

# Fiscal Decentralization and Regional Development

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## Abstract

The economic and financial effects of fiscal decentralization have been reviewed. The effects could not be argued conclusively because circumstances and institutions differ from country to country. Several studies done for the high income countries show economic efficiency through fiscal decentralization cannot be earned. In the case of Korea, any policy measures for further fiscal decentralization within the existing framework should be careful because economic efficiency cannot be accrued in no uncertain terms. Regional development cannot be carried out by the hands of the central government. Furthermore, balanced local development needs a concerted approach by all level of governments as well as many private enterprises. The existing imbalance, between rural areas and large metropolitan areas, and between capital region(Seoul Metropolitan Area) and the other regions, cannot be alleviated by the leverage of fiscal policy tools alone. A dual system of fiscal scheme, which deals rural areas and prospering urban areas with different fiscal design, is suggested to cope with the dissimilar problems. Especially, it is highlighted that many urban local governments should propel self-efforts to consolidate their fiscal capacity.

**Key Words:** fiscal decentralization, fiscal autonomy, local revenue and expenditure, regional development.

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## I . Introduction

After overcoming the centralized system of government operation in 1980s, local autonomy system was reintroduced as a way of deepening democracy in the Korean society. Decentralization reform was carried out in the form of holding local elections to form a local self-governance. Administratively, tasks that had been carried out by the central government has been transferred to the regional(wide area) and local(basic) governments step by step basis. Despite concern over inefficiencies and poor capacity of localities, the system has been stabilized

and smoothed for the way of local democracy and better governance.

Decentralization advocates, which includes scholars of the related disciplines and indigenous local residents and free market liberalists, argued a wide variety of benefits and attained a great deal of legitimacy. They believe devolution, which means transferring of power from the central government to subordinate regional bodies, without (unlike federalism) leading to shared sovereignty, should be accompanied consolidation by fiscal decentralization. In the federal system of government fiscal federalism does the same role.

Fiscal decentralization connotes, in a narrow sense, the devolution of power to sub-national governments to raise tax revenues and decide on their spending programs on their own will. Legal framework, if institutionalized in fiscal and administrative spears, will help substantiate fiscal decentralization as well as devolution of functions. There are many theoretically favorable arguments for fiscal decentralization in accordance with devolution of the national government functions and tasks to sub-national governments. At the same time, however, it is true that there still are ambiguous and dissimilar arguments regarding the effects of fiscal decentralization in high income countries as well as emerging nations.

In theory, it was argued that fiscal decentralization contributes to efficient local policy that results in regional development and higher residential wellbeing. Local government know damn well what their residents want. And they do exactly what is the order of priority for local government expenses. But decentralized use of fiscal resources inevitably results in inequities among rich and poor regions. If there is spillover effects and economies of scale of supplying local public goods and services, the favorable arguments became weak and, in some case, national efficiency loss will be brought to realization. It is, however, very hard to find any coherent finding of the real and/or empirical effects of fiscal decentralization up until now.

In this paper, theoretic arguments of fiscal decentralization are investigated. Next, economic effects of fiscal decentralization will be reviewed and issues related to regional balanced development explored in the context of the Korean situation. Fiscal decentralization is defined from many aspects and each definition goes hand in hand with different finding. Major empirical studies, which pertain to the relationship between the fiscal decentralization and economic development, are reviewed and contrasted.

For the last 25 years, a unique devolution process, in political as well as administrative arenas, has been carried out in Korea. Full fledged local autonomy system has been reintroduced after provisional one generation's halt, and the central government has initiated, in various ways, transferring the government function and financial resources to regional and local governments. Fiscal decentralization, in a broad sense, has also followed the functional devolution process with varying fiscal schemes and rearrangement of local fiscal management tools. The fundamental

characteristics of the Korean intergovernmental relation (relation between the central government and local government) has undergone substantive change and innovation.

After discussion of the economic effects of fiscal decentralization, its relation with regional development will be examined. Traditionally, in the developmental state, the role of the central government has held predominant position. As decentralization proceeds, the regional and local governments have taken parts of the role of the central government, especially in the areas of infrastructure building, local economic development, community development and some portions of complimentary welfare service delivery, and so on. The role of the sub-national government in relation to regional development will be discussed in the context of the current Korean development stage and center-local government relation. And foreseeable effects of fiscal decentralization to regional and local developments are discussed. As a way of developing institutional design, a differentiation of fiscal decentralization scheme will be suggested. Regions and localities are grouped into two different areas: (1) rural areas, including small and medium sized cities, and (2) large metropolitan cities. And different institutional design for financial resource mobilization method is suggested.

