

# Transformation of municipal Finance in the context of globalization

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## Abstract.

**Research background:** In the context of globalization, a steady trend towards the formation of "open" economies in the context of the international division of labor, the idea of states defending their national economic interests as the basis for their economic and political independence becomes particularly important. The basis for strengthening the economic base seems to be the formation of sustainable finances at all levels of government, especially at the municipal level, which is directly close to the needs of the population, as well as the active involvement of civil society in ensuring the independent and comprehensive development of territories.

**Purpose of the article:** To study the transformation of municipal finances, turning them into the economic basis of "state-population" political exchange

**Methods:** The research is based on J. Buchanan's theory of constitutional economics about the "state-population" political exchange as a condition of social development.

**Findings & Value added:** The research conducted by the authors allows them to conclude that due to the constitutional and legal status of the municipality, local government is the level where the real and most effective "state-population" political exchange takes place, acting as a driver of socio-economic transformations. Because of this, municipal finance becomes the economic basis for such an exchange and an indispensable condition for the harmonious sustainable development of territories, which gives special importance to the issues of their formation and evaluation of the effectiveness of public participation in the organization of their functioning.

**Keywords:** *globalization; economic independence; municipal finance; "state-population" political exchange; theory of constitutional economy*

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## **1 Introduction**

The process of transformation of economic systems is objectively determined by modern trends towards building a social economy, a social state, ensuring its stability and sustainable development. As a rule, the problem of the crisis of the transformational (transitional) process is of an institutional character, which determines the necessity to develop the theory, the practice and statutory regulations of the way the public finances are organized in general, and, in particular, on the municipal level.

The research is based on the identification and assessment of conditions for the transformation of municipal finances, and a radical change in their role in socio-economic transformations and development of the territory.

The purpose of the study is to substantiate the relationship between budget decentralization, the potential of globalization, civil society, and the transformation of municipal finance from the traditional economic basis of development to the economic basis of the "state-population" political exchange. Due to its close proximity to the population, it is the municipal level where the consequences of the crisis and the results of changes are most obvious and acute. Local administration and the participation of civil society in territorial transformations should be considered as one of the direct ways to build a social state, which brings the issues of forming and strengthening its financial basis, the municipal finances up to date. These problems and essential relationships determine the research approaches and structure of the article.

## **2 Methodology, databases and analytical sources of research**

The authors consider the economic theory of welfare and the theory of budget decentralization as the methodological basis for studying the transformation of municipal finances, their transformation from the traditional economic basis of development to the economic basis of the "state-population" political exchange.

Data from open sources The Russian Treasury (The Federal Treasury), the OECD, and The Fund for Peace served as an information base for analyzing and evaluating the relationships between budget decentralization and the transformation of municipal finances in Russia and in the world, as well as for assessing the stability of countries.

The analytical basis of the research is based on scientific works of Russian and foreign scientists on the problem of the relationship between budget decentralization and the transformation of municipal finances, their transformation into the economic basis of the "state-population" political exchange.

The research is based on open sources of statistical information and methods of system analysis and statistical data processing (analytical grouping, statistical series, graphical methods, etc.).

## **3 Results and Discussion**

### **3.1. The acceleration of the transformation of municipal finance: the objective conditionality**

The acceleration of the transformation of municipal finances is objectively determined by the entire course of social development and, therefore, various aspects of municipal transformations are at the center of research by the world scientific community. First of all, it is a search for a new paradigm of municipal development that can adequately reflect the current changes in the global economy [1], the demands of civil society for quality of life and an active lifestyle. The close proximity of the municipal level of government to the people, their interests and needs, the speed of response to their changes, attach great significance to the formation of financial bases of these processes – the municipal finance and their transformation from the traditional economic basis to the economic basis of "state-population" political exchange [2].

Under the current conditions, integration processes and partnership relations of all economic entities come to the foreground in order to meet the interests of an individual citizen [3], and the quality of life becomes a constant motive for the development of the state [4]. In this context, the development of the "state-population" political exchange, the inclusion of civil society in the process of territorial transformation is one of the direct ways to build a social state, which necessitates a corresponding transformation of municipal finances.

### **3.2. Formation of the problem of budget decentralization**

The research is based on J. Buchanan's theory of constitutional Economics on "state - population" political exchange, which substantiates the mechanism and methods of political exchange in both direct democracy and representative democracy [5]. However, in J. Buchanan's theory there is no answer to the question of where, at what level of power, the exchange under consideration occurs most effectively. According to the authors' hypothesis, direct political exchange is carried out at the municipal level, in the format of local administration, which results in the population's satisfaction with the power, or loyalty. The methodological basis for finding an answer to this fundamental question is the economic theory of welfare and the theory of budget decentralization.

