

Should Vertical Fiscal Imbalance be equalized?
Does fiscal decentralization facilitate Economic Growth?
Lessons for Georgia

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Abstract

There is no consensus among political scientists and economists how decentralization influences economic growth, poverty and other indicators of development. Some scholars argue that there is no direct relationship between decentralization and growth. Others claim that the relationship is positive. Some scholars argue that decentralization negatively affects economic development.

At the same time decentralization reforms are on the policy agenda in the post-Soviet Union states, which are trying to depart from the former socialist centralization of powers. In the majority of countries decentralization reforms are considered to be the main means for improved governance. It is believed that reforms can increase service provision efficiency and enhance citizens' participation in the political processes.

The aim of this paper is to assess the outcomes of decentralization in transition countries and infer lessons for the post Soviet Union countries and particularly for Georgia. It aims to study how economic rationales of decentralization are applied in the post-Communist arena. The paper tries to answer the question: does decentralization leads to economic growth or not and which factors should be taken into consideration during the implementation of the reforms.

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Decentralization is neither good nor bad for efficiency, equity, or macroeconomic stability; but rather that its effects depend on institution-specific design...

Litvak, Ahmad and Bird (1998)

Introduction

Decentralization process in Central and Eastern Europe (CEE) and post Soviet Union was parallel to the general political and economic reforms. The transformation of the political and economic system was painful in most transition countries. However, some countries have successfully dealt with challenges, restructured their economies and integrated with the European Union. Others were engaged in civil wars, ethnic conflicts, political and economic instability, which led to deterioration of wealth, collapse of public institutions and spread of poverty.

The difference in systemic transformation policies had its effect on the decentralization process too. Some countries, like Hungary and Slovakia choose high degree of decentralization, while in most post Soviet countries the implemented reforms lacked clear institutional arrangements. The central governments still keep political and administrative power, control the most productive revenue bases and appoint officials of intermediate tier. In some countries the legislation gives the responsibilities to the head of the state to appoint local officials too.

Nowadays, the decentralization reforms are still on the policy agenda in former Soviet Union. In 2007 the new law on Local Self Governments started to work in the Russian Federation and 10 thousand new municipalities have emerged. Georgia adopted the new law on Local Government in 2006 and soundly changed the structure of local governments. Armenian Non Governmental Organizations and financial experts are demanding reforms at local government

level. They claim that very fragmented municipalities are not able to provide public goods and services efficiently (Tumanian, 2006).

The proponents of decentralization who are demanding reforms provide economic and political arguments for it. Based on the First Generation Fiscal Federalism literature, decentralization is considered as the means for improved public service delivery. Financially strong and motivated local governments can better address citizens' preferences, effectively impose and administer local fees and taxes. The strong linkage between costs and benefits as well as citizens ability to move across jurisdictions leads to Pareto efficient outcome.

The political arguments for decentralization are highlighted by the Second Generation Fiscal Federalism. It is considered as the necessary element for democratization of the government. Elected local officials who have relevant political and financial power are more transparent and accountable to citizens than upper levels of government. The citizens have more opportunity to participate in the public decision making process which leads to more efficient redistribution of political and economic resources among population.

The opponents of decentralization reforms, which are often supported by the central authorities, base their arguments on the experience of developing countries, especially that of Latin America and Africa. They claim that the literature of decentralization, both normative and empirical, is based on the experience of developed nations which have very different institutional arrangements (Ahmed, 1998). Fiscal Federalism works in countries which have an adequate level of political and economic development. In many cases decentralization policy has caused asymmetric development of fiscal relations, when soaring spending responsibilities of local authorities have no backup in the form of own revenue base. The increase of local spending responsibilities and difference in economic potential has sharpened disparities among regions and communities with respect to their abilities to finance expenditures (Slukhai, 2003).

The debate about the effects of decentralization is not new. During the two decades, in order to test the outcomes of decentralization, scholars have conducted cross country econometric analyses. The other part of empirical work consists in case studies and country comparisons; however the findings are contradictory. The difference in empirical findings can be explained by variation of the measurement of decentralization. In academia there is no agreement on it. The situation is complicated because decentralization has multi-dimensions. Looking only at political or economic aspect of it can lead to misinterpretation of decentralization effects.

The empirical literature about the outcomes of decentralization reforms in former Communist countries is scarce. Most studies focus on country specific problems and provide policy solutions based on the experience of industrial countries¹. However, the successful country examples cannot be generalized in the whole transition world. The only cross-country quantitative research, evaluating effects of decentralization, was conducted by Ebel and Yilmaz in 2003; however their study does not take into consideration factors which, together with decentralization, can also be responsible for outcomes. I argue that institutional development, human capital, the role of the European Union and organizational culture should be included in the analysis in order to avoid omitting of variables.

The aim of this Master Thesis is to assess the outcomes of decentralization in transition countries and infer the lessons for post Soviet Union and particularly for Georgia. It intends to study how economic rationales of decentralization are applied in the post-Communist arena. The paper will examine the relationship between decentralization and economic growth which in literature is considered as an indirect measure of service provision efficiency. We also intend to find out what role decentralization has played in economic transformation process.

¹ See for example Local Government and Public Sector Reform Initiative Publications

The paper is organized as follows: The first chapter overviews the notion of decentralization, its development over time and main argument for and against. The second chapter is devoted to document analysis and studies empirical work testing theoretical framework on practice. The third chapter overviews the process of decentralization in transition countries and focuses on reforms in Georgia. The empirical econometric cross-country analysis is the task of the fourth chapter, which tests the relationship between decentralization and economic growth in the post-communist arena. Based on empirical findings the final chapter draws lessons for Georgia.

Chapter 1: Decentralization, pros and cons

The current chapter overviews the notion of decentralization, its founding principles and development across time. Although decentralization has many dimensions I focus on its main aspects. The chapter also provides the most valuable theoretical arguments for transferring the power to sub-national tiers of government as well as identifies main challenges of the process.

1.1 The notion of Decentralization

The decentralization theory relies on Richard Musgrave's, Wallace Oate's and Charles Tiebout's notion on fiscal federalism. According to Musgrave there are three economic functions that should be assigned to the government: stabilization, distribution and allocation functions (1989). The first deals with employment and price stability. In public finance theory the stabilization function is assigned to the central government. Because local governments have no monetary policy instruments and production factors can move freely across jurisdictions, municipalities cannot effectively use the stabilization tools. The second function entails the distribution of income and wealth. Like the stabilization function, the distribution task should be the responsibility of the central or sub-central levels of government (Oates, 1991). The mobility of residents across jurisdictions restricts the power of the redistribution programs on state or local level. The allocation function deals with the efficient provision of public goods and services. According to Oates (1991), allocation function, the provision of public goods and services, is best placed with local government organs. The author formulated the **decentralization theorem** which confirms the inefficiency of uniform service provision by central government (1991). He argues that if there are no economies of scale from centralized provision, welfare can be maximized by diversifying services in accordance with local needs.

The theory assumes that in a multi-tier government setting, each level seeks to maximize the social welfare of its respective constituency. This assumption in modern literature is often called the fundamental principle of the “First Generation Fiscal Federalism” (Oates, 2004; Garzarelli, 2004 and Weingast, 2006). According to theory local government provides the optimal level of public goods that meets demand of its respective jurisdiction. It is generally recognized (Oates, 2004) that jurisdictions hardly coincide with the pattern of geographical benefits, but decentralized provision of public goods might still ensure more welfare gains than centralized, uniform provision.

The preferences of individuals are revealed by paying taxes, which ensures Pareto-efficient service provision. According to Oates’s spatial mobility model, a citizen chooses preferred supply of public goods and taxes by selecting among competing local jurisdictions and moves to that community which most satisfies her set of preferences. Hence, the consumer preferences are more adequately represented at the municipal than at the national level.

To summarize, the First Generation Fiscal Federalism relies on two assumptions: 1) local governments are closer to people, hence are better prepared to respond to local preferences and 2) citizens are mobile across jurisdictions and choose preferred sets of public goods. Oates points out that even with immobile individuals, systematic differences in preferences still exists (2004). Hence decentralized service provision is more preferred. The First Generation fiscal federalism places great emphasis on intergovernmental transfers. The center should raise taxes and transfer funds to municipalities in order to finance their expenditures (Weingast, 2006).

