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Fiscal Decentralization and Task Responsibilities in the Baltic Sea Region

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KEY MESSAGES

- ▶ **Rural regions can benefit most from decentralization.** Local actors know the preferences of their citizens and the place-specific circumstances to provide services best. A literature review revealed the advantages of decentralized states with more responsibilities for municipalities or intermediate sub-national levels in comparison to more centralized states
- ▶ **The allocation of financial resources needs to be ensured in rural regions.** Rural regions often have a smaller tax base and higher costs for public services and infrastructure because of a lower population density and larger distances to urban centers.
- ▶ **Within the Baltic Sea Region, most countries have a comparatively high degree of decentralization.** While Germany is the most decentralized country, decentralized structures can have different dimensions: Latvia, Estonia, and Lithuania have quite high political decentralization scores, whereas Denmark has a high fiscal decentralization score.

Background

Countries surrounding the Baltic Sea are characterized by a comparatively high amount of rural areas (Eurostat 2023). The supply of public infrastructure and services of general interest depends on a critical mass of demand within a given region to ensure accessibility for the population. In rural/peripheral regions, demand is often insufficient because of low population density or long distances to agglomerations. Nevertheless, infrastructure and services for education, social and health care as well as recreational, sports and cultural entities need to be provided to a certain degree in all regions. It is already stated in the literature that the provision of services of general interest has a positive impact on local welfare (Li et al. 2022 & 2020). These services of general interest offered at the local level and the different models to finance them are at the core of our research. To examine the role of local governments in different countries of the Baltic Sea Region, we distinguish public finance systems and decision making power by their degree of decentralization. More centralized states seem to be more efficient in supplying infrastructure and services in administrative terms. Nevertheless, decentralization may lead to a better supply of public goods in

all kinds of regions because municipalities know their citizens' preferences best (fiscal federalism, Oates 1972 & 1999).

Fiscal Decentralization: Theoretical Background and Literature Findings

The countries of the Baltic Sea Region have different levels of decentralization in providing services and infrastructure of general interest. We are primarily interested in the fiscal and administrative decentralization of states. In general, the more influence the local level has over its own budget, the more it is considered decentralized.

On the one hand, centralized governments combine budget and administrative powers at the state level and can make the same public goods and infrastructure available everywhere. Cost efficiency arises if economies of scale can be utilized (Shani et al. 2022). That means, in terms of public goods, shrinking costs due to one-size-fits-all solutions and high user numbers. Additionally, spillover effects and free riders can be reduced (Shani et al. 2022), because subnational administrative borders are less important. In contrast, if a local government provides goods and infrastructure in and for its own jurisdiction, it cannot exclude users from other cities and municipalities. These users (free-riders) are not taxpayers in the municipality's jurisdiction. Therefore, negative effects like cost disadvantages could arise for the municipality which provides the public infrastructure. It is assumed that negative effects are bigger for small municipalities (Zimmermann & Döring 2019, 64f.), which are often located in rural regions. As already mentioned initially, in rural regions, public infrastructure and services need to be provided for a smaller number of users, and cost efficiency should not be the only criteria for it.

On the other hand, according to the fiscal federalism theory, public services should be decentralized to the lowest possible level for reasons of efficiency (Oates 1972, 54). The administration at the local level knows the specific conditions and can take citizens' preferences into account more easily than central governments for the best-tailored solutions. Therefore, decentralization is expected to result in a better supply of public goods (Oates 1999). Martinez Vazquez and McNab (2003, 1604) show that centralized states have high transaction and administrative costs. States in which fiscal decentralization is practiced are probably more efficient, as they can respond better to local differences. In an empirical study on the effects of decentralization on municipal budgets for Israel, Tan and Avshalom-Uster (2021) have shown that a regional policy with its own financial administration was able to increase its revenues compared to centrally-administered municipalities.

If administrative decentralization is accompanied by fiscal decentralization, municipal decision-making sovereignty is significantly increased. Additionally, regional competition between municipalities is sparked, which can lead to economic welfare benefits (Martinez-Vazquez & McNab 2003, 1598).

