

## **Empowering States and Provinces or Unshackling Local Governments: Does It Matter for Peace, Order, Good Government, and Growth?**

ANWAR SHAH

Globalisation and the information revolution are profoundly influencing the division of power within, across, and beyond nation-states. Within nations, this mega change has led to a diminished economic relevance of the intermediate order of government (states and provinces) and an enhanced need for home rule (empowered local governments) in both unitary and federal countries. Considerations of peace, order, and good government further warrant that intermediate orders of governments must assume a relatively less prominent role in multi-order governance. The recent fiscal crisis and the ever-growing concern about corruption have further heightened the need to get the government right, thereby creating additional pressures to limit the size of the government by possibly downsizing the role of the states/provinces and reconstituting these as provincial councils of local governments to perform inter-local functions and coordination. These economic imperatives, calling for an *hourglass model of federalism*, are at odds with the political realities in countries conforming to the *traditional dual federalism model*, i.e., federalism of the provinces model of economic governance as prevalent in Australia, India, Mexico, and Pakistan, among others. The political order in these latter countries has blocked local governments from assuming their due role as the primary agents of the people providing oversight on the shared rule and as facilitators for network governance to improve the economic and social outcomes. Such a role of local government is also critical to international competitiveness and growth as demonstrated by the experiences of China, Japan, Korea, and the Nordic countries. This paper outlines reform options for multi-order governance to conform with the new world economic order. The paper elaborates the role of local governments under 'glocalised governance'—the new vision of multi-order governance—and argues that growth and economic prosperity of nations in the coming decades would critically depend on how quickly political and institutional impediments to the new (or the oldest?) paradigm of local governance are overcome. The paper concludes that path dependency makes such radical reforms infeasible in countries with strong provincial governments run by feudal, military, and industrial elites.

### **INTRODUCTION: MOTIVATIONS FOR RETHINKING FISCAL FEDERALISM**

Globalisation and the information revolution are profoundly influencing economic governance in both the industrial and the industrialising world.

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Globalisation has lifted millions of people out of poverty and the information revolution has brought about a degree of citizen empowerment and activism in state affairs that is unparalleled in past history. They have also acted as catalysts for “reshuffling” government functions within and beyond nation states [Friedman (1999); Courchene (2001); Castells (1998); Shah (1999, 2002); Boadway and Shah (2009)]. Globalisation has also meant liberating markets and bringing market discipline to governments. Recent global financial crisis has significantly shattered common faith in the workings of free markets. Providing bailouts to markets have also endangered the fiscal health of governments around the globe while creating a crisis in public confidence in national politics and leadership. This paper reflects upon special challenges in adapting multi-order governance to make it incentive compatible with growth with equity and fiscal sustainability, urgency of which is brought home by these mega changes.

Because of globalisation, it is increasingly apparent that “..the nation-state is becoming too small for the big problems of life , and too big for the small problems of life” [Bell (1987), pp.13–14]. In other words, nation-states are gradually losing control of some of their customary areas of authority and regulation, including macroeconomic policy, corporate taxation, external trade, environment policy, telecommunications, and financial transactions (see Box 1). Globalisation is also making small open economies vulnerable to the whims of large hedge funds and polarising the distribution of income in favour of skilled workers and regions with higher skills and access to information, thus widening income disparities within nations while improving overall levels of incomes and standards of living. Because of the information revolution, governments have less ability to control the flow of goods and services, ideas, and cultural products. The twin forces of globalisation and the information revolution are also strengthening localisation. They are empowering local governments and “beyond-government” service providers, such as neighbourhood associations, non-governmental non-profit and for-profit organisations, self-help groups and networks to exercise a broader role in improving economic and social outcomes at the local level through greater connectivity to markets and resources elsewhere. Localisation is leading to citizen empowerment in some areas while simultaneously strengthening local elites in others. Courchene (1993, 2001) has termed the overall effect of these changes “*glocalisation*”, which implies the growing role of global regimes and local governments and beyond government entities and changing roles of national and provincial (state) governments in an interconnected world. The culture of governance is also slowly changing from a bureaucratic to a participatory mode of operation, from a command-and-control model to one of accountability for results, from being internally dependent to being competitive and innovative, from being closed and slow to being open and quick, and from being intolerant of risk to allowing freedom to fail or succeed. Recent global financial crises has hampered this change, but with improved macro stability in future, the new vision of governance is expected to gradually taking hold in the 21st century (see Table 1). Nevertheless, in many developing countries, this vision may not take hold or may take a long time to materialise because of political and institutional difficulties.

**Box 1****Emerging Rearrangements of Government Assignments: Glocalisation**

*Beyond nation-states:* Regulation of financial transactions, corporate taxation, international trade, the global environment, telecommunications, international standards, international migration, surveillance of governance conditions, global security and risk management, transnational production, investment and technology transfer, combating of money laundering, corruption, pandemics, and terrorism.

*Centralisation:* Social and environmental policy through international agreements, skills enhancement for international competitiveness, securing common economic union through bridging economic, social and digital divide within nations, social safety nets, oversight, financing of education, social services and technical assistance to sub-national governments.

*Localisation, and Privatisation:* All regional and local functions.

Source: Boadway and Shah (2009).

Table 1

*Governance Structure: 20th versus 21st Century*

20th Century	21st Century
Centralised or provincialised	Globalised and localised
Centre that manages	Centre that leads
Citizens as agents, subjects, clients and consumers	Citizens as governors and principals
Bureaucratic	Participatory
Command and control	Responsive and accountable
Internally dependent	Competitive
Closed and slow	Open and quick
Intolerance of risk	Freedom to fail or succeed
Focus on government	Focus on governance with interactive direct democracy
Competitive edge for resource based economies	Competitive edge for human capital based economies
Federalism as a tool for coming together or holding together	Global collaborative federalism with a focus on network governance and reaching out
Residuality principle, ultra vires, "Dillon's rule"	Community governance principle, subsidiarity principle, home- or self-rule and shared rule
Limited but expanding role of global regimes with democracy deficits	Wider role of global regimes and networks with improved governance and accountability
Emerging federal prominence in shared rule	Leaner but caring federal government with an enhanced role in education, training, and social protection
Strong state (province) role	Ever-diminishing economic relevance of states (provinces) and tugs-of-war to retain relevance
Diminishing role of local government	Pivotal role of local government as the engine of economic growth, primary agent of citizens, gatekeeper of shared rule, facilitator of network governance; wider role of "beyond government" entities
Tax and expenditure centralisation with revenue sharing and input based conditional grants to finance subnational expenditures	Tax and expenditure decentralisation with fiscal capacity equalisation and output-based national minimum standards grants

Sources: Boadway and Shah (2009).

