

Principle of Subsidiarity: Concept and Criteria



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Subsidiarity is a principle which applies to the division of functions between different levels of government and society.

At the core of the principle of subsidiarity lies freedom of action of individuals, communities, municipalities, and other small entities which the central government can only intervene if the said entities fail to perform independently.

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DEPENDING
ON THE LEVEL
OF AUTONOMY
OF SELF-GOVERNMENT,
DECENTRALIZATION
CAN BE ACHIEVED
BY MEANS
OF DECONCENTRATION,
DELEGATION,
OR DEVOLUTION

The principle of subsidiarity presupposes decentralization of government functions. The benefits of decentralization include better service provision due to a closer proximity to citizens and hence better access to information, increased likelihood of innovative solutions, lower monitoring costs, and a more stable system of government.

Depending on the level of autonomy of self-government, decentralization can be achieved by means of deconcentration, delegation, or devolution. To achieve better

government accountability, the application of the subsidiarity rule should involve fiscal decentralization, including both spending and revenue generation, balancing the amount of money collected and expended by local government.

SUBSIDIARITY MATTERS

The division of functions between central and local governments is a question yet to be solved. Economies throughout the world, especially those of developing nations, are gradually decentralizing by transferring government functions to lower levels. There is a growing need for a comprehensive analysis of how government functions should be divided. On the one hand, optimal division may vary between countries due to unique local circumstances. On the other hand, scientific research is not intended to discover a factual answer but rather an algorithm for evaluating functions regardless of such factors as a country's size, system of government, and the like.

Subsidiarity is one of the most important principles applicable in the analysis of the functional division between central and local governments. According to the principle of subsidiarity, government functions should be performed at a lower level unless local government fails to cope with them and the performance of said functions at a higher level would be more efficient. It is thus essential to identify criteria for determining whether a certain function should be elevated to a higher level of government.

The principle of subsidiarity is oftentimes stipulated in national legislation. Yet, its implementation framework is not always clear. For example, the principle of subsidiarity is not explicitly defined in the Constitution of the Republic of Lithuania, but rather it is derived from other constitutional principles and provisions. Notably, Lithuania's system of government is supposed to build



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on the principle of subsidiarity, yet no criteria nor system of monitoring and assessment are defined, so it is unclear whether the process is systematic and justified.

This article is intended to elicit and substantiate criteria that should be used as a basis for the division of functions between the central government and local government (municipalities) according to the principle of subsidiarity.

DEFINING SUBSIDIARITY

There is no unanimous definition of the principle of subsidiarity in theory or in practice. Subsidiarity is compatible with separation of powers in the European Union (EU) between different levels of government since subsidiarity implies decision making at the lower rather than higher level of governance. The principle is intended to ensure a certain degree of independence to lower-tier government institutions from the institutions of a higher level. This means that institutions at different levels share authority.

In accordance with the principle of subsidiarity, the EU has no right to act in areas which member states are able to efficiently regulate at the national, regional or local levels. On the other hand, according to the same principle, the EU has the right to exercise its authority if member states fail to properly achieve pre-defined objectives and if such action creates added value at the EU level¹.

In Lithuania, the principle of subsidiarity is laid down in the Law on Public Administration. It states that the decisions of public administration entities must be adopted and implemented at a level that is considered to be the most effective (The Law of the Republic of Lithuania on Public Administration).

However, considering its origins, the principle of subsidiarity has a broader meaning. Althusius in the 16-17 c., also known as the father of federalism, was the first to describe the principle of subsidiarity. He claimed that society and communities were fundamental in helping individuals to fulfill their preferences².