Strong arguments for furthering devolution are well heard in the circle of the scholars who study local politics and administration. They also argue that more fiscal resources are allocated in favor of regional and local governments: by transferring the national tax base to local tax base and increase of the size of general grants-in-aid. Nevertheless there are many counter arguments mainly coming from businessmen and economic scholars: they point out the existing system has raised inefficiencies in the local governments and lack of responsibility for their fiscal health. Local governments relying on financial resources from the central government can not be operated autonomously and efficiently. Potential efficiency loss of specific subsidy programs requiring high ratio of matching is well known. They perceive the real cost of a program seriously less than the total budget which comprises of the local money and fund from the central government. Local government does not stir a finger about finding its own source of revenue. It is also true that there is serious criticism about bureaucratic management of intergovernmental financial relation.

Balanced regional development is a hot political issue in Korea. Financial resources transferred to a specific locality will certainly help the local government carry out its developmental programs. Needless to say, every local government expects a financial decentralization scheme which treats the local government most favorably. Existing scheme of fiscal transfer and coordination and items of expenditure should be analyzed in detail in order to find out its effects on regional development. A presumption that fiscal decentralization will deteriorate the resident's income equality and balanced regional development cannot be

validated. A creative scheme of fiscal coordination which, within the constrain of total national and local fiscal resources, should be designed to ameliorate the present inequality and imbalance.

In this paper, an alternative system is suggested: introducing a new dual system of fiscal intergovernmental coordination, reduction of local matching ratio of national subsidy system, transfer of a couple of national tax bases to large cities, adjustment of public pricing system reflecting fair market price, substitution of public goods and services by the private goods and services, and direct voucher from the upper level of government.

## II. Fiscal Decentralization: Theoretic Arguments

The economic functions of the government were focused in three categories: growth and efficiency, stabilization, and equity and redistribution. Musgrave argued that out of the three main functions of the government, only allocation function may be shared by different levels of government. (Musgrave, 1959) Its financing should be relied – to a maximum extent possible – on the benefits-received principle in order to preserve fairness and economic efficiency.

Local government does not have financial and fiscal policy tools that the central government utilize to stabilize the economy. Functions such as promoting exchange rate stability, controlling inflation, and ensuring common internal market were carried out by central government. And, excessive redistribution policy by a single local government will induce lower income families move into its jurisdiction, raising welfare demands and putting burden to its budget constraint. Therefore any local government will nor afford to appropriate level of welfare for the resident. That's why the national government tries to keep national minimum through the uniform standards which are specified in welfare related laws.

At the same time, every central government controls local debt, which is not intended to finance investment, in various ways, such as, a credible no-bailout policy, debt ceiling, oversight and screening of the borrowing. Controlling debt or borrowing will contribute enhancing stabilization and ameliorating redistributive- oriented incentives of the local government.

Fiscal decentralization, which involves the devolution of government fiscal responsibilities to lower levels of governments, was advocated on the ground that it enabled better resource allocation by finding productive way of expending public money, that is, by more appropriately adapt to regional and local conditions. Allocation of locally needed goods and services by the hand of local government was considered efficient. Tiebout initially emphasized local autonomy in resource mobilization and set out diverse conditions of local financial arrangement that should be considered in public expenditure decision making. (Tiebout, 1956)

Diverse public good provision and pricing system which reflect different local conditions will contribute enhancing efficiency. And it is better system than that having a nationwide uniform pricing mechanism: less uniform, more efficient. Also, competition among different regional and local governments, if any, promotes lower tax and, at the same time, efficient provision of local public goods under same revenue constrain.

Oates took Tiebout's thinking as a starting point in developing a more comprehensive theory about the optimal level of decentralization. (Oates, 1972, and 1993) The 'diversification theorem' or 'decentralization theorem' maintains that national uniform levels of public goods and services across jurisdictions will generate inefficiency. This theorem, of course, requires no spillover effects and scale of economies. He identified a trade-off in arguing for the efficiency of local provision of public good and services: responsiveness of government to local preferences v.s. capacity to internalize externalities and achieving scale economies. (Lockwood, 2002)

It is inefficient for local government to provide public goods and services whose beneficial effects spill over into adjoining constituencies. If there is economies of scale in provision of public good and service, the upper level government is at the better position to carry out the task more chiefly. They believe people can move easily and the central government is unable to target bundles of public goods and services to different region nor meet heterogenous local preferences relevant way.