The Musgrave-Oates-Tiebout assumption that government seeks to maximize the social welfare was challenged by the Public Choice School. The school argues that bureaucrats, who are representing the government, are utility maximizers and serve their own objectives. Bureaucrats aspire for power and influence, larger salaries. In this case the public sector can be considered as

a “Leviathan” which aims to maximize the revenue it extracts from the economy. The consumer mobility hypothesis, which leads to competition among jurisdictions in order to “attract” wealthier citizens, was also put under the question mark. Competition may lead to “tax wars” among municipalities, which is detrimental to society (Oates, 2002)

In order to overcome the theoretical weaknesses, the notion of decentralization was further developed at the end of 20 century by Oates, Garzarelli and Weingast. The Second Generation Fiscal Federalism does not consider the state as the benevolent social welfare maximizer. It focuses on political process and the behavior of political agents (Oates, 2004). The theory also highlights the problem of imperfect information. Under these conditions the trade-off between centralization-decentralization departs from the economic rationale of decentralized versus uniform provision of public goods.

The Second Generation Fiscal Federalism theory looks more at the political factors like local accountability. It stresses the importance of the fiscal autonomy of each level of government. Local government revenue generation is critically important because it makes municipalities more responsive to citizens, reduces corruption and increases incentives to provide market-enhancing public goods (Weingast, 2006).

To sum up, modern decentralization theory looks at the economic and political dimension of the territorial organization of the state and provides a functional framework for successful decentralization². It highlights two necessary conditions (Bird and Vaillancourt, 1998). First, the local decision process must be democratic in the sense that decisions should be made transparently and those affected should have the opportunity to participate or influence the decision making process. Second, the costs of decision must be fully borne by the level of government which is making the decision.

² For further details see Bahl and Martinez-Vazquez, 2006.

Besides above defined theoretical principles, we can identify the political, economic and administrative aims of decentralization. The political aspect of decentralization is to give citizens and their elected representatives the power in public decision making. Administrative decentralization considers redistribute authority, responsibility, and financial resources for providing public services. It also implies the power to hire local staff without any reference to upper levels of government. In economic point of view, decentralization is a method to increase the efficiency of the public sector. Fiscal decentralization ensures that elected officials weigh carefully their spending decisions while spending money levied from local taxes in order to avoid pains associated with the possibility to be voted out (Shah, 2004).

1.2. Forms of decentralization

In order to achieve the theoretical goals, decentralization may be based on two alternative theoretical models, each expressing a different philosophy of state building (Kimball, 1999). One model is based on the “top-down” approach that considers the local and regional government as being derived from a center, transferring the level of autonomy by the central state and promoting state interests on a local level.

Bird and Vaillancourt distinguish three varieties of “top-down” decentralization (1998). First, “deconcentration” considers the dispersion of responsibilities from the central government to regional or to local units. Two key features of the deconcentration model are: 1) local government is represented by the central government regional branches and 2) central government has the authority to appoint and fire local employees.

In the second variant, local governments act as agents for the central government, executing functions on its behalf, which is called delegation. In this model the central government formulates policies, while the implementation issues are delegated to the local

governments. It permits central government to keep control over the design and standards of service provision, while local governments are allowed to have the discretion power in the service delivery process.

Third, devolution refers to a situation in which the whole process of policy making is in the hands of the local governments. This form of decentralization requires that the central government keep its commitment to transfer the power and functions and local officials have the will to make the choice and develop capacities in order to implement developed policies (Ebel and Ionescu, 2004).

The alternative “bottom-up” model is based on federalist arguments. The local state as a political form is primary, while any higher level governments are derived from it and exercise the power transferred to them from below.

In each country decentralization takes one of these forms because it is impossible to provide all public functions from the center, especially in countries with a large territory. Also, historical and cultural factors play an important role, especially in federal countries. The first, the deconcentration model is pervasive in unitary and totalitarian states. It does not involve any transfer of authority to sub-national levels of government. Although the political benefits of decentralization can not be achieved, central authorities try to ensure the efficiency of service delivery by their regional branches.

Delegation is intermediate form of decentralization and is used unitary states and in some spheres in federal countries, when supreme level of government wants to ensure the provision of specific services, for example social protection. The central-local government interaction can be characterized as principal-agent relationship, when municipalities act as the agents (Litvak et al, 1998).

In the point of view of Fiscal Federalism devolution is most efficient framework for intergovernmental relations. All benefits stated in the decentralization literature can be achieved in these circumstances. Local governments can impose and levy taxes, citizens can “vote in their feet”; hence there is a direct linkage between costs and benefits, which is the prerequisite for Pareto efficiency. The devolution model works successfully in developed federations, like Switzerland, the United States, Canada and Australia.

1.3. Arguments for and against decentralization

As we can see from the previous section, there are variants of decentralization from which countries can choose which to follow. Not surprisingly, some countries tend to be decentralized while others have a high concentration of power in the hands of the central government. The diversity of the degree of decentralization is determined not only by historical and geographical circumstances. The political and economic rationale for decentralization is debatable among scholars. The debate relies on the experience of past decades as well as on theoretical implications. The paper further defines arguments for and against decentralization.

The case for decentralization:

The main argument for fiscal decentralization is that it can enhance *efficiency* (Bodman, 2006). Decentralization can contribute to a more efficient provision of services by enhancing links between local expenditures and preferences (Capkova, 1997). A decentralized, democratic government may be better informed about local needs and, hence is more likely to be responsive to address them. Thus, local taxpayers are able to “vote in their feet” for different tax/benefit packages. The revealed preferences, based on the consumer mobility hypothesis, and municipalities’ competitive response leads to Pareto-efficient public service output. The larger the variance in the demands of public goods, the larger the benefits of decentralization tends to be

(Theißen, 2001). Better matching individuals' preferences increase their welfare which effects work effort, saving and investment and consequently the economic growth. Decentralization enhances “producer efficiency” by fostering experimentation and innovation in the production and supply of public goods (Martinez-Vazquez and McNab, 1997). The more responsive and efficient government implies the simplification of complex bureaucratic procedures and improvement in competitiveness (Litvack and Seddon, 1999).

The second argument for fiscal decentralization is that it can enhance **revenue mobilization** (Bahl, 2006). Collection of some taxes is better suited to local government because their collection requires the knowledge of local economy and population. In addition, some taxes are considered as quasi-benefit charges. In such circumstances local governments have better possibility to collect tax revenues with less administrative effort.

The third argument is based on Brennan and Buchanan's “**Leviathan**” hypothesis (in Theißen, 2001, p 3.). The revenue maximizing behavior of government discussed above can be prevented by horizontally and vertically competing levels of government. In order to attract consumers municipalities lower tax rates which prevents revenue maximization. Decentralization is a way of reducing the role of the state, introduction of more intergovernmental competition and checks and balances (Bardhan, 2002).

The fourth argument, highlighted especially by the Second Generation Fiscal Federalism literature, is increased **accountability** of the public sector. Elected local public officials are “on the hook of service delivery to the local population that elected them” (Bahl, 2006). Decentralization can overcome information asymmetries, enhance transparency and accountability and increase the legitimacy of the state.

The decentralization literature speaks also about the positive impact on poverty, interregional equity and macroeconomic stabilization; however, the signs of these effects are highly debatable.

The **political proponents** for decentralization argue about better political integration on minority groups, well defined property rights, transparency in governments' transactions, promotion of free market principles and democratic governance (Theißen, 2001).

Based on the above, all countries should choose the devolution form of decentralization in order to achieve their political and economic goals. Not surprisingly, decentralization in developing countries in 80s was considered as a "cure for all ills" (Bird and Vaillancourt, 1998). However, the experience of these countries put the question mark on many issues and has led to the formation of the opposition camp against the decentralization. Below are provided the main arguments against decentralization.

