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The New Vision of Local Governance and the Evolving Roles of Local Governments

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We will strive increasingly to quicken the public sense of public duty; that thus . . . we will transmit this city not only not less, but greater, better, and more beautiful than it was transmitted to us.

—*Oath of office required of council members in the ancient city of Athens*

Introduction: Local Government and Local Governance

Local government refers to specific institutions or entities created by national constitutions (Brazil, Denmark, France, India, Italy, Japan, Sweden), by state constitutions (Australia, the United States), by ordinary legislation of a higher level of central government (New Zealand, the United Kingdom, most countries), by provincial or state legislation (Canada, Pakistan), or by executive order (China) to deliver a range of specified services to a relatively small geographically delineated area. *Local governance* is a broader concept and is defined as the formulation and execution of collective action at the local level. Thus, it encompasses the direct and indirect roles of formal institutions of local government and government hierarchies, as well as the roles of informal norms, networks, community organizations, and neighborhood associations in pursuing collective action by defining the framework for citizen-citizen and citizen-state interactions, collective decision making, and delivery of local public services.

Local governance, therefore, includes the diverse objectives of vibrant, living, working, and environmentally preserved self-governing communities. Good local governance is not just about providing a range of local services but also about preserving the life and liberty of residents, creating space for democratic participation and civic dialogue, supporting market-led and environmentally sustainable local development, and facilitating outcomes that enrich the quality of life of residents.

Although the concept of local governance is as old as the history of humanity, only recently has it entered the broad discourse in the academic and practice literature. Globalization and the information revolution are forcing a reexamination of citizen-state relations and roles and the relationships of various orders of government with entities beyond government—and thereby an enhanced focus on local governance. The concept, however, has yet to be embraced fully by the literature on development economics, because of the longstanding tradition in the development assistance community of focusing on either local governments or community organizations while neglecting the overall institutional environment that facilitates or retards interconnectivity, cooperation, or competition among organizations, groups, norms, and networks that serve public interest at the local level.

Several writers (Bailey 1999; Dollery and Wallis 2001; Rhodes 1997; Stoker 1999) have recently argued that the presence of a vast network of entities beyond government that are engaged in local services delivery or quality of life issues makes it unrealistic to treat local government as a single entity (see also Goss 2001). Analytical recognition of this broader concept of local governance is critical to developing a framework for local governance that is responsive (doing the right thing—delivering services that are consistent with citizens' preferences or are citizen focused); responsible (doing the right thing the right way—working better but costing less and benchmarking with the best); and accountable (to citizens, through a rights-based approach). Such analysis is important because the role of local government in such a setting contrasts sharply with its traditional role.

This chapter traces the evolution and analytical underpinnings of local governance as background to a better understanding of the case studies of developing countries in this book. The next section outlines analytical approaches to local governance that can be helpful in understanding the role of governments and comparing and contrasting institutional arrangements. It further develops a model of local governance that integrates various strands of this literature. This model has important implications for evaluating and reforming local governance in both industrial and developing countries. The third section presents stylized models and institutions of local governance as practiced in different parts of the world during past centuries. It compares and contrasts the ancient Indian and Chinese systems of local governance with Nordic, Southern European, North American, and Australian models. The last section provides a comparative overview of local government organization and finance in selected developing countries as an introduction to the in-depth treatment of these countries in the rest of the book.

The Theory: Conceptual Perspectives on Local Governance and Central-Local Relations

Several accepted theories provide a strong rationale for decentralized decision making and a strong role for local governments, on the grounds of efficiency, accountability, manageability, and autonomy.

- *Stigler's menu.* Stigler (1957) identifies two principles of jurisdictional design:
  - — The closer a representative government is to the people, the better it works.
  - — People should have the right to vote for the kind and amount of public services they want.

  These principles suggest that decision making should occur at the lowest level of government consistent with the goal of allocative efficiency. Thus, the optimal size of jurisdiction varies with specific instances of economies of scale and benefit-cost spillovers.
- *The principle of fiscal equivalency.* A related idea on the design of jurisdictions has emerged from the public choice literature. Olson (1969) argues that if a political jurisdiction and benefit area overlap, the free-rider problem is overcome and the marginal benefit equals the marginal cost of production, thereby ensuring optimal provision of public services. Equating the political jurisdiction with the benefit area is called the *principle of fiscal equivalency* and requires a separate jurisdiction for each public service.
- *The correspondence principle.* A related concept is proposed by Oates (1972): the jurisdiction that determines the level of provision of each public good should include precisely the set of individuals who consume the good. This

principle generally requires a large number of overlapping jurisdictions. Frey and Eichenberger (1995, 1996, 1999) have extended this idea to define the concept of functional, overlapping, and competing jurisdictions (FOCJ). They argue that jurisdictions could be organized along functional lines while overlapping geographically, and that individuals and communities could be free to choose among competing jurisdictions. Individuals and communities express their preferences directly through initiatives and referenda. The jurisdictions have authority over their members and the power to raise taxes to fulfill their tasks. The school communities of the Swiss canton of Zurich and special districts in North America follow the FOCJ concept.

- *The decentralization theorem.* According to this theorem, advanced by Oates (1972, p. 55), "each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision," because

  — local governments understand the concerns of local residents;
  — local decision making is responsive to the people for whom the services are intended, thus encouraging fiscal responsibility and efficiency, especially if financing of services is also decentralized;
  — unnecessary layers of jurisdiction are eliminated;
  — interjurisdictional competition and innovation are enhanced.

  An ideal decentralized system ensures a level and combination of public services consistent with voters' preferences while providing incentives for the efficient provision of such services. Some degree of central control or compensatory grants may be warranted in the provision of services when spatial externalities, economies of scale, and administrative and compliance costs are taken into consideration. The practical implications of this theorem, again, require a large number of overlapping jurisdictions.
- *The subsidiarity principle.* According to this principle, taxing, spending, and regulatory functions should be exercised by lower levels of government unless a convincing case can be made for assigning them to higher levels of government. This principle evolved from the social teaching of the Roman Catholic Church and was first proposed by Pope Leo XIII in 1891. Subsequently, Pope Pius XI highlighted the principle of subsidiarity as a third way between dictatorship and a laissez-faire approach to governance. The Maastricht Treaty adopted it as a guiding principle for the assignment of responsibilities among members of the European Union (EU). This principle is the polar opposite of the *residuality principle* typically applied in a unitary country, where local governments are assigned functions that the central government is unwilling or thinks it is unable to perform.

Implementation Mechanisms

Achieving the optimal number and size of local jurisdictions requires the operation of community formation processes and the redrawing of jurisdictional boundaries.

- *Voting with feet.* According to Tiebout (1956), people consider tax costs and the public services menu offered by a jurisdiction in deciding where to live. Thus, voting with feet leads to the formation of jurisdictions, creating a market analog for public service provision. Oates (1969) argued that if people vote with their feet, fiscal differentials across communities are capitalized into residential property values. This conclusion has been refuted by formal tests of allocative efficiency proposed by Brueckner (1982) and Shah (1988, 1989, 1992). Both tests suggest that optimal provision of public services is not ensured by voting with feet alone but depends also on rational voting behavior.
- *Voting by ballot.* This line of research suggests that collective decision making may not ensure maximization of the electorate's welfare, because citizens and their governmental agents can have different goals.
- *Voluntary associations.* Buchanan (1965) postulates that the provision of public services through voluntary associations of people (clubs) ensures the formation of jurisdictions consistent with the optimal provision of public services.
- *Jurisdictional redesign.* An important process for community formation in modern societies is redrawing the boundaries of existing jurisdictions to create special or multipurpose jurisdictions.

Roles and Responsibilities of Local Governments: Analytical Underpinnings

There are five perspectives on models of government and the roles and responsibilities of local government: (a) traditional fiscal federalism, (b) new public management (NPM), (c) public choice, (d) new institutional economics (NIE), and (e) network forms of local governance. The federalism and the NPM perspectives are concerned primarily with market failures and how to deliver public goods efficiently and equitably. The public choice and NIE perspectives are concerned with government failures. The network forms of governance perspective is concerned with institutional arrangements to overcome both market and government failures.

Local government as a handmaiden of a higher government order: Traditional fiscal federalism perspectives

The fiscal federalism approach treats local government as a subordinate tier in a multitiered system and outlines principles for defining the roles and responsibilities of orders of government (see Shah 1994 for such a framework for the design of fiscal constitutions). Hence, one sees that in most federations, as in Canada and the United States, local governments are extensions of state governments (*dual federalism*). In a few isolated instances, as in Brazil, they are equal partners with higher-level governments (*cooperative federalism*), and in an exceptional case, Switzerland, they are the main source of sovereignty and have greater constitutional significance than the federal government. Thus, depending on the constitutional and legal status of local governments, state governments in federal countries assume varying degrees of oversight of the provision of local public services. In a unitary state, subnational governments act on behalf of the central government. Therefore, a useful set of guidelines for the assignment of responsibilities for local public services in a unitary state would be the following:

- Policy development and standards of service and performance are determined at the national level.
- Implementation oversight is carried out at the state or provincial level.
- Services are provided by the local governments or by the metropolitan or regional governments.

In all countries, the production of services can be public or private, at the discretion of local or regional governments. Responsibilities for public services other than such purely local ones as fire protection could be shared, using these guidelines.

The assignment of public services to local governments or to metropolitan or regional governments can be based on considerations such as economies of scale, economies of scope (appropriate bundling of local public services to improve efficiency through information and coordination economies and enhanced accountability through voter participation and cost recovery) and cost-benefit spillovers, proximity to beneficiaries, consumer preferences, and budgetary choices about the composition of spending. The particular level of government to which a service is assigned determines the public or private production of the service in accordance with considerations of efficiency and equity. Large metropolitan areas with populations in excess of 1 million could be considered for subdivision into a first tier of municipal governments of smaller size responsible for neighborhood-type services and a second tier of metropolitanwide government providing areawide services. The first-tier governments could be directly elected, and elected mayors of these governments could form the metropolitan council at the second tier. Two-tier structures for metropolitan governance have been practiced in Melbourne, Australia; Vancouver, Canada; Allegheny county, Pennsylvania, United States; and Stockholm, Sweden.