The three emerging trends resulting from this mega change in the shifting balance of powers within nations are: (a) the role of the central government is slowly changing from that of a managerial authority to a leadership role in a multi-centred government environment with enhanced emphasis on securing a common economic union through economic and social risk management and dealing with economic and digital divide within nations; (b) a steady erosion in the economic relevance of the role of the provinces (used interchangeably with states in this paper)—the second (intermediate) tier—and (c) an enhanced but redefined role of local government in multi-order governance to serve as the primary agent of people providing oversight on the shared rule and as a facilitator for network governance for economic and social uplift of its residents.

This paper is concerned with potentials and perils associated with adaptive responses to these challenges especially in reshaping the role of provinces and local governments. The paper is organised as follows. Section 2 discusses the role of the provinces (states) and local governments under a traditional fiscal federalism approach. Section 3 discusses the same under a new vision of multi-order governance. Section 4 draws implications of the alternate models for peace, order, good government and growth from cross country and country case studies. A final section draws broader policy implications of this analysis.

## **2. EMPOWERING PROVINCES AND STATES— POTENTIALS AND PERILS**

Federalism represents either a “coming together” or a “holding together” of constituent geographic units to take advantage of greatness and smallness of nations. Traditionally it represented a “foedus” (treaty or compact or alliance) among states (provinces) “each of which recognised the legitimacy of an overarching central government to make decisions on some matters once exclusively the responsibility of individual member states” as done in the USA [Inman (2007), p. 530]. “Coming together” has been the guiding framework for mature federations such as the United States, Canada, and more recently the European Union. The alternative “holding together” view of federalism, also called the “new federalism” represents an attempt to decentralise responsibilities from federal government to the states or provinces with a view to overcome regional discontent with central policies and forestall secessionist tendencies. This view is the driving force behind the current interest in principles of fiscal federalism in unitary countries and relatively newer federations such as Brazil, India and Pakistan and emerging federations such as Iraq, Nepal, Spain, Sri Lanka and South Africa. In Pakistan this was the primary motivation for unanimous consent to a recent passing of the 18th Amendment to the Pakistan’s constitution to empower provinces. Federal countries broadly conform to one of two models: dual federalism or cooperative federalism. A third model, the so called ‘competitive federalism’. Where all governments have overlapping responsibilities and compete vertically and horizontally to establish their clientele of services, is simply a theoretical construct and not practiced anywhere. Under dual federalism, federalism compact is between federal and provincial governments and they have separate and distinct responsibilities and local governments are typically creatures of the provinces as in Canada, USA, India and Pakistan. Under cooperative federalism, central and provincial roles can assume one of three forms:

interdependent spheres as in Germany, marble cake with overlapping responsibilities as in Belgium or independent spheres as in Brazil. In all these models with the sole exception of independent spheres model, provinces have a strong constitutional role and local governments remain creatures of provinces and states.

The dual federalism model empowers provinces and states. This is considered a welcome move as it moves decision making somewhat closer to people and it also has the advantage of dealing with ethnic and linguistic conflicts if provinces are numerous and are small enough in geographic area and represent population with relatively homogeneous characteristics and similar tastes and preferences for a menu of taxes and public services (as Cantons in Switzerland). If provinces are properly delineated as economic regions then they could also enhance efficiency of the internal common market by exploiting economies of scale and scope. They also have the potential to deal with inter-local spillovers and intra-regional inequities. Provincial governments can also be responsive to citizen preferences if provincial government is not captured by feudal, industrial and military elites. The absence of well developed communication and transportation system and a lack of urbanisation also makes provinces almost a necessity for countries that span a large geographic area.

The dual federalism model empowering provinces, nevertheless, has significant shortcomings.

*Tragedy of Commons Associated with Common Pool Resources.* Under dual federalism, both the centre and the provinces compete to claim a larger share of the fixed national pie. This accentuates universalism and pork barrel politics leading to a tragedy of commons where all federating units outcompete each other in profligate spending and giveaways in taxes and subsidies. This tug of war over resources and the resulting swings in the balance of powers within nations is a perpetual feature of dual federalism model.

*A Leviathan Model of Governance.* Empowering provinces leads to a potential for greater duplication of government structures and processes at central and provincial levels leading to increased costs for the exchequer and higher transactions costs for citizens. This may also lead to overgrazing by politicians and bureaucrats. As a result the growth in the size of government becomes unrelated to quality and quantity of service delivery. Opportunism and pork barrel politics leads to governments acting as employment creation agencies detracting them from their primary role in financing public services.

*Agency Problems with Incomplete Contracts.* In most large countries, empowering provinces does not necessarily imply that the decision making moves closer to people. Provinces and states are often larger in geographic size and population than smaller countries. Governments of New York, California, Ontario, Sao Paulo, Punjab, Sindh, Balochistan, and Indian states of Bihar and Gujarat have jurisdictions exceeding the size of many countries. Having decision making far removed from people implies that provincial governments have incomplete contracts with their citizens and could not be held to account by people at large. In countries where politics is dominated by feudal, military and industrial elites such as Pakistan, this leads to complete alienation of governments from their people. This lack of accountability in governance is further accentuated by a constraining of voice and exit options under provincial empowerment.

*Weaker and Fragmented Local Governance.* Empowered provinces create incentives for weaker and numerous local governments. The exigencies of provincial politics dictate that local governments are given straight jacket mandates with little resources and are kept under tight provincial reigns as in done in India and Pakistan [see Shah (1997)]. The empowered provincial governments typically encourage local fragmentation in the interest of higher degree of intrusive controls. In India, there are 254,119 local governments responsible for a pitience of (5 percent) of national expenditures. Most of these expenditure go towards financing the salaries and allowances of civil servants and 3 million elected officials with little left to deliver public services. In contrast, in China where provincial role is restricted and local governments are empowered, there are only 43,965 local governments accounting for 51.4 percent of national expenditures [see Qiao and Shah (2006)].

*Stifling Local Innovations.* Provinces and states often impose one size fit all straight jacket mandates that constrain local choices and flexibility and stifle any innovative approaches. In Pakistan, provincial ordinances in 2000 required all local governments, small or large, to have 16 departments and fixed number of positions. In the United States, outdated state laws that are rooted in unjustified distrust of local decision making have stifled successful cities to develop and implement any coherent vision of their future and serve their residents better [see Frug and Barron (2008)].