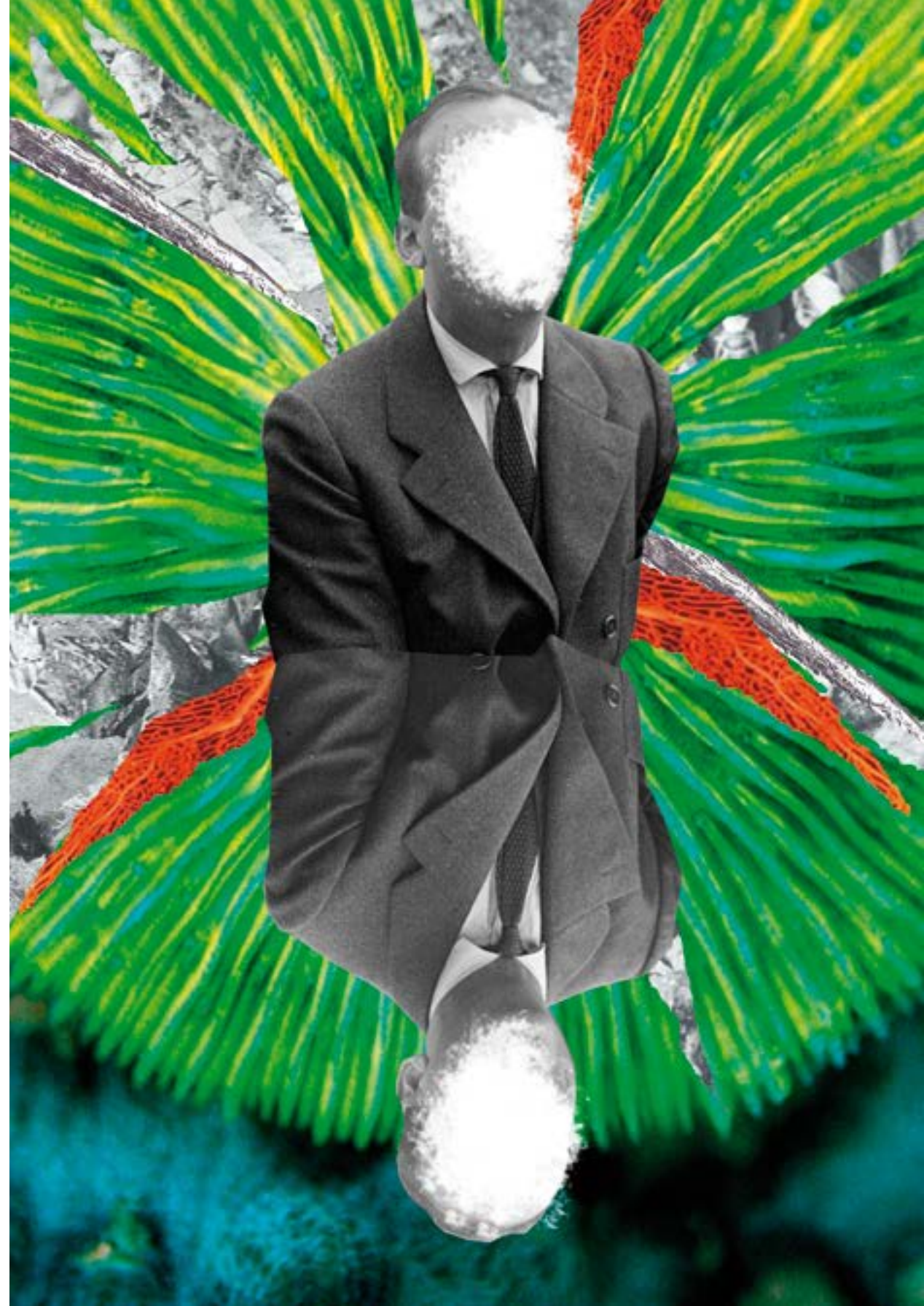
This highlights the inherent link between the principle of subsidiarity and freedom: individuals are free to act and fulfill their preferences, while the role of government is not to regulate but rather to facilitate the freedom of action of individuals³.

A more comprehensive approach to the rule of subsidiarity can be found in Christian teachings. At the end of the 19th century,

¹ Chateau, C. (2016) *Fact Sheets on the European Union. The Principle of Subsidiarity*. Available [online]: http://www.europarl.europa.eu/ftu/pdf/en/FTU_1.2.2.pdf

² Føllesdal, A. (2013) "Competing Conceptions of Subsidiarity", [in:] *Nomos LV: Federalism and Subsidiarity*, New York: New York University Press. Available [online]: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2359964

³ Ibid.