In industrial countries, special-purpose agencies or bodies deliver a wide range of metropolitan and regional public services, including education, health, planning, recreation, and environmental protection. Such bodies can include library boards; transit and police commissions; and utilities providing water, gas, and electricity. These agencies deal with public services whose delivery areas transcend political jurisdictions and are better financed by loans, user charges, and earmarked benefit taxes, such as a supplementary mill rate on a property tax base to finance a local school board. If kept to a minimum, such agencies help fully exploit economies of scale in the delivery of services where political boundaries are not consistent with service areas. A proliferation of these agencies can undermine accountability and budgetary flexibility at local levels. Accountability and responsiveness to voters are weakened if members of special-purpose bodies are appointed rather than elected. Budgetary flexibility is diminished if a majority of local expenditures fall outside the control of local councils.

Table 1.1 presents a matrix for a normative assignment of spending responsibilities among different orders of government. Table 1.2 provides a subjective assessment of how various allocative criteria favor local or metropolitan assignment and whether public or private production is favored for efficiency or equity. The criteria and the assessment presented in this table are arbitrary; practical and institutional considerations should be applied to this analysis, and the reader may well reach different conclusions using the same criteria.

Private sector participation can also take a variety of forms, including contracting through competitive biddings, franchise operations (local government acting as a regulatory agency), grants (usually for recreational and cultural activities), vouchers (redeemable by local government with private providers), volunteers (mostly in fire stations and hospitals), community self-help activities (for crime prevention), and private nonprofit organizations (for social services). Thus, a mix of delivery systems is appropriate for local public services. In most developing countries, the financial capacities of local governments are quite limited. Fostering private sector participation in the delivery of local public services thus assumes greater significance. Such participation enhances accountability and choice in the local public sector.

TABLE 1.1 Representative Assignment of Expenditure Responsibilities

Function	Policy, standards, and oversight	Provision and administration	Production and distribution	Comments
Interregional and international conflicts resolution	U	U	N,P	Benefits and costs international in scope
External trade	U	U,N,S	P	Benefits and costs international in scope
Telecommunications	U, N	P	P	Has national and global dimensions
Financial transactions	U,N	P	P	Has national and global dimensions
Environment	U,N,S,L	U,N,S,L	N,S,L,P	Externalities of global, national, state, and local scope
Foreign direct investment	N,L	L	P	Local infrastructure critical
Defense	N	N	N,P	Benefits and costs national in scope
Foreign affairs	N	N	N	Benefits and costs national in scope
Monetary policy, currency, and banking	U, ICB	ICB	ICB, P	Independence from all levels essential; some international role for common discipline
Interstate commerce	Constitution, N	N	P	Constitutional safeguards important for factors and goods mobility

Immigration	U,N	N	N	U because of forced exit
Transfer payments	N	N	N	Redistribution
Criminal and civil law	N	N	N	Rule of law, a national concern
Industrial policy	N	N	P	Intended to prevent “beggar thy neighbor” policies
Regulation	N	N,S,L	N,S,L,P	Internal common market
Fiscal policy	N	N,S,L	N,S,L,P	Coordination possible
Natural resources	N	N,S,L	N,S,L,P	Promotes regional equity and internal common market
Education, health, and social welfare	N,S,L	S,L	S,L,P	Transfers in kind
Highways	N,S,L	N,S,L	S,L,P	Benefits and costs vary in scope
Parks and recreation	N,S,L	N,S,L	N,S,L,P	Benefits and costs vary in scope
Police	S, L	S,L	S,L	Primarily local benefits
Water, sewer, refuse, and fire protection	L	L	L,P	Primarily local benefits

Source: Shah 1994, 2004.
Note: U = supranational responsibility, ICB = independent central bank, N = national government, S = state or provincial government, L = local government, P = nongovernmental sectors or civil society.

TABLE 1.2 Assignment of Local Public Services to Municipal and Regional or Metropolitan Governments

	Allocation criteria for provision							Allocation criteria for public vs. private production		
Public service	Economies of scale	Economies of scope	Benefit-cost spillover	Political proximity	Consumer sovereignty	Economic evaluation of sectoral choices	Composite	Efficiency	Equity	Composite
Firefighting	L	L	L	L	L	M	L	P	G	P
Police protection	L	L	L	L	L	M	L	P	G	G
Refuse collection	L	L	L	L	L	M	L	P	P	P
Neighborhood parks	L	L	L	L	L	M	L	P	G	G
Street maintenance	L	L	L	L	L	M	L	P	P	P
Traffic management	L	M	L	L	L	M	L	P	P	P
Local transit service	L	M	L	L	L	M	L	P	P	P
Local libraries	L	L	L	L	L	M	L	G	G	G
Primary education	L	L	M	M	L	M	M	P	G	P,G
Secondary education	L	L	M	M	L	M	M	P	G	P,G
Public transportation	M	M	M	L,M	M	M	M	P,G	G	P,G
Water supply	M	M	M	L,M	M	M	M	P	G	P,G
Sewage disposal	M	M	M	M	M	M	M	P,G	P,G	P,G
Refuse disposal	M	M	M	M	M	M	M	P	P	P
Public health	M	M	M	M	M	M	M	G	G	G
Hospitals	M	M	M	M	M	M	M	P,G	G	P,G
Electric power	M	M	M	M	M	M	M	P	P	P
Air and water pollution	M	M	M	M	M	M	M	G	G	G
Special police	M	M	M	M	M	M	M	G	G	G
Regional parks	M	M	M	L,M	M	M	M	G	G	G
Regional planning	M	M	M	L,M	M	M	M	G	G	G

Source: Shah 1994.
Note: L = local government, M = regional or metropolitan government, P = private sector, G = public sector.

However, assigning responsibility for the provision of service to a specific level of government does not imply that government should be directly engaged in its production. Limited empirical evidence suggests that private production of some services promotes efficiency and equity.

Fiscal federalism literature also provides guidance on financing choices for local governments. Four general principles require consideration in assigning taxing powers to various governments. First, the *economic efficiency* criterion dictates that taxes on mobile factors and tradable goods that have a bearing on the efficiency of the internal common market should be assigned to the center. Subnational assignment of taxes on mobile factors may facilitate the use of socially wasteful "beggar thy neighbor" policies to attract resources to own areas by regional and local governments. In a globalized world, even central assignment of taxes on mobile capital may not be very effective in the presence of tax havens and the difficulty of tracing and attributing incomes from virtual transactions to various physical spaces. Second, *national equity* considerations warrant that progressive redistributive taxes should be assigned to the center, which limits the possibility of regional and local governments following perverse redistribution policies using both taxes and transfers to attract high-income people and repel low-income ones. Doing so, however, leaves open the possibility of supplementary, flat-rate, local charges on residence-based national income taxes. Third, the *administrative feasibility* criterion (lowering compliance and administration costs) suggests that taxes should be assigned to the jurisdiction with the best ability to monitor relevant assessments. This criterion minimizes administrative costs as well as the potential for tax evasion. For example, property, land, and betterment taxes are good candidates for local assignment because local governments are in a better position to assess the market values of such assets. Fourth, the *fiscal need* or *revenue adequacy* criterion suggests that to ensure accountability, revenue means (the ability to raise revenues from own sources) should be matched as closely as possible with expenditure needs (see table 1.3 for a representative assignment of taxing responsibilities). The literature also argues that long-lived assets should primarily be financed by raising debt, so as to ensure equitable burden sharing across generations (Inman 2005). Furthermore, such large and lumpy investments typically cannot be financed by current revenues and reserves alone (see box 1.1).

These four principles suggest that user charges are suitable for use by all orders of government, but the case for decentralizing taxing powers is not as compelling as that for decentralizing public service delivery. This is because lower-level taxes can introduce inefficiencies in the allocation of resources

TABLE 1.3 A Representative Assignment of Taxing Powers

Types of tax	Determination of base	Determination of rate	Collection and administration	Comments
Customs	F	F	F	International trade taxes
Corporate income tax	F,U	F,U	F,U	Mobile factor, stabilization tool
Resource taxes				
Resource rent (profits and income) tax	F	F	F	High, unequally distributed tax bases
Royalties, fees, charges; severance taxes; and production, output, and property taxes	S,L	S,L	S,L	Benefit taxes and charges for state-local services
Conservation charges	S,L	S,L	S,L	Intended to preserve local environment
Personal income tax	F	F,S,L	F	Redistributive, mobile factor, stabilization tool
Wealth taxes (taxes on capital, wealth, wealth transfers, inheritances, and bequests)	F	F,S	F	Redistributive
Payroll tax	F,S	F,S	F,S	Benefit charge, such as social security coverage
Multistage sales taxes (value added tax)	F	F	F	Border tax adjustments possible under federal assignment; potential stabilization tool
Single-stage sales taxes (manufacturer, wholesale, and retail)				
Option A	S	S,L	S,L	Higher compliance cost
Option B	F	S	F	Harmonized, lower compliance cost

"Sin" taxes				
Excises on alcohol and tobacco	F,S	F,S	F,S	Health care a shared responsibility
Betting and gambling taxes	S,L	S,L	S,L	State and local responsibility
Lotteries	S,L	S,L	S,L	State and local responsibility
Racetrack taxes	S,L	S,L	S,L	State and local responsibility
Taxation of "bads"				
Carbon tax	F	F	F	Intended to combat global or national pollution
Energy taxes	F,S,L	F,S,L	F,S,L	Pollution impact may be national, regional, or local
Motor fuels tolls	F,S,L	F,S,L	F,S,L	Tolls on federal, provincial, and local roads
Effluent charges	F,S,L	F,S,L	F,S,L	Intended to deal with interstate, intermunicipal, or local pollution issues
Congestion tolls	F,S,L	F,S,L	F,S,L	Tolls on federal, provincial, and local roads
Parking fees	L	L	L	Intended to control local congestion
Motor vehicles				
Registration, transfer taxes, and annual fees	S	S	S	State responsibility
Driver's licenses and fees	S	S	S	State responsibility
Business taxes	S	S	S	Benefit tax
Excises	S,L	S,L	S,L	Residence-based taxes
Property tax	S	L	L	Completely immobile factor, benefit tax
Land tax	S	L	L	Completely immobile factor, benefit tax
Frontage and betterment taxes	S,L	L	L	Cost recovery
Poll tax	F,S,L	F,S,L	F,S,L	Payment for local services
User charges	F,S,L	F,S,L	F,S,L	Payment for services received

Source: Shah 1994.
Note: U = supranational agency, F = federal, S = state or province, L = municipal or local government.