*Constraining Good Governance and Strangling Metropolitan Growth.* Empowered provinces typically block rationalisation of local government functions especially when the local government empowerment implies chipping away at their own powers. A classic example in this regard is the powers assigned to metropolitan areas under dual federalism. Fiscal federalism literature suggests that large metropolitan areas should have autonomous two tier regional governments with powers equivalent to that of a province and with direct interface with the centre. For this reason, Shanghai and Beijing, Bangkok and Seoul local governments are treated by China, Thailand and South Korea respectively as provinces. In contrast, in India and Pakistan, where provinces are relatively more powerful, metropolitan areas with large populations and significant economic bases such as Mumbai, New Delhi, Karachi and Lahore among others are treated as typical local governments with limited autonomy. Such treatment deprives residents of the benefits of home rule and constrains their efforts in local economic development.

*Fragmentation of Internal Common Market.* Empowered provinces also have the potential to create internal barriers to trade and factor mobility through domicile (residence) requirements and by creating protective regulatory and trade barriers across provincial borders. Mature federations like the USA have circumvented these problems through interstate commerce clause in the constitution. These barriers, however, are formalised in the political and bureaucratic system of India and Pakistan resulting in fragmented common economic union.

*Increased Threat of Succession.* Empowering provinces represent a potential threat to the political union especially in countries with ethnic, linguistic and religious divides and having smaller number of provincial jurisdictions with one or more dominant provinces such as Pakistan. Fiscal federalism literature shows that as a rule of thumb all dual federalism models with less than 10 provincial jurisdictions are likely to face internal conflicts and potential political instability.

*Diminished Economic Relevance of Intermediate Order of Government (Provinces and States) under Globalised Governance.* Finally and most importantly globalisation and information revolution are working to make the economic role of provinces largely redundant. Globalisation empowers supranational regimes and local governments at the expense of national and provincial governments. Globalisation also implies that international competitiveness of a nation is decoupled from its resource base but directly linked with its knowledge base. This suggests a greater role of national government in financing education and training. National government also assumes greater importance in social risk management due to vagaries of global system and social dumping by corporations to stay internationally competitive. National government also assumes a greater role in securing a common economic union. Provincial economic role on the other hand is on the wane as the information revolution makes national coordination and oversight over local governments and horizontal coordination at the local level through inter-local partnerships feasible as done in Finland. In view of the above pressures, states and provincial governments are under growing tension to reposition their roles to retain economic relevance. The political role of states and provinces, however, remains strong in all nations and even on the rise in some nations as in Germany, Pakistan and India. In Germany, the Lander has assumed a central role in implementing European Union directives and in policy making for regional planning and development. In India, states have effectively blocked implementation of the 73rd and 74th amendments to the Constitution empowering local governments. In Pakistan provinces have recently moved to scale back the fiscal and administrative autonomy of local governments.

In conclusion while economic considerations warrant a leaner role for provinces and an expansive role for local governments, developing countries are unlikely to adapt a smooth transition of such role reversals.

### **3. UNSHACKLING LOCAL GOVERNMENTS— EMERGING IMPERATIVES**

#### **Motivations for Rethinking the Role of Local Governments**

Globalisation and information revolution has brought about a paradigm shift in international competitiveness of nations. Economic prosperity of a nation is now more closely linked to the knowledge, skills and information base of its citizens rather than the country's resource endowments. It is increasingly recognised now that local governments, especially cities, are at the core of the future prosperity of a nation in view of their better positioning to forge a competitive advantage to spur economic growth by fostering a new knowledge based economy. With capital mobility and deregulation, local governments as providers of infrastructure related services, are more appropriate channels for attracting domestic and foreign investment. Cities are increasingly becoming important players in international economic alliances. Global financial crisis has diminished people's trust both in the markets and role of central governments in regulating such markets. With a cloud of fiscal distress looming over the world horizon from bailouts of financial markets, local governments may also hold the key to fiscal health and sustainable public finances as costly centrally determined and delivered services are replaced by locally demanded and competitively delivered services at the

local level. Closer to home, people are increasingly more likely to link their identities with local jurisdictions and are demanding higher quality local services to improve economic and social outcomes. But local governments with few exceptions (e.g. China, Denmark and Finland) are hamstrung to play a leadership role in local economic development in view of the constraints imposed by higher orders of government. To reshape the role of local governments to conform to the new world economic order, one has to review both the theory and the past legacy in practice.

### **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 [see Shah and Shah (2006, 2007)].

### **Local Government as a Handmaiden of a Higher Government Order:**

#### **Traditional Fiscal Federalism Perspectives**

The fiscal federalism approach is focused on internalising benefits and costs of service provision to the same jurisdiction and treats local government as a subordinate tier in a multi-tiered system and outlines principles for defining the roles and responsibilities of various orders of government [see Boadway and Shah (2009) 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 creatures of state (intermediate order) 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, intermediate order governments in federal countries assume varying degrees of oversight of the provision of local public services. In general, this perspective constrains the role of local governments as their expansive role comes at the expense of the powers of the intermediate order of government. As globalisation and information revolution leads to diminished economic relevance of the intermediate order of governments, these conflicts are accentuated and intermediate order governments have a tendency to play a more intrusive role at the local level to stay politically relevant. The fiscal federalism perspectives serve as a response to market failures and heterogeneous preferences with little recognition of government failures or the role of entities beyond 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. It argues that the role of public managers in local governments is to tap free resources of the community (goodwill, good Samaritan values) and push the frontiers of improved social outcomes beyond what may be possible with meagre local revenues [Moore (1996)]. Thus, public managers create value by mobilising and facilitating a network of providers beyond local government. 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.

### **Local Government as an Institution to Advance Self-interest:**

#### **The Public Choice Approach**

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 constrained only by direct democracy provisions 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) and Bailey (1999)].

### **The Government as a Runaway Train: Neo-institutional Economics (NIE)**

#### **Concerns with the Institutions of Public Governance**

Shah and Shah (2006) apply NIE principles in developing a framework for analysing 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 as interpreted by Shah and Shah (2006), 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 minimising transaction costs for the principals.