THE PRINCIPLE OF SUBSIDIARITY IS UNDERSTOOD AS A CONCEPT THAT HOLDS THAT INDIVIDUALS, COMMUNITIES, MUNICIPALITIES, AND OTHER SMALL ENTITIES HAVE FREEDOM OF ACTION, WHICH CAN BE INTERVENED BY A HIGHER LEVEL OF GOVERNMENT ONLY WHEN SAID ENTITIES ARE UNABLE TO ACT ON THEIR OWN ACCORD

Pope Leon XIII wrote in *Rerum Novarum* that the state must allow people the freedom of action rather than exploiting them and intruding into their everyday lives⁴. Pius XI (beginning of the 20th c.) furthered the concept of subsidiarity. He wrote that subsidiarity started with the individual, while an intervention from a higher level was warranted only when an entity was unable

⁴ Ibid.

to cope without it⁵. The term subsidiarity comes from the Latin word *subsidium*, meaning "assistance"⁶.

There are multiple interpretations of subsidiarity in theory and in practice. Here, the principle of subsidiarity is understood as a concept that holds that individuals, communities, municipalities, and other small entities have freedom of action, which can be intervened by a higher level of government only when said entities are unable to act on their own accord.

The following analyzes the application of the principle of subsidiarity in the division of functions between the central government and self-governments.

PERFORMING FUNCTIONS AT A LOWER LEVEL OF GOVERNMENT IS DESIRABLE

In practice, subsidiarity is often equated to decentralization. However, the two concepts are not the same. Subsidiarity is defined as a rule by which government functions are performed at the lowest level. Only when such an arrangement is inadequate in terms of the accomplishment of a certain task (also considering the criteria described further in the article) can the said task be transferred to a higher level of government. Meanwhile, decentralization is the transfer of power, authority, and responsibility from a higher to a lower level of government⁷.

⁵ Ibid.

⁶ Sirico, R. A. (2014) "Subsidiarity, Society, and Entitlements: Understanding and Application", [in:] *Notre Dame Journal of Law, Ethics & Public Policy*, no. 549. Available [online]: <http://scholarship.law.nd.edu/nd-jepp/vol11/iss2/8/>

⁷ World Bank. Decentralization & Subnational Regional economics. *What, Why and Where*. Available [online]: <http://www1.worldbank.org/publicsector/decentralization/what.htm>

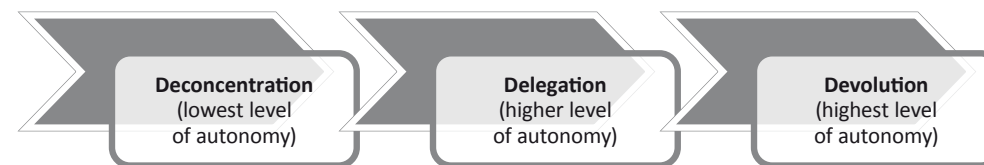
Decentralization is a complex and multifaceted concept. It can mean political, fiscal, administrative or market decentralization. These types of decentralization are frequently interrelated. For instance, fiscal decentralization occurs together with political decentralization.

ADMINISTRATIVE DECENTRALIZATION

Administrative decentralization is the division of functions and responsibility between entities at different levels of public administration or state government that is accomplished by transferring functions to a lower level. In other words, administrative decentralization occurs when the responsibility to perform certain public functions is transferred from central government entities to territorial government units or local and regional municipalities.

According to the World Bank⁸, the aim of administrative decentralization is to redistribute authority, responsibility, and financial resources in order to provide public services at different levels of government [See Figure 1].

Figure 1: Types of decentralization by the level of autonomy



Source: Compiled by LFMI based on Schneider (2006)⁹

⁸ Ibid.

⁹ Schneider, A. (2006) "Who Gets What from Whom? The Impact of Decentralisation on Tax Capacity and Social Spending", [in:] *Commonwealth and Comparative Politics*, 44(3) pp. 344-369.