Many scholars, regardless of their ideological orientation nor speciality, majors, or concentration, argue that decentralization encourages to provide their residents over particularistic goods and services in the first place. Think about any specific welfare services for the elderlies and disables. Members of the family is the person who best knows the specifics of particularistic help needed. Also the communication between the member of the family and public servant of the local government is the most efficient and effective way of designing welfare service delivery.

A number of empirical researches have examined the effects of fiscal decentralization. Some studies have found that fiscal decentralization contributed improvement of education services and formation of local human resources and reducing poverty, and so on. Some studies concluded that fiscal decentralization leads to slower economic growth and some have found the opposite relationship in developing countries. (Smoke, 2006)

### III. Dimensions of Fiscal Decentralization

Here, we should be careful when we use the term of fiscal decentralization: the term has many

facets of meaning. It can be captured from the revenue side as well as expenditure side. Attention should be paid to the composition of the financial resources. Each subsidy has its own conditions and requirements of resource mobilization: some are specific and some are general (block) in categorizing spending breakdown (details of expenditure) and each country has a unique characteristics for its revenue sharing and general intergovernmental grant scheme.

First, the most narrow definition involves financial independence rate (FIR) of local government. This indicator represents the true independence of the local financial capacity because the formular does not includes any resources from national government: It does not includes general grants-in-aid and other adjustment grants and compensation grants. The rate equals to the share of local government's own revenue out of national total revenue, which is usually called local fiscal independence rate(ratio). Here, local government means both of basic level local government and upper level local (regional) government. For more detailed analysis, the two levels can be treated separately. The indicator above corresponds to the most approximate measure of the allocation of autonomy when local government has full authority and discretion of deciding the local tax base and rate.

Second, a broad definition involves realistic autonomy of a local government fiscal capacity. For his definition, outside resources without strict strings is treated as an autonomous resources from the local government. Here, general grants-in-aid, adjustment grants and compensation grants are included as a autonomous fiscal resources because a local government can allocate revenue from these grants to its expenditure breakdown without any direct control from the upper governments. General grants-in-aid from the central government comprises a large share of revenue, especially for small rural local governments. Its share out of internal tax collected is legally fixed. And the distributional scheme among local governments is handled by the hands of central government bureaucrats. Each local government makes free use of the transferred resource. The grant is an important fiscal equalization scheme, reducing local fiscal disparity, but causes fiscal capacity reversal among various local governments. Although an analysis can come of with specific rate or ration, it is limited in delivering true meaning of fiscal decentralization, because no local governments in Korea have full discretion over the local tax base and rate. In this sense, careful qualification is essential.

Third, expenditure side indicators can also be used for finding out the level of fiscal decentralization. Category of expenditure contains useful qualitative informations pertaining to matching methods and control from the upper government. The share of a local government expenditure without control from the upper governments out of combined total expenditure, which includes grants that are conditional and required for matching fund, shows the degree of expenditure autonomy. Usually the formularr for the lump-sum grants (general revenue sharing,

general local grant tax, general local subsidy, general grants-in-aid) is designed by the upper level governments, and authority associated with spending is in the hand of local government. But categorical subsidies, which usually requires high rate of local matching fund, reduce local autonomy and the total money expended cannot be interpreted as fiscal decentralization.

Fourth, diverse combined indicators from revenue and expenditure side classifications also serve measuring fiscal decentralization. Actually, several researches used combined indicators. But some of those statistical composite indicators could not be clearly interpreted semantically.

When we design or reform a system of fiscal intergovernmental relation, we should pay attention to economic principles should be more concerned. The principle of subsidiarity should be put emphasis. At the same time, spatial distribution of income and balanced regional development should be carefully examined. The situations each local government faced is quite heterogeneous reflecting differing demographics, composition of industries, qualification of human resources, economic openness, and so on. Therefore, appropriate definition of the fiscal decentralization should be used for designing a specific policy.

## IV. Empirical Findings: focusing on economic growth

Empirical studies explored the relationship between fiscal decentralization and economic growth of region and nation. Despite the theoretical prediction that fiscal decentralization improves the efficiency of government and public sector and promote economic development, as summarized in the previous section, none of the recent studies has been successful in precisely substantiating or verifying the potential contribution of fiscal decentralization to economic growth. (Akai and Sakada, 2002, Im 2010) The findings obtained in major previous studies can be briefly summarized as follows.

(1) There are several studies that found negative relation between the two variables. In the case of China, based on the panel data covering the local reforms of the late 1970s, a study found that fiscal decentralization reduced provincial level economic growth. Negative relation between fiscal decentralization and the growth of 28 provincial incomes during 1986-1992 was founded. (Zang and Zou, 1998) They attempted to explain their results by taking infrastructure project as an example: infrastructure project planned and carried out by central government has wider and greater impact than equal amount of separated several similar projects introduced by several provinces.