The case against decentralization:

The first argument against decentralization is that in developing countries citizens' preferences are not reflected in budget and decentralization leads to increased costs, decreases efficiency and results in greater inequality (Prud'homme, 1995, in Bird and Vaillancourt, 1998, p-1). It has been argued that the **efficiency criterion may not work** for decentralized provision of services for the following reasons: First of all provision of services may have spillover effects to residents of other municipalities, which can challenge efficiency. This may lead to the "free rider" problem in the case of positive externalities. The inefficiency will be more in the case of negative externalities. For example the misuse of water or air by local residents has the negative effect on other jurisdictions too. Secondly, taxes, levied in local level government may be shifted onto residents of other municipalities. This undermines the linkage between local costs and preferences. Moreover, Oates states that taxes, efficiently imposed on central level, may be

unproductive at municipal level (1991). Thirdly, the consumers' mobility hypothesis is less applicable for developing countries, where ties of family, culture and tradition are strong (McLure and Martinez-Vazquez, 1997). Bahl states that in developing countries, which are sometimes quite small, the budget revenues often depend on primary exports and the local expenditure/preference model might not work (1999). The author's second argument is central government's ability to invest in projects with big externalities.

Bardhan claims that local governments may underprovide services because of presence of externalities, especially in poor areas (2002). Lack of clearly defined responsibilities of central and sub-national governments and weak accountability to citizens may make expenditure policy less effective.

The argument against decentralization is the negative effect on **regional equity** (Guess et al, 1997). Incomes and taxes are unequally distributed across municipalities. Decentralization increases regional disparities because wealthier communities attempt to fend off poor households. Because of scarcity of economic resources, the rationale for centralization of service provision is that it prevents sharpening regional disparities.

Theißen states that decentralization may hinder **macroeconomic stabilization** and hence slowing down the economic growth (2001). Sub-national governments have less incentives and possibilities to act counter-cyclically and respond to economic recessions and booms. International Financial Institutions, especially the International Monetary Fund often requires from the central governments of transition countries to hold all necessary instruments in order to eliminate fiscal imbalances. Thus, effective and timely coordination of fiscal policies among different levels of government is difficult to achieve, which hinders stabilization. In order to ensure macroeconomic stabilization, central government should control sufficient tax and borrowing power (Guess et al, 1997).

Prud'homme states that local level often **lacks qualified administrative personnel** (in Theißen, 2001, p. 6.). They often cannot acquire well-trained people because central government provides better career opportunities. Moreover, local administrators are closer to people and are more susceptible for capture from local elite.

Decentralization is considered beneficial for countries with high level of economic development (Prud'homme, in Theißen, 2001, p. 6). In low income countries decentralization might be expensive for high fixed costs. It might worsen fiscal performance of government in relatively small countries where the society is more homogenous and the same can be said about preferences.

Local governments in rural areas of developing countries often face scarce tax base. Administration of local taxes may be costly and difficult and in some situations politically feasible. In that case the linkage between benefits and costs is poor and democratic control may function less well (Prud'homme, in Theißen, 2001, p. 7).

As we can see from the above, both camps (proponents and proponents) provide strong theoretical arguments. For this reason it is very difficult for countries' political establishment to choose between the dilemma: to decentralize or not to decentralize. It is like the situation when the patient is buying a drug which has too many side effects; hence nobody can tell if the medicine will cure the disease or will worsen the health.

I think that the answer about the outcomes of decentralization is not a straightforward issue. As Litvak et al state the effect depends on institutional specific design (1998). The outcome is difficult to measure because decentralization affects a wide range of issues from service delivery to poverty. Also, decentralization reforms are often conducted simultaneously with general economic and political ones; hence it is difficult to separate which reform is

responsible for the particular outcome. The evaluation of decentralization is a rather difficult task in developing countries where the problem of reliable data exists.

Because the aim of this MA thesis is to evaluate the effects of decentralization in transition countries, which is a difficult task, I need to look at the empirical work. I conduct the document analysis of the empirical literature in order to identify which research technique is more useful. Another rationale for document analysis is to identify which measurement of decentralization is more convenient to use. According to Guess et al (1997, p11):

“Fiscal decentralization is so multidimensional that specification of a formal hypothesis for statistical testing requires stepping down from a view of the general picture, to a level which provides only a narrow slice of the panorama. Thus, one is not likely to be able to compare the experience of countries only on the basis of empirical hypothesis testing, except when dealing with narrowly defined issues.”

The other reason for looking at empirical literature is to identify most suitable dependent variables for our research. Because decentralization may affect many things, we should choose the most important ones to focus on. The next chapter provides the overview of empirical literature about the outcomes of decentralization.

Chapter II: Outcomes of decentralization, document analysis

The present chapter provides the analysis of empirical work about the effects of decentralization. It identifies the variables, which from the point of view of researchers, based on theory can be affected by decentralization. The studies are grouped by topic and by type of findings.

During the last two decades many scholars have tried to measure the impact of decentralization by economic and non-economic variables. Most empirical analysis use econometric methods, comparing the effects of decentralization using cross-country regressions (Ebel and Yilmaz, 2002; Zhang and Zhou, 1998, Davodi and Zhou, 1998; Thießen, 2001; Martinez-Vazquez and McNab, 2005; Jin et al, 1999; Lin and Liu, 2000). Some authors tried to evaluate the impact using qualitative methods like case studies and interviews (Jutting et al, 2004; Bardhan and Mookherjee, 2005;).

Most empirical research about the impact of decentralization, conducted last two decades, is devoted to economic growth, poverty/income inequality, public sector size, macroeconomic stabilization and efficiency. In our opinion, scholars took these dependent variables because they are the most sensitive indicators assessing the direction of countries' development. Also, most of the economic reforms aim to address these issues; hence the impact of decentralization should be evaluated too.

2.1 Decentralization and growth

The empirical analyses on decentralization and growth can be divided into two frameworks (Bodman and Ford, 2006). The first framework uses cross-country econometric

regressions, while the second uses informal growth regression. In the latter case theoretical models are used to justify the inclusion of decentralization.

Some scholars report that there is a negative relationship between the two, while others claim the opposite. The empirical findings about the relationship between decentralization and growth are contradictory. The first group of researchers who state the negative relationship include Zhang and Zhou's work (1996). The authors conducted the research of 28 Chinese provinces from 1980 to 1992. They tested the relationship between provincial income growth rate and production inputs, fiscal decentralization and other variables effecting growth, and report significant and negative relationship. Zhang and Zhou's arguments are further supported by Davoodi and Zhou (1998). Their research relies on cross-country panel data for the period 1970-1989 and concludes that there is a negative relationship between decentralization and growth in developing countries and in the World in general, while there is no significant relationship for developed nations. However, the authors state that the proxy for decentralization might be incomplete because it does not capture the level of sub-national autonomy.

The second part of academia thinks that the linkage between decentralization and growth is hard to measure, because the latter is effected by other stronger economic and political variables; hence a direct empirical connection is not available (Guess et al, 1997). The weak relationship between the two is reported by Jin and Zhou who have studied the Chinese provincial panel data for two time periods (2000). The authors found that revenue decentralization is positively correlated to provincial growth while the effect of expenditure decentralization is negative. However, imposition of control variables in the econometric model makes the relationship between expenditure decentralization and growth insignificant. The weak relationship hypothesis is endorsed by Feld et al (2004), who studied the relationship between decentralization and economic performance, using panel data of 26 Swiss cantons from 1980 to

1998. They state that although the effect is positive, it is statistically insignificant. The next research on OECD countries conducted by Theißen (2001) based on growth regression models reports the limited impact of decentralization. However, as many other scholars, Theißen uses the share of sub-national expenditures in the total expenditures as the proxy for decentralization and mentions its imperfectness. Bondman and Ford's research also reports the confusing results because different measurement of decentralization lead to different outcomes (2006).

The third group of scholars argues that the impact of decentralization on growth is positive and significant. On the opposite of the Zhang and Zhou who uses the Chinese data for empirical research, Lin and Liu (2000), based on panel data of 28 provinces from 1970 to 1993, find a positive, nonlinear relationship between decentralization and growth. Their argument is further supported by Ebel and Yilmaz's work (2002). However, it is important to mention that authors' empirical cross-country analysis covers a relatively small number of transition countries and it is difficult to generalize their finding all over the world. The same findings are reported by Malik et al (2006), who studied the effect of decentralization on economic growth in Pakistan for the period of 1971-2005.