BOX 1.1 Local and Metropolitan Finance: Options for Own-Source Revenues

The fiscal federalism literature argues for local assignment of the following taxes and charges in addition to debt finance for long-lived assets: user charges; property and land taxes; frontage and betterment taxes and charges; poll taxes and charges; single-stage (retail) sales taxes; piggyback flat tax on residence-based national income taxes; duties on hotel rooms, airport use, entertainment, taxis, and rental cars; vehicle registration fees; single business or profession permits; resource royalties; severance taxes; local conservation charges; taxes on local "bads" (BTU taxes, congestion tolls, parking fees, and effluent charges); and "sin" taxes (taxes on betting, gambling, lotteries, racetracks).

Source: Author.

across the federation and cause inequities among people in different jurisdictions. In addition, collection and compliance costs can increase significantly. These problems are more severe for some taxes than others, so the selection of which taxes to decentralize must be made with care, balancing the need to achieve fiscal and political accountability at the lower levels of government against the disadvantages of having a fragmented tax system. The tradeoff between increased accountability and increased economic costs from decentralizing taxing responsibilities can be mitigated by fiscal arrangements that permit joint occupation and harmonization of taxes to overcome fragmentation and by fiscal equalization transfers that will reduce the fiscal inefficiencies and inequities that arise from different fiscal capacities across regional and local governments (see table 1.4 on the design of fiscal transfers).

The fiscal federalism perspectives presented above are helpful, but in practice they have resulted in some major difficulties—especially in developing countries—because the practice seems to emphasize fiscal federalism's structures and processes as ends rather than as means to an end. These structures and processes were designed as a response to market failures and heterogeneous preferences with little recognition of government failures or the role of entities beyond government. The NPM and the NIE literature (synthesized in the following paragraphs) sheds further light on the origins of these difficulties. This literature highlights the sources of government failures and their implications for the role of local government.

TABLE 1.4 Principles and Better Practices in Grant Design

Grant objective	Grant design	Better practices	Practices to avoid
Bridge fiscal gap	Reassignment of responsibilities, tax abatement, or tax-base sharing	Tax abatement in Canada and tax-base sharing in Brazil, Canada, and Pakistan	Deficit grants; tax-by-tax sharing
Reduce regional fiscal disparities	General nonmatching fiscal capacity equalization transfers	Fiscal equalization programs of Canada and Germany	General revenue sharing with multiple factors
Compensate for benefit spillovers	Open-ended matching transfers with matching rate consistent with spillover of benefits	Grant for teaching hospitals in South Africa	
Set national minimum standards	Nonmatching block transfers with conditions on standards of service and access	Roads and primary education grants, as in Indonesia (now defunct); education transfers, as in Colombia and Chile; health transfers in Brazil and Canada	Transfers with conditions on spending alone; ad hoc grants
Influence local priorities in areas of high national but low local priority	Open-ended matching transfers (preferably with matching rate to vary inversely with fiscal capacity)	Matching transfers for social assistance	Ad hoc grants
Provide stabilization	Capital grants with maintenance possible	Limited use of capital grants and encouragement of private sector participation by providing political and policy risk guarantee	Stabilization grants with no future upkeep requirements

Source: Shah 1994, 2004.

Local government as an independent facilitator of creating public value: New public management perspectives

Two interrelated criteria have emerged from the NPM literature in recent years determining, first, what local governments should do and, second, how they should do it better.

In discussing the first criterion, the literature assumes that citizens are the principals but have multiple roles as governors (owner-authorizers, voters, taxpayers, community members); activist-producers (providers of services, coproducers, self-helpers obliging others to act); and consumers (clients and beneficiaries) (see Moore 1996). In this context, significant emphasis is placed on the government as an agent of the people to serve public interest and create public value. Moore (1996) defines *public value* as measurable improvements in social outcomes or quality of life. This concept is directly relevant to local and municipal services, for which it is feasible to measure such improvements and have some sense of attribution. The concept is useful in evaluating conflicting and perplexing choices in the use of local resources. The concept is also helpful in defining the role of government, especially local governments. It frames the debate between those who argue that the public sector crowds out private sector investments and those who argue that the public sector creates an enabling environment for the private sector to succeed, in addition to providing basic municipal and social services.

Moore (1996) has argued that, rather than diverting resources from the private sector, local governments use some of the resources that come as free goods—namely, resources of consent, goodwill, Good Samaritan values, community spirit, compliance, and collective public action. This argument suggests that the role of public managers in local governments is to tap these free resources and push the frontiers of improved social outcomes beyond what may be possible with meager local revenues. Thus, public managers create value by mobilizing and facilitating a network of providers beyond local government. Democratic accountability ensures that managerial choices about creating public value are based on broader consensus by local residents (see Goss 2001). Thus, the local public sector continuously strives to respect citizen preferences and to be accountable to them. This environment, focused on creating public value, encourages innovation and experimentation, bounded by the risk tolerance of the median voter in each community.

The main current of the NPM literature is concerned not with what to do but with how to do it better. It argues for an incentive environment in which managers are given flexibility in the use of resources but held accountable for results. Top-down controls are thus replaced by a bottom-up focus on results. Two NPM models have been implemented in recent years. The first model is focused on making managers manage. In New Zealand, this goal is accomplished through new contractualism, whereby public managers are bound by formal contracts for service delivery but have flexibility in resource allocation and choice of public or private providers. Malaysia attempts to achieve the same through client charters, under which public managers are evaluated for their attainment of specified service standards (Shah 2005).

The second model creates incentives to let managers manage. It applies the new managerialism approach, as used in Australia and the United States, whereby government performance in service delivery and social outcomes is monitored, but there are no formal contracts, and accountability is guided by informal agreements. In China and the United Kingdom, autonomous agency models are used for performance accountability. Canada uses an alternative service delivery framework: public managers are encouraged to facilitate a network of service providers and to use benchmarking to achieve the most effective use of public monies. The emerging focus on client orientation and results-based accountability is encouraging local governments to innovate in many parts of the world (Caulfield 2003).

Local government as an institution to advance self-interest: The public choice approach

Bailey (1999) has conceptualized four models of local government:

- A local government that assumes it knows best and acts to maximize the welfare of its residents conforms to the *benevolent despot* model.
- A local government that provides services consistent with local residents' willingness to pay conforms to the *fiscal exchange* model.
- A local government that focuses on public service provision to advance social objectives conforms to the *fiscal transfer* model.
- A local government that is captured by self-interested bureaucrats and politicians conforms to the *leviathan* model, which is consistent with the public choice perspectives.

In the same tradition, Breton (1995) provides a comprehensive typology of models of government. He distinguishes two broad types of government. The first embodies the doctrine of the common good, and the second acts to preserve the self-interest of the governing elites. The second type can assume either a monolithic or a composite structure. In a monolithic structure, local government is subject to capture by bureaucrats or interest groups. Also, local government may maximize economic rents for dominant interest groups (as in the leviathan model) or may advance compulsion or coercion. If the self-interest model assumes a composite structure, it may encourage Tiebout-type competition among local governments.

The public choice literature endorses the self-interest doctrine of government and argues that various stakeholders involved in policy formulation and implementation are expected to use opportunities and resources to advance their self-interest. This view has important implications for the design of local government institutions. For local governments to serve the interests of people, they must have complete local autonomy in taxing and spending and they must be subject to competition within and beyond government. In the absence of these prerequisites, local governments will be inefficient and unresponsive to citizen preferences (Boyne 1998). Bailey (1999) advocates strengthening exit and voice mechanisms in local governance to overcome government failures associated with the self-interest doctrine of public choice. He suggests that easing supply-side constraints for public services through wider competition will enhance choice and promote exit options and that direct democracy provisions will strengthen voice (see also Dollery and Wallis 2001). The NIE approach discussed below draws on the implications of opportunistic behavior by government agents for the transaction costs to citizens as principals.

The government as a runaway train: NIE concerns with the institutions of public governance

The NIE provides a framework for analyzing fiscal systems and local empowerment and for comparing mechanisms for local governance. This framework is helpful in designing multiple orders of government and in clarifying local government responsibilities in a broader framework of local governance. According to the NIE framework, various orders of governments (as agents) are created to serve the interests of the citizens as principals. The jurisdictional design should ensure that these agents serve the public interest while minimizing transaction costs for the principals.