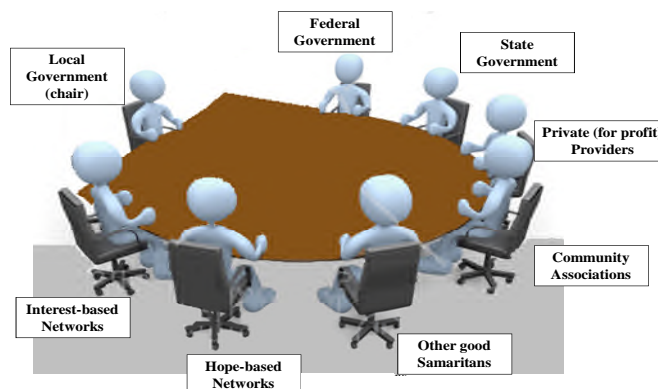
The existing institutional framework does not permit such optimisation, because the principals have bounded rationality; that is, they make the best choices on the basis of the information at hand but are ill informed about government operations. Enlarging the sphere of their knowledge entails high transaction 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 (officials of 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 behaviours 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**

Given the high transaction costs and perceived infeasibility of market and hierarchical mechanisms of governance for partnerships of multiple organisations, 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)] and the catalytic and mediating role played by local governments.

#### **LG as a Facilitator of Network Forms of Local Governance**



### **A Synthesis: Reshaping the Role of Local Governments for the 21st Century**

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.

Multi-order governance 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 sub-national 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 creatures 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 emphasised in the literature are the subsidiarity principle, the principle of fiscal equivalency, the creation of public value, results-based accountability, and the minimisation of transaction costs for citizens, as discussed earlier. These themes are useful but should be integrated into a broader framework of citizen-centred 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 and also incentive-compatible with globalisation. 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 behaviour. Table 2 provides general principles for rethinking the role of local government based upon a synthesis of the conceptual and empirical literature.

Table 2

*The Role of a Local Government under the New Vision of Local Governance*

Old View: 20th century	New View: 21st century
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-centred 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	Recognises 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 centralised system	Is connected in a globalised and localised world

Source: Shah and Shah (2006, 2007).

The framework emphasises reforms that strengthen the role of citizens as the principals and create incentives for government agents to comply with their mandates. The commitment problem may be mitigated by creating citizen-centred 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. Formula based revenue sharing arrangements, on the other hand, weaken government accountability to citizens.

### **Implications for Division of Powers Within Nations: Role Reversals for Central, Provincial 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 providers, provincial/regional (state), and federal or central government authorities and engaging networks and entities beyond government, and (b) local, provincial/regional (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 province/state (intermediate order) 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. Provincial legislatures would not be directly elected and would simply be constituted from local government representatives to perform inter-municipal services. The provincial chief executive (governor) could either be directly elected or nominated by the Centre subject to confirmation by the provincial legislature (provincial council). The provincial council will make policies on inter-local issues and provide oversight on the provincial executive headed by the governor. The governor could be removed by a three-fourth majority of the provincial council. In Finland—a country with no provincial (intermediate order) governments—

inter-municipal functions are performed through voluntary partnerships among local governments. The national government is assigned redistributive, security, foreign relations, and interstate (inter-regional) functions such as harmonisation and consensus on a common framework. The Chinese and the Swiss systems bear some affinity to this model and Finland incorporates elements of this framework.

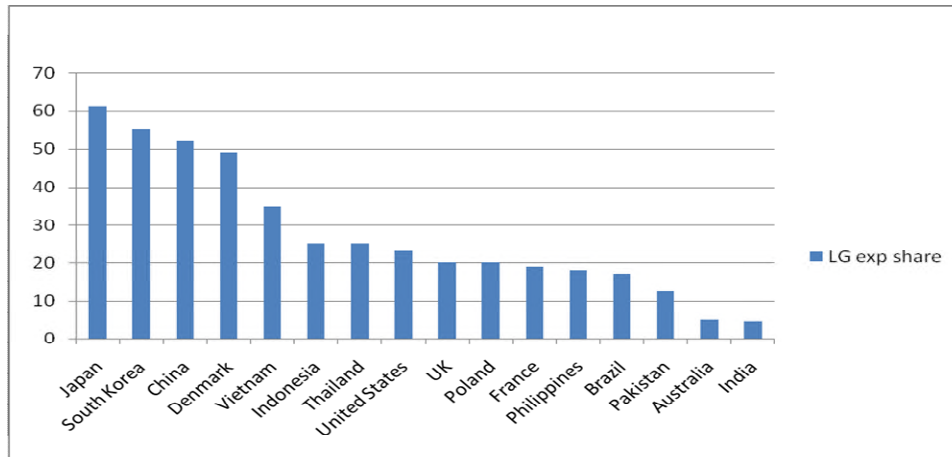
*Option B: Various Orders of Government as Independent Agents.* An alternative framework for establishing the supremacy of the principals is to clarify the responsibilities and functions of various orders as independent agents. This framework limits shared rule. Finance follows function strictly, and 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 history of internal or external conflict in recent times. It is already practiced to some degree in Switzerland, Finland, Denmark, Sweden, and China. 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. Globalisation and the information revolution have already brought pressures for much larger and stronger roles for local governments. 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 globalisation and by citizen empowerment, facilitated by the information revolution.

### **The Practice of Local Governance and Lessons for Reform**

The legal status of local government varies across countries, with local government deriving authority from national constitutions in Brazil, Denmark, France, Germany, Korea, the Netherlands, and Sweden; from state constitutions in Australia, Switzerland, and the United States; and from national legislation in the United Kingdom and New Zealand and from provincial legislation in Canada and Pakistan and from executive order in China. It is interesting 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. However, local governments that are created through legislation are significantly weaker.

The relative importance of local governments is compared in Figure 1 using local government share of consolidated public sector expenditures. Using this indicator, Japan, South Korea, China, Denmark are the leaders; Indonesia, Thailand, USA, UK, Poland, France, Philippines, and Brazil are in the mid range; Pakistan, Australia and India are in the lowest range. Considering another indicator i.e. local government share of GDP, local government in Denmark stands out, claiming about 50 percent of total expenditures, which account for about 30 percent of GDP. Among the industrial countries, Australia is an outlier with local expenditures accounting for less than 3 percent of GDP.



**Fig. 1. The Rising Tide of Local Governance—2010**

Relative importance of local government is quite small and local government role in local economic development is quite weak in Australia (“roads and rubbish” only), India (largely ornamental), Pakistan, France and United Kingdom. In these countries local governments were seen in the past more as instruments of political participation rather than autonomous institutions for self-government and service provision. This view has been reshaped to give greater autonomy to local governments in municipal services in recent years in UK and France. Local governments are relatively more important and play a moderate role in local economic development in Japan, Germany, Canada, USA and Brazil. In these countries, local governments have an exclusive role in municipal services but limited role in social services. The role of local government is expansive in Nordic countries (Denmark, Norway, Sweden and Finland), Switzerland and China. In Nordic countries, local governments act as the primary agent of citizens and provide a broad role in support of a client-oriented welfare state. For example, in Finland, local governments assume a predominant role in social services [Moisio, Loikkanen, Oulasvirta (2010)]. In Switzerland cantons (higher order of local governments) enjoy autonomy not only in fiscal matters but also in such areas as immigration, citizenship, language and foreign economic relations. China affords its local governments one of the strongest role in local economic development. Local governments below provincial level employ 89 percent of the public workforce and command 51 percent of public expenditures. A unique feature of local government in China is that local autonomy varies directly with success in local performance as measured by local economic development, service delivery and citizen satisfaction. Nordic countries, Switzerland and China appear to have local government role more consistent with the demands of new world economic order. In these countries, intermediate orders of government have limited (China) or no role (Nordic countries).