One of the first basic approaches to the exchange and demand for public goods was proposed by A. Pigou [6], according to which an individual receives positive utility from the consumption of public goods and negative utility from taxation. For each consumer, the optimum is achieved when the marginal benefit of the public good is balanced by the marginal tax burden of the individual. And the main issue is related to the level where the marginal benefit from the provision of public goods is directly felt.

This approach finds fruitful implementation in the context of the theory of budget decentralization, various aspects of which are presented in the works of its founders, who revealed its positive aspects in terms of the efficiency of resource allocation and territorial development. Thus, R. Masgrave [7] believed that, in general, budget decentralization promotes efficient allocation of resources, but a balanced approach to decentralization in the budget sphere is necessary. In particular, the provision of public goods at the local level is efficient when the benefits of consumption are shared by local residents, as, for example, is with street lighting. Providing public goods at the federal level is efficient when the benefits of consumption are nation-wide, take for instance, national defense. C. Tiebout [8] notes that decentralization increases the efficiency of resource allocation, since local authorities are

better informed about the needs of their residents as compared to the central government. At the same time, according to the hypothesis of C. Tiebout, fiscal decentralization increases competition among local authorities, due to the fact that economic agents choose the administrative-territorial unit in which they will meet the need for local public goods and the level of the tax burden will most correspond to their preferences - "voting with their feet".

Developing the theory of budget decentralization, W. Oates formulates the decentralization theorem[9], which is based on the postulate that the decentralization of expenditures is determined by the effect of information asymmetry, i.e. the inability of central authorities to obtain comprehensive information about the preferences of municipality residents and about local production costs of public goods (budget services). Consequently, the level of government that is closest to the consumers of public services is able to ensure a full account of specific needs of the local population and the most efficient expenditure of budget means (cost efficiency) to meet local needs, when the benefits from these services outweigh the costs.

These approaches help to draw the conclusion that direct political exchange in its most effective form is carried out at the municipal level, in the format of local administration, which stipulates the necessity to transform municipal finances as the basis of this exchange.

### **3.3. Allocation and production efficiency of public goods provision**

Studies conducted in recent years by the foreign and Russian authors show that municipal finances are well-developed in those territories where there is high budget decentralization, rational redistribution of revenue powers and expenditure powers between budget levels. It is the possible allocation and production efficiency of the provision of public goods that form the basis of budget decentralization. Notably, allocation efficiency refers to the best possible satisfaction of individual needs due to the fact that lower-level authorities know the needs of residents better, while production efficiency refers to meeting individual needs at lower costs.

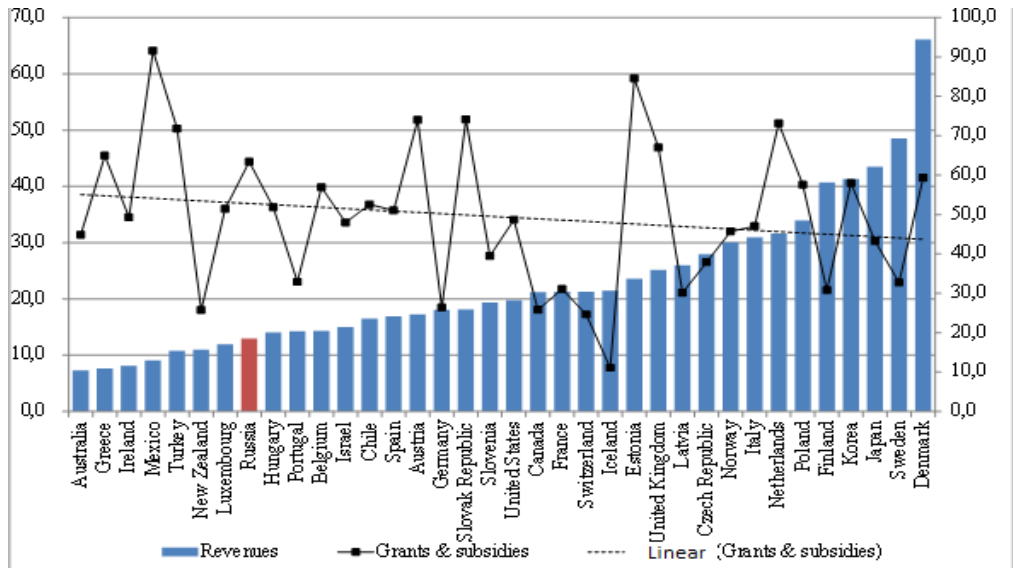
The study of the impact of budget decentralization on allocation and production efficiency in modern Russia and the degree to which it influences the economic growth shows that steady-state values of economic growth depend on the share which different government levels have in the total volume of public expenditures – expenditure decentralization [10]. If expenditures exceed revenues, there is either a positive interrelation between income decentralization and economic growth, or negative interrelation – between expenditure decentralization and economic growth, which generally confirms the interrelation between budget decentralization (municipal finance development) and economic growth. In addition, the analysis showed that transfers from the federal budget to the regions (at 10% level) are significant and positive for the resulting model of economic growth in Russia, and any decrease in their amount under the general conditions of budget decentralization leads to a slowdown in economic growth. It is also obvious that expenditure decentralization correlates with income decentralization, since the more revenue the municipality generates, the greater the share of the consolidated regional budget expenditures they undertake.