Another study found similar outcome: using time-series data for the United States during the years of 1948-1994, further fiscal decentralization may be detrimental to economic growth.(Xie

et. al. 1999) These two studies cover a period of high economic growth in China and the United States, respectively.

(2) There are indefinite studies, too. In case of 46 developing and developed countries, covering the 1970-1989, a negative relationship (but not statistically significant) was found for developing countries and no clear relationship for developed countries. (Davoodi and Zou, 1998) It is commonly pointed out that the problem of using cross-country data is neglecting significant differences in historical, cultural, and institutional characteristics between countries. It is difficult to control those differences across countries and single out the true effects of fiscal decentralization on economic growth of each country.

Woller and Phillips reported no significant relationship between the ratios of sub-national revenues and expenditure to total revenue and expenditure using average data for 1974-1991 for 23 developed and developing countries. (Woller and Phillips, 1998).

Another recent study, which covers the periods of 1972-2007, and dealt with 63 countries, which were divided into three categories, developing countries (under per capita GDP, us \$10,000), semi developed countries (between us\$10,000-30,000), and developed countries (above us\$ 30,000), came up with different relationship for the different categories of group. A negative relationship for the developing and semi developed groups was found, and no relationship for the developed countries, which is similar to the finding of the above study. (Im, 2010)

Thiessen, covering high and middle-income European countries found that the two variables have limited relation. (Thiessen, 2000) In his later studies (Thiessen, 2001 and 2003), he argued that the benefits of the fiscal decentralization on economic growth and capital formation are limited. He also reported a positive relation between the fiscal decentralization and growth when decentralization is increasing from low level, but that as decentralization increased, the relation eventually turned negative in a cross-section of high income OECD economies using annual data for 1973-1998.

(3) However, there are studies that found positive relation between the two variables. Yilmaz, who distinguished between unitary states and federal states in a panel study of 46 developed and developing countries using annual data for 1971-1990, found that fiscal decentralization had a positive and statistically significant impact on growth in unitary states.

Lin and Liu found the opposite result to the previous Zang and Zou study. They found that the fiscal decentralization reform measures in the mid-1980s, which increased marginal retention rate of national budget revenue collected at the provincial level, contributed per capita GDP growth in China through the channel of resource allocation efficiency. (Lin and Liu, 2000)

Im, also, found, employing instrument variables technique, fiscal decentralization was beneficial due to significant increase in per capita GDP it creates with cross-country data for 51

developed and developing countries, covering the years 1992-1996 period. Another study, using data from 50 states of the United States, found a positive relation between the two variables. (Akai and Sakata, 2002) The periods covered in the study was years of 1988-1992, in which economic growth was not so high. Also there are no substantial historical and cultural differences across the 50 states.

Another study attempted to find out the relationship between fiscal decentralization and national competitiveness. They found that revenue side decentralization had positive effect on national competitiveness and expenditure side decentralization had positive effect only when the income level was high. (Ha, Ha, and Moon, 2013) Because economic growth becomes favorable condition for national competitiveness, the positive relation they found cast positive implications for the relation of the two variables above.

Definition of fiscal decentralization is important and may have crucial effects on empirical findings. For example, Akai and Sakada study used the share of the 'own' revenue of sub-national governments out of total government revenue and did not found statistically significant result. If they added subsidies with no strict control from the upper governments to the 'own' revenue, the result might be different. In order to find true financial autonomy of local government, local tax system, user charge for local service, local debt, and various kinds of subsidy schemes should be analyzed in detail. The same problems with measurement occur when expenditure side definition is employed.

Sub national discretionary tax revenue out of total national and sub national tax revenue is rather small in many countries, such as, United Kingdom, Austria, Germany, New Zealand. In cases of Switzerland, Sweden, Demark, and Finland, the share of local tax shows about 20% of the total tax revenue. In these cases, including the Korean case whose local tax share is about 20% of the total national and local tax revenue, unconditional transfer program should be analyzed. Also, in finding out the effects of fiscal decentralization, the share of total tax out of GDP(Gross Domestic Product) should be carefully taken into considered. When the share is rather small, its effect on economic growth will be small. The private economic activity plays more significant role.

## V. Regional Development: A Fiscal Standpoint

Regional development is an important issue to deal with from the standpoint of fiscal policy. Balanced regional development is one of the goal of fiscal institution of a country. In fiscal policy area, the emphasis on decentralization should go side by side with vertical fiscal balance.