As we can see from the above, the empirical evidence on the link between fiscal decentralization and economic growth is mixed. The reasons for that are the following: First of all, the authors use different measures of decentralization, which leads to different results. The clear example of that are above stated researches conducted on Chinese data. Secondly, as Guess et al (1997) state, empirical works rarely take into consideration other factors influencing the growth. Thirdly, different researches focus on countries with different levels of political and economic development. The lesson that can be inferred from these studies is that the effect of decentralization varies by regions, from wealthier nations to poorer ones and also depends on institutional settings.

2.2 Decentralization and poverty

Although decentralization has been in vogue for the past two decades, its relationship to poverty has recently received more attention (Jutting et al, 2004). Thus, decentralization may affect poverty by increased possibility for citizen participation which can improve the access to publicly provided services; however, the link between the two is not direct.

Jutting et al. define political and economic channels by which poverty might be influenced by decentralization (2004). The authors conducted case studies in a number of countries and have analyzed the effect taking into consideration the objectives of decentralization, information background of the respective country and conditions related to the process. All in all, they conclude that the relation is mixed. Despite the fact that in one third of the studied countries the impact was positive, it can not be said about the majority where public institutions are poorly designed the impact tends to be negative. Using the example of Ethiopia, Guinea and Mozambique the weak relationship is reported by Bossuyt and Gould (2000) too. Despite their hypothesis that poverty can be influenced by political devolution, resource mobilization and participation in decision making, the experience of poor countries shows little evidence.

However, there is the view that small developing or decentralized countries deal better with poverty. It is reported in Von Braun and Grote's empirical work (2000). Although their measurement of decentralization is not the best, it still leaves the space for reporting positive relationship.

All in all, the empirical literature does not give enough evidence to link poverty and decentralization. Like in the case of economic growth, there are many factors affecting the former, so direct linkage can not be seen. It should be taken into consideration that in poor

countries public institutions are underdeveloped, the administrative personnel is unqualified and often corrupt. All these result in unfavorable conditions for the implementation of any kind of reforms.

2.3 Decentralization and macroeconomic stability

The benefits of decentralization were seriously questioned by scholars after the economic crisis in Latin America in 1980s, when the overborrowing by sub-national governments led to the financial crisis of the whole public sector in Argentina and Mexico. However, the relation between decentralization and stabilization has not received the attention it deserves, especially in developing countries (Tanzi, 1995).

De Mello, based on empirical findings, argues that the impact of fiscal decentralization promotes fiscal imbalance which leads to macroeconomic instability (2000). Rodden et al also support the hypothesis that fiscal decentralization exacerbates macroeconomic instability and hampers the process of resolving chronic fiscal imbalance (2003). Moreover, the authors claim that decentralization may be dangerous in developing countries.

Ebel and Yilmaz challenged de Mello's findings arguing that the author used imperfect proxy for decentralization (2002). The scholars redefined sub-national tax autonomy and claimed that on the opposite, decentralization improves the fiscal position of the general government. Thus, dependency on intergovernmental transfers worsens the position of municipalities which may lead to instability.

In our opinion, decentralization and stabilization should not be linked. The same opinions are shared by Martinez-Vazquez and McNab, who argue that the empirical evidence does not provide any significant relationship between macroeconomic instability and decentralization (2005). According to Musgrave's framework, the stabilization function should be assigned to the

upper levels of governments, not to municipalities. The example of Argentina and Mexico, which are federal countries, is irrelevant. The instability in these countries was caused by ineffective organization of power between the federal and state levels of government, rather than by decentralization reforms.

2.4. Decentralization and efficiency

Theoretical research suggests that decentralization improves public service delivery through matching public services to local preferences (allocative efficiency) and increased accountability (productive efficiency) of local governments, lower level of bureaucracy and better knowledge of local costs (World Bank, 2001). There is scant empirical literature on the relationship between decentralization and service provision efficiency, because efficiency is difficult to quantify. Hence, scholars often use economic growth as an indirect measure of efficiency (Rodríguez-Pose et al, 2007).

The empirical findings about the impact of decentralization on efficiency are less contradictory. Barankay and Lockwood studied the relationship between decentralization and the productive efficiency in health and education services from the example of Swiss cantons (2004). The authors found that decentralization improves service efficiency in both sectors via reducing costs. The finding is supported by Schelker (2005), who based on the evidence of Switzerland, state that more decentralized cantons have more efficient and smaller governments. The same conclusion was reached by Kwon (2002) who looked at the whole public sector efficiency in South Korea and Afonso et al (2003) in OECD countries. However, the link between decentralization and efficiency is weak because the analysis covers the whole public sector. The part of academia thinks that benefits of decentralization are not materialized in increased efficiency. Balaguer-Coll et al (2006) found that large and medium sized local governments are

more efficient than smaller ones. The pessimistic view is expressed by Azfar et al (2001), which conducted qualitative research in the Philippines and Uganda in order to assess the effect of decentralization in healthcare and education service provision efficiency.

I think that efficiency gains from decentralization can not be captured in short period of time, especially in developing countries. The impact is diminished by the low quality of governance. The capacity of local governments, citizens' participation together with other political factors plays important roles. However, the above researches lack the analysis of how political and economic factors influence both decentralization and efficiency.

As we can see, most empirical literature uses quantitative research technique in order to measure the effects of decentralization. Their focus on general economic indicators is not accidental. Because most decentralization reforms are taking place in developing countries, it is necessary to consider the wide range of issues that can be influenced by decentralization. I think that the reason for differing empirical results is the measurement of decentralization. Also, it should be highlighted that studies often do not take into consideration institutional design, a very important variable (Litvak et al, 1998). The authors suggest that researches should focus more on institutions, legal and regulatory systems, transparency and accountability while measuring the effects of decentralization.

Before conducting the research on the impact of decentralization in the transition region, it is necessary to overview the general intergovernmental reforms which started after the collapse of the Soviet Union. As highlighted above, in order to assess the process, special attention is paid to the institutional basis of reforms. It could be argued, that almost all countries choose one or another form of decentralization, because under the Communist regime power was highly centralized. Hence, the decentralization process in transition countries has been diverse. Some

countries choose to decentralize their governments at an early stage of transition (Hungary, Slovakia), while others keep strong control over the central government (Azerbaijan, Georgia).

Chapter III. Decentralization in Transition

The current chapter overviews the decentralization process in transition countries and later on focuses on Georgia. Because decentralization is a multidimensional phenomenon I highlight only general aspects.

3.1. General Trends of decentralization in transition countries

The decentralization process started immediately after the collapse of the Soviet regime and was implemented in every country of the region (Bird et al, 1995). The reason for rearrangement of intergovernmental relations in post-Soviet countries was the collapse of economies of collective ownership and control in the early 90s.

At the very beginning, the delegation of functions to sub-sovereign levels was seen as the possible way to restructure inefficient organization of government, macroeconomic instability and inadequate economic growth (Bird and Vaillancourt, 1998). The political and fiscal decentralization process in the transition countries were closely linked (Horvath, 1997). In spite of some positive achievements, local government reform was not implemented and municipalities mostly remain the deconcentrated units of central authorities. There are several reasons for that.

First of all, in most transition countries, central governments continue to have the same powers as they held prior to independence (Popa and Munteanu, 2001). Kimball argues that the reason for that was the fear of central governments “that they would have to give up some of their prerogatives and would lose control of the country’s development” (1998). Central authorities often argued that less decentralization gave them the possibility to maintain national integration in general. This was often justified by the need for controlling economic and social differences

among territories, especially in crisis. Consequently, central governments in transition countries tend to maintain the control on the distribution of resources.

Secondly, although national legislation granted political and economic power to municipalities, key elements needed for efficient sub-national government were missing in most countries. The examples are the assignment of expenditure responsibilities and the establishment of institutions responsible for intermediation between the levels of government (Bird et al, 1995). Also, in most countries the sub-national revenue base was scarce and municipalities remained highly dependent on ad hoc transfers. Most sub-national tax base and rates are established by the central government. Many taxes have fixed rates in nominal terms and are vulnerable to erosion through inflation (Bird et al, 1995). Some of the local taxes yield less than they cost to collect. Direct control over sub-national borrowing used to be the way for central governments to ensure that municipalities will not undermine the macroeconomic stability by overborrowing (Bird et al, 1995). The transfer system in transition countries discouraged local responsibility too.

