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Decision making factors and fiscal decentralization

Фактори доношења одлука и фискална децентрализација

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Abstract: Adam Smith addressed the significance of the distribution of public revenues and expenditures across different levels of government administration in his 18th-century work "The Wealth of Nations." Fiscal decentralization is gaining more and more importance today. In the decision-making processes regarding the method, degree, and type of fiscal decentralization, significant roles are played by factors that need to be defined and can be classified into two categories: justificatory and restrictive. The authors of this paper examine the factors that influence fiscal decentralization in a positive or negative manner, thereby establishing equitable distribution across various levels of government and contributing to balanced economic development and the reduction of regional inequalities. The study employs descriptive and deductive methods to derive conclusions about the predefined research subject.

Keywords: Fiscal decentralization, Decision-making, Factors, Inequality, Development.

Анстракт: Значајем расподеле јавних прихода и расхода на различитим нивоима државног управљања, бавио се још у 18. веку Адам Смит у делу „Богатства народа“. Фискална децентрализација данас добија све више на значају. У процесима доношења одлука о начину, степену и врсти фискалне децентрализације, значајну улогу имају фактори које је неопходно дефинисати, а које је могуће класификовати у две категорије: оправдавајући и ограничавајући. Аутори се у овом раду баве питањима фактора који на позитиван или негативан начин опредељују фискалну децентрализацију и на тај начин успостављају правичну расподелу на различитим нивоима власти и доприносе уједначеном економском развоју и смањењу регионалних неједнакости. У раду се користи метод дескрипције и дедуције у сврху добијања закључака о напред дефинисаном предмету истраживања.

Кључне речи: фискална децентрализација, доношење одлука, фактори, неједнакост, развој.

Introduction

The well-being of the state and the satisfaction of the individual is an axiom not only of public finances, but also of the economy of a society as a whole. This issue presents, to some degree, a "Conditio sine qua non" ("A condition without which not"), yet also raises the question "Cui bono?" ("For whose benefit?"), which has been a subject of study for economists since the inception of economic thought.

On one hand, there is the ever-growing and increasingly complex state apparatus that needs to be financed in the areas of public and common goods (the collective principle). On the other hand, the source of this financing lies in the individual capacities (the individual principle) of the members involved in social and economic life. From the very outset, a collision of principles arises, thus posing the question of establishing an efficient model that would harmonize these two principles in a complementary dimension.

The foundational principle, which is shared by both sides, is the principle of taxation. In its collective dimension, taxation serves as the source for the functioning of the state as a system, while in its individual dimension, it represents a burden on individuals who, in return, receive certain public goods and services. Achieving balance is possible by considering all factors affecting the principles of taxation and attempting to establish a model that, with the greatest benefits and the least drawbacks, meets the needs of both sides, thus bringing the collective and individual principles into equilibrium.

1. Elaboration

1.1. Fiscal decentralization – a historical overview

One of the earliest economist of state welfare and individual satisfaction was Adam Smith. In his 1776 work *The Wealth of Nations*, he presents, in the chapter "Of the Expenses of the Sovereign or Commonwealth," the following thesis: *"In a prosperous and civilized society, where all classes of the populace are daily increasing their expenditure on their houses, furniture, tables, clothes, and carriages, it cannot be expected that the sovereign alone should resist such a trend. Indeed, it even appears that his dignity demands that he follow suit."* (Smith, 1776 (1998))

Smith views an efficient taxation system as one grounded in the following principles: (Smith, 1776 (1998))

- *"The expense for administering justice can, without doubt, be considered as an expenditure in the interest of society as a whole... those who benefit most directly from this expenditure are those whom the courts restore or maintain in their rights. Therefore, the cost of justice can very appropriately be covered by contributions from either or both of these groups, namely, through court fees."*
- *"Those local or provincial expenses whose benefits are local or provincial should be covered by local or provincial revenues and should not fall upon the general revenues of society."*
- *"The expense for maintaining good roads and transportation networks undoubtedly benefits the entire society and, thus, can justly be covered by the general contributions of society."*
- *"The expense for educational institutions and religious instruction is, without doubt, beneficial to society as a whole. However, this expense could equally appropriately be covered by those who derive a direct benefit from such education and religious instruction."*

Adam Smith emphasizes the importance of sectoral and synergistic analysis of social determinants through the lens of the efficient allocation of public expenditures and their utility for both society and the individual. (Smith, 1776 (1998))

Smith also addresses taxation issues from the perspective of state welfare and individual satisfaction: (Smith, 1776 (1998))

- *"Subjects of every state should contribute to the maintenance of the government, as far as possible, in proportion to their abilities."*
- *"The tax that each individual is obligated to pay should be fixed, not arbitrary. The taxpayer and every other person should have a clear and understandable understanding of the time of payment, method of payment, and the amount to be paid."*
- *"Every tax should be collected at a time or in a manner that is most likely to be convenient for the taxpayer to pay."*
- *"Every tax should be structured so that it extracts and retains from the pockets of the people as little as possible beyond what is required to bring funds into the state treasury."*