1. **Deconcentration** is the weakest form of decentralization. Its purpose is to redistribute the decision-making authority, financial and managerial responsibility between different levels of central government. Deconcentration can be used to transfer responsibilities from central government authorities in the capital city to regional or district authorities. It can also serve to strengthen local administration while under the supervision of central government representatives.
2. **Delegation** is a broader form of decentralization. It involves transferring the responsibility of making and administering decisions related to public functions to semi-autonomous institutions (those not under complete control of central government but accountable to it). These institutions may charge users for their services.
3. **Devolution** is based mainly on political decentralization. It is the transfer of decision-making, finances, and man-

agement to semi-autonomous local branches of government (municipal companies). In such a system there are clear geographical and legal boundaries between local governments, separating the territories where public functions are performed.



IN A POLITICAL SYSTEM THAT IS HIGHLY DECENTRALIZED, CITIZENS SHAPE INTERESTS BASED ON LOCAL NEEDS, WHILE ORGANIZATIONS AND POLITICAL PARTIES ACT AT THE LOCAL LEVEL AND COMPETE IN LOCAL ELECTIONS

The use of these three measures decentralizes the public administration system and reduces fiscal centralization of the government.

POLITICAL DECENTRALIZATION

Political decentralization entails transferring the state management authority to public administration entities, which function on the basis of autonomy¹⁰. In the case of political decentralization, citizens are involved in political activities and their opinion is taken into account while making and implementing public policies on a larger scale¹¹.

¹⁰ Astrauskas, A. (2007) "Internal Decentralization: Purport and Forms", [in:] *Viešojoji politika ir administravimas*, no. 20. Available [online]: https://www.mruni.eu/upload/iblock/1f3/1_a.astrauskas.pdf

¹¹ Chattopadhyay, S. (2013) "Decentralised Provision of Public Services in Developing Countries: A Review of Theoretical Discourses and Empirical Evidence", [in:] *Social Change*, 43(3): 421-441.

In a political system that is highly decentralized, citizens shape interests based on local needs, while organizations and political parties act at the local level and compete in local elections¹².

MARKET DECENTRALIZATION

Market decentralization results in more deregulation and privatization. Market decentralization involves non-governmental organizations as well as the private sector¹³.



PURE FISCAL DECENTRALIZATION IS A SYSTEM WHERE LOCAL GOVERNMENTS COLLECT TAXES AND ALLOCATE EXPENDITURES WITHOUT THE INTRUSION OF CENTRAL GOVERNMENT. IN REALITY, SUCH MARGINAL SITUATIONS DO NOT EXIST

¹² Schneider, A. (2006) "Who Gets What from Whom? The Impact of Decentralisation on Tax Capacity and Social Spending" [in:] *Commonwealth and Comparative Politics*, 44(3), pp. 344-369.

¹³ Halaskova, M. and R. Halaskova (2014) "Impacts of Decentralisation on the Local Government Expenditures and Public Services in the EU Countries", [in:] *Lex Localis*, 12(3), pp. 623-642.

In pursuing market decentralization, the task of the government is not to regulate but to implement such methods of governing that allow the market to develop on its own.

FISCAL DECENTRALIZATION

Fiscal decentralization is the type of decentralization that usually comes to one's mind when the topic of decentralization is addressed. It means that when local governments are assigned additional functions, an adequate increase in their revenue should be ensured.

In other words, fiscal decentralization occurs when lower-tier government institutions are assigned new functions and together with these functions they are given the right to make decisions regarding revenue collection¹⁴. Pure fiscal decentralization is a system where local governments collect taxes and allocate expenditures without the intrusion of central government¹⁵. In reality, such marginal situations do not exist.

