetary limitations and without guarantees given by central authorities for the borrowed funds. This is why lower political and territorial units do not rely on this form of obtaining funds as much as they rely on transfers provided by central authorities: funds obtained by transfers do not have to be returned, the situation is the reverse with credits and loans (not only does the borrowed amount have to be returned, but the interest has to be paid as well).

In comparison to modern countries with developed market economy and a fairly developed fiscal federalism, in countries undergoing transition with a prominent tendency to decentralized public sector as much as possible, the situation is quite the reverse. In those countries, fiscal federalism is, as a rule, undeveloped or developed partly, which is a cause of numerous problems. There is a similar situation in Serbia and Montenegro. In these countries, both of them having a very long mutual heritage, fiscal federalism can be discussed taking into account the existing decentralization of public revenues, while the others have been managed quite unclearly or are undeveloped. In the process of allocating public outgoings there are numerous deficiencies which should be eliminated; the system of interbudgetary transfers is very undeveloped,

and local communities have the possibility of becoming indebted, although regulated in a general way, it is mostly unemployed (Serbia) i.e. it has led to excessive indebtedness of municipalities (Montenegro).

The method used in the process of decentralization of public functions in Serbia and Montenegro has produced numerous doubts, because it often cannot be determined if carrying out a specific job presents outgoings of the republic or a municipality, i.e. if the specific situation is an example of decentralization, delegation or devolution of jurisdiction.

Legal limits of both countries which have been the subject of our analysis and research, determine existence of executive local affairs and the possibility of entrusting certain operations by central authorities, but the category of entrusted operations has not been specified at all, nor it has been determined the budget of which political and territorial unit will be used for financing.

There is even greater inaccuracy when it comes to defining regional structures of authority. For example, in Serbia, by the so called „omnibus“ law, jurisdiction for performing a large number of operations from the domain of republic functions has been transferred to the province, without stating the exact form of decentralization (except for the social security) and who shall finance securing specific public property. Such inaccuracy produces a large number of doubts, because it is often not clear which political and territorial unit should finance performance of a specific job, which can result in not providing the necessary funds, and thus in inability of the citizens to satisfy their consumption of a specific (usually very important) public property. Montenegro has recently adopted the Law on regional development, but it is still questionable how this Law should be put into effect, namely, how the regions and the management system at this level shall be organized.

## II. CONCLUSION

One of the major deficiencies is also the fact that decentralization of outgoings is "late" in comparison to decentralization of revenues, and this is the reason why some local communities handle funds which are larger than the ones needed for financing outgoings. This, eventually, leads to using money for numerous irrational purposes.

## REFERENCES

- [1] Alesina, A., & Drazen, A. (1991). Why are stabilizations delayed?. *American Economic Review*, 81.
- [2] Bohn, H., & Inman, R. P. (1996). Balanced budget rules and public deficits: evidence from the United States NBER Working Paper No. 5533, NBER, Cambridge, MA.
- [3] Martimort, D. (1996). The multiprincipal nature of government. *European Economic Review*, 40, 673-685.
- [4] Tanzi, V. (1999) The Changing role of the state in the economy: A historical perspective. In L. R. de Mello Jr., & K. Fukasaku, *Fiscal decentralization, intergovernmental fiscal relations and macroeconomic governance*. OECD Development Center, Paris.
- [5] Wildasin, D. (1996). Introduction: Fiscal aspects of evolving federations. *International Tax and Public Finance*, 3, 121-135.