The existing institutional framework does not permit such optimization, because the principals have bounded rationality; that is, they make the best choices on the basis of the information at hand but are ill informed about government operations. Enlarging the sphere of their knowledge entails high transaction costs, which citizens are not willing to incur. Those costs include participation and monitoring costs, legislative costs, executive decision-making costs, agency costs or costs incurred to induce compliance by agents with the compact, and uncertainty costs associated with unstable political regimes (Horn 1997; Shah 2005). Agents (various orders of governments) are better informed about government operations than principals are, but they have an incentive to withhold information and to indulge in opportunistic behaviors or "self-interest seeking with guile" (Williamson 1985, p. 7). Thus, the principals have only incomplete contracts with their agents. Such an environment fosters commitment problems because the agents may not follow the compact.

The situation is further complicated by three factors—weak or extant countervailing institutions, path dependency, and the interdependency of various actions. Countervailing institutions such as the judiciary, police, parliament, and citizen activist groups are usually weak and unable to restrain rent-seeking by politicians and bureaucrats. Historical and cultural factors and mental models by which people see little benefits to and high costs of activism prevent corrective action. Further empowering local councils to take action on behalf of citizens often leads to loss of agency between voters and councils, because council members may interfere in executive decision making or may get co-opted in such operations while shirking their legislative responsibilities. The NIE framework stresses the need to use various elements of transaction costs in designing jurisdictions for various services and in evaluating choices between competing governance mechanisms.

Local government as a facilitator of network forms of local governance

The NIE approach provides an evaluation framework for alternative forms and mechanisms of local governance. It specifically provides guidance in dealing with government failures in a hierarchical form of public governance. The framework is also suitable for examining local government involvement in a partnership of multiple organizations. Dollery and Wallis (2001) extend the NIE approach to these issues. They argue that a structure of resource dependency vitiates against collective action in the interest of the common good because of the tragedy of commons associated with common pool resources. This scenario results in failures in horizontal coordination in a multiorganization partnership.

One possible solution is to introduce a market mechanism of governance, whereby a contract management agency enters into binding contracts with all partners. However, this solution is unworkable because the potential number of contingencies may simply be too large to be covered by such contracts. A second approach to overcome horizontal coordination, the so-called hierarchical mechanism of governance, relies on institutional arrangements to clarify roles and responsibilities and to establish mechanisms for consultation, cooperation, and coordination, as is done in some federal systems. Such institutional arrangements entail high transaction costs and are subject to a high degree of failure attributable to the conflicting interests of partners.

Given the high transaction costs and perceived infeasibility of market and hierarchical mechanisms of governance for partnerships of multiple organizations, a network mechanism of governance has been advanced as a possible mode of governance for such partnerships—the kind to be managed by local governments. The network form of governance relies on trust, loyalty, and reciprocity between partners with no formal institutional safeguards. Networks formed on the basis of shared interests (interest-based networks) can provide a stable form of governance if membership is limited to partners that can make significant resource contributions and if there is a balance of powers among members. Members of such networks interact frequently and see cooperation in one area as contingent on cooperation in other areas. Repeated interaction among members builds trust. Hope-based networks are built on the shared sentiments and emotions of members. Members have shared beliefs in the worth and philosophy of the network goals and have the passion and commitment to achieve those goals. The stability of such networks is highly dependent on the commitment and style of their leadership (Dollery and Wallis 2001).

Local government has an opportunity to play a catalytic role in facilitating the roles of both interest-based and hope-based networks in improving social outcomes for local residents. To play such a role, local government must develop a strategic vision of how such partnerships can be formed and sustained. But then the local government requires a new local public management paradigm. Such a paradigm demands local government to separate policy advice from program implementation, assuming a role as a purchaser of public services but not necessarily as a provider of them. Local government may have to outsource services with higher provision costs and subject in-house providers to competitive pressures from outside providers to lower transaction costs for citizens. It also must actively seek the engagement of both interest-based and hope-based networks to supplant local services. It needs to develop the capacity to play a mediating role among various groups.

A synthesis: Toward a framework for responsive, responsible, and accountable local governance

We have reviewed ideas emerging from the literature on political science, economics, public administration, law, federalism, and the NIE with a view to developing an integrated analytical framework for the comparative analysis of local government and local governance institutions.

The dominant concern in this literature is that the incentives and accountability framework faced by various orders of government is not conducive to a focus on service delivery consistent with citizen preferences. As a result, corruption, waste, and inefficiencies permeate public governance. Top-down hierarchical controls are ineffective; there is little accountability because citizens are not empowered to hold governments accountable.

Fiscal federalism practices around the world are focused on structures and processes, with little regard for outputs and outcomes. These practices support top-down structures with preeminent federal legislation (that is, federal legislation overrides any subnational legislation). The central government is at the apex, exercising direct control and micromanaging the system. Hierarchical controls exercised by various layers of government have an internal rule-based focus with little concern for their mandates. Government competencies are determined on the basis of technical and administrative capacity, with almost no regard for client orientation, bottom-up accountability, and lowering of transaction costs for citizens. Various orders of government indulge in uncooperative zero-sum games for control.

This tug of war leads to large swings in the balance of powers. Shared rule is a source of much confusion and conflict, especially in federal systems. Local governments are typically handmaidens of states or provinces and given straitjacket mandates. They are given only limited home rule in their competencies. In short, local governments in this system of "federalism for the governments, by the governments, and of the governments" get crushed under a regime of intrusive controls by higher levels of governments. Citizens also have limited voice and exit options.

The governance implications of such a system are quite obvious. Various orders of government suffer from agency problems associated with incomplete contracts and undefined property rights, as the assignment of taxing, spending, and regulatory powers remains to be clarified—especially in areas of shared rule. Intergovernmental bargaining leads to high transaction costs for citizens. Universalism and pork-barrel politics result in a tragedy of commons, as various orders of government compete to claim a higher share of common pool resources. Under this system of governance, citizens are treated as agents rather than as principals.

On how to reverse this trend and make governments responsive and accountable to citizens, the dominant themes emphasized in the literature are the subsidiarity principle, the principle of fiscal equivalency, the creation of public value, results-based accountability, and the minimization of transaction costs for citizens, as discussed earlier. These themes are useful but should be integrated into a broader framework of citizen-centered governance, to create an incentive environment in the public sector that is compatible with a public sector focus on service delivery and bottom-up accountability. Such integration is expected to deal with the commitment problem in various levels of government by empowering citizens and by limiting their agents' ability to indulge in opportunistic behavior.

CITIZEN-CENTERED LOCAL GOVERNANCE. Reforming the institutions of local governance requires agreement on basic principles. Three basic principles are advanced to initiate such a discussion:

- *Responsive governance.* This principle aims for governments to do the right things—that is, to deliver services consistent with citizen preferences.
- *Responsible governance.* The government should also do it right—that is, manage its fiscal resources prudently. It should earn the trust of residents by working better and costing less and by managing fiscal and social risks for the community. It should strive to improve the quality and quantity of and access to public services. To do so, it needs to benchmark its performance with the best-performing local government.
- *Accountable governance.* A local government should be accountable to its electorate. It should adhere to appropriate safeguards to ensure that it serves the public interest with integrity. Legal and institutional reforms may be needed to enable local governments to deal with accountability between elections—reforms such as a citizen's charter and a provision for recall of public officials.

A framework of local governance that embodies these principles is called *citizen-centered governance* (Andrews and Shah 2005). The distinguishing features of citizen-centered governance are the following:

- Citizen empowerment through a rights-based approach (direct democracy provisions, citizens' charter);
- Bottom-up accountability for results;
- Evaluation of government performance as the facilitator of a network of providers by citizens as governors, taxpayers, and consumers of public services.

The framework emphasizes reforms that strengthen the role of citizens as the principals and create incentives for government agents to comply with their mandates (table 1.5).

TABLE 1.5 Key Elements of Citizen-Centered Governance

Responsive governance	Responsible governance	Accountable governance
Has subsidiarity and home rule Has direct democracy provisions Has budget priorities consistent with citizens' preferences Specifies and meets standards for access to local services Improves social outcomes Offers security of life and property Offers shelter and food for all Has clean air, safe water, and sanitation Has a noise-free and preserved environment Offers ease of commute and pothole-free roads Has primary school at a walking distance Has acceptable fire and ambulance response times Has libraries and Internet access Has park and recreation programs and facilities	Follows due process: ■ The principle of ultra vires or general competence or community governance ■ The procedure bylaw ■ Local master plans and budgets ■ Zoning bylaws and regulations ■ Funded mandates Is fiscally prudent: ■ Operating budget in balance ■ Golden rule for borrowing ■ New capital projects that specify upkeep costs and how debt is to be repaid ■ Conservative fiscal rules to ensure sustainable debt levels ■ Major capital projects that are subject to referenda ■ Maintenance of positive net worth ■ Commercially audited financial statements Earns trust: ■ Professionalism and integrity of staff ■ Safeguards against malfeasance ■ Streamlined processes and e-governance ■ Complaints and feedback acted on ■ Honest and fair tax administration ■ Strict compliance with service standards ■ Citizen-friendly output budgets and service delivery performance reports	Lets the sunshine in: ■ Local government bylaw on citizens' right to know ■ Budgetary proposals and annual performance reports posted on the Internet ■ All decisions, including the costs of concessions, posted on the Internet ■ Value for money performance audits by independent think tanks ■ Open information and public assessment Works to strengthen citizen voice and exit: ■ Citizens' charter ■ Service standards ■ Requirements for citizens' voice and choice ■ Sunshine rights ■ Sunset clauses on government programs ■ Equity- and output-based intergovernmental finance ■ Citizen-oriented performance (output) budgeting ■ Service delivery outputs and costs ■ Citizens' report card on service delivery performance ■ Budget, contracts, and performance reports defended at open town hall meetings

(continued)

TABLE 1.5 Key Elements of Citizen-Centered Governance (*continued*)

Responsive governance	Responsible governance	Accountable governance
	■ Participatory budgeting and planning Works better and costs less: ■ All tasks subjected to alternative service delivery test—that is, competitive provision involving government providers and entities beyond government ■ Financing that creates incentives for competition and innovation ■ Comparative evaluation of service providers ■ Public sector as a purchaser through performance contracts but not necessarily a provider of services ■ Managerial flexibility, but accountability for results ■ No lifelong or rotating appointments ■ Task specialization ■ Budgetary allocation and output-based performance contracts ■ Activity-based costing ■ Charges for capital use ■ Accrual accounting ■ Benchmarking with the best ■ General administration costs subjected to public scrutiny ■ Boundaries that balance benefits and costs of scale and scope economies, externalities, and decision making ■ Boundaries consistent with fiscal sustainability	■ All documents subjected to citizen-friendly requirements ■ Open processes for contract bids ■ Mandatory referenda on large projects ■ Steps taken so that at least 50 percent of eligible voters vote ■ Citizens' boards to provide scorecard and feedback on service delivery performance ■ Provisions for popular initiatives and recall of public officials ■ Bylaw on taxpayer rights

Source: Author's views.