Fiscal decentralization can also be described as the shift of fiscal impact from the central level to lower levels of government. The aim is to reduce the vertical fiscal gap, the gap between decentralized expenditure and decentralized revenue [See Figure 2]. A large vertical gap means that municipalities spend more money than they themselves collect. If the vertical fiscal gap is large, the system holds that the local government is able to make decisions regarding a relatively large part of its expenditure, while receiving a still higher proportion of its revenue from the central government. In such cases, the local government spends more than it otherwise would because there is no link

¹⁴ Kim, A. (2008) "Decentralization and the Provision of Public Services: Framework and implementation", [in:] *Policy Research Working Paper 4503*, The World Bank.

¹⁵ Prud'homme, R. (2005) "The Dangers of Decentralization", [in:] *The World Bank Research Observer*, 10(2), pp. 201-220.



A WIDE VERTICAL FISCAL GAP CAN IMPAIR ECONOMIC DEVELOPMENT, INCREASES DEBT, AND MAKES LOCAL GOVERNMENTS LESS ACCOUNTABLE TO THE PEOPLE

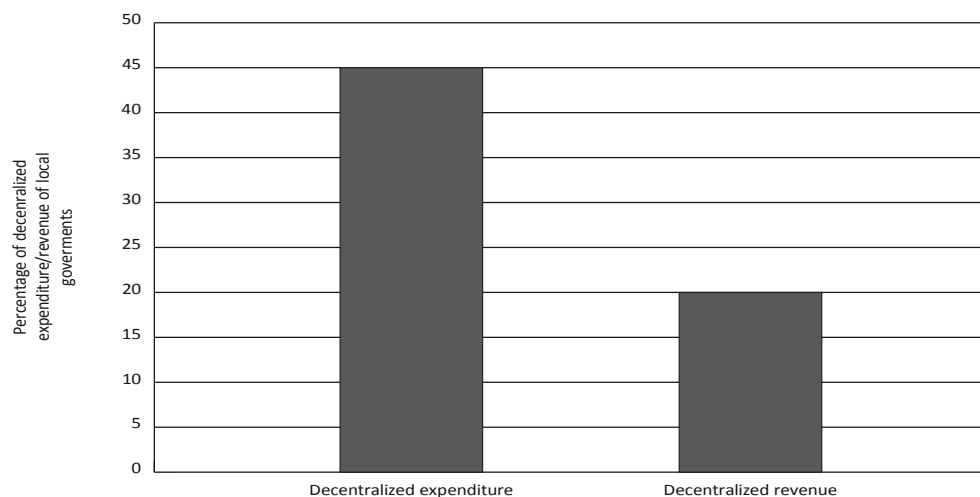
between revenue and expenditure. Philip Booth claims that revenues should be generated by the same level of government that spends them¹⁶.

The aim should be to reduce the vertical fiscal gap because it creates incentives for the government to expand, over-spend, and borrow more. When the local government receives a large share of its proceeds from the central government, it feels less responsible for spending and so the link between revenue and expenditure is weaker. Research shows that a wide vertical fiscal gap can impair economic development, increases debt, and makes local governments less accountable to the people.

The above explains that decentralization is a complex and multifaceted process-system. Its main attribute is the transfer of authority and responsibility from a higher level to a lower level of government.

¹⁶ Booth, P. (2015) *Federal Britain. The case for Decentralisation*. The Institute of Economic Affairs. Available [online]: <http://www.iea.org.uk/publications/research/federal-britain-the-case-for-decentralization>

Figure 2: Vertical fiscal gap



Note: decentralization of expenditure = spending of local government / (spending of local and central governments); decentralization of autonomous revenue = autonomous revenue of local government / (revenue of local and central governments).

Source: Compiled by LFMI based on Sorens (2016)¹⁷

Why then is the decentralization of government functions the primary concern when applying the principle of subsidiarity? Philip Booth and other economists outline the following benefits of decentralization:

1. **Local government can organize the provision of resources and public services in ways that better meet people's preferences.** Local government is closer to its citizens and therefore better positioned to properly evaluate citizens' varying needs and to adopt more effective solutions. Information can be used at a more immediate level, and this ensures better public policy decisions. As economist Friedrich Hayek wrote, decentralization is needed precisely for the purpose of collecting and using such knowledge. People are a source

of information, and a closer proximity to the source allows sounder and better-suited decisions.