Regional development and economic growth cannot be determined by the level of political, administrative, or fiscal decentralization alone. The relationship between the state and the market is crucial to advancement of the economy as well as society. Fiscal decentralization contributes local and regional development in a limited way. Empirical study found out that income inequality reduce economic growth. (Xie et. al., 1999 and Akai and Sakda, 2002) Korea has the problem of excessive concentration in Seoul area. Every government put serious attention to regional balance without having some notable results. Recently regional innovation system and openness of the urban economy has been emphasized. (Lee, 2005, p. 707)

Balanced regional development will significantly improves efficient use of national territory, also reducing congestion costs raised in the overcrowded Seoul area. At the same time, it will contribute to strengthening the base of upgrading national welfare minimum in the areas of agricultural, mountainous, and fishing rural villages which are left behind during the process of urbanization. The important fiscal policy question, still pending, is the appropriate distribution of government and public sector resource and competence among the regions of different conditions and potentials.

With fiscal decentralization, which emphasize self-reliance and autonomy, the balanced national living standard is not able to be realized: poor localities do not have enough discretionary revenue and fiscal capacity because of weak tax bases. If there is no prosperous private sector in the region, decentralization inevitably results in inequities. Small rural local governments in the many Asian countries, even though they are able to attain some level of local democracy, has shown difficulties in upgrading its developmental capacity and quality. They faced disadvantageous conditions in attracting outside investment and qualified manpower, resulting in poor quality of public service and inefficiencies.

Therefore, the central government has strengthen fiscal equalization role through grants-in-aid system and various subsidy schemes. General grants-in-aid, which does not have any strings or regulations, helps the localities to carry out their development programs. When the various subsidy scheme requires matching fund from the local government and is regulated from the central government. The share of specific government subsidy is very high and the central government does not trust the local government capacity of fiscal management. The central government controls even minor handling of the subsidy administration and frequent auditing hinders autonomy and motivation of the local government.

In many small rural localities have faced economic recession and does not have effective tax base. Their population size is decreasing and they show signs of premature old age. They cannot carry out their basic function without transferred fund from the upper level governments. So they rely on upper level governments for revenue and do not have incentive to develop fiscal capacity

and their motivation is very low. They often complain their obligation of match fund needed in the area of public health and welfare.

Heavy share of transfer fund, even in the urban area local government, demolishes volition and self-effort of mobilizing their financial resources. They expect financial helps from the upper level of governments. Policies and institutional redesign should be pursued in order to encourage localities with moderate economic potentials cultivate their fiscal capacity and discover new financial revenue.

## VI. A Dual System for Regional Development

### 1. Vertical Fiscal Imbalance

The Korean system of fiscal intergovernmental relationship is evolved into a complex system as it has experienced several changes and adjustments. Heavy reliance on the transfer resource from the central government results in actual reduction of fiscal autonomy in the local government. And heavy rate of local matching fund reduced autonomous capacity for capital investment for regional development.

The present system can be summarized as follows. First, the share of general grants-in-aid is very high and can be divided into four categories: (1) most importantly general grants (revenue sharing for general local administration and educational administration, which is unconditional grants based on formular), (2) special grants for contingencies, (3) real estate grants, and (4) fire fighting and security grants.

Second, central government subsidy can be divided into two categories: (1) government subsidy (block and specific subsidies, usually require matching fund from the local government), and (2) special regional development accounts.

And lastly, coexistent local development fund, which is a kind of horizontal financial transfer system, introduced in 2010 when local consumption tax was introduced. Basically, the fund has been used by less developed localities.

Total local revenue which includes local tax collected and fiscal transfer after 1991 showed upward increase every year, except two years: the transfer of public finance decreased only two years, in 2002 and 2003, because of economic crisis. Formally, revenue side fiscal decentralization has been accelerated after introduction of local autonomy system. But vertical fiscal imbalance has not been ameliorating. Fiscal autonomy of the local government plummeted to 73.45%, which is decreasing from 77.22% in 2012. And fiscal independence ratio stays at

50.33% in 2014, and 50.56% in 2015. Although absolute size of the local expenditure has been increased, the autonomy or independence of the local fiscal management has been marginally improved.

Various proposals for realizing actual fiscal decentralization have been studied. (Im, 2016 and Rha 2014) Im found that 37.2% of the local expenditure is central government subsidy which brings stings and controls with the transfer. Especially social welfare expenditure in the local government bears heavy duty of matching responsibility, reducing local fiscal autonomy. Based on the findings of the previous studies, some idea of system change will be discussed in the following chapter.