According to Heide Mihajl, in the 19th century, the German economic school based the principles of taxation on the following postulates (Heide, 1999):

- Tax as revenue for the state budget
- Ethics and the welfare of the people
- Economic policy

- Legal and administrative framework

According to the same author, the American school holds opposing views, and according to it, the basic principles of tax policy are as follows (Heđe, 1999):

- The optimal allocation of production factors must not be disrupted by tax policy.
- It must fulfill the conditions of flexibility and adaptability, thereby acting as a stabilizer of economic policy.
- It must be clearly defined and transparent.
- Tax collection must have greater positive effects than harm.

In accordance with all the previously mentioned points, the conclusion is that tax policy should satisfy two principles, namely:

- The principle of equity
- The principle of efficiency

The principle of equity represents a positive effect of taxation, in terms of reducing costs and ensuring a fair allocation. The second principle corresponds to the normative principle of establishing a fair and effective system and policy of taxation (Heđe, 1999).

The principle of equity is viewed through the lens of the ability-to-pay principle and the principle of utility. The ability-to-pay principle has both horizontal and vertical dimensions and supports the individual dimension. The horizontal aspect is reflected in the equal treatment of taxpayers based on income and wealth, while the vertical dimension relates to defining progressive, proportional, and regressive taxes according to the classes of taxpayers. The principle of utility supports the collective principle, as it generates fairness in consumption within the public sector.

The principle of efficiency in the tax system implies that taxes should not be an excessive burden and that a system should be created with the lowest possible costs. The relationship between taxes and the taxable income should be optimal and realistic.

Governance in society continues to be functional, with strict vertical principles and horizontally separated functional units. However, in the case of businesses, the management scheme has shifted toward networked connections between sectoral units in order to achieve optimal outcomes and satisfaction for each individual in society, in line with Bentham's principle. (Dragičević Radičević, 2014)

Therefore, contemporary economic thought must respond to the changes occurring in society and base its theoretical and pragmatic foundations on a model that will enable the frequently emphasized concept of sustainable development, because without the satisfaction of a large number of individuals, there can be no sustainable development within a society. (Dragičević Radičević, 2014)

2. Pro and contra fiscal decentralization - complexity and heterogeneity of factors

Thus, the previous considerations bring us to the intersection of two fundamental principles: satisfying the needs of the individual and satisfying the needs of the state. As we have previously emphasized, these two principles are in conflict and assume the cost of individual and collective goals.

"Human social history began with his rise from a state of unity with nature to an awareness of himself as an entity separated from the surrounding nature and people." (Fromm, 1941 (1983)) " However, if the economic, social, and political conditions upon which the entire process of human individuality depends, in the sense just mentioned, and if people simultaneously lose the connections that once provided them with security, this gap makes freedom an unbearable burden. It then becomes equated with doubt, with a life that lacks meaning and direction. Powerful tendencies emerge to escape such freedom into subjugation or into some form of binding of man to the world, which promises relief from uncertainty, even if it deprives the individual of freedom" (Fromm, 1941 (1983)).

The previous considerations point to the fact that in the process of fiscal decision-making, individual and collective goals should find a corresponding determinant in the form of considering all factors that can simultaneously address the demands of satisfying the needs of both the individual and society, while also rationally and optimally bearing the burden so that the model is directed towards long-term sustainability and a fair social distribution of public goods and services. The efficiency of society is the benchmark for a satisfied individual, who, in this case, is willing to bear the burden required by such a model.

In this regard, it is necessary to identify the factors that need to be recognized in order to achieve the goals discussed. First and foremost, it is essential to define the environment and levels of government.

The functioning of the state is facilitated by considering the needs of all members of society and maximizing their level of satisfaction. The types and degrees of individual needs, as well as those of their environment, can be observed within the immediate surroundings. Even Smith viewed societal needs through various levels of government—local and central (state needs and the needs of individual local communities). He also emphasized the need for decentralization in order to achieve more efficient governance of the state.

According to the criteria of the World Bank, decentralization is implemented through three dimensions:

- Political
- Fiscal
- Administrative.

“Political decentralization transfers political and legislative powers from central governments to autonomous assemblies at lower levels and local councils democratically elected by their constituencies. To be effective, regular elections, clearly defined competencies and powers, and an appropriate legal, political, and functional space are necessary.

Administrative decentralization places the responsibilities for planning and implementation in the hands of civil servants at the local level, with these local civil servants under the authority of the elected local governments.