At the same time, budget decentralization being lessened in terms of expenditures within the region, with low income decentralization being kept, which, in fact, means reducing the budgets as the basis for municipal finances, has a negative impact not only on growth but also on living standards, and, consequently, on the efficiency of the “state-population” exchange. Thus, municipal finances can be unambiguously regarded as the economic foundation of not only local government, but of political exchange as well.

The stability and significance of these relationships is confirmed by a number of modern researchers [11]. At the same time, it is noted that decentralization is effective if specific, quantified costs overlap with equally specific, quantified benefits [12], and that taxes, in

relation to the volume and quality of public goods presented, directly affect the population's behavior [13].

The transformation of municipal finances into the basis for “state-population” political exchange leads therefore to the fact that the development strategy of municipalities moves to the sphere of interests of the central government in terms of decentralization, division of power. Ultimately, according to the study carried out by the authors and publications by other analytical scientists, it contributes to a more effective political exchange, stability of the financial system and the country as a whole [14, 15]. The data presented in Fig. 1 and Table 1 show a close interrelation between the budgetary decentralization of local budget revenues and the stability of countries.



**Fig.1.** Budget Decentralization of Local Budget Revenues in OECD countries and the Russian Federation in 2016, in %

Source: Compiled by the authors based on [16, 17]

The analysis of the level of budget decentralization, i.e. the development of local, subfederal budgets in various countries (Fig.1) shows that in 2016, this indicator in Russia was lower than average as compared to other countries. The same countries where this indicator is high (Switzerland, Sweden, Norway, etc.) traditionally occupy high positions in the annual stability assessments of the world's countries.

**Tab 1.** 2016 Stability Rating by Country, Around the World

Rating	States with a high level of stability – absence of risks	Index
174	Switzerland	21.8
175	Denmark	21.5
176	New Zealand	21.3
177	Norway	21.2
....		
65	Russia	81.0

*Source:* Compiled by the authors based on [18]

Russia is classified by the analysts as being among the countries with stability level below average and a high level of risk (according to the researchers, Russia's rating is 65, its index is 81,0).

In general, it confirms the hypothesis that achieving a balance between revenues and expenditure at the lower levels of government is positively associated with economic stability and growth. On the other hand, according to Buchanan's theory, if political decisions do not depend on rules that restrict government activities, then all models of contracts (laws as rules of the game) will be useless. The practical task of constitutional political economy is to help voters, who ultimately control their social system, in their constant search for such principles of the political game that would best suit their diverse interests [19]. All the above circumstances are aimed at creating incentives for local authorities to develop independently, to form a stable and flexible system of municipal finance, to protect market institutions [20] and, especially, development institutions [21].

A special place in these transformations should be given to the civil society, for example, in the format of initiative budgeting, the creation of a comfortable environment, the monitoring of budget fund movements, etc. Civil society must also undergo a transformation from an opponent to an active participant in socio-economic transformations, which can result in the population's satisfaction with the authorities and the ensured stability of the state.

Globalization, in its turn, provides new opportunities for developing and disseminating best practices in the functioning of local administration and local finances as the basis for "state-population" political exchange, expanding the forms of international cooperation at the level of states and specific territories, ensuring their appropriate transformation and their role in the formation of social economy.

## 4 Conclusion

Thus, as the study shows, public goods that are provided in a particular territory are the object of the "population-state" political exchange, which is studied in constitutional economics.

Notably, the authors come to the conclusions which prove that this exchange is most productive and cost-effective at the municipal level, which determines the objective transformation of municipal finances from the economic basis of local administration to the basis of political exchange. In this regard, it is obvious that the strategy for the development of municipal finances should be in the sphere of interests of the federal authorities, since it is the municipal level that is directly responsible for the political exchange. This hypothesis is verified on the basis of the impact of budget decentralization indicators on the economic growth of regions, as well as on the stability of the state as a whole.

This study shows, that in Russia, the budget decentralization is lessening in terms of revenues and expenditures, both at the level of the federal subjects and at the municipal level. Such trends may result not only in deteriorating the financial stability of municipalities and lowering the speed of economic development of territories. The most crucial negative consequence may be a decrease in public satisfaction with the services rendered by the state, especially in the context of rising taxes, which will inevitably lead to the failure in the “state-population” political exchange. Accordingly, it is not the reduction in the powers of the local administrative bodies that the state (federal level of government) should be concerned about, but their development, improvement and corresponding transformation of municipal finances as the basis of these processes.

As an objective condition for the effectiveness of municipal finances, as a basis for political exchange, it is advisable to involve in this process the full potential of civil society, the best world practices of budget decentralization, which globalization opens up access to.

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