## 2. Dual System of Fiscal Decentralization

### 1) Differences of the Rural Government and Large Urban Government

As mentioned above, the economic conditions among local governments in Korea is very diverse and fiscal capacity shows big difference. Therefore, the government introduced complex formularr system of general grants-in-aid and differing matching ratio for government subsidy and local adjustment subsidy. Present system, however, shows limitation in ameliorating regional development inequity and, at the same time, improving fiscal autonomy for local governments. The present system of intergovernmental fiscal relation is at best keep national minimum in public service.

Due to over-concentration of economic activities in the greater Seoul area, horizontal fiscal imbalance could not be ameliorated easily. The fiscal equalizing functions of the general revenue sharing system has shown hopeless limitation in bringing about balanced local development. There is a statistic that shows inequity of horizontal fiscal balance: (e/t per capita) per capita local expenditure divided by per capita local tax. In the rural county, for the 25 years (from 1991- to 2015), e/t per capita average is 10.4 (ranging from 6.3 to 13.0), in the city and in metropolitan district 3.6 (2.5-4.1) and 4.4 (3.3-5.6), respectively. It is evident that there is big difference of own fiscal capacity among the rural local government. As city gets bigger, the difference becomes smaller. The upper tier of the local governments show a little difference, in provinces the average of e/t per capita is 1.5 (1.3-2.0) and in metropolis 2.8 (1.4-3.3).

The population range of 88 rural counties spreads from 10,153 to 219,419 in 2015. The following table shows population size of basic level local governments in 2015. 50(2+48) local governments has only 3.6 (0.1+3.5)% of total population.

**〈Table 1〉 Population of Basic Local Government (year: 2015)**

Size	# of Governmnt	% of Total Population
under 20,000	2	0.1 %
20,000– 50,000	48	3.5%
50,000–200,000	81	17.1%
above 200,000	105	79.3%

Range of population size of basic level of the local governments is from about 10,000 to about 1,200,000. In addition, as can be seen in the following table, the population of rural counties will decrease to a very small in the near future.

**〈Table 2〉 Forecast of Population Size in 2030(Basic Level Local Governments)**

Size	# of Local Governmnt	% of Total Population
under 20,000	27	0.7%
20,000– 50,000	47	2.7%
50,000–200,000	59	11.9%
above 200,000	93	84.7%

So, it is not an appropriate system that a single fiscal transfer arrangement covers for the diverse 226 basic level local governments with huge differences in terms of population, economic structure and size, and residential environment.

Fundamentally different financial systems for different localities should be developed: local fiscal conditions of the agricultural, mountainous, and fishing localities are too different to be treated same way as other larger urban governments.

Rural county governments, in which demand for public goods and services may be relatively low and homogeneous, with low level of fiscal independence, barely manage to keep the national minimum level of public service provision, and can not find any alternatives of private provision public services. Also, their population size will be decreased in the near future. Large cities, however, have large population and various business activities, and the residents have sensitive income elastic demand for public services. Urban governments have relatively diversified tax bases and user charge system can be applied to a certain services they provide. Also, they are able to find alternative provision of public services through hands of private and non-profit entities. Urban development is determined, to a large extent, by the private sector investment and business activities. Based on the above observations of essential differences of the rural and urban conditions of the basic level local governments, the following two different and separated systems of fiscal coordination are proposed.

## 2) System A: Small Rural Counties

75 out of 226 total local governments could not afford to pay for the local civil servants' payroll costs with their earnings. The local governments whose fiscal independence are below 10% includes 52(out of 82) rural counties, 4(out of 75) small cities, and 3(out of 69) urban districts. They can not find additional tax base. Or switch over of national tax to local tax does not enhance small rural local governments because objects subject to taxation is very scarce.

Only, the idea that some of the liquor tax, which is presently a national tax, can be transferred to local tax, seems attractive. Local liquor business is located in several rural and small city areas in Korea, and the prospects for a local government to invite the business seems better than any other businesses.

Rural counties have faced similar difficulties in terms of population decrease and aging phenomenon, and their pattern of expenditure turns out very similar. Several small cities and urban districts have been recommended to be consolidated with nearby localities to expand their fiscal capacity.

Of course there is some differences among the sizes of their revenues. But almost all of them heavily rely upon the central government's help, such as, general grants-in-aid (unconditional grants) and various specific welfare related subsidies. A study found that the Theil index of the rural local government expenditure size distribution became smaller and smaller, indicating their total amount of public resources have been equalized.

