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# Decentralization in the public sector: quantitative aspects in federal and unitary countries

Floriana Cerniglia\*

*Facoltà di Scienze Politiche, Università Cattolica del Sacro Cuore,  
L.go Gemelli 1, 20123 Milan, Italy*

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## Abstract

The purpose of this paper is to investigate empirically the extent and evolution of fiscal (de)centralization in a sample of OECD countries. We ask whether and how some factors derived by the economic theory on this issue are empirically significant either for centralization or decentralization. Then, building a new panel data set, we test the significance of these factors using a random effects model. Our results seem to confirm that land area, population, degree of urbanization and income per capita are negatively correlated with centralization. Moreover, we find that heterogeneity in ethno-linguistic groups is significantly related to the observed decentralization in the patterns of expenditure on education and on religious, cultural and recreational services.

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## 1. Introduction

Over the last few decades, the demand for a higher degree of decentralization or even for political independence by some regions or locally based groups has been

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\* Tel.: +39-02-72342302; fax: +39-02-72342475.

*E-mail address:* floriana.cerniglia@unicatt.it (F. Cerniglia).

a hotly debated issue in many countries. A world-wide interest in decentralized forms of government has emerged in “mature” federations (Canada, Australia, United States), in unitary states (for example, Italy, Spain, UK), in developing countries and in some states of Eastern Europe. Furthermore, in the European Union the introduction of the subsidiarity principle in the Maastricht Treaty has led to a renewed emphasis on the virtues of decentralization and a growing pressure to remodel the distribution of power both within the community and the states and within the states. The very recent Treaty of Nice annexes, a declaration on the future of the Union. This declaration calls for a deeper and wider debate about the future of the European Union to be concluded in 2004 when an Intergovernmental Conference will be convened. In such debate the main point on the agenda is how to establish and monitor a more precise delimitation of powers, competences and responsibilities between the European Union and the member states. As a matter of fact, an European Convention is currently working on a preliminary draft of the European Constitutional Treaty and, among other things, it must propose a clear answer to the question of the allocation of powers between the European Union and the member states.

In the economic theory, building on Oates’s “decentralization theorem” (1972), many studies in fiscal federalism or local finance literature have indicated some factors that would make either decentralization or centralization desirable. In broad terms, much of this theoretical literature, which has been primarily normative, considers how taxing and expenditure powers can be assigned to various levels of government in order to achieve the most efficient outcome in the whole economic system. In this literature there is a “presumption” in favor of decentralization which results from the assumption that if the central government supplies local public goods it would provide a uniform quantity for all local jurisdictions: the central government is “insufficiently sensitive” to heterogeneity in citizens’ preferences as to their demand for local public goods. Therefore, the most compelling argument in favor of decentralization is that it can better match citizens preferences for public goods. Moreover, decentralization make governments more accountable to citizens and very recently it has also been regarded as an extraordinary institutional framework to enhance economic growth<sup>1</sup>. This literature also points out the costs of decentralization which can be, for instance, administrative ones, or they may be due to the difficulty of exploiting the economies of scale in local governments. To sum up then, focusing on the trade-off between centralization and decentralization, the literature’s main objective has been to determine the “optimal degree” of decentralization. This means that this literature offers some predictions or testable hypotheses to explain the observed variations in the degree of fiscal decentralization across countries (both federal and unitary) and over time. In other words, according to the theory, we should expect that there are some determinants of the “optimal degree” of decentralization among levels of govern-

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<sup>1</sup> See Bardhan (2002) for a recent review on this issue.

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