Decentralization among the Baltic Sea Region States

Germany is the only federal state among the states in Baltic Sea Region, which means the intermediate level (Bundesländer) are autonomous state levels with their own legislative and executive powers (Zimmermann & Döring 2019).

All the other countries are unitary states, organised more or less on a decentralized basis (European Committee of the Regions). The smallest units with self government are the municipalities. In Germany, there are around 10,700 municipalities (Destatis 2023), whereas the other Baltic Sea States have between 60 (Lithuania) and 2,478 (Poland) local units (European Committee of the Regions).

Figure 1: Overall Decentralization Score

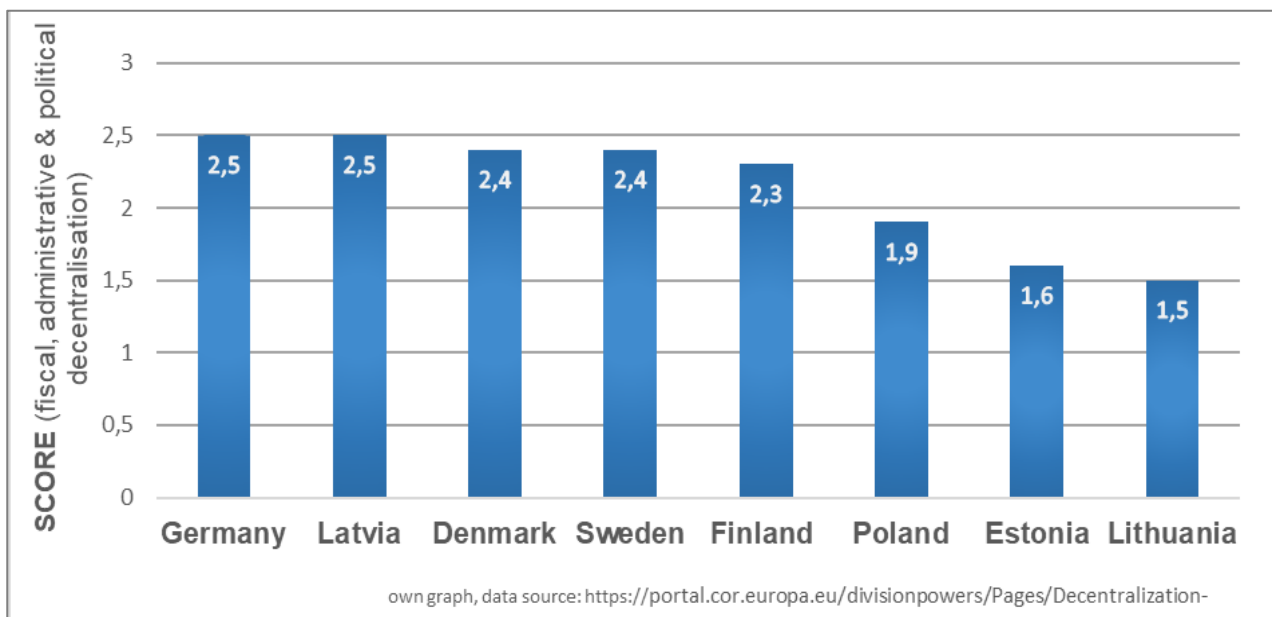


Figure 1 shows the overall decentralization score from zero to three, measured by the European Committee of the Regions. The score includes the political, administrative, and fiscal (autonomy) dimensions of decentralization. It considers many data, like share of local expenses and revenues in the total government budget, as well as documents about the administrative structure and political representation of regional and local authorities at the national level. A score of three means that the subnational levels have a high impact in all dimensions. Due to its federal system, Germany has the highest score. Although Latvia has lower values in terms of fiscal decentralization (expenditure and revenues), it shares a similarly high score with Germany. The high level of decentralization in Latvia is owed to high political decentralization. In Latvia, the ability to influence policymaking and

representation at the national level is quite high. There is also a good legal basis for self-government at the local level.