Fiscal decentralization grants significant autonomy over revenue and expenditure to local governments, including the authority to levy taxes and user fees. For it to be effective, it requires linking satisfaction with spending to the pain of revenue generation, increasing revenue autonomy, building capacity for data analysis for budgetary decisions, and establishing appropriate fiduciary controls.” (World Bank, World Bank, 2013).

From the definitions, it is clear that the efficiency of decentralization is directly dependent on the level and diversity of public revenues from which regional and local public authorities are financed, as well as on the understanding of political, cultural, economic, and other elements at lower levels of the community compared to the central level. For this reason, special attention in this paper is devoted to the efficiency of fiscal decentralization.

The foundation of fiscal decentralization lies primarily in the fact that central authorities often lack sufficient information, and consequently, an understanding of the needs of specific regions. Additionally, the heterogeneity of a particular region (cultural, ethnic, racial, linguistic, etc.) leads to heterogeneity in political views and arguments, making decentralization necessary. It is essential to address the diverse needs of these regions through public goods and services (Aleksić, 2015).

The reasons that justify the processes of fiscal decentralization, according to the previous arguments, can be divided into three groups: economic, political, and administrative (Aleksić, 2015).

Economic reasons are reflected in the efficient management of public revenues and expenditures at the local level, with a direct assessment of the needs of the residents of a specific region or local community. This approach improves resource allocation, enhances control, and increases accountability, which in turn reduces tax evasion.

Political reasons stem from the strengthening of democratic processes, which involves building the social awareness of each citizen and encouraging a higher degree of involvement in the community. On the one hand, this fosters greater civic participation, while on the other hand, it emphasizes the increased responsibility of regional and local authorities. Moreover, the political reasons for fiscal decentralization point to a greater degree of autonomy for local and regional government units, which can promote efficiency in governance.

Administrative decentralization is contingent upon fiscal decentralization, as it is the result of the latter. It is necessary, but also complicates and expands the administrative apparatus.

All the most numerous factors, to varying degrees and intensities, determine the methods of introducing and implementing fiscal decentralization. On the one hand, there is an increase in the needs of the local population, along with the promotion and strengthening of regional and local development, which leads to more balanced development. On the other hand, this also implies a more complex and larger administrative apparatus. While the former increases efficiency, the latter tends to reduce it.

3. Fiscal decentralization in practice

Countries seeking to join the European Union face the need to harmonize their fiscal frameworks with EU regulations. In this context, fiscal decentralization and its institutional implementation are crucial determinants of the efficiency of the accession process, aiming at unifying territorial economic development. The fundamental laws supporting fiscal decentralization are the Law on Local Self-Government and the Law on Financing Local Self-Government, which provide the framework for effective fiscal decentralization. Systemic incentives and reforms should be directed towards the sustainability of economic development, which entails continuous analysis and control of public revenues and expenditures. Therefore, it is essential to identify the factors influencing the degree of fiscal decentralization, as discussed in the previous chapter. The heterogeneity of these factors points to different levels of decentralization even in European Union member states.

Table 1. Index of decentralization in EU countries and the degree of fiscal decentralization

Country	Rank	Decentralization index overall / local level	Fiscal decentralization / revenue autonomy
Germany	1/27	2.5	74.00%
Latvia	2/27	2.5	65.00%
Denmark	3/27	2.4	45.00%
Sweeden	4/27	2.4	71.00%
Finland	5/27	2.3	71.00%
Spain	6/27	2.2	46.00%
Belgium	7/27	2.1	40.00%
Poland	8/27	1.8	43.00%
Czech Republic	9/27	1.9	57.00%
Slovenia	10/27	1.8	55.00%
Netherlands	11/27	1.8	30.00%
France	12/27	1.7	64.00%
Italia	13/27	1.7	45.00%
Estonia	14/27	1.6	14.00%
Portugal	15/27	1.6	60.00%
Croatia	16/27	1.6	47.00%
Lithuania	17/27	1.5	11.00%
Austria	18/27	1.5	27.00%
Bulgaria	19/27	1.4	27.00%
Romania	20/27	1.4	19.00%
Hungary	21/27	1.4	42.00%
Greece	22/27	1.3	31.00%
Luxembourg	23/27	1.2	52.00%
Slovakia	24/27	1.2	32.00%
Cyprus	25/27	1.1	54.00%
Malta	26/27	0.8	6.00%
Ireland	27/27	0.8	36.00%

Processing: Authors

Source: (European Comitee of the Region / Division Power, 2024)

When it comes to the Republic of Serbia, fiscal decentralization is based on the following laws:

- The Law on Local Self-Government from 2007 (and the latest amendments from 2021) (Official Gazette No. 127/2007, 2007), and
- The Law on Financing of Local Self-Government from 2006, with the latest amendments from 2024 (Official Gazette RS, No. 62/2006, 2006).