The third reason is that newly formed local governments in many transition countries were too small to provide services efficiently (Bird et al, 1995). At the same time the intermediate tier of government was ineffective with ambiguous functions and low capacity.

Despite the slow process of decentralization, most Eastern European countries maintained the tendency of development and successfully transformed their economies from administrative-command to market economy. Except for the Balkan states all countries have joined the European Union, which can be considered as a measurement of success. It is important to mention, that the “Lisbon Criteria” which was the prerequisite for joining the EU do not touch the issue of decentralization. It can be inferred that, the local governance reform was not considered as a necessary indicator of political democratization and economic liberalization.

The decentralization process was slower in the former Soviet Union than in Eastern Europe. Collectivist behavior remains widespread, while public participation in the political process is still limited; local elections often play a decorative role under the influence of the central authorities (Popa and Munteanu, 2001). The transfer of power to sub-national governments was further challenged by the territorial and ethnic conflicts in some countries, which made the political elite highly reluctant to implement reforms in the administrative organization of government.

The ethnic tensions were especially strong in the South Caucasus region, and as a consequence had their negative affect on the decentralization process. All three countries' (Armenia, Azerbaijan, Georgia) local governments face the problem of scarce tax base, ambiguity of assigned responsibilities, high dependence on central transfers and strong political and administrative control from the centre (Mshvidobadze, 2006). The next section discusses decentralization trends in Georgia.

3.2. Decentralization trends in Georgia

International experts characterize Georgia as a highly centralized, unitary state, with 53 districts including the autonomous Republics of Abkhazia and Adjara and the Autonomous Region of South Ossetia. Conditions hampering the state-building process are ethnic nationalism, insufficient socio-economic integration, parochialism, clientelism and familism. Society lacks traditions of democratic thinking and has preferences for strong authoritarian leadership (Huber, 2004).

Because of unresolved territorial conflicts, the administrative-territorial organization of the country is not completed. According to Item 3 of Article 2 of the Constitution, the internal territorial state arrangement of Georgia is determined by constitutional law, on the basis of the

authority demarcation principle effective over the whole territory of Georgia at such a time when there is full restoration of Georgian jurisdiction.

Unresolved territorial organization of the state complicates local self-governance in Georgia. Political circles, the public and ethnic minorities regard this as a sensitive problem, which in recent years has frequently turned critical. Widespread ethnic prejudice and unresolved socioeconomic problems create additional difficulties for the state.

Decentralization reforms in Georgia can be divided into two phases. The process started in 1997 when the parliament of Georgia adopted the law on “Local-Self Government and Government”. According to legislation two level of local-self government were established:

- Level I: villages, communities, and towns (successors of Soviet-era local councils);
- Level II: districts and large towns (the territory of Soviet-era districts).
- The capital city³.

In total 1069 local self governments were established in 49 towns, 843 communities, 164 villages within the region and 55 cities not within the region.

Before the municipal reform in 2005 three sub-national levels existed in Georgia:

- Nine regions (though they were not stipulated in the legislation) and two autonomous units (Adjara and Abkhazia). The President of Georgia’s representatives appointed the executives of the regions. No legislation regulated this level.
- 65 districts and six cities not under the district administration. This level is a de-concentrated structure of the state. The head of the executive branch is appointed by President of Georgia from the associated council members.
- 1004 (villages, communities, and towns) with elected local councils and executives.

³ The administrative organization of the capital city is regulated by the law on the Capital City of Georgia;

- The capital, Tbilisi, was a separate body, with functions of both a municipality and a region;

Representative bodies were elected at both levels and executive structures were elected at the lower level. However, the head of the district's executive body was appointed directly by the President. The newly elected local self-governments, however, were highly inefficient due to an unclear division of competencies and functions and the lack of financial resources, especially in rural areas (Losaberidze, 2007).

The ineffectiveness of local level of government stimulated further reform in 2005, after the "Rose Revolution", when the Parliament of Georgia passed the new law on "Local Government" and the law on "Local Government Budget". During the second phase of decentralization the lowest tier of local-self government was abolished. The number of municipalities was decreased to 65 in the scope of raion's⁴ administrative territory by the amalgamation of fragmented ones. The equalization mechanism was established by the law which obliges the central government to strengthen the capacity of low income municipalities.

The "mixed" election system (proportional-majority) has been introduced in districts and self-governing towns. Ten council members are to be elected through proportional representation. In addition, each of the former first-level self-governing units of the district should elect one representative in a first-past-the-post ballot. The administration executive is elected indirectly by members of elected council.

The amalgamation process of municipalities, which was done last year, has been highly discussed among Georgian NGO's (Non Governmental Organization) and independent experts operating in the local governance sector. The member of Caucasus for Peace, Democracy and Development, David Losaberidze argues that amalgamation will estrange the government and the

⁴ The lowest administrative territorial unit under the Soviet Union

people and the quality of the service will decline (2007). Moreover, he claims that tax revenues have been removed from local budgets which will also worsen the performance of municipalities. At the same time, central government has taken over many of competences that had earlier belonged to local self governments and this by author is assessed as a negative event (Losaberidze, 2007).

The president of the Association of Young Economists of Georgia, Tengiz Shergelashvili, argues that despite the current reforms, issues regarding the transfer distribution and other institutional issues of intergovernmental relations remain unregulated (Shergelashvili and Narmania, 2006). Without transferring more financial power to municipalities an effective system of self-governance cannot be achieved.

The empirical evidence shows that the taxing power of municipalities is limited. Georgia has a high vertical fiscal imbalance, which has the tendency to increase. Table 1 below provides numerical example. As we can see from Table 1, the share of local governments' revenues in the consolidated budget revenues has decreased from 20 percent in 2004 to 10.1 percent in 2007. The situation is even worse for shared tax revenues. In 2004 shared tax revenues constituted 15.4 percent of consolidated budget revenues, which was 77 percent of local governments' revenues. Thus, in 2007 the shared tax revenues make up 6.5 % of consolidated budget revenues, which is 65 percent of local governments' revenues. It is important to mention that the share of local governments' own revenues is relatively stable.

Table 1: Consolidate budget revenues in ml. GEL⁵

	2004 ⁶	%	2005	%	2006	%	2007 ⁷	%
I. State Budget	1544,8	77	2639,7	80,3	3879,0	85,5	869,3	88,2
II. Autonomous republics	49,5	2	25,0	0,7	53,7	1,2	7,3	0,7
III. Total local government revenues (IV+V)	403,4	20	624,5	20	605,3	13,3	108,3	10,1
IV. Local Governments own revenues	95,2	4,6	136,5	5,2	221,3	4,8	44,1	4,5
V. Local governments revenues from shared taxes	308,2	15,4	488,0	14,8	384,0	8,5	64,2	6,5
Consolidate budget revenue (I+II+III)	1997,7	100	3289,2	100	4538,0	100	984,9	100

Source: Ministry of Finance of Georgia;

Despite the fact that central government promised local governments to compensate revenue losses from abolishing local taxes by transfers, table 2 below states the opposite. The amount of transfers to local government decreased from 80.7 ml in 2004 to 48.1 ml. in 2007. It is worth mentioning that all transfers provided by the central government have a conditional character and can not be used for other purposes. The purpose of the transfer is prescribed by the current state budget. Therefore, the revenues mobilized by own sources or revenue sharing were used by the discretion of the local governments.

Table 2: Transfers from state budget to sub-sovereign governments in ml. GEL⁸

	2004	2005	2006	2007
Transfers to local governments	80,7	72,0	25,5	48,1
Transfers to autonomous republics	11,0	54,9	30,0	0,0
Transfers to capital city	0,0	0,0	132,3	0,0
Total	91,7	126,9	187,8	48,1

Source: The 2004, 2005, 2006, 2007 laws on “State Budget” of Georgia

⁵ 1 dollar equals to 1.75 Georgian national currency- GEL;

⁶ The data are available for April-December of 2004. On April 2004 treasury single account was established.

⁷ Information consists revenues of first two month of current year.

⁸ Source: www.mof.ge

As we can see from the above, the financial capacity of local governments is low and has even diminished since 2004. At the same time, the central budget of Georgia reached 3,000 million GEL in 2006 which allows the central government to provide the most important public services (e.g. education and healthcare, as well as social service provision) directly, without involvement of municipalities.