### Some Lessons

Historical evolution and the current practice of local governance is instructive in drawing lessons for reform of local governance. There is great diversity in practice in local governance in industrial countries, but there are also some common strands. The

diversity is in the institutional arrangements, which have evolved incrementally over a long period. This evolution has resulted in diverse roles for local governments and diverse relations with central governments across countries. In Nordic countries, local government serves as the primary agent of the people, whereas in Australia, that role is entrusted to state governments, and local government has a minimal role in local affairs.

There is no uniform model for local government size, structure, tiers, and functions across OECD countries. There are nevertheless a number of interesting common features. First, most countries recognise that finance must follow function to ensure that local governments are able to meet their responsibilities efficiently and equitably. Second, home rule is considered critical to meeting local expectations and being responsive to local residents. Therefore, local governments must have significant taxing, spending, and regulatory autonomy, and they must have the ability to hire, fire, and set terms of reference for employees without having to defer to higher levels of governments. Only then can local governments innovate in management by introducing performance-based accountability and innovate in service delivery by forging alternative service delivery arrangements through competitive provision, contracting, and outsourcing wherever deemed appropriate as done in Finland [see Moisio, Loikkanen, and Oulasvirta (2010)]. They can also facilitate a broader network of local governance and harness the energies of the whole community to foster better social outcomes. Third and most important, accountability to local residents has been the factor most critical to the success of local governance in industrial countries. This accountability is strengthened through democratic choice, participation, transparency, performance budgeting, citizens' charters of rights, and various legal and financing provisions that support wider voice, choice, and exit options to residents.

In conclusion, 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 province/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. Globalisation 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 especially Nordic countries and ancient civilisations in China, India and Pakistan. Local government was the primary form of government until wars and conquest led to the transfer of local government responsibilities to central and provincial/regional governments. This trend continued unabated until globalisation and the information revolution highlighted the weaknesses of centralised rule for improving the quality of life and social outcomes. The new vision of local governance (Table 2) presented here argues for a leadership role by local governments in a multi-centred, multi-order, or multi-level system. This view is critical to creating and sustaining citizen-centred governance, in which citizens are the ultimate sovereigns and various orders of governments serve as agents in the supply of public governance. This view is also relevant for carving and sustaining a competitive edge in international economic relations as demonstrated by the recent experience of China.



Empowering local governments and strengthening their role in local economic development ushered China in an era of sustained economic growth and lifting billions out of the poverty trap.

### Box 2

#### **China is Shining on the World Economic Stage—Thanks to Its Unshackling of Its Local Governments**

China is an economic powerhouse poised to assume world economic leadership in the coming decades. It had a sustained record of economic growth (average annual growth rate in real per capita GDP of 10 percent over the past three decades resulting in nearly tripling of per capita income from 1978 to 2010) and prosperity. Its record in alleviating poverty is unparalleled in the economic history of the world – reducing poverty headcount rate from 31 percent in 1978 to less than 2 percent in 2008. These facts are well known. But what is less well known is that this came about because Deng Shao Peng in 1979 unshackled local governments and unleashed their innovative spirits and energies in pursuit of economic growth and local economic development. China has one of the most empowered local governments serving their residents from cradle to grave. Local Government command 89 percent share of public sector employment and 51 percent share of consolidated public expenditures. Other than defense, debt and foreign affairs that are the exclusive domain of the Centre, all other functions including education, health, and social insurance are the responsibility of local governments. There is no uniform model and all local governments pursue their own unique approach to service delivery and local economic development. Contracting out service delivery to autonomous service units is practiced widely. Provincial role is largely limited to agriculture and providing coordination and oversight of local governments on behalf of the centre. Thus China while having a unitary constitution bears affinity to an hour glass model of federalism. There is strict government accountability to citizens at all orders through directly elected people's congress at each level. In addition, the Communist Party oversight committees at each level monitor citizen satisfaction as well as dissatisfaction (number of protests). Higher level oversight of local governments is based on objective results based criteria that incorporates: (a) local economic development performance; (b) local service delivery performance; and (c) citizen satisfaction. Local government success is rewarded by greater local autonomy and sustained failure is punished by reduced autonomy and intrusive oversight and controls by higher order governments.

*Source:* Qiao and Shah (2006).

## **4. EMPIRICAL PERSPECTIVES ON ALTERNATE MODELS OF DIVISION OF POWERS AMONG PROVINCES AND LOCAL GOVERNMENTS AND THEIR IMPLICATIONS FOR GOOD GOVERNANCE AND GROWTH**

Earlier sections presented normative, institutional and historical perspectives on the newer roles of provincial and local governments. It argued for leaner role of the provinces and an expansive role of local governments to comply with the new world economic order. This section attempts to supplement the analytical perspectives presented in earlier sections with empirical evidence on the implications of alternate roles for good governance and growth. Using a worldwide sample of countries, this section

attempts to compare economic performance with different strengths of state and local governments. The conjecture is that for good governance and growth, decentralisation of government authority to local government is more important than decentralisation to intermediate tiers i.e. provinces or states.

For our analysis we group countries according to the roles assumed by state and local governments. State governments are classified as strong or weak depending upon expansive or limited range of functions assigned to them. Local governments on the other hand are ranked on a scale of weak, fair and strong governance based upon their share of national expenditure adjusted for the degree of political, administrative and fiscal autonomy they enjoy [for methodological details, see Ivanyina and Shah (forthcoming)]. With a few notable exceptions, data shows that strong and fair local governance is usually associated with weak state governments (see Annex Table 1) and strong state governments typically imply weak local governments.

Once classified in this way, group averages are then calculated on 11 good governance and growth indicators for the period 1999–2008. These indicators include: GDP per capita, GDP per capita growth rate, central government debt as a percent of GDP, human development index, perceived corruption, incidence of internal conflicts, citizen centric indexes of responsive governance (government delivers services consistent with people preferences), fair governance (protects minority and disadvantaged groups), responsible governance (costs less) and accountable governance (accountable to citizens) and durability of political system. In 10 out of these eleven indicators, countries with strong local governments and weak state governments do better than countries with strong state governments. The only exception is fair governance—a higher order task best assigned to central government (see Figures in the Annex).

