Fiscal Decentralisation and Fiscal Outcomes

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In recent years, EU policymakers have increasingly raised the concern that the behaviour of subnational governments may hinder the achievement of budgetary targets at general government level. Moreover, budgetary targets set within the EU fiscal surveillance framework apply to the whole of general government – which consists of central government, subnational governments and social security funds, whereas the responsibility for their achievement rests solely on central government.

This paper analyses the relationship between fiscal decentralisation and fiscal outcomes of general government, by testing through econometric regressions the impact of the main indicators of fiscal decentralisation generally used in the literature on the primary balance, expenditures and revenues of the general government in the EU. Results show that (i) expenditure decentralisation leads to a higher primary balance, through lower expenditures and higher revenues; (ii) the impact of fiscal decentralisation largely depends on the way subnational governments are financed: if their revenues come predominantly from taxes and fees (and, among those, from autonomous taxes) the effect of decentralisation on the budget balance is improved, whereas if they mainly come from transfers decentralisation is more harmful for fiscal balances; (iii) high coverage of subnational expenditures with taxes and fees (rather than with transfers) is associated with an improved budget balance, reflecting a negative effect on expenditures and a positive one on revenues; (iv) with respect to fiscal rules applying to subnational governments, borrowing rules appear to partly counteract the adverse effect of transfers on fiscal balances, whereas no significant effect is found for balanced budget rules.

Overall, this analysis suggests that fiscal decentralisation is not harmful for budgetary discipline per se, although it is likely to have an adverse effect if predominantly financed by
transfers from the central government and if not matched by subnational governments' responsibility to finance their expenditures through taxes and fees. This is in line with theoretical predictions underlining the risk of a 'soft-budget constraint' associated with a high reliance on transfers, as subnational governments can justify their deficits by the lack of own revenue sources and so credibly threaten the central government to drastically cut their services if the centre does not provide them with additional transfers. Therefore, policy concerns should not focus on decentralisation as such but on a 'bad' design of decentralisation, i.e. one which is not accompanied by subnational financial responsibility.