The commitment problem may be mitigated by creating citizen-centered local governance—by having direct democracy provisions, introducing governing for results in government operations, and reforming the structure of governance, thus shifting decision making closer to the people. Direct democracy provisions require referenda on major issues and large projects and require that citizens have the right to veto any legislation or government program. A "governing for results" framework requires government accountability to citizens for service delivery performance. Hence, citizens have a charter defining their basic rights as well as their rights of access to specific standards of public services. Output-based intergovernmental transfers strengthen compliance with such standards and strengthen accountability and citizen empowerment (Shah 2006b).

Implications for division of powers within nations: Role reversals for central and local governments

The framework described above has important implications for reforming the structure of government. Top-down mandates on local governance will need to be replaced by bottom-up compacts. Furthermore, the role of local government must be expanded to serve as a catalyst for the formulation, development, and operation of a network of both government providers and entities beyond government. Local government's traditionally acknowledged technical capacity becomes less relevant in this framework. More important are its institutional strengths as a purchaser of services and as a facilitator of alliances, partnerships, associations, clubs, and networks for developing social capital and improving social outcomes. Two distinct options are possible in this regard, and both imply a pivotal role for local governments in the intergovernmental system. The options are (a) local government as the primary agent, subcontracting to local, state, and federal or central government authorities and engaging networks and entities beyond government, and (b) local, state, and national governments as independent agents.

OPTION A: LOCAL GOVERNMENTS AS PRIMARY AGENTS OF CITIZENS. In this role, a local government serves as (a) a purchaser of local services, (b) a facilitator of networks of government providers and entities beyond government, and (c) a gatekeeper and overseer of state and national governments for the shared rule or responsibilities delegated to them. This role represents a fundamental shift in the division of powers from higher to local governments. It has important constitutional implications. Residual functions reside with local governments. State governments perform intermunicipal services. The national government is assigned redistributive, security, foreign relations, and interstate functions such as harmonization and consensus on a common framework. The Swiss system bears close affinity to this model.

OPTION B: VARIOUS ORDERS OF GOVERNMENT AS INDEPENDENT AGENTS. An alternative framework for establishing the supremacy of the principals is to clarify the responsibilities and functions of various orders as independent agents. This framework limits shared rule. Finance follows function strictly, and fiscal arrangements are periodically reviewed for fine-tuning. Local governments enjoy home rule, with complete tax and expenditure autonomy. The Brazilian fiscal constitution incorporates some features of this model, albeit with significant deviations.

FEASIBILITY OF OPTIONS. Option A is well grounded in the history of modern governments and is most suited for countries with no history of internal or external conflict in recent times. It is already practiced in Switzerland. War, conquest, and security concerns have led to a reversal of the roles of various orders of governments and to a reduction in local government functions in more recent history. Globalization and the information revolution have already brought pressures for much larger and stronger roles for local governments (see Shah 2001). Although a majority of governments have done some tinkering with their fiscal systems, the radical change recommended here is not in the cards anywhere. This is because the unlikelihood of overcoming path dependency—a tall order for existing institutions and vested interests—makes such reform infeasible. Under such circumstances, option B may be more workable, but here the clarity of responsibilities may not be politically feasible. In general, there is unlikely to be political will to undertake such bold reforms. Piecemeal adaptation of this model will nevertheless be forced on most countries by the effects of globalization and by citizen empowerment, facilitated by the information revolution.

The Practice: Alternative Models of Local Governance and Central-Local Relations

Local governance historically predates the emergence of nation-states. In ancient history, tribes and clans established systems of local governance in most of the world. They established their own codes of conduct and ways of raising revenues and delivering services to the tribe or clan. Tribal and clan elders developed consensus on the roles and responsibilities of various members. Some tribes and clans with better organization and skills then sought to enlarge their spheres of influence through conquest and cooperation with other tribes. In this way, the first Chinese dynasty, the Xia, was established (2070 BC to 1600 BC) (see Zheng and Fan 2003). A similar situation prevailed in ancient India, where in the third millennium BC (about 2500 BC) a rich civilization was established in the Indus Valley (now Pakistan). This advanced civilization placed great emphasis on autonomy in local governance and enshrined a consensus on division of work for various members of the society. This emphasis led to the creation of a class society in which each member had a defined role: upholder of moral values, soldier, farmer, tradesperson, worker. Each community formed its own consensus on community services and how to accomplish them.

Native American tribes in North America and tribes and clans in Western Europe also enjoyed home rule. Subsequent conquests and wars led to the demise of these harmonious systems of self-rule in local governance and to the emergence of rule by central governments all over the world. This development (roughly around 1000 BC in Western Europe) ultimately led to the creation of unique systems of local governance and central-local relations in most countries. Those systems can nevertheless be classified into the following broad categories for analytical purposes.

The Nordic Model

In the 15th century, Denmark, Norway, and Sweden were ruled by a Danish king. Residents in those countries contributed to the king's coffers but were allowed to run local affairs autonomously (Werner and Shah 2005). In the absence of central intrusion, the seeds for a locally run, client-oriented, welfare state were sown. As a result, local governments assumed most functions of the state while the central government largely assumed a ceremonial role and foreign relations functions. Local governments therefore assumed responsibility not only for local service delivery but also for social protection and social welfare functions. Local governments in Nordic countries serve their residents from cradle to grave. They deliver property-oriented as well as people-oriented services.

In modern times, the central governments in Nordic countries have assumed wider regulatory and oversight functions, but the predominance of local government—more than 30 percent of gross domestic product (GDP) in Denmark—and its autonomy are still preserved because of citizen satisfaction with local government performance. The Nordic model emphasizes small local governments (average jurisdiction of fewer than 10,000 inhabitants) that are primarily self-financing. In Denmark and Sweden, nearly 75 percent—and in Norway, 64 percent—of local expenditures are financed from own-source revenues. Personal income taxes (piggybacking on a national base) are the mainstays of local finance (almost 91 percent of tax revenues), and property taxes contribute a pitiful 7 percent of tax revenues.

The Swiss Model

The origins of the Swiss Confederation can be traced to the defensive alliance signed by the cantons of Uri, Schwyz, and Unterwalden in 1291. Before that event, the Swiss territories were under the control of independent local governments (cantons). This tradition of local government domination continues in the Swiss system today: local governments enjoy autonomy not only in fiscal matters but also in such areas as immigration, citizenship, language, and foreign economic relations.

This tradition of strong local government is further strengthened through direct democracy provisions in the Swiss constitution, including (a) people's initiatives, (b) referenda, and (c) petitions. The people's initiatives empower citizens to seek a decision on an amendment that they want to make to the constitution. A people's initiative may be formulated as a general proposal or as a precisely formulated text whose wording can no longer be changed by parliament or the government. For such an initiative to be considered, the signatures of 100,000 voters must be collected within 18 months. A popular majority and a majority of all cantons are required for the acceptance of such an initiative.

Through the referenda provision, the people are entitled to pronounce their judgments on matters under consideration by the legislature or the executive or matters on which a decision has already been made. In the latter case, the referendum acts as a veto. Federal laws and international treaties are subject to optional referenda, provided that 50,000 citizens request it within 100 days of the publication of the decree. Under the petition provision, all eligible voters can submit a petition to the government and are entitled to receive a reply. Switzerland consists of 26 cantons and 2,842 communes. Each canton has its own constitution, parliament, government, and courts. The communes are handmaidens of the cantons. They perform some delegated tasks such as population registration and civil defense, but they have autonomous competencies in education and social welfare, energy supply, roads, local planning, and local taxation (Government of Switzerland 2003).

The French Model

In the French model, the primary role of local governments is to allow citizens at the grassroots level a sense of political participation in decision making at the national level. The system embodies the thinking of Rousseau and Voltaire on rationality and social cohesion and that of Napoleon on a sense of order and an unbroken chain of command. The national government and its agencies represent the apex of this system, with an unbroken chain of command through regional and departmental prefects to chief executives and mayors of communes at the lowest rung of the system. There is a similar chain of command through line and functional ministries. Therefore, the model is sometimes referred to as the *dual supervision* model of local governance.

The system permits *cumul des mandats* (concurrent political mandates or holding multiple offices or positions concurrently) to provide elected leaders at lower echelons with a voice at higher levels of governments. Public service delivery remains the primary responsibility of the national government, and its agencies may be directly involved in the delivery of local services. The average size of local government jurisdiction is small (covering fewer than 10,000 inhabitants), and local governments have a limited range of autonomous service delivery responsibilities. Local governments use a mix of local revenue instruments and rely significantly on central financing. This model, with its focus on strong central command and dual supervision, proved very popular with colonial rulers from France, Portugal, and Spain, as well as with military dictators, and was widely replicated in developing countries (Humes 1991).