### **Econometric Analysis**

We explored further the relationship of alternate roles of state and local governments using regression analysis. Such an analysis allows control for many other factors affecting a country's economic and governance performance and isolate the impact of alternate models of division of powers. The results of these analyses are presented in Annex Tables 2 and 3. The results reconfirm our qualitative and simple quantitative analysis findings. Strong local governments have positive association with economic performance and quality of governance indicators in 9 out of 12 performance indicators though not all of the relationships are statistically significant. Having strong state government helps only in 1 out of 12 cases while it hurts in four cases. Thus while the data limitations prevent us from more thorough empirical analysis of these choices, the results presented here provide tentative support to the basic hypothesis of this paper that strong local governments accompanied by leaner provincial/state governments are needed to improve economic and social outcomes for citizens.

## **5. CONCLUDING REMARKS: ADAPTING TO A CHANGING WORLD**

This paper has reflected on the unfinished agenda for the reform of multi-order governance. Broad contours of the reform include freeing local governments from shackles of centralised and provincialised control so as to enable them to assume a leadership role in improving economic and social outcomes for local residents. This leadership role requires

local governments to assume a catalyst's role in directing and coordinating governmental (including central government) and non-governmental agencies and networks to local economic development. Local governments would be in a position to play this role if their responsibilities are determined by home rule and community governance principles and they have adequate access to revenues from own sources or they can piggyback on central tax bases. In addition to strengthen their accountability to local residents not only finance should follow function but intergovernmental finance should be structured so as to strengthen local autonomy while enhancing results based accountability. Thus there is a need to move away from manna from heaven transfers (general revenue sharing schemes) to output-based (performance oriented ) grants that respect local autonomy while creating incentives for service delivery performance accountability [see Shah (2010)]. There is also need for reform of the budgetary institutions so that all orders of government are bound by a common framework of fiscal responsibility, integrity, fiscal discipline and fiscal sustainability. There should also be a framework to ensure that local government performance is measured and monitored for compliance with the principles of responsive and fair, responsible and accountable governance.

Intermediate order governments have limited economic relevance in this framework but can usefully play a coordinating role for inter-local services. The paper has also argued that while there is a strong case for directly elected central and local governments, in the interest of restraining government expenditures, provincial councils (assemblies) can be constituted simply from elected heads of local governments and provincial chief executives can either be directly elected by people or appointed by the Centre subject to confirmation by the provincial council. The provincial council determines policies on inter-local functions and also provides oversight on the provincial executive headed by the provincial governor that implements these mandates. Such a framework minimises costs of intergovernmental coordination while reducing transactions costs for citizens to hold governments to account. Analytical, institutional and empirical analysis presented in this paper further shows that such a framework of multi-order governance is conducive to minimising internal conflicts while promoting good governance and growth. The paper has, however, recognised that such a reform agenda may not be feasible in some countries with dual federalism where provinces (states) have strong political clout and are governed by elites. This is because of the unlikelihood of overcoming path dependency—a tall order for existing institutions and vested interests to wither away—makes such reform infeasible. Under such circumstances, there is unlikely to be political will to undertake such bold reforms. In these countries, citizen activism would be required to build consensus for such fundamental reforms. Such activism is, however, unlikely to materialise in the absence of educated and enlightened citizenry. Therefore, such radical reforms would not be in the cards in the foreseeable future.

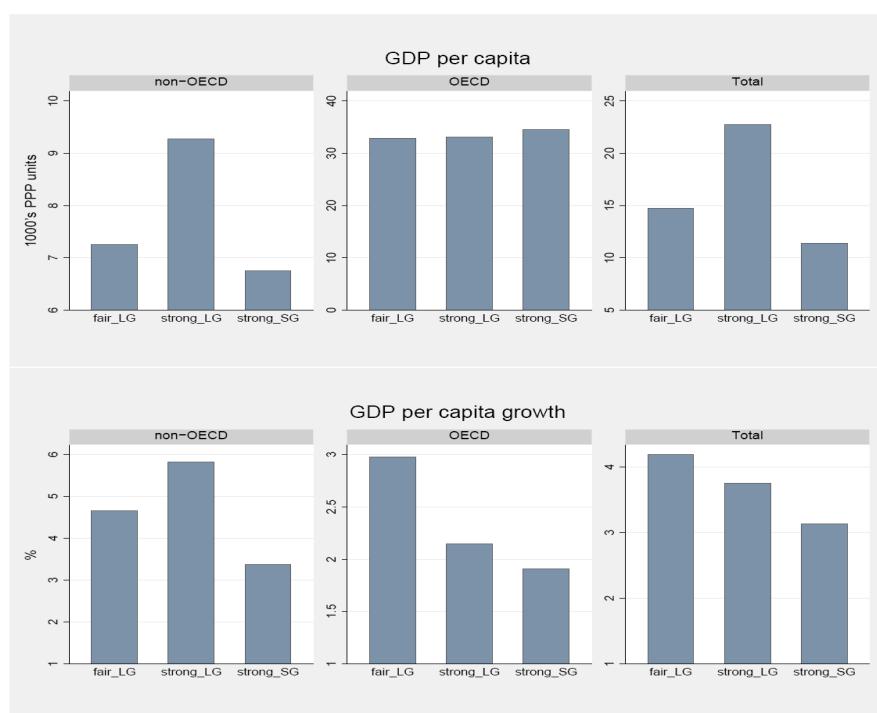
Our survey of the literature also suggests that local governance even in most industrial countries does not fully correspond to the governance principles enunciated here or even to the needs of economic success in this information age. There are only few exceptions and these are found mostly in Nordic countries and in East Asia (China, South Korea and Japan). Other countries would be well advised to follow the lead of these countries in adapting multi-order governance especially local governance to the needs of the 21st century.