Within the framework of fiscal decentralization, the following provisions are stipulated:

- Personal income tax from activities such as agriculture, forestry, self-employment, lease of movable property, insurance, and other income.
- 74% of the income tax on salaries is allocated according to the residence of the employee.
- Inheritance and gift tax.
- Tax on the transfer of absolute rights.
- Property tax is determined and administered by local self-government.
- 1.7% of GDP is transferred to local self-governments.
- If the per capita income from taxes is less than 90% of the national average per capita income, local governments are entitled to transfers for equalization.

The aforementioned details pertain specifically to fiscal decentralization in the Republic of Serbia. The authors conducted a study aimed at obtaining relevant indicators regarding fiscal revenues and expenditures and their impact on economic growth in the Republic of Serbia, using secondary data for the period from 2001 to 2020. The aim was to consider both positive and negative correlations, as well as their degrees, to assess the fairness of the distribution of public revenues and expenditures. The main issue identified was the lack of data, especially for the period before the adoption of the aforementioned laws. Despite this, Pearson's correlation revealed the significant importance of decentralization in increasing the share of tax revenues in GDP. The empirical hypothesis was a positive correlation between fiscal decentralization and economic growth, which was confirmed. Excerpts from this research are presented in Tables 2 and 3.

Table 2. Decentralization of tax revenues in Serbia and share in GDP 2001-2020

YEAR/indicator	1.Tax revenue decentralization (share of general government) SERBIA	2.Tax revenue decentralization (share of local government) SERBIA	11.Tax revenue (% of GDP) SERBIA
2001			
2002			
2003			
2004			
2005			
2006			
2007	0.87	0.13	21.30
2008	0.87	0.13	21.15
2009	0.87	0.13	20.00
2010	0.87	0.13	20.23
2011	0.86	0.14	19.05
2012	0.82	0.18	18.55
2013	0.94	0.06	20.84
2014	0.94	0.06	21.97
2015	0.94	0.06	22.36
2016	0.94	0.06	23.29
2017	0.95	0.05	24.07
2018	0.94	0.06	23.60
2019	0.95	0.05	24.05
2020	0.95	0.05	23.50

Processing: Authors

Source: (World Bank, Fiscal Decentralization, 2022), Database

This paper presents an excerpt from a comprehensive study conducted for Serbia, North Macedonia, and Croatia. For the purposes of this work, the following indicators of fiscal decentralization were used: decentralization of tax revenues (share in central government), decentralization of tax revenues (share in local government), and the share of tax revenues in GDP for the period 2001–2020.

Using the SPSS Statistics software for statistical analysis and Pearson correlation, it was determined that there is a significant correlation (sig. (2-tailed) < 0.01).

Regarding the correlation between the decentralization of tax revenues (central government share) and the decentralization of tax revenues (local government share), a strong negative correlation was found at a level of -1. The correlation between the decentralization of tax revenues (central government share) and the share of tax revenues in GDP is also strong, but in a positive direction.

Table 3. Pearson correlation of fiscal decentralization criteria

		Correlations		
		Tax revenue decentralization (share of general government) SERBIA	Tax revenue (% of GDP) SERBIA	Tax revenue decentralization (share of local government) SERBIA
Tax revenue decentralization (share of general government) SERBIA	Pearson Correlation	1	.870**	-1.000**
	Sig. (2-tailed)		0.000	0.000
	N	14	14	14
Tax revenue (% of GDP) SERBIA	Pearson Correlation	.870**	1	-.870**
	Sig. (2-tailed)	0.000		0.000
	N	14	14	14
Tax revenue decentralization (share of local government) SERBIA	Pearson Correlation	-1.000**	-.870**	1
	Sig. (2-tailed)	0.000	0.000	
	N	14	14	14

** . Correlation is significant at the 0.01 level (2-tailed).

Conclusion

Fiscal decentralization is a complex and long-term process, which has been the subject of research by economists from various economic schools since the 19th century to the present. The fact that the complexity of factors indicates that the decision-making process in defining the fiscal decentralization model encompasses a large number of supporting and limiting factors. Additionally, the paper clearly demonstrates that the fiscalization process is carried out in parallel with two other processes, namely administrative and political decentralization. The fiscal decentralization model should support two basic principles: the principle of equity and the principle of efficiency. The paper proves that in the process of fiscal decision-making, individual and collective goals must find a corresponding determinant in the form of considering all factors that can simultaneously respond to the needs of both individuals and society, while rationally and optimally bearing the burden, in order to ensure that the model is focused on long-term sustainability and a fair social distribution of public goods and services. This assertion is also demonstrated through examples in EU countries, where the decentralization index clearly correlates with the level of economic development. Furthermore, through the application of Pearson's correlation, using the example of Serbia, a strong positive correlation between the participation of tax revenues in GDP and decentralization has been proven.

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