Harry Kitchen
Melville McMillan
Anwar Shah

Local Public Finance and Economics

An International Perspective

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"This two volume project on the financing and governance of public spending, taxation, and borrowing in federal economies is sure to become the "go-to" reference for practitioners and policy-makers for implementing small changes or major reforms for the efficient and fair financing of national, provincial and local public goods. The authors bring their academic expertise and the wisdom earned through years of experience to the task. Highly recommended."

—Robert Inman, Richard K. Mellon *Professor, Wharton School, University of Pennsylvania*

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Harry Kitchen
Department of Economics
Trent University
Peterborough, ON, Canada

Melville McMillan
University of Alberta
Edmonton, AB, Canada

Anwar Shah
Governance Studies
Brookings Institution
Washington, DC, USA

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Preface

This book is a part of a two-volume series on local governance: “Local Public Finance and Economics: An International Perspective” as volume 1 and “Local Public, Fiscal and Financial Governance: An International Perspective” as volume 2. This series is intended to serve as a comprehensive guide/reference for policymakers, practitioners, policy analysts and interested researchers, scholars, and students in local public governance and local public finance and economics worldwide. The series would also be of interest to government officials, policymakers, and public policy students internationally as it provides a comprehensive coverage of issues and presents a synthesis of lessons from worldwide experiences in local economic and fiscal governance. The series would also serve as useful reference books for undergraduate and graduate courses in public economics. The existing literature on local public finance and economics has typically a country-specific focus mostly of an industrial country, for example, *State and Local Public Finance* by Ronald Fisher, published by Routledge in 2016, has a US focus. Also, the literature does not give special attention to local public governance issues. This series attempts to fill this void by providing a state-of-the-art synthesis of the academic literature and supplementing it with lessons of experience from both industrial and developing countries. The series further presents one of the most comprehensive treatments of local economic and fiscal governance issues. Some of the newer topics covered include neo-institutional perspectives on the role of local government; tax instruments for environmental protection; performance-based budgeting; output-based intergovernmental transfers; fiscal rules and fiscal discipline; combating corruption; measuring, monitoring, and evaluating local government performance; and worldwide indicators on localization and closeness of the government to its people. In view of this, we hope that this series would be of interest to a wider range of audiences in both industrial and developing countries.

Peterborough, ON, Canada — Harry Kitchen
Edmonton, AB, Canada — Melville McMillan
Washington, DC, USA — Anwar Shah

Acknowledgments

This book represents the knowledge gained from several decades of research and teaching local public economics to graduate and undergraduate students in North America. In addition, it captures the practical experiences of policymakers and practitioners from industrial and developing countries gained through policy advice, senior policymakers, and high-level executives' retreats, conferences, workshops, seminar, and short courses. The authors are grateful to students, practitioners, and policymakers around the globe for enriching their knowledge with the insights gained from these interactions.

The authors are also grateful to their families and the editors of Palgrave Macmillan for their support and encouragement for completion of this volume.

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About the Authors

Harry Kitchen is Professor Emeritus in the Economics Department at Trent University, Canada. Over the past 20 years, he has completed more than 100 articles, reports, studies, and books on issues relating to local government expenditures, finance, structure, and governance in Canada. In addition, he has served as a consultant or advisor for a number of municipal and provincial governments in Canada and the federal government, and has worked on projects in Russia and China. In 2013, he was awarded a Queens Diamond Jubilee medal for policy analysis and research contributions to municipal finance, structure, and governance in Canada. In 2017, he was appointed visiting scholar at the Institute of Municipal Finance and Governance, Munk School of Global Affairs, University of Toronto.

Melville McMillan is Professor Emeritus in the Department of Economics and a fellow of the Institute of Public Economics at the University of Alberta, Canada. McMillan's research and teaching interests are in public economics, particularly urban and local economics, fiscal federalism, and the demand/supply of public goods and services. He has written in these areas and has advised governments and organizations nationally and internationally (e.g., the World Bank). Although "retired," McMillan remains actively involved in academic and policy matters.

Anwar Shah is a senior fellow (non-resident) at the Brookings Institution, Washington, DC, USA; advisor/consultant to the World Bank; and Distinguished Visiting Professor of Economics, Southwestern University of Finance and Economics, Chengdu/Wenjiang, China. He has previously served the Government of Canada (Ministry of Finance), the Government of Alberta, and the UN Intergovernmental Panel on Climate Change. He has written more than two dozen books in English, subsequently translated in Spanish, Chinese, Vietnamese, and Russian languages and numerous articles in leading economic journals on governance, public management reforms, budget reform, federalism, local governance, fiscal reforms, and global climate change issues.