As mentioned above, the centralization of political and financial power is undesirable in the eyes of independent Georgian experts, who regard the central government's step as a return to Stalinist era (Losaberidze, 2007). Is high centralization detrimental for Georgia? Will centralization of power effect negatively country's economic performance and worsen service provision efficiency? In order to provide policy implications for Georgia, we should study the effect of decentralization in CEE countries and post-Soviet Union. As stated above, I believe that the impact of reforms varies by region and depends on many factors, including institutional design.

Chapter IV: Effects of Decentralization in Transition, cross-country evidence

The current chapter is devoted to the empirical research of the outcomes of decentralization in transition countries. In order to assess the impact I focus on GDP growth. As we can see from the second chapter, this variable is most frequently used by researchers to measure the economic development and efficiency. Before defining the methodology, the weaknesses of previous empirical researches in transition are defined. After conducting the econometric analysis the findings are reported later on.

4.1. Weaknesses of empirical researches on decentralization reforms in transition

The most systematic and comprehensive literature about decentralization reforms in Central and Eastern Europe and post Soviet Union countries is compiled through Local Government and Public Sector Initiative (LGI). LGI publications cover almost all topics related to local governance and overview decentralization tendencies, and each country's success and impediments of local capacity building.

However, the LGI literature is driven by theoretical rationales for decentralization and provides political and economic arguments for it. Despite the fact that most authors of LGI publications conduct case studies or country comparisons and suggest policy solutions in order to improve local governance, their arguments are rarely supported by empirical work. Also, the experience of the particular country can not be generalized for all transition states. The policy which can work in Czech Republic might not apply for Kazakhstan because of the difference in the political, cultural and historical environment.

The most comprehensive empirical study about the effects of decentralization in transition countries relies on Ebel and Yilmaz (2002), who conducted a cross-country analysis, based on OECD survey data in 10 transition countries. The authors' findings are introduced in the second chapter of this thesis but can not be generalized to the whole post-Communist World for the following reasons:

First of all, the countries covered by the above research are present members of the European Union. Before getting into the Union, these countries received pre-accession funds which influenced the economic indicators. Besides, potential member states received huge political and economic support from Western Europe in the form of foreign direct investment and expert help to reconstruct their economies.

Secondly, except for the Baltic States all countries covered by Ebel and Yilmaz were independent members of the international community and law, consequently had the experience of governance. It is important to mention that in the ten transition countries, covered by Ebel and Yilmaz's work, the Communist regime lasted for less than in the former Soviet Union. As a result the political and cultural ties with the West were relatively easy to recover. In some countries (Czech Republic and Baltic States) the political elite migrated from the United States and the Western Europe bringing democratic values and political support. As a result the quality of governance in these countries was higher than in the post-Soviet Union.

Thirdly, the OECD countries studied are geographically closer to Western Europe than post-Soviet countries and the political influence of Russia is smaller. In many post-Soviet countries, secessionist movements were unofficially supported from Russia, which led to civil wars and ethnic conflicts in the Caucasus and Moldova. Forth, the location of the countries studied is favorable for trade and transit.

Fifth, the present organizational culture in Eastern Europe differs from that of post-Soviet Union countries which are former “Gubernias” of Russian Empire. The explanation in the difference of organizational culture can be given by analyzing unique cultural and bureaucratic traditions in Tsarist Russia, which later on influenced the organization of Soviet bureaucracy. Ledeneva (2001) states based on Keenan’s explanations that Russian political culture developed from early Slavic settlers. According to Keenan an important feature of Tsarist cultural traditions was: conspiracy in decision making, favoring of stability and risk-avoidance over progress and the reluctance to proclaim codified law. The organizational culture, relying on these principles favors informal social relations and there is little place left for formal law. Post-Soviet people’s mistrust towards law can be seen in Miller et al’s (2001) finding. As the authors state “reflecting the difference in traditions, we found that in Ukraine people were almost twice as likely as people in the Czech Republic to say that people should ignore or avoid the law if it is unreasonable or unjust” (2001, p.135). They further mention that the majority in Ukraine did not equate law with morality.

I think that omitting all these factors, while evaluating the effects of decentralization in post Communist countries may lead to incomplete results for analysis. However, these variables have not been included in Ebel and Yilmaz’s empirical study. Thus, Guess et al state that while evaluating effects of decentralization based on cross-country data analyses, a number of issues should be taken into consideration (1997). Countries differ by size, historical influence on institutional development, social cohesion and government values; hence these variables should be included in the analysis.

4.2 Methodology

Achieving economic growth has been the most important goal of all countries. It increases the wealth of the nation, decreases unemployment and ensures stabilization of prices. Growth is often considered as the basic indicator of countries' economic development. The European Union's Stability and Growth Pact also demands from member states to pursue this goal. In CEE it has been also considered as an instrument to European Union admission process and gaining access to international funds. In order to facilitate growth, all transition countries carried out sound political and economic reforms. The International Monetary Fund, which closely cooperated with most transition countries during the last two decades, demanded from central governments to adjust their fiscal architecture in order to ensure the growth.

One of the ways how the government can facilitate the economic development can be effective organization of the public sector. The World Bank has highlighted that good governance, a corruption-free and responsive public sector are prerequisites for economic development.

Successful decentralization should be considered as a very important step towards good governance. The main objective of decentralization is to improve resource allocation and hence service provision efficiency (Guess et al, 1997). The efficiency criterion has been the main argument for decentralization in the First Generation Fiscal Decentralization literature.

Decentralization increases efficiency because sub-national governments at the same level of expenditures are more productive in provision of goods and services than central ones. Better quality of public services over time has its effect on income and growth over time (Martinez-Vazquez and McNab, 2003). Improvement of allocative efficiency also has an impact on economic growth. Decentralization also causes the change of expenditure structure. Local

governments are more prone to finance investment and construction projects which accelerate growth.

The objective of the current research is to evaluate the effect of decentralization on economic growth in transition countries. In a cross-country comparison, I estimate a model of the form

$$Y_i = \beta_1 + \beta_2 * DEC_i + \beta_3 * IN_GDPPERC_i + \beta_4 * INS_DEV_i + \beta_5 * HC_i + \beta_6 * PG_i + \beta_7 * GEO_i + \beta_8 * W_D_i + \beta_9 * EU_D_i$$

Where Y_i is economic growth of country i over the period 1996-2006, DEC measures decentralization of country i , $IN_GDPPERC$ measures initial GDP per capita of country i , INS_DEV measures institutional development of respective country, HC measures human capital, PG measures average population growth, GEO is geographical measure of closeness to Western Europe, W_D is dummy variable measuring particular country encountered civil and ethnic wars or not, EU_D is dummy variable measuring the European Union membership.

Based on the discussion I expect that there is a positive relationship between decentralization and economic growth.

It should be noted that there might be a problem of endogeneity, which I do not specifically tackle in this paper.

I expect that countries with higher levels of institutional development experience higher economic growth. My argument is based on Beck and Laeven's (2005) findings. It is natural to expect that wars have a negative impact on economic development. Beck and Leaven's research finds that conflicts in Armenia, Azerbaijan, Georgia, Moldova and former Yugoslavia had short term negative effect on growth.

Based on the economic literature I expect that population growth is negatively correlated with GDP growth holding other production factors constant. I claim that countries close to Western Europe should grow faster than others. The closeness to advanced democracies should have resulted in importing democratic values, which is a necessary factor for good governance. Together with political changes, the short distance might be favorable for financial capital and foreign direct investment, facilitating economic growth.

Relying on the results of Coulombe et al. (2004), I expect that human capital has a positive and significant effect on GDP growth. I include the initial GDP to control for initial development.

4.3. Data and measurement

While conducting cross-country regressions, researchers rely on the International Monetary Fund's "Government Financial Statistics" (GFS). GFS is considered as "the best data source for cross-country empirical analysis of fiscal flow" (Bell et al, 2006, p.11). Relying on IMF's data, the degree of decentralization is often measured as 1) sub-national revenue as a share of the total revenue, 2) sub-national revenue as a share of total expenditures, 3) vertical imbalance between sub-national revenue and expenditure, 4) sub-national tax revenue as a share of total revenue and grants, or 5) sub-national revenue as a percentage of GDP (Gross Domestic Product).