2. **Local government becomes more accountable to its citizens.** As residents are able to migrate between local governments, or *foot vote*, local authorities have more incentives to function efficiently. Just like in an ordinary market, competition improves the quality of services provided by self-governments, and promotes the adoption of decisions that are designed to better meet citizens' preferences.
3. **The more variations of service provision exist, the higher the possibility to find a better and more innovative solution.** When functions are performed by a unified central government, this likelihood decreases¹⁸.

¹⁷ Sorens J. (2016) "Vertical Fiscal Gaps and Economic Performance. A theoretical Review and an Empirical Meta-Analysis", *Mercatus Working Paper*.

¹⁸ Booth, P. (2015) *Federal Britain. The case for Decentralisation*, The Institute of Economic Affairs. Available [online]: <http://www.iea.org.uk/publications/research/federal-britain-the-case-for-decentralization>



COMPETITION IMPROVES THE QUALITY OF SERVICES PROVIDED BY SELF-GOVERNMENTS' FULFILLMENT OF CITIZENS NEEDS

4. **The costs of monitoring (of consumer needs and behavior) are lower under decentralization** because local government is closer to its citizens¹⁹.
5. **A more stable system of government.** When there are several sources of power instead of one, complications affect only a part of the country, reducing their negative effects.

As regards the fulfillment of citizens needs, it is logical to think that a problem should first be addressed at the most immediate level where the most information about the problem exists. Obtaining the information from the most immediate level is instrumental for finding the most suitable solution. Only when the efforts fail can the solution be entrusted to a higher level.

Admittedly, this condition is not specific enough to determine when the rule of subsidiarity should be applied to transfer government functions to a higher level. It requires more explicit criteria that would help to systematize the application of the subsidiarity principle under the most objective conditions possible.

¹⁹ Ibid.

CRITERIA FOR APPLYING THE PRINCIPLE OF SUBSIDIARITY

Analysis of the application of the principle of subsidiarity reveals a lack of criteria to justify the transfer of government functions to a higher level. A general condition is that such a transfer occurs when a certain function fails to be adequately performed at a lower level. However, without knowing specific circumstances it is impossible to determine whether the transfer of a certain function was justified.

One of the most frequently used criteria is efficiency. The Lithuanian Public Administration Law stipulates that activities of public administration entities must be based on the principle of subsidiarity which holds that decisions must be adopted and implemented at the most efficient level of public administration.

Efficiency means performance that uses the lowest amount of inputs to create the greatest amount of outputs. It is outputs divided by inputs. If moving a function to a higher-level leads to a better ratio of the two, then the rule of subsidiarity comes into effect.

However, this is not an easy criterion to follow as it requires knowing specific numerical values of outputs and spending on particular occasions. In addition, the efficiency criterion is too narrow to define the rule of subsidiarity. In the division of functions, it is also essential to ensure that the principle of freedom of action is not restricted.

Explicit criteria are needed to perform a justified evaluation of the division of functions between central and local governments. Such criteria should help even when specific conditions and circumstances of a situation are unknown.



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The following outlines the criteria for the division of functions between the central and local governments following the principle of subsidiarity. The criteria include differentiation of consumer preferences, economies of scale, competition, and externalities. Importantly though, prior to applying these criteria, the principle of freedom of action at a lower level should be observed. The move to a higher level should be made only when the lower level fails to cope with its functions or when functions are performed inefficiently.

DIFFERENTIATION OF CONSUMER PREFERENCES

It is of the most important criteria that is used to decide on the application of the subsidiarity principle. Consumer preferences can be homogeneous or heterogeneous. Homogeneous preferences are characterized by similar features, for instance all citizens have similar preferences for national defense. In contrast, heterogeneous preferences vary, as illustrated by the example of social services: people of old age, people with disabilities,

and children at social risk all have different needs. Heterogeneous preferences are better met by local government. Self-governments are closer to citizens, and this makes it easier for them to decide which services are the most suitable to best meet the citizens' preferences.