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CHAPTER 1

Local Public Finance and Economics: Theory and the Practice—Introduction and Overview

"We will strive increasingly to quicken the public sense of civic duty. Thus in all these ways, we will transmit this city not only not less, but greater and more beautiful than it was transmitted to us."

—Oath of office required of council members in the ancient city of Athens
Source: National League of Cities Website https://www.nlc.org/the-athenian-oath

Introduction

Globalization and the information revolution during the past several decades have motivated a large and growing number of countries around the globe to reexamine the roles of various orders of government and their partnership with the private sector and civil society. These reforms typically involve shifting higher-order government responsibilities to local governments and beyond government providers, with the objectives of strengthening local governance. This movement has generated a large interest in learning from the history of nations as well as from current conceptual views and practices across countries on local government organization and finance.

A large body of conceptual and empirical evidence has also emerged during the past several decades that shows that external aid and technocratic solutions are of little help in alleviating poverty and misery and combat corruption in the developing world. Instead, the key to peace, order, good government, prosperity, growth, and a world free of poverty, hunger,

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deprivation, and oppression lies in decentralized local governance with home rule that empowers citizens to hold governments to account for ensuring FAIR (fair, accountable, incorruptible, and responsive) governance. Empowered local governments hold the promise of good jobs, good homes, a good life, a good time for the young and the young at heart, and sweet dreams of a prosperous future for all. In an information age with a borderless world economy, where economic success is more closely tied to the competitive advantage garnered by skills and information base, local governments are at the core of the future growth and prosperity of any nation. In an age of mistrust in governments, local governments serve as a tool to overcome a lack of trust and restore confidence in governments through their commitment to improve social and economic outcomes. To meet these great expectations, local governments must be empowered to act as the primary agents of citizens exercising oversight on the shared rule by higher-order governments and beyond government entities in the local area. They must have the authority to act as facilitators of network governance at the local level supervising and coordinating the activities of higher-order governments and beyond government stakeholders such as hope, faith, and interest-based networks, private for profit and non-profit providers, and good Samaritans.

As noted earlier, a silent revolution has swept the globe during the past several decades to bring public decision-making closer to the people. Regrettably though in most parts of the developing world, people empowerment through local self-rule remains an unrealized dream due to path dependency and state capture by political, bureaucratic, and military elites. Formidable political and institutional hurdles stand in the way especially those that impede the poor to shape their own destiny. Reform is eternal; we never fully succeed but we owe it to billions of disempowered citizens of this world to keep trying to usher in a better future for all. This book takes a small step in this regard by bringing the international knowledge on the theory and practice of good local governance to the attention of a wider set of stakeholders and students. This introductory chapter provides foundation material for local governance and introduces the reader to the contents of this volume.[1]

[1] This chapter is a revised version of the introductory chapter in Shah, ed. (2006), "A Comparative Institutional Framework for Responsive, Responsible and Accountable Local Governance" Chapter 1: 1–38.

The chapter begins with an overview of basic concepts. It then provides a synthesis of conceptual perspectives on local government and central-local relations. A comparative analysis of local government organization and finance is also presented. Contrasting experiences of local governance in industrial and developing countries are highlighted. Conclusions of empirical evidence on the impact of localization/decentralization on good governance and growth are summarized. A final section introduces the two-volume series on local public governance and presents an overview of the contents of rest of this volume.

Basic Concepts in Local Government, Local Governance, and Local Public Economics and Finance

Local government refers to specific institutions or entities created by national constitutions (Brazil, Denmark, France, 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, India, Pakistan); or by executive order of the central government (China) to deliver a range of specified services to a relatively small geographically delineated area. Local governments are distinct administrative units from intermediate order governments, that is, states and provinces, in most countries. The overall objective of local governments is to maximize economic and social outcomes for residents and provide an enabling environment for private-sector development through efficient provision of local public services in a small geographical area.

Local governance is a broader concept and is defined as the formulation and execution of collective action at the local level to serve public interest. 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.