The German Model

The German model emphasizes subsidiarity, cooperation, and administrative efficiency. It entrusts policy-making functions to the federal level and service delivery responsibilities to geographically delineated states and local governments, to which it gives a great deal of autonomy in service delivery. All purely local services are assigned to local governments. The average local government covers 20,000 inhabitants, and local expenditures constitute about 10 percent of GDP. General revenue sharing serves as a major source of local finances.

The British Model

The British model has elements of the French dual supervision model. It emphasizes a stronger role for centrally appointed field officers and sectoral and functional ministries in the provision of local services. Local governments must coordinate their actions with these officials. Local governments are given substantial autonomy in purely local functions, but they can access only a limited range of revenue instruments. Local governments play a dominant role in such property-oriented services as road maintenance, garbage collection, water, and sewerage and a limited role in such people-oriented services as health, education, and social welfare. Property taxes are the mainstay of local governments. Local governments typically derive two-thirds of their revenues from central transfers. They do not have access to personal income taxes. The role of the chief executive is weak, and local councils play a strong role in local decision making. The average local government is large, covering about 120,000 inhabitants, and local expenditures account for about 12 percent of GDP (McMillan forthcoming). In former British colonies, the role of field officers was strengthened to provide general supervision and control of local governments on behalf of the central colonial government.

The Indian Model

India had one of the oldest traditions of strong self-governance at the local level. In the pre-Moghul period, local government was in operation more extensively in India than anywhere else in the world. Small villages and towns were regulated by custom and community leadership, with authority normally vested in an elders' council headed by a *sarpanch* or *numberdar*. The apex institution was the *panchayat*, with responsibilities for law and order, local services, land management, dispute resolution, administration of justice, provision of basic needs, and revenue collection. These institutions enabled each village and town to function harmoniously.

Subsequent wars and conquest led to a weakening of local governance in India. During the Moghul period, panchayats were required to collect central taxes, but local government autonomy was not disturbed (Wajidi 1990). During the British Raj, with its central focus on command and control and little concern for service delivery, the system of local governance received a major setback. Powers were centralized, and loyalty to the British regime was rewarded with land grants, leading to the creation of a class of feudal aristocrats who dominated the local political scene on behalf of the British government. The central government also appointed roving bureaucrats to run local affairs. Since independence in both India and Pakistan, centralized governance has been maintained, while small steps have been taken to strengthen local autonomy. In India, feudal aristocracy was abolished through land reforms, but in Pakistan, such reforms could not be carried out. As a result, in areas of feudal dominance in Pakistan, local self-governance led to capture by elites.

The Chinese Model

This model places strong emphasis on making provincial and local governments an integral and dependent sphere of national government. This is accomplished in two ways: through democratic centralism, which integrates the local people's congress with the national People's Congress through a system of elections, and through dual subordination of local governments, whereby provincial and local governments are accountable to higher-level governments in general, but the functional departments are also accountable to higher-level functional agencies and departments. The personnel functions are also integrated among various orders of government. Because of its integrative nature, the model permits a large and expansive role for provincial and local governments in service delivery. The average local government jurisdiction is very large. Subprovincial local government expenditure constitutes 51.4 percent of consolidated public expenditures. Subprovincial local governments employ 89 percent of the total government workforce. Some clearly central functions such as unemployment insurance, social security, and social safety nets are assigned to provincial and local governments. Local autonomy varies directly with the fiscal capacity of a local government, with richer jurisdictions calling their own tunes while poor jurisdictions follow the pied piper of higher-level governments.

The Japanese Model

The local government system introduced in Meiji Japan in about 1890 had elements of the French and German models. It emphasized centralized control, as in the French model of local governments, through the Ministry of Interior appointing heads of regional governments (governors of prefectures), who controlled local districts and municipalities. The local government simply implemented policies determined by the central government. In the post–World War II period, direct elections of governors, mayors, and councils were introduced. The practice of agency delegation (German model) was retained, and local governments were expected to perform functions mandated by the central government and its agencies. The Ministry of Home Affairs, which had a supportive role for local governments, was introduced in 1960 (Muramatsu and Iqbal 2001). Income taxes are the mainstay of local government finance, contributing 60 percent of own-source tax revenues, followed by property taxes (about 30 percent) and sales taxes (about 10 percent).

The North American Model

In the early period of North American history, local communities functioned as *civic republics* (Kincaid 1967) governed by mutual consent of their members. The framers of the U.S. constitution did not recognize local governments. The Civil War led to the centralization of powers in the United States. Subsequently, the formal institutions of local government were created by states. The judiciary further constrained the role of local government through recognition of *Dillon's rule:* local governments may exercise only those powers explicitly granted to them under state legislation. Subsequently, most states have attempted to grant autonomy to local governments in discharging their specified functions through *home rule* provisions (Bowman and Kearney 1990).

Local governments in Canada are faced with circumstances similar to those in the United States. Thus, the North American model recognizes local government as a handmaiden of states and provinces but attempts to grant autonomy (home rule) to local governments in their specific areas of responsibility—predominantly delivery of property-oriented services. Local governments perform an intermediate range of functions. The average jurisdiction of local government in the United States is about 10,000 and in Canada about 6,000 inhabitants. Property taxes are the dominant source of local revenues. Local government expenditures constitute about 7 percent of GDP (see McMillan forthcoming).

The Australian Model

The Australian constitution does not recognize local governments. It is left to the states to decide on a system of local governance in their territories. Most states have assigned a minimal set of functions to local governments, including engineering services (roads, bridges, sidewalks, and drainage); community services (old-age care, child care, fire protection); environmental services (waste management and environmental protection); regulatory services (zoning, dwellings, buildings, restaurants, animals); and cultural services (libraries, art galleries, museums). Local governments raise only 3 percent of national revenues and are responsible for 6 percent of consolidated public sector expenditures. Property taxes (rates) and user charges are the mainstay (about 70 percent) of revenues, and central and state grants finance about 20 percent of local expenditures. Transportation, community amenities, and recreation and culture command two-thirds of local expenditures. Local government in New Zealand bears a close resemblance to the Australian model.

A Comparative Overview of Local Government Organization and Finance in Selected Developing Countries

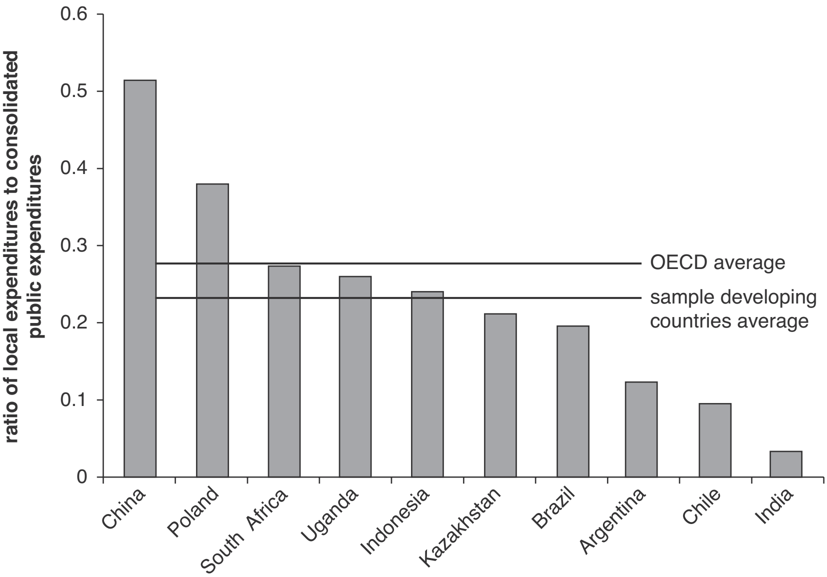
The conceptual literature argues for a strong role of local governments in local development, thereby improving public services and quality of life at the local level. It would therefore be instructive to learn about the role of such governments in developing countries. The following paragraphs provide a bird's-eye view of local government organization and finance in 10 selected developing countries.

Legal Status of Local Governments

The legal status of local governments varies across developing countries. In Brazil, Chile, India, South Africa, and Uganda, local governments have a constitutional status. In Indonesia, Kazakhstan, and Poland, local governments were created by national legislation, in Argentina by provincial legislation, and in China by an executive order of the central government. It is interesting to note that there is no clear pattern in the autonomy and range of local services provided by local governments deriving their status from national and state constitutions or legislation. However, local governments that are created through legislation, in general, are significantly weaker—with the notable exception of Poland.

Relative Importance of Local Governments

The relative importance of local governments in developing countries is compared using two indicators: share of consolidated public sector expenditures (figure 1.1) and local expenditures as a percentage of GDP (figure 1.2). According to both criteria, local governments in China command the largest share—more than 51 percent of consolidated public expenditures and 10.8 percent of GDP—whereas in India, it is the smallest share—3 percent of the expenditures and 0.75 percent of GDP. The rank order of some countries, however, is not consistent across both criteria. For example, South Africa does better than Brazil on the first and worse on the second criterion. On average in sample countries, local government



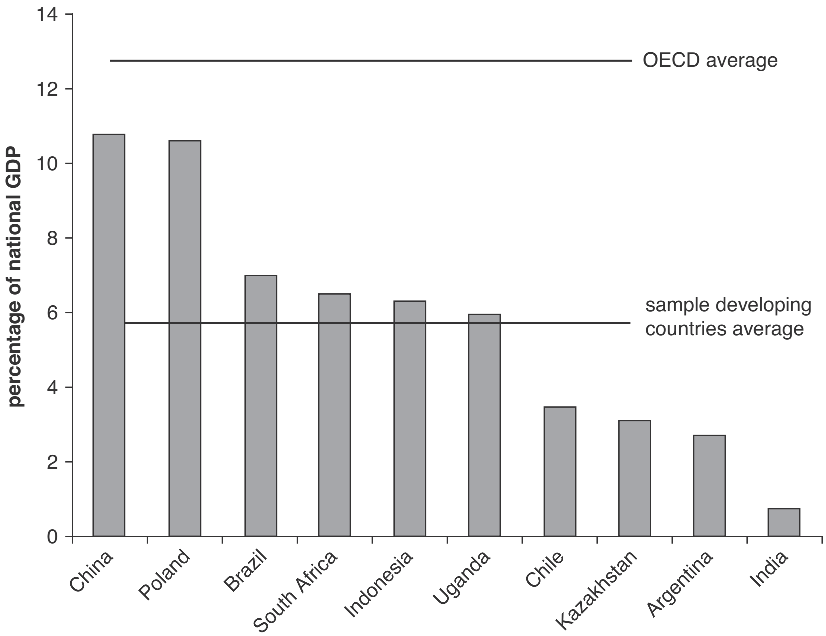
Source: Calculations based on World Development Indicators Online; government finance statistics; chapters 2–11 (this volume); and Werner forthcoming.
Note: The data are the latest available for each country—1997, Poland; 2001, Chile, Indonesia, and South Africa; 2002, India; and 2003, Argentina, Brazil, China, Kazakhstan, and Uganda.