Table 1

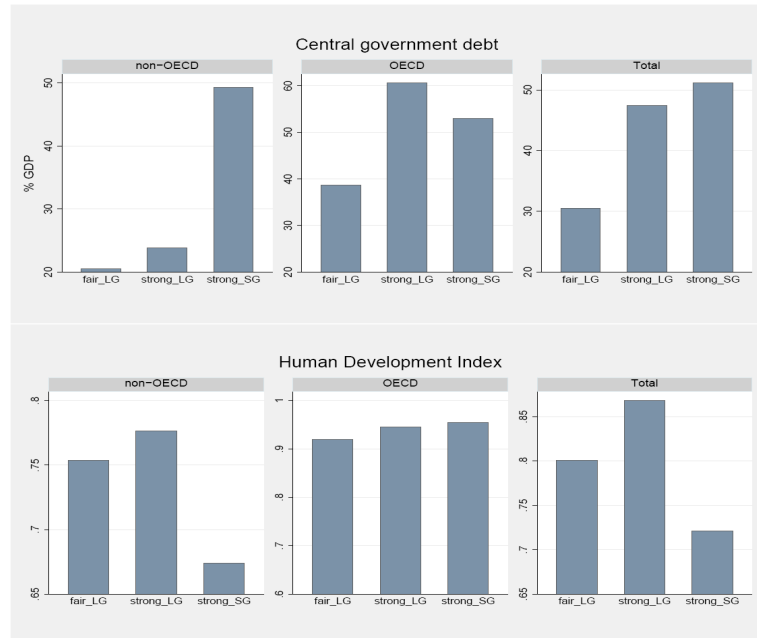
*Countries Grouped by Strength of Local and State Governments*

Strong SG	ETH, NPL, MYS, AUT, DEU, BRA	USA, CAN
	MEX, VEN, IND, AUS, ARG, BIH, PAK, BEL, SDN	
Weak SG	Rest of the World	TZA BOL ECU KOS LTU, NLD, LVA POL
		KGZ EST BGR ALB UKR NGA GBR HUN
		PHL URY NZL SRM BUS CUB GEO FRA
		TJK LUX TWA PER IDN COL CHE JPN
		PRT KAZ SVK ZAF ITA KOR ISL NOR
		BLR IRL CZE ESP FIN SWE CHN DNK
		MNG ROM UZB LTU
	Weak LG	Fair LG Strong LG

*Note:* Abbreviations: SG – state government, LG – local government. Division by strength of SG: based on opinion of WB experts. Division by strength of LG: strong LG – share of own local expenditures is more than 10 percent of government expenditures, fair LG – the share is between 5 percent and 10 percent, weak LG – the share is less than 5 percent.

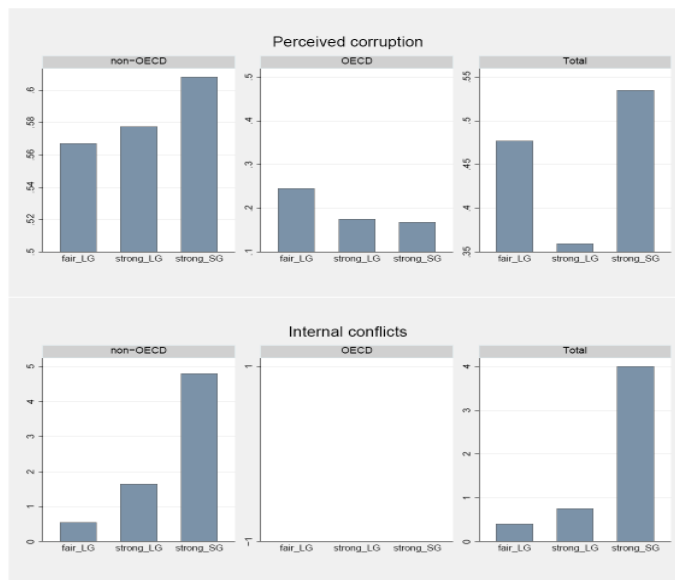
**Fig. 1. State Governments vs. Local Governments: Comparing Averages**

*Note Definitions:* GDP per capita – 2008, PPP Units, datasource – WDI; GDP per capita growth – real average 1999–2008, datasource – WDI.



**Fig. 2. State Governments vs. Local Governments: Comparing Averages**

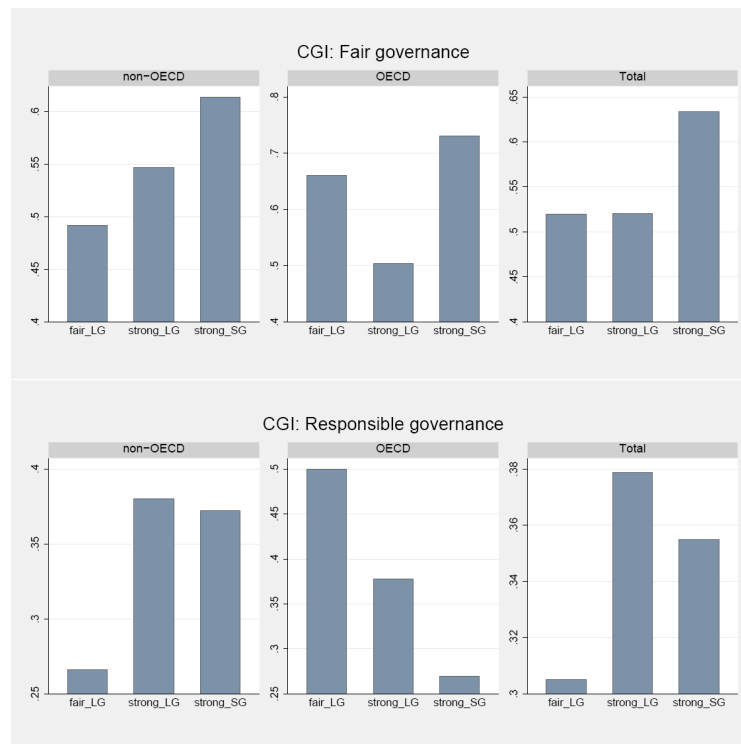
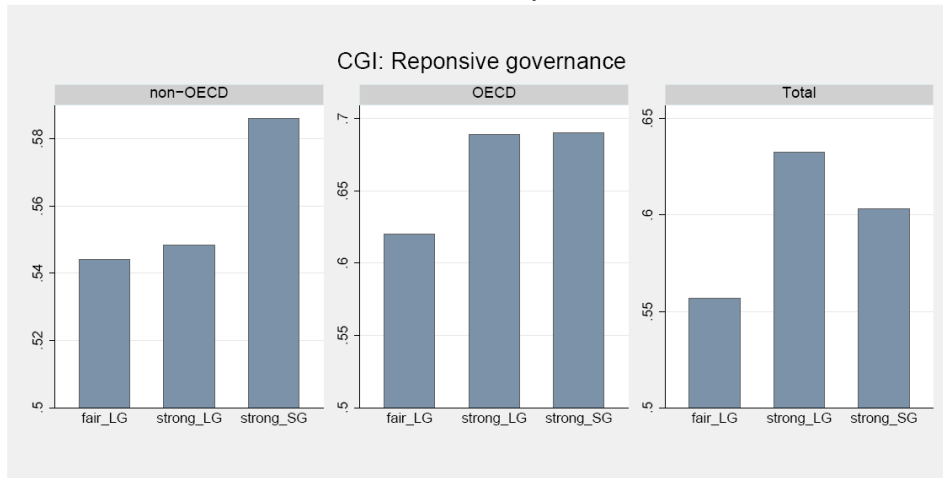
*Note Definitions:* Central government debt – 2008, % GDP, datasource – WDI; Human Development Index – 2005, datasource – UNDP.