Local public economics and finance is primarily concerned with the subset of issues in local governance that have a direct bearing on the quantity and quality of local public services and their matching with local preferences and their impact on the economic and social outcomes for local residents and advancing local economic development. Thus it is more focused on local jurisdictional design, local autonomy in provision and finance of local public services, and facilitating network governance and regulating local production of public and private goods. Note that local government's primary role is in the provision of local services, that is, ascertaining local resident's preferences for public services and financing choices and articulating and aggregating local preferences for local public goods and public regulation of private activities. Production of local public services, that is, combining of diverse inputs to produce outputs efficiently and organize methods of delivery to final consumers in the least-cost manner, is a task that can be better done by public and private actors working in partnerships or in competition with each other. Separation of provision and production decisions has important implications for jurisdictional design. Jurisdictional design for provision would focus on ensuring responsiveness to local preferences, whereas technical efficiency considerations such as economies of scale and scope will determine production choices. These choices, however, can be harmonized by networking, contracting, franchising, and vouchering (Oakerson 1999; Ostrom et al. 1962).

Globalization and information revolution have recently created a heightened interest in public economics and finance in view of the growing role of local governments in advancing international competitiveness and growth. 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 government and 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 national governments while neglecting the role of local governments or community organizations and the overall local 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 (Dollery and Wallis 2001; Bailey 1999; 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. The principle of FAIR local governance requires adherence to that a local government is *fair* (is concerned with inclusiveness of all its residents), *accountable* (to citizens, through a rights-based approach), *incorruptible* (ensures openness and integrity of its operations), *responsive* (doing the right thing—delivering services that are consistent with citizens' preferences or are citizen focused), and *responsible* (doing the right thing the right way—working better but costing less and benchmarking with the best). 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 government and governance as background to a better understanding of local public economics and finance 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 Theory: Conceptual Perspectives on Local Government 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 is 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*, where local governments are assigned functions that the central government is unwilling or thinks it is unable to perform. It also negates the principle of ultra vires where local governments can only undertake tasks defined in law by higher-order government.

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 consolidated, special, or multi-purpose 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 are 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 multi-tiered system and outlines principles for defining the roles and responsibilities of orders of government (see Shah 1994, 2004, 2014 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 (cantons) are the main source of sovereignty and have greater constitutional significance than the federal government (see Switzerland 2003). 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. Note that this view of federalism contrasts with Kincaid's (1967) idea of a federal state comprising civic republics where civic republics were intended to be autonomous local governments and the federal government discharged responsibilities entrusted to them by civic republics. 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 that

- 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.
- Provision and finance of local services by the local governments or by the metropolitan or regional governments.

In all countries, the *production* of services can be public or private or both, 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 one 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 metropolitan-wide government providing area-wide 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.

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 non-profit organizations (for social services). Thus, a mix of production and 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. 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 and delivery 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. 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 Table 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 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 trade-off 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.

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

Table 1.1 Key considerations and tools for local government finances

Key considerations

The overall objective of local governments is to maximize social outcomes for residents and provide an enabling environment for private-sector development through efficient provision of public services. This requires that local financing should take into account the following considerations:

- Local government should limit self-financing of redistributive services
- Business should be taxed only for services to businesses and not for redistributive purposes
- Current period services should be financed out of current year operating revenues and future period services should be financed by future period taxes, user charges/fees, and borrowing
- Residential services should be financed by taxes and fees on residents
- Business services should be financed on site/land value taxes and user charges. Profit, output, sales, and moveable asset taxes may drive business out of the jurisdiction

Tools for local finance

- *Local taxes* for services with public goods or public bads characteristics—streets, roads, street lighting (public goods), traffic congestion, water and air pollution (public bads)
- *User charges* for services with private goods characteristics—water, sewerage, solid waste
- *Conditional, nonmatching, output-based grants* from national/state-order governments for merit goods or redistributive public services: education and health
- *Conditional matching grants* for spillovers in some services
- *Unconditional grants* for fiscal gap and equalization purposes
- *Capital grants* for infrastructure if local fiscal capacity is low
- *Capital market finance* for infrastructure if local fiscal capacity is high
- *Development charges* for financing growth with higher charges for developing land on local government boundaries
- *Public-private partnerships* for infrastructure finance but keeping public ownership and control of strategic assets
- *Tax increment financing districts* to deal with urban blight. For this purpose, the area should be designated for redevelopment and annual property tax revenues frozen at pre-vitalization levels. For a specified period, say 15–35 years, all tax revenues above base are used for redevelopment. Capacity improvements are undertaken through municipal borrowing/bonds against expected tax increments

Source: Inman (2005) and Boadway and Shah (2009)

heterogeneous preferences with little recognition of government failures or the role of entities beyond government. The new public management (NPM) and the new institutional economics (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.

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, co-producers, 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 2005a).

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