However, Ebel and Yilmaz argue that sub-national governments' expenditure or revenue share is not a good proxy for decentralization (2002). The reason is that Government Financial Statistics do not capture sub-national governments' fiscal autonomy. It can not be distinguished whether municipalities spend their "own" money or central government's transfers. It is not possible to determine the source of tax revenues, non-tax revenue and grants. Consequently there

is no information whether revenues are collected by tax-sharing, piggybacked taxes, or from locally levied “own” sources. Bell et al (2006), note that GFS data are incomplete for developing countries, especially in the African region and neglect non-monetary transfers.

The second source for cross-country analysis is OECD (Organization for Economic Cooperation and Development) Revenue Statistics. The OECD statistics was established in order to effectively classify tax revenues across levels of governments (Bell et al, 2006). However, the data coverage is limited to a sample of transition countries in Central and Eastern Europe.

The third source of cross-country analysis is the World Bank database, which covers almost all developed and developing countries. The decentralization indicators are classified by fiscal and electoral types. However, the fiscal indicators are mostly taken from the International Monetary Fund’s Government Finance Statistics. Other world-wide sources which can be used are the Database of Political institutions and the USAID (United States Agency for International Development) database. Thus, users of these sources mostly look on the political dimension of decentralization.

Dependent variables:

My measure of economic growth is the natural log of GDP growth in 1996 and 2006 years. Although this variable does not encompass all aspect of economic development, GDP growth is often used to measure economic growth in regressions. The examples of that are Martinez-Vazquez and McNab’s (2005), Davoodi and Zhou’s (1998) and Ebel and Yilmaz’s (2002) work. The source of GDP growth data is the International Monetary Fund’s online statistical database.

Independent variables: Fiscal decentralization is measured by Vertical Fiscal Imbalance (VFI). In order to measure VFI I use the Hunter⁹ coefficient.

$$\text{VFI} = (\text{revenue sharing} + \text{transfers}) / \text{total sub-national expenditure}$$

I choose Vertical Fiscal Imbalance because it captures both, the revenue and expenditure side of local governments' budgets. It reflects on what extent the central governments have control on most productive tax bases, while expenditure responsibilities may fall largely on local governments (Ebel and Peteri, 2006).

In order to compute VFI I collected the information about the structure of local government revenues and expenditures from LGI publications by country. In addition the information was gathered from the official internet sites (for Czech Republic, Uzbekistan, Bulgaria, Lithuania, Latvia, Estonia, Romania) of the Ministry of Finance and Department of Statistics of the respective transition countries.

Control Variables:

The information about the initial GDP per capita by countries is collected from the International Monetary Fund's online statistical database. Thus, initial year is defined as 1996. I use 1996 as a starting year of regression because in most post-Soviet countries it is the beginning decentralization reforms¹⁰.

I measure institutional development relying on World Bank's "Governance Indicators" which is available online, on the organization's official website. This indicator is generated by

⁹ for further details see Slukhai S, 2003, P-23,

¹⁰ For further details see Popa and Munteanu, (2001)

combination of six parameters: 1) control of corruption, 2) political stability, 3) regulatory quality, 4) rule of law, 5) voice and accountability and 6) effectiveness of government sector. I think that World Bank's "Governance Indicators" capture differences in political and organizational differences across transition countries identified in the firsts section of this chapter. This measurement was also used by Beck and Laeven (2005). I define institutional development as an average of 1996-2006 years for each transition country.

Initial human capital is measured as gross tertiary enrolment ratio in 1996. Human capital is usually measured by using educational attainments and/or enrolment rates (Coulombe et al, 2004). The data is gathered from the World Bank's official internet site.

The data on average population growth is taken from World Bank's official internet site. The closeness to Western Europe is calculated as the distance of the capital city of each country from Vienna.

The EU dummy variable takes the value of 1 if a transition country is a member of the European Union and 0 if it is not.

The War dummy variable takes the value of 1 if a country was involved in wars during the period 1996-2006 and 0 if it was not.

4.4. Empirical results

Table 3 below provides the results of the cross-country regression. There is a statistically insignificant relationship between fiscal decentralization and economic growth. The same result was obtained while controlling the country sample by dummy variables. The relationship between decentralization and economic growth is not different from the whole number in the non EU member countries or in the states with no war experience. The value of R^2 of the regression is very low as well as p values for the independent and control variables.

I acknowledge that there may be the mis-specification of the regression. More specifically a better indicator of economic development would have been GDP per capita or the Human Development Index. The data I rely on either is not a qualified measure for the respective control variables or the findings of the researchers about the positive relationship do not apply on the country sample I focus on. The evidence for that is that according to regression results the Institutional Development and Human Capital negatively affect the dependent variable.

My expectation about the direction of influence of independent variable holds, however the relationship is very weak. The higher degree of decentralization, expressed by the vertical fiscal imbalance, leads to more economic growth. Hence, transition countries with higher vertical fiscal imbalance have experienced a lower degree of economic development.

The distance from Western Europe, as I predicted, is negatively correlated with economic growth. Countries which are located farther have less chance to attract investment leading to economic development. Unfortunately, the relationship between the variables is insignificant too.

Finally, as the economic theory suggests, the impact of population growth on economic development is negative. However the relationship is statistically insignificant. I think that the significant correlation could not be detected because of the similar population growth tendencies for the last decades among the transition countries.

Table 3: Fiscal Decentralization and Economic Growth in Transition¹¹

	All transition countries	Non EU member countries	Countries with no war experience
Initial GDP per capita	-4.02E-005 (0.367)	-7.30E-005 (0.628)	-1.44E-005 (0.806)
Institutional Development	-0.101 (0.619)	-0.544 (0.15)	-0.179 (0.544)
Human Capital	-0.01 (0.316)	-0.019 (0.168)	-0.013 (0.384)
Distance	-2.43E-005 (0.787)	-8.82E-005 (0.466)	-4.40E-007 (0.997)
Population Growth	-0.096 (0.419)	-0.116 (0.431)	-0.344 (0.195)
Vertical Fiscal Imbalance	-0.128 (0.844)	-1.157 (0.408)	-0.299 (0.698)
R^2	0.217	0.377	0.271
<i>Number of Observations</i>	27	16	18

The empirical research conducted leads to the generalization of our findings and to proposing future policy implications for Georgia, which is the aim of the next chapter.

¹¹ p values are given in parenthesis

Chapter V: Lessons for Georgia

What lessons can we learn from the empirical research? If decentralization does not lead to economic growth, why should countries follow such reforms? Why does the degree of decentralization vary across countries? How should decentralization reforms proceed in transition?

First of all, we can infer from the cross-country regression that in transition countries there is no direct linkage between decentralization and economic growth. This supports the hypothesis of Guess et al (1997) that the direct connection between the two can not be established. There are varieties of political and economic factors which affect development more. This is the case especially for post-Soviet Union, where frequent changes of the political elite have often has led to social and economic instability. It is important to mention that economic growth in these countries highly depends on export of raw materials (such as oil in case of Russian Federation and Azerbaijan) which is under the control of the central government. In case of Georgia, according to the Department of Statistics, almost 80 percent of exports consist of raw materials (wood, steel, animals, and agricultural products). In such circumstances decentralization reforms will have little influence on growth.

Time span is another important factor. In most countries sound economic reforms started in the middle of 90s. Devolution of power from the center to the regions began later and in most post-Soviet countries the process is still ongoing. In such a short period of time the positive affects of decentralization are difficult to detect.

Empirical research shows that the variance among the transition countries in the degree of decentralization can not be explained by economic factors. I think it should be viewed from the historical point of view. In some of the transition countries the formation of municipalities,

parallel to the restitution process, was the return to pre-Communist territorial organization. This is the case for Central and Eastern Europe. In post-Soviet Union the municipalities were mostly formed under the scope of “raion” level which had been the lowest territorial unit in communist era. Some countries (Georgia, Armenia) had the attempt to departure from the communist tradition, however reforms fail. In Georgia fragmented municipalities were unable to provide adequate services, which led to amalgamation in 2006. The lessons we can infer are that the culture of self governance among the population is weak because the former Soviet Union countries had lived under the Russian Empire for over one century.