FIGURE 1.1 A Comparative Perspective on Local Government Share of Consolidated Public Expenditures

expenditures amount to 23 percent of consolidated public sector expenditures and 5.7 percent of national GDP. Comparable figures for a sample of Organisation for Economic Co-operation and Development (OECD) countries would be 28 percent of consolidated expenditures and 12.75 percent of GDP. Thus, local governments' role is large, but in comparison with central and intermediate governments in developing countries and local governments in OECD countries, it is relatively much smaller in most developing countries—with the exception of China and Poland. In China, subprovincial local governments employ 38.7 million people and account for 89 percent of total public employment.

Population Size Covered by Local Governments

There are wide variations in the number and median size of municipal governments in the sample countries. Uganda has only 70 municipal governments, whereas China has 43,965 (table 1.6). The mean population



Source: Calculations based on World Development Indicators Online; government finance statistics; chapter 2–11 (this volume); and Werner forthcoming.
Note: The data are the latest available for each country—1997, Poland; 2001, Chile, Indonesia, and South Africa; 2002, India; and 2003, Argentina, Brazil, China, Kazakhstan, and Uganda.

FIGURE 1.2 Local Expenditures as a Share of National GDP

covered by municipal government is fewer than 10,000 people in Indonesia and Kazakhstan and more than 100,000 people in China, South Africa, and Uganda. Argentina and Poland have mean populations of less than 20,000, and Brazil has a mean municipal government population of about 31,000. Municipal governments in Chile and India have mean populations between 60,000 and 70,000 (table 1.7).

Local Spending Responsibilities

Local governments vary in their responsibilities across developing countries. China grants most extensive expenditure responsibilities to local governments. In addition to traditional local and municipal services, local governments in China are responsible for social security (primarily pensions and unemployment allowances) and have a much larger role in local economic development than local governments in other countries. Local governments' role in delivering local services is minimal in India and South Africa and largely focused on delivery

TABLE 1.6 Size Distribution of Municipal Governments in Developing Countries

Number of inhabitants	Argentina (2001)	Brazil (2002)	Chile (1992)	China (2004)	India (2001)	Indonesia (1990)	Kazakhstan (2002)	Poland (2003)	South Africa (2001)	Uganda (2002)
0–4,999	1,770	1,365	269	43,258	230,161	1,237	7,660	604	0	0
5,000–9,999		1,316	16		16,115	62	201	1,049	4	1
10,000–19,999	360	1,342	40		5,536		81	731	16	0
20,000–24,999		989							7	0
25,000–49,999	24				1,386	7			36	6
50,000–99,999		309			498		7	54	61	6
100,000–199,999		123			388	6	18	22	67	9
200,000–499,999		82		374				13	52	31
500,000–999,999		20		283				5	25	15
1,000,000 or more		14		50	35		1		14	2
Total number of municipalities	**2,154**	**5,560**	**325**	**43,965**	**254,119**	**1,312**	**7,968**	**2,478**	**282**	**70**

Source: Chapters 2–11 (this volume); Werner forthcoming.
Note: An arrow indicates that the value is an aggregate and covers the range indicated.

TABLE 1.7 Average Population per Local Authority in Sample Developing Countries

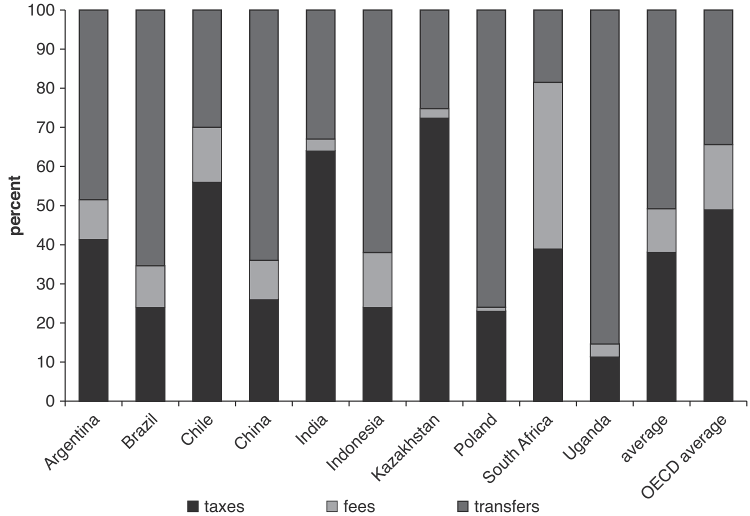
Country	Average population per local authority
India, rural	3,278
Kazakhstan	4,331
Indonesia	5,915
Argentina	14,972
Poland	18,881
Brazil	30,099
Chile	64,592
India, urban	68,027
China	107,334
South Africa	238,839
Uganda	373,321
All sample countries	79,000

Source: Table 1.6 (this volume).

of municipal services. In Kazakhstan, all local services are shared central-local responsibilities; local governments do not have independent budgets and have no fiscal autonomy. Education and health account for nearly half of local government expenditures in Argentina, Brazil, Chile, Indonesia, Kazakhstan, Poland, and Uganda. In Uganda, education alone accounts for about 40 percent of local expenditures. In India and South Africa, municipal services (such as water, sewer, and garbage) and municipal administration dominate local expenditures. In China, education, municipal administration, justice, and police account for nearly half of local expenditures.

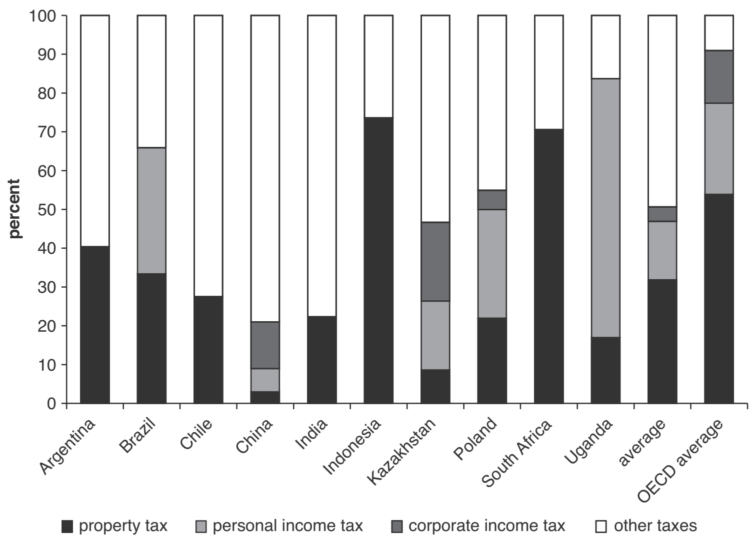
Local Revenues and Revenue Autonomy

Local governments in sample countries raise 39.6 percent of revenues from taxes, another 9.5 percent from fees and charges, and the remaining 50.9 percent from higher-level transfers (figure 1.3 and table 1.8). Comparable figures for OECD countries are 49 percent for taxes, 16.6 percent for fees, and 34.4 percent for transfers. The role of fiscal transfers is much larger than average in Uganda (85.4 percent), Poland (76.0 percent), China (67.0 percent), Brazil (65.4 percent), and Indonesia (62.0 percent). The sample countries have diverse revenue structures. On average, they raise 32 percent of tax revenues from property taxes, 15 percent of revenues from personal income taxes, 4 percent from corporate income taxes, and the other 49 percent from a large number of small taxes, fees, and charges. In comparison, OECD countries raise 54 percent of local revenues from property taxes, 23 percent from



Source: Calculations based on World Development Indicators Online; government finance statistics; chapters 2–11 (this volume); Werner forthcoming.
Note: The data are the latest available for each country—1997, Poland; 2000, India: 2001, Chile, Indonesia, and South Africa; and 2003, Argentina, Brazil, China, Kazakhstan, and Uganda.

FIGURE 1.3 Composition of Operating Revenues for Local Authorities



Source: Calculations based on World Development Indicators Online; government finance statistics; chapters 2–11 (this volume); Naresh 2004; Werner forthcoming.
Note: The data are the latest available for each country—1997, Poland; 2000, India: 2001, Chile, Indonesia, and South Africa; and 2003, Argentina, Brazil, China, Kazakhstan, and Uganda.

FIGURE 1.4 Composition of Local Tax Revenues

TABLE 1.8 Intergovernmental Transfers as a Share of Local Government Revenues in Developing Countries, 2003

Transfers as a percentage of total local revenues	Countries (listed in ascending order of the share of transfers)
10–20	South Africa
20–30	Kazakhstan, Chile
30–40	India
40–50	Argentina
60–70	Indonesia, Brazil, China
70–80	Poland, Uganda

Source: Chapters 2–11 (this volume).
Note: There were no countries with percentages in the 50–60 range.

personal income taxes, 14 percent from corporate taxes, and 9 percent from other taxes. Thus, local governments place a much greater reliance on property and income taxes in OECD countries than in developing countries. Property taxes raise only 3 percent of local revenues in China and 74 percent in Indonesia (centrally administered property tax) (figure 1.4).