Consumer preferences may not be only homogeneous or heterogeneous but also unevenly distributed across the country. For example, local government near the sea or another large body of water is concerned about providing rescue and beach maintenance services, whereas the rest of the country has no such need. Therefore, in the case of uneven division of consumer preferences, assigning functions by relevant municipalities is a better decision. The opposite stands when a preference is relevant uniformly across the country. For instance, tax administration services are needed across local governments regardless of geographical differences, so this function can be left to the central government [See Table 1].

On the other hand, some may claim that varying consumer preferences could be met just as well if more local government units

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IN THE CASE
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BY RELEVANT
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IS A BETTER DECISION

Table 1: Criteria for the application of the principle of subsidiarity

Criterion	Functions of Self-Government	Functions of Central Government
Differentiation of consumer preferences	Heterogeneous (different) preferences	Homogeneous (similar) preferences
	Geographically uneven preferences	Geographically even preferences
Economies of scale	Low economies of scale; low fixed costs	High economies of scale; high fixed costs
Competition	Strong competition	Weak or no competition
Externalities	A small spill-over effect	A large spill-over effect

were in place. An important consideration here is that the performance of a certain task is not limited to implementation. The Lithuanian Public Administration Law states that public administration comprises not only the provision of administrative services, but also the adoption of administrative decisions, control of the implementation of laws and administrative decisions, and so on. It means that the very act of establishing more local units to accomplish defined functions cannot be regarded as a transfer of government functions if the said units are not able to adopt decisions and empower other public entities (such as communities, non-governmental organizations, and the like).

A function can be said to have been transferred between levels of government when the transfer involves the authority to adopt decisions, control their implementation, and empower smaller public entities to act. Of course, a partial transfer (for instance, the transfer of the implementation task) is more significant than no transfer at all, but without the authority to make decisions and exert control, the process is not complete.

ECONOMIES OF SCALE

Economies of scale²⁰ occur when an increase of outputs produced (goods or services) reduces the inputs that are required to produce them. In this case, social services are an example of low economies of scale. Providing social services to additional recipients does not make service delivery any cheaper, as allowance amounts as well as salaries of social workers remain unchanged. However, when economies of scale are achieved, it is advisable to provide services at a higher level of government because more goods can be produced, or services rendered at lower costs. This makes the performance more efficient.

High economies of scale are linked to fixed costs. Normally, municipalities do not have sufficient financial or other resources to afford an airport or fleet of their own. Services such as waste collection have limited fixed

²⁰ Kim, A. (2008) "Decentralization and the Provision of Public Services: Framework and implementation", *Policy Research Working Paper 4503*, The World Bank.



SERVICES THAT REQUIRE HIGH-FIXED COSTS SHOULD BE PROVIDED BY CENTRAL GOVERNMENTS

costs. It is thus obvious that services that require high-fixed costs should be provided by central governments.

COMPETITION

The third criterion is competition. Normally, competition is desirable because it reduces prices, increases quality, and essentially improves the fulfillment of consumer preferences. This holds true for many public services. For instance, parents choose to send their children to schools which they think are better than others. In such conditions, schools compete to attract as many students – and, consequently, public funding – as possible. Services which can show quality improvements due to competitive forces should be transferred to local government so that local governments can compete with one another. After all, for competition to occur, at least two parties must be in play.

It is important to note though, that for certain functions, competition may bring undesired effects in terms of the efficiency of performance and the general stability of a country. For example, if every local government had its own central bank, it would be inconvenient to use different currencies in each municipality. Macroeconomic stability could be affected too. Therefore, centralization works better in such cases.



LARGE-SCALE POSITIVE EXTERNALITIES DISCOURAGE CITIZENS WHO PAY FOR SERVICES OR FUNCTIONS BECAUSE ANYONE IS IN A POSITION TO ENJOY THE BENEFITS

EXTERNALITIES²¹

This criterion shows how the presence of external effects can encourage centralization. Externalities occur when some utility provided by organizations in one municipality spills over to create welfare for citizens in other municipalities. Such cases lead to the "free rider" problem when non-payers benefit from the paying entities in a different municipality. Naturally, utility spillover effects always occur to some extent.