Their fiscal autonomy is very limited because they receive most of the fiscal resources from upper level of governments. This is inevitable because their fiscal capacity is very limited and their local economic activities are dwindling away into minimal stage. Also, population size gets smaller and the residents gets older. Local innovation potentials is decaying and endogenous capabilities for promoting local industry is diminishing very rapidly. They expect strategic promotion of regional industry with collaboration of big business and central government help.

For the local governments in this category, their share of local tax collected out of total tax collected (local tax + national tax) will not be increased in the near future. When the index of fiscal decentralization measured at the revenue side, there is some room for increasing fiscal decentralization and some fiscal autonomy. The local revenue sharing with the central government (general grants-in-aid) does not have any strings except the fact that the amount was decided by formular designed by the central government. Also, the local adjustment grants coming from the provincial government does not have many strings. However, the resource that can be transferred to the category of local governments seems very limited.

When the fiscal decentralization is measured by the expenditure side, any room for enlarged

autonomy is also very slim. The share of local expenditure out of total expenditure (local government expenditure + central government expenditure) is expected to decrease as the population who reside in those rural counties gets smaller.

Fiscal decentralization for this category of the local governments cannot be easily deepened without more transfer of upper level governments' financial support. Their own efforts cannot contribute furthering original meaning of fiscal decentralization. There may be two channels of transferring fiscal resource from upper level governments: (1) more general grants-in-aid as mentioned above, and (2) reducing the local matching rate of various subsidies. Both of the two channels require additional transfer of money from upper level governments and higher fiscal dependency of the local governments.

Many specific grants have swarm in the welfare policy area and requires high level of matching fund, resulting in shrunk disengaged budget for business expenses. The basic level local governments can enjoy more freedom when the ration of matching specific grants diminishing and at the same time the shortage is covered by general grants (or increased revenue sharing) and increased share of the central related ministry budget of the central government. Actually, many studies pointed out that specific grant system should be changed for allowing more fiscal autonomy and efficiency. The same logic can be applied to education grant-in-aid system. A research on the quality of children's life showed that the index of metropolitan area was 110.7, small and mid-size city 98.38, and rural area 90.91. Especially in rural area, education and safety areas showed very vulnerable and needs adequate remedy from the government. (SNU. 2015) For the areas with specific vulnerability, the central government and wide area regional government should pay attention with more financial help.

In summary, for the small rural counties, revenue and expenditure fiscal decentralization can not be easily pursued further. The present subsidy system, however, should be changed in order to enhance fiscal autonomy by lowering the matching ratio.

### 3) System B: for Cities and Metropolis

Cities are the place for business innovation and vitality. Many large cities in Korea are prospering and have sound economic bases and their fiscal potential is high. There are wide range of variety among 75 Korean urban local governments (excluding metropolitan district governments), in terms of population, physical and cultural infrastructures, social composition, and economic structure. The population size of Suwon, Changwon, Goyang have reached more than 1 million and Sungnam follows. Their internal demand market revs up and their endogenous as well as exogenous development engine is still strong. At this time, several cities in Kangwon,

Chunbook, Chunnam, Kyungbuk and Kyungnam provinces have faced many barriers in reviving their economy. Among 75 cities, many cities are showing that their potential for lead economic challenge is still there. In regional development strategy, the gravitational sphere of the business is ever expanding. Although large manufacturing plants in the urban area have moved to outskirts or other East Asian countries, there still remains potential for economic vitality.

For large cities whose population size are over 500,000, local financial self-help should be urged. And some measure of switch over of national tax to local tax will help their financial self-reliance. Several efficient local taxes should be developed and adequate level of fees and user charges should be actualized to cover real costs. Property tax rate can be upwardly adjusted and higher percentage of actual market value of residential and commercial property can be considered in calculating the tax base. (Kim, 2004) Therefore, intervention as well as outside help of the central government should be cautious and dwindling.

Actually, in the large urban setting, the quality of its resident's life and regional development are, to a large extent, depend upon the private business and urban economy. In the large city whose business runs high power, the private sector is the engine of regional development, enlarging fiscal capacity for the city government. The key for fiscal decentralization lies in their efforts of establishing vibrant and sustainable partnership with their private sector.

For the high-density autonomous districts in metropolis should take positive actions for more fiscal decentralization, raising more district taxes and covering service costs by higher user charges. In an empirical research done with the data from states of the United States, came up with a conclusion that high level of local autonomy, measured by district's own revenue share of its total revenue, did not have any significant effects on income or economic benefits. (Akai and Sakata, 2002, p.102)

Although it should be careful in making interpretation and the above findings are subject to serious qualifications, high level of local fiscal autonomy in only a couple of districts in metropolitan area are not desirable. For example, public sector of KangnamGu (District), before sharing of its property tax with other districts, might have not significantly contribute to balanced economic development of Seoul metropolis.