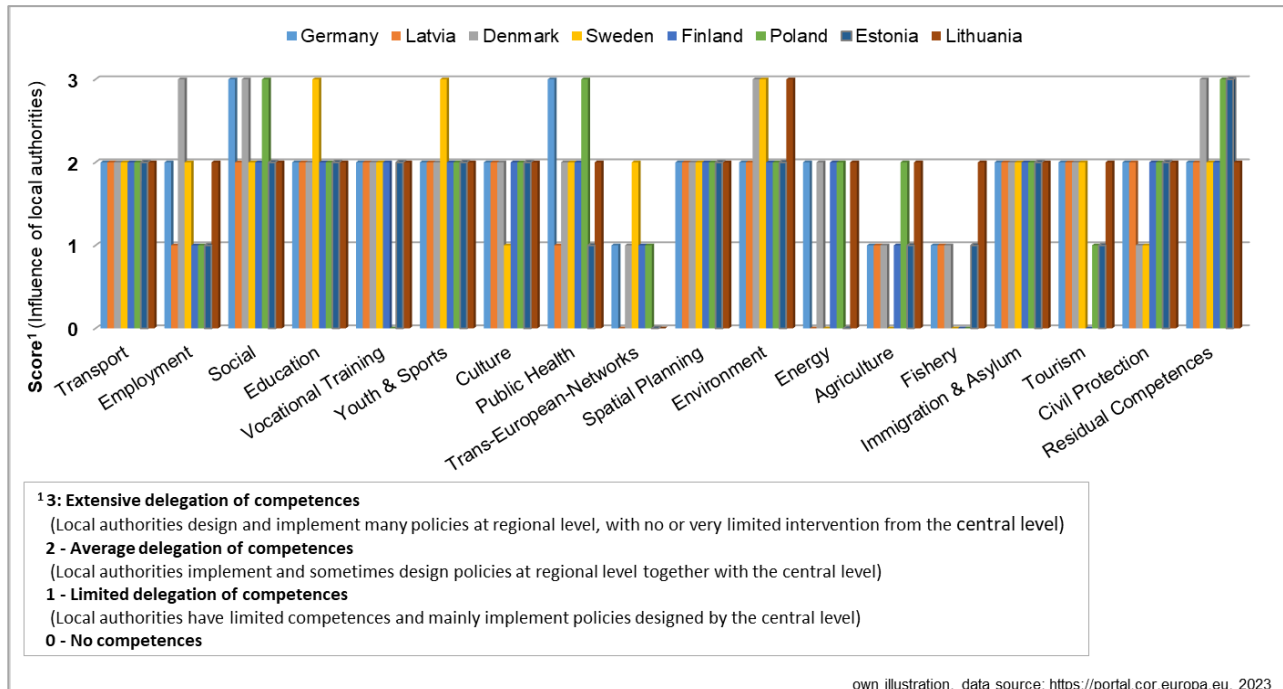
Denmark and Sweden have lower political decentralization values, but in terms of administrative and fiscal decentralization they perform well. In Denmark, local government expenditures account for 62 % of total government expenditures. Sweden and Finland have quite a high local revenue autonomy. Besides Germany, Finland is the only country with legislative powers on sub-national levels (European Committee of the Regions). In addition, 51 % of the income of Finnish municipalities are local taxes and 21 % of charges and fees apply to local services (European Committee of the Regions). That means, local welfare is strongly connected to local public infrastructure and services.

Poland and the other two Baltic States possess significantly lower decentralization scores. Poland started its devolution process in 1990 with the reestablishment of municipalities. In 1999, major reforms in providing public infrastructure (esp. education and health care) and local administration were introduced (Myck & Najsztub 2020). Especially in rural regions in the Western parts of Poland, municipalities developed well in terms of local economic activities (Freier et al. 2021, 4248 & 4250ff.). Since then, Poland has a solid legal basis for self-government, but less fiscal autonomy. After Poland was on a path towards democratization and decentralization for many years, Brzezinski et al. (2022, S. 1) found that Poland has experienced a "democratic backsliding" since 2016.