The empirical research has shown that although decentralization does not promote economic growth at least it does not hamper it. This leads us to suggest that countries should focus on political rationales for decentralization rather than on economic ones, especially in ethnically diverse societies. Transferring power to lower tiers of government could increase the political representation of a variety of local interest groups. Minorities and local groups in post-Soviet countries which blame the government for being excluded from participating in political processes will be more represented. Representation of diverse interest groups will lead to creation of prerequisites for civil society foundation too.

The political benefits of decentralization in Georgia can be reaped more than in other transition countries. The need for political change, towards fiscal federalism is necessary for Georgia for the following reasons: First of all, the country *de jure* has two autonomous republics: Abkhazia, and Adjara. Abolishment of autonomous status of South Ossetia by the parliament of Georgia in 1991 led to territorial conflict later on. Secondly, Georgia is an ethnically multinational society. The population of Georgia speaks three languages: Georgian, Abkhazian and Ossetian. Thus, the Georgian language has two sub-dialects, Mingrelian and Svanetian, which are completely different from official Georgian language. Thirdly, the country is religiously diverse.

The majority of Georgia's population is orthodox Christians, and ethnic Georgians in the autonomous republic of Adjara are Muslims. Forth, the population of Georgia differs region by region. The difference can be seen in culture, physiology and social habitats. The reason for that is the fragmentation of the country into kingdoms in the 15th century which were reunified under the Russian Empire in the 18th century.

In order to achieve political goals, the decentralization process should be organized carefully. While designing reforms, the experience of developing countries especially that of Latin America should be taken into consideration. The transfer of excessive power to sub-national governments can undermine economic stabilization. There must be a strong central authority which monitors, evaluates and leads the decentralization process. This requires the establishment of sufficient data collection mechanisms and well trained staff. It also needs the foundation of adequate legal procedures and political institutions which regulate the competences of each level of government. It is important to mention that reforms should also include the middle tier levels of government which are often omitted in the decentralization process.

In almost all post-Soviet Union countries the necessary institutions are lacking from the political arena. This is also the case in Georgia. The political and economic power is concentrated in the central level. The president of Georgia has the right to dismiss parliament; He also has the legal right to appoint and dismiss judges, which makes the political game between levels of government *a priori* unfair. The lack of political culture and the legacy of communism make political parties completely dependent on the will of a particular leader. Consequently, the political party arena can not compensate the lack of institutional mechanisms, which makes formal cooperation between levels of government almost impossible.

Decentralization is a political act, an opportunity imposed by political change. Without establishing necessary political institutions which are independent from the control of central

authorities, the political benefits of decentralization could not be achieved. Politically dependent sub-national governments will have inadequate financial resources to implement the political and social preferences of the population which will undermine economic benefits too. Building adequate political institutions is the first necessary step toward reforms needed in post-Soviet Union. Without establishing political mechanisms the decentralization reforms will fail, which will give the opportunity to central authorities toward further centralization.

Conclusion

The aim of the MA thesis was to assess the affects of decentralization in transition countries in order to draw lessons for Georgia. The first part of the paper was focused on the overview of the decentralization literature and its development in the 20th century. The literature shows that political and economic rationales for decentralization, which have been highlighted in the First and Second Generation Fiscal Decentralization literature, are often challenged by part of academia skeptical about the affects of reforms in developing countries. They argue that the consumer mobility hypothesis does not hold in developing countries while sub-national governments are politically dependent on central ones. The lack of capacity and accountability in local levels will undermine the efficiency of service provision and negatively effect economic growth, income distribution and wealth.

The document analysis of empirical researches conducted by scholars shows that the effects of decentralization are contradictory. Part of empirical literature reports that there is a negative relationship between decentralization economic growth and stability so power should be centralized. On the other hand, another group of scholars proves a positive relationship and argues that power should be decentralized in order to improve the economic performance. However, some researches show that the relationship between economic variables and decentralization could not be established because of a variety of reasons.

The third part of the paper is devoted to empirical research. The relationship of decentralization and economic growth has been tested in order to assess the impact of decentralization reforms in transition countries, especially in the post-Soviet zone. While conducting econometric research I failed to find any statistically significant relationship between decentralization, measured as the vertical fiscal imbalance and economic growth, measured as

natural log of GDP growth. It supports the hypothesis that the linkage between the two is hard to detect especially in developing countries; decentralization and economic growth are influenced by other variables.

Based on empirical research, lessons for Georgia are provided in the final part of the paper. Despite the fact that there is no statistically significant relationship between economic growth and decentralization, the focus should be on the political rationales of the process. Decentralization is the political opportunity to change the political and administrative organization in order to increase accountability, citizens' participation and transparency in the public sector. In ethnically diverse societies, like in Georgia, decentralization is the way out of the political stalemate. Transferring the power to sub-national governments can reunify states suffering from ethnic conflicts. However, the process of reforms should be organized carefully in order to achieve the planned results. The key role should be played by politically neutral and independent institutions which guarantee the "fair play" of different levels of government.

Appendices

Appendix 1

Descriptive statistics of variables

	N of observations	Minimum	Maximum	Mean	Std. Deviation
Initial GDP per capita	27	176.84	14570.45	2374.8126	2885.82442
Institutional Development	27	-1.830	.770	-.37259	.680269
Distance	27	56.00	4488.00	1555.7037	1402.03903
Population Growth	27	-2.56	1.67	-.1359	.93365
War dummy	27	.00	1.00	.2963	.46532
EU dummy	27	.00	1.00	.3704	.49210
Vertical Fiscal Imbalance	27	.15	.79	.4077	.17210
Natural log of GDP growth	27	4.75	6.82	5.6178	.44838

Appendix 2

Variable data by Country

Country	Initial GDP per capita	institutional development	Human capital	Distance from Vienna	Average population growth	Vertical Fiscal Imbalance	GDP growth (percent)
Albania	983.761	-0.22	12.02	812	0.00	0.34	303.1
Armenia	421.274	-0.47	12.22	2405	-0.78	0.49	401.4
Azerbaijan	409.191	-1.02	17.43	2788	1.00	0.28	623.8
Belarus	1,425.37	-0.71	43.75	999	-0.22	0.345	255.1
Bosnia and Herzegovina	833.649	-0.96	15.93	509	1.67	0.3	375.0
Bulgaria	1,203.66	-0.25	41.2	818	-1.22	0.45	309.1
Croatia	4,421.75	-0.34	27.88	269	-0.56	0.29	213.7
Czech Republic	6,011.54	0.77	23.52	252	0.00	0.15	228.7
Estonia	3,257.98	0.58	41.81	1357	-0.44	0.55	353.4
Georgia	651.62	-0.82	41.96	2341	-1.11	0.33	257.1
Hungary	4,375.71	0.62	26.03	233	0.00	0.65	253.0
Kazakhstan	1,349.64	-0.73	33.05	3897	-0.67	0.313	369.7
Kyrgyz Republic	389.204	-0.40	11.82	4488	1.11	0.278	155.7
Latvia	2,261.68	0.11	33.33	1096	-1.22	0.72	351.3
Lithuania	2,241.35	0.16	31.43	948	-0.78	0.43	369.0
Macedonia	2,235.79	-0.38	19.51	841	0.22	0.69	141.4
Moldova	471.033	-0.32	26.52	946	0.00	0.44	191.3
Poland	4,056.01	0.52	39.32	565	-0.22	0.47	216.2
Romania	1,565.73	-0.29	22.5	866	-0.22	0.23	345.2
Russia	2,641.77	-0.79	41.31	1674	-0.11	0.392	249.9
Serbia	2126.48	-1.19	21.91	492	-2.56	0.36	352.4
Slovak Republic	3,989.51	0.28	22.08	56	0.00	0.68	257.2
Slovenia	14,570.45	0.74	37.97	279	0.00	0.79	129.0
Tajikistan	176.844	-1.83	20.45	4292	1.00	0.325	267.2
Turkmenistan	566.496	-1.42	19.79	3556	1.11	0.25	918.3
Ukraine	872.738	-0.66	41.76	1054	-1.00	0.274	237.8
Uzbekistan	609.713	-1.04	36.61	4171	1.33	0.19	115.6

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