In summary, fiscal decentralization in revenue side should be pursued further in cities and metropolitan areas. They should be encouraged to develop new tax bases and raise local tax rates. For example, property tax rate in the large cities and metropolitan areas can be adjusted a little bit upward for furthering fiscal decentralization. At the same time fees and user charge system should be widely utilized when they face revenue shortages. In the long run, higher tax and user charge burden in the metropolitan area will result in national even distribution of residence and population, eventually arriving at national balanced regional development. Similar

line of logic can be applied the present transfer income tax.

## VIII. Concluding Remarks

The effects of further fiscal decentralization in Korea can be hardly captured precisely. At present juncture, it may not be without costs: several studies found some negative effects of fiscal decentralization, no indication of improvement in the government efficiency. And impoverishment in rural, agricultural, mountain, and fishing villages is easily foreseeable. A comprehensive examination of the present fiscal distribution between central and local government without furthering fiscal decentralization seems urgent.

In this paper, the author proposed a dual system of intergovernmental fiscal relations as an alternative to the present system. Small rural local government and large metropolitan government have faced quite different conditions of fiscal capacity change, so they should be approached differently from each other. For the small rural counties, both of revenue side as well as expenditure side fiscal decentralization is not feasible. For them subsidy system should be redesigned in order to enhance fiscal autonomy of the local government by lowering the local matching ratio. As level of local matching ratio gets lower, total subsidy from the related central government ministries will increase.

For large cities, fiscal decentralization in revenue side should be pursued further, especially in major metropolitan cities. They should be encouraged to develop new tax bases and raise their tax rates. At the same time, higher level of fees and user charge system should be widely utilized when they face revenue shortages. The central government can adjust their burden in accordance with increase of local revenue. At the same time, the central government can ask provinces and metropolitan governments, ie. wide area regional governments, to take a more positive actions for locally balanced development. Fiscally horizontal equalization function of the regional governments is of importance.

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이달곤(李達坤): 하버드대학교 대학원에서 정책학박사학위를 취득('Backward Mapping' Analysis of an Urban Energy Policy: A Fuel Subsidy to the Rich?, 1987)하고, 가천대학교 교수로 재직중이다. 관심분야는 지방자치, 도시행정, 갈등관리이며 주요 저술과 발표논문으로 「지방자치론」, 「협상론」, "Government Administrative Control Tower in Crisis Management System: Definition, Issues, and Policy Implications" (*The Korean Journal of Policy Studies*, 2015), "지방정부간 원원협상을 위한 모형의 개발과 적용에 관한 연구"(*한국행정학보*, 2014), "Political Leadership during a Policy Shift: The Effort to Revise the Sejong City Plan"(*The Korean Journal of Policy Studies*, 2011) 등이 있다. 주요 경력은 행정안전부장관(2009-2010), 대통령비서실 정무수석(2012-2013), 국회의원(비례대표, 2008-2009) 등이다(dalgon@gachon.ac.kr).

## 국문초록

## 재정분권과 지역발전

이달곤

그동안 재정분권의 경제적, 재정적 효과에 대한 논의가 다양하게 이루어졌지만, 국가별로 처한 환경과 제도가 다르기 때문에 그 효과가 어떠한지에 대한 논란이 지속되고 있다. 소득이 높은 국가들을 사례로 하는 몇몇의 연구들은 재정분권을 통한 경제적 효율성은 달성될 수 없다고 주장하고 있다. 한국의 경우, 현재의 틀 안에서 재정분권을 강화하는 정책수단은 경제적 효율성이 담보될 수 없다는 점에서 매우 신중하게 추진되어야 한다. 지역발전은 중앙정부 주도적으로 이루어질 수 없다. 더욱이 지역간 균형발전은 중앙과 지방을 포함한 모든 수준의 정부부문과 민간기업을 아우르는 접근방법을 통해 이루어질 필요가 있다. 현재 도시와 농촌, 수도권과 비수도권 사이의 불균형은 재정정책 수단만 가지고 완화될 수는 없다. 농촌지역과 도시지역의 발전계획은 각각의 특성을 반영하고, 지역별로 고유한 문제를 해결하기 위하여 별도로 추진될 필요가 있다. 특히 많은 도시 지역 지방정부들은 자체적인 노력을 지역발전을 추진하기 위한 재정역량을 강화할 필요가 있다.

주제어: 재정분권, 재정자율성, 지방 세입과 세출, 지역발전