Among the states of the Baltic Sea, Estonia and Lithuania have shown the least progress in terms of devolution. The main reason for their low score is the small share of overall subnational expenditures and revenues compared to the total government budget. Nevertheless, they perform well in political (shared rank 2) decentralization, especially with the "ability of sub-national entities to influence policymaking" and having "direct relations with the EU". Additionally, Estonia has high competence in administrative decentralization (rank 2 among all EU states). Estonia (in 2017) and Latvia (in 2009) abolished the regional (intermediate) level of government and empowered the municipalities (European Committee of the Regions).

Task Responsibilities on local level Local competencies for different tasks show a rather homogenous picture for many tasks. Figure 2 shows the local competencies in providing different public infrastructure and services. The higher the score, the greater the influence of the municipalities and the less intervention from the central level. It is notable that even in Germany, a federal country, only social tasks and public health are fully in the hands of local authorities. The German "Kreise" as the superior municipal level are responsible for health care and social security.

Figure 2: Task Responsibilities: Local Competences



Also in Poland, the tasks of public health and social care are delegated extensively to the municipalities. In Denmark, the local level has full responsibility for employment, social, environmental, and residual public tasks. Swedish municipalities, in comparison, focus on education, youth/sports, and the environment. Latvia, which has the same decentralization score as Germany, has no local competences without any intervention possibilities from the central government. The same is true for Finland. Transport and spatial planning are tasks on the local level everywhere, but not without intervention from the central government. In contrast to that, trans-European networks, agriculture, and fisheries are quite often not delegated to municipalities. A probable reason for that is that these tasks have nationwide implications and are therefore better placed at the central level.

Conclusion

The degree of decentralization is strongly connected to the responsibility for providing public infrastructure and services at a local level, i.e., municipalities or intermediate sub-national levels. A literature review revealed the advantages of decentralized states in comparison to more centralized states. Particularly rural regions can benefit from decentralization because local actors know their citizens preferences best.

However, the allocation of financial resources needs to be ensured in rural regions, which often have a smaller tax base and higher costs for public services and infrastructure because of a lower population density.

Within the Baltic Sea Region, Germany is the most decentralized country. However, most of the other countries have quite high decentralization indices, too. Decentralized structures can have different dimensions: Latvia, Estonia, and Lithuania have quite high political decentralization scores, whereas Denmark has a high fiscal decentralization score, for example. If different tasks are analyzed in more detail, it can be seen that tasks that are exclusively fulfilled by the municipalities differ among the considered states. Most of the tasks are minimum implemented and fulfilled by local and central levels in cooperation. Some countries, like the Baltic States (Latvia, Estonia, and Lithuania), are still on a path towards more decentralized structures. Nevertheless, some tasks with nationwide consequences are still better placed at the central level.

Policy Recommendations

- 1. Responsibility for tasks should be maintained at a decentralized level and, where possible, further expanded.** Although the Baltic Sea region already enjoys a high degree of decentralization, differences still exist between countries and across different tasks. When increasing the level of decentralization, consideration should be given to ensuring compatibility with existing administrative systems and fostering productive interaction between the various levels of government.
- 2. Decentralization of responsibilities to municipalities or other sub-national entities needs to be accompanied by the allocation of sufficient fiscal resources.** The fiscal situation of municipalities in rural areas requires particular attention. Therefore, appropriate funding instruments are recommended that take account of the specific situation in rural areas. The specific requirements for the provision and funding of public services in rural areas should be addressed in political debates.
- 3. National and local governments in the Baltic Sea Region should learn from each other's experience with decentralization.** The analysis has shown that decentralization levels in the Baltic Sea Region are in general quite high, but with a wide variety with regard to specific approaches and tasks. An exchange among government actors and other providers of public services from rural regions is expected to be particularly fruitful to learn from best practices and approaches that did not work well, yet.

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The Interdisciplinary Centre for Baltic Sea Region Research (IFZO) at the University of Greifswald studies cooperation and conflict in the Baltic Sea Region, focusing on key societal, political and economic questions of our time. Across its research projects, IFZO seeks shared solutions in the fields of ecology, innovation, energy and security.

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