For all developing countries, revenues from property taxes amount to 0.5 percent of GDP compared with about 2 percent (1 to 3 percent) of GDP in industrial countries. This finding suggests that property taxes may represent significant untapped potential for further exploitation. User charges are a significant source of revenues, but often such charges are poorly designed and administered and do not satisfy equity and efficiency principles or provide special safeguards for the poor. Autonomy in local tax base determination and administration is significant in Argentina, Brazil, and Poland; is limited in other countries; and does not exist in Kazakhstan. Overall, the degree of tax centralization in the sample countries is far greater than would be dictated by economic principles or political accountability considerations.

Sample countries in general follow a formula-based approach to general-purpose transfers. Nevertheless, the transfers are often not well designed compared with principles and better practices laid out in table 1.4. China, Indonesia, Poland, and South Africa attempt to use fiscal capacity and fiscal need measures in their fiscal equalization transfers, whereas most other countries have revenue-sharing programs with multiple factors that work at cross-purposes. The practice of fiscal equalization transfers is welcome; however, none of the sample countries use explicit equalization standards that determine both the total pool and the allocation of these transfers. As a result, the transfers do not achieve jurisdictional fiscal equity goals. Specific-purpose transfers are usually ad hoc and do not create incentives to safeguard their objectives. In particular, none of the sample countries practice output-based fiscal transfers to set national minimum standards of basic services and to enhance local accountability to citizens for results or performance. Thus, the reform of fiscal transfers to ensure equitable and accountable governance remains an unfinished task.

Facilitating Local Access to Credit

Local borrowing from capital markets is permitted in most of the sample countries with the exception of China, Chile, and Indonesia. In China, however, central government may borrow or issue bonds on behalf of local governments, and local enterprises owned by local governments can also borrow directly from the capital markets. In Argentina, Brazil, and Poland, local borrowing from domestic and international capital markets is allowed but constrained by fiscal rules, to ensure fiscal prudence and debt sustainability. In South Africa most such borrowing takes place from public agencies such as the Infrastructure Finance Corporation and the Development Bank of Southern Africa. The central government in South Africa provides regulatory oversight of all such borrowing and has the authority to intervene if a local government fails to meet its debt servicing obligations. South Africa has enacted a comprehensive framework for fiscal prudence at the local level, including provisions for declaring bankruptcy. In Kazakhstan, local governments can borrow only from the central government.

Large infrastructure deficiencies in developing countries call for significant access to borrowing by local governments. But local access to credit requires well-functioning financial markets and creditworthy local governments. In developing countries, undeveloped markets for long-term credit and weak municipal creditworthiness limit municipal access to credit. Nevertheless, the predominant central government policy emphasis is on central controls. Consequently, less attention has been paid to assistance for borrowing. In a few countries, such assistance is available through specialized institutions and central guarantees to jump-start municipal access to credit. These institutions are typically quite fragile, not likely to be sustainable, and open to political influences. Interest rate subsidies provided through these institutions impede emerging capital market alternatives. Furthermore, these institutions fail to smooth the transition to a market-based capital finance system.

Thus, in developing countries, the menu of choices available to local governments for financing capital projects is quite limited, and the available alternatives are not conducive to developing a sustainable institutional environment for such finance. Such limitations exist because macroeconomic instability and lack of fiscal discipline and appropriate regulatory regimes have impeded the development of financial and capital markets. In addition, revenue capacity at the local level is limited because of tax centralization. A first transitory step to provide limited credit market access to local governments may be to establish municipal finance corporations run on commercial principles and to encourage the development of municipal rating agencies to assist in such borrowing. Tax decentralization is also important to establish private sector confidence in lending to local governments and sharing in the risks and rewards of such lending. Central government bailouts and guarantee of subnational debt should, however, be ruled out through enactment of comprehensive frameworks of fiscal responsibility and fiscal insolvency, as was done in Brazil and South Africa recently. Transparency in local budgeting and independent credit rating agencies are also essential to smooth the transition to a market-based approach to subnational lending.

Some Conclusions about Local Governance in Developing Countries

Recent years have seen positive developments regarding local governance in developing countries. Local governments are increasingly assuming a larger role in public services delivery. However, with the exception of a handful of countries such as Brazil, China, and Poland, local governments continue to play a very small role in people's lives. They typically are bounded by the principle of ultra vires and allowed to discharge only a small number of functions, which are mandated from above. They have limited autonomy in expenditure decisions and hardly any in revenue-raising decisions. Their access to own-source revenues is constrained to a few nonproductive bases. Political and bureaucratic leaders at the local level show little interest in lobbying for more taxing powers and instead devote all their energies to seeking higher levels of fiscal transfers.

As a result, tax decentralization has not kept pace with political and expenditure decentralization. Hence, one does not find many examples of tax-base sharing, and even the limited existing bases available to local governments are typically underexploited. Fiscal transfers typically account for 60 percent of revenues in developing countries (51 percent in sample developing countries) as opposed to only 34 percent in OECD countries. This distinct separation of taxing and spending decisions undermines accountability to local citizens because local leaders do not have to justify local spending decisions to their electorates.

Local self-financing is important for strengthening governance, efficiency, and accountability. Although most countries have opted for formula-driven fiscal transfers, the design of these transfers remains flawed. They do not create any incentive for setting national minimum standards or accountability for results and typically do not serve regional fiscal equity objectives either.

Local governments also typically have very limited autonomy in hiring and firing local government employees. In a number of countries with decentralization, such as Indonesia and Pakistan, higher government employees are simply transferred to local levels; financing is then provided to cover their wage costs. This approach limits budgetary flexibility and opportunities for efficient resource allocation at the local level.

Overall, local governments in developing countries typically follow the old model of local governance and simply provide a narrow range of local services directly. The new vision, with the local governments assuming a network facilitator role to enrich the quality of life of local residents, as discussed earlier in this chapter, is yet to be realized in any developing country.

Concluding Remarks

We have presented a brief overview of the conceptual and institutional literature on local governance. A synthesis of the conceptual literature suggests that the modern role of a local government is to deal with market failures as well as government failures. This role requires a local government to operate as a purchaser of local services, a facilitator of networks of government providers and entities beyond government, and a gatekeeper and overseer of state and national governments in areas of shared rule. Local government also needs to play a mediator's role among various entities and networks to foster greater synergy and harness the untapped energies of the broader community for improving the quality of life of residents. Globalization and the information revolution are reinforcing those conceptual perspectives on a catalytic role for local governments.

This view is also grounded in the history of industrial nations and ancient civilizations in China and India. Local government was the primary form of government until wars and conquest led to the transfer of local government responsibilities to central and regional governments. This trend continued unabated until globalization and the information revolution highlighted the weaknesses of centralized rule for improving the quality of life and social outcomes. The new vision of local governance (table 1.9) presented here argues for a leadership role by local governments in a multicentered, multiorder, or multilevel system. This view is critical to creating

TABLE 1.9 Role of a Local Government under the New Vision of Local Governance

20th century: Old view	21st century: New view
Is based on residuality and local governments as wards of the state	Is based on subsidiarity and home rule
Is based on principle of ultra vires	Is based on community governance
Is focused on government	Is focused on citizen-centered local governance
Is agent of the central government	Is the primary agent for the citizens and leader and gatekeeper for shared rule
Is responsive and accountable to higher-level governments	Is responsive and accountable to local voters; assumes leadership role in improving local governance
Is direct provider of local services	Is purchaser of local services
Is focused on in-house provision	Is facilitator of network mechanisms of local governance, coordinator of government providers and entities beyond government, mediator of conflicts, and developer of social capital
Is focused on secrecy	Is focused on letting the sunshine in; practices transparent governance
Has input controls	Recognizes that results matter
Is internally dependent	Is externally focused and competitive; is ardent practitioner of alternative service delivery framework
Is closed and slow	Is open, quick, and flexible
Has intolerance for risk	Is innovative; is risk taker within limits
Depends on central directives	Is autonomous in taxing, spending, regulatory, and administrative decisions
Is rules driven	Has managerial flexibility and accountability for results
Is bureaucratic and technocratic	Is participatory; works to strengthen citizen voice and exit options through direct democracy provisions, citizens' charters, and performance budgeting
Is coercive	Is focused on earning trust, creating space for civic dialogue, serving the citizens, and improving social outcomes
Is fiscally irresponsible	Is fiscally prudent; works better and costs less
Is exclusive with elite capture	Is inclusive and participatory
Overcomes market failures	Overcomes market and government failures
Is boxed in a centralized system	Is connected in a globalized and localized world

Source: Author.

and sustaining citizen-centered governance, in which citizens are the ultimate sovereigns and various orders of governments serve as agents in the supply of public governance. In developing countries, such citizen empowerment may be the only way to reform public sector governance when governments are either unwilling or unable to reform themselves.

Acknowledgments

This chapter is an amended version of chapter 1 in Shah (2006a). It replaces the section on industrial countries with a section on developing countries; the rest of the chapter makes only minor revisions to the original chapter. This repetition of the substantive part of this introductory chapter was necessitated by the division of the original manuscript on local governance into two volumes. This chapter owes a great deal of intellectual debt to Professors Stephen Bailey, Brian Dollery, Sue Goss, Samuel Humes IV, Melville McMillan, and Joe Wallis, on whose works this chapter draws quite liberally. The principal author is also grateful to Sana Shah and Mike Lombardo for their briefs on local governance in developing countries and to Baoyun Qia for his help with data, tables, and figures for the section on developing countries.

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