However, large-scale positive externalities discourage citizens who pay for services or functions because anyone is in a position to enjoy the benefits. The free rider problem does not exist when utility is gained mostly by those who pay for it. Thus, in the case of zero or marginal spillover, functions can be performed by local government. Otherwise, they should be left to central government [See Table 1].

²¹ Ibid.



IF A MUNICIPALITY IS SMALL, IT MIGHT NOT BE ABLE TO PERFORM A CERTAIN FUNCTION ADEQUATELY DUE TO A LACK OF RESOURCES (BOTH FINANCIAL AND HUMAN)

The criteria discussed above help to determine how functions should be assigned to a certain level of government. However, a comprehensive analysis should consider specific characteristics, such as the size of the municipality. If a municipality is small, it might not be able to perform a certain function adequately due to a lack of resources (both financial and human).

The practical division of functions is illustrated by Norway's example. At present, Norway is implementing a reform that is intended to merge municipalities into large units. A decision to merge and revise the division of functions was made after evaluating the efficiency level of the performance of local government functions. It was concluded that some municipalities were too small and had insufficient resources to properly perform functions assigned to them. The ongoing reform is to be accompanied by a transfer of additional functions to municipalities²².

²² Report of the Ministry of Local Government and Regional Development of Norway (2015–2016) Available [online]: <https://www.regjeringen.no/no/dokumenter/meld.-st.-22-20152016/id2481778/>

The main criteria that Norway used to evaluate the division of service provision were financial capacity, experience of performance, efficiency, and freedom of action. The two main considerations were ensuring that new municipalities were able to perform the tasks assigned to them (have sufficient resources) and that the same functions could also be performed outside the boundaries of a municipality considering population density and geographical distance²³.

This example shows that to ensure an effective division of functions it is necessary to consider specific circumstances at play; the characteristics of municipalities, a country's geographical peculiarities, division of the population, and so on. The criteria outlined in this article may therefore provide guidance for better-informed decisions regarding the transfer of certain government functions to a higher level. However, it is important to keep in mind that functions should be moved up only when a municipality is unable to perform them independently. (It is necessary to consider if measures to reduce the vertical fiscal gap were taken. Also, municipalities can fail to perform if the revenue-expenditure mechanism is misadjusted.)

CONCLUSIONS

The principle of subsidiarity holds that individuals, communities, municipalities, and other small entities have the freedom of action, which can be intervened by a higher level of government only when the said entities are unable to act on their own accord.

Local government should be warranted the freedom to act, whereas the transfer of functions to central government under the rule of subsidiarity should only take place when self-government is unable to perform its functions, or the performance is ineffi-

²³ Ibid.



TO ENSURE AN EFFECTIVE DIVISION OF FUNCTIONS IT IS NECESSARY TO CONSIDER SPECIFIC CIRCUMSTANCES AT PLAY; THE CHARACTERISTICS OF MUNICIPALITIES, A COUNTRY'S GEOGRAPHICAL PECULIARITIES, DIVISION OF THE POPULATION, AND SO ON

cient. The following criteria thus help to apply the principle of subsidiarity and determine what government functions need to be transferred:

- A. **Differentiation of consumer preferences.** Functions are transferred to the central level when citizens' preferences are highly homogeneous and/or geographically uniform.
- B. **Economies of scale.** Functions should be transferred to the central level when high economies of scale occur.
- C. **Competition.** Functions should be transferred to the central level when competition between municipalities which provide certain public services are not functional.

- D. **Externalities.** Functions should be moved to the central level when their provision produces large spill-over effects between municipalities.

The vertical fiscal gap in municipalities should be as low as possible. It is important to reduce the gap between decentralized expenditure and decentralized revenue. A proper link between revenue and expenditure is the key factor in order to disincentivize government expansion, over-spending, and borrowing, to increase government accountability and to promote economic development. •



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