**Fig. 3. State Governments vs. Local Governments: Comparing Averages**

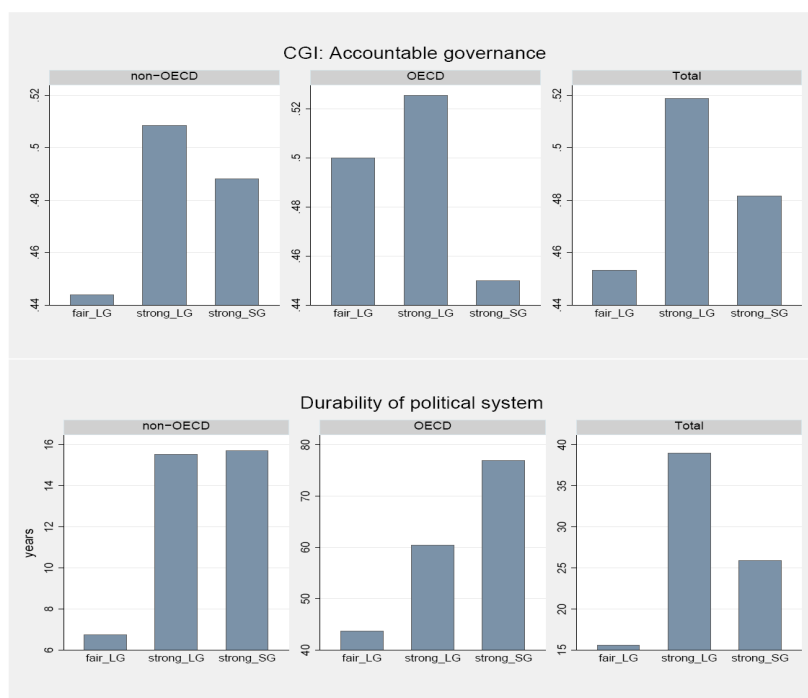
*Note Definitions:* Perceived corruption – average 1999–2008, datasource – WGI, linear transformation; Number of internal conflicts – 2005, violent conflicts where 3 or more persons died, datasource – Uppsala Peace Institute.

**Fig. 4. Citizen Centric Governance Indicator: Responsive Governance**  
(Source: basic data from Ivanyna and Shah, 2009)



**Fig. 5. State Governments vs. Local Governments: Comparing Averages**

*Note Definitions: Fair governance – 2005–2008, datasource – Ivanyna and Shah (2009); Responsible governance – 2005–2008, datasource – Ivanyna and Shah (2009).*



**Fig. 6. State Governments vs. Local Governments: Comparing Averages**

*Note Definitions:* Accountable governance – 2005–2008, datasource – Ivanyna and Shah (2009); Durability of political regime – 2005, datasource – Polity IV project.

**Table 2**

*State vs. Local Governments: Regressions*

Dep. Variable	(i) Gdp-cap	(ii) Gdp-growth	(iii) Debt	(iv) Hdi	(v) Corr	(vi) Conf
Own LG Exp.	3.47*** (1.16)	8.05* (4.35)	-114.11** (49.36)	0.48** (0.19)	-0.17 (0.16)	6.63 (4.42)
1=SG is Strong	0.39 (0.26)	0.27 (0.60)	-7.66 (14.57)	0.06* (0.03)	0.00 (0.03)	2.83 (1.84)
Product	6.99* (3.86)	6.99 (10.27)	195.53 (155.84)	1.01* (0.54)	-0.86** (0.42)	-35.59 (33.04)
Observations	110	116	37	116	116	116
R-squared	0.707	0.244	0.623	0.673	0.741	0.249

*Note:* \*significant at 10 percent level, \*\* – significant at 5 percent level, \*\*\* – significant at 1 percent level, Years analysed in all regression—1999–2008. Dependent variables: *gdp\_cap*—GDP per capita, *gdp\_growth*—GDP per capital growth, *debt*—central government debt, *hdi*—Human Development Index, *corr* – perceived corruption, *confl*—number of internal conflicts. See previous Section for definitions of dependent variables. Right hand side variables – *own LG expenditures*, *SG strength*—both defined in the previous Section—and their product. Other variables included as controls in all regressions: UK legal origin, number of tiers of sub-national government, government consumption, openness, number of procedures needed to open business, number of days needed to enforce contract, Freedom House index of political and civil rights, ethnic and religious fractionalisation. Estimation method in all regressions: OLS. Standard errors are heteroscedasticity robust.

Table 3

*State vs. Local Governments: Regressions*

Dep. Variable	(i) Cgi	(ii) r-ve gov	(iii) Fair gov	(iv) r-le gov	(v) acc-gov	(vi) Dur
Own LG Exp.	0.14 (0.21)	-0.08 (0.26)	0.28 (0.49)	0.24 (0.26)	-0.18 (0.25)	55.04 (40.81)
1=SG is Strong	-0.00 (0.06)	-0.02 (0.06)	0.01 (0.10)	-0.07 (0.06)	-0.10* (0.05)	8.98 (11.30)
Product	-0.26 (0.73)	-0.02 (0.86)	-0.17 (1.25)	-0.68 (0.85)	0.09 (0.71)	562.57** (236.40)
Observations	41	41	41	41	41	115
R-squared	0.318	0.395	0.202	0.405	0.473	0.560

Note: \*significant at 10 percent level, \*\* – significant at 5 percent level, \*\*\* – significant at 1 percent level, Years analysed in all regression—1999–2008. Dependent variables: *cgi* – Citizen-centric Governance Indicator, *r-ve gov* – Responsible Governance, *fair gov* – Fair Governance, *r-le gov* – Responsible Governance, *acc-gov* – Accountable Governance, *dur* – durability of political regimes. See previous Section for definitions of dependent variables. Right hand side variables – *own LG expenditures*, *SG strength* – both defined in the previous Section – and their product. Other variables included as controls in all regressions: UK legal origin, number of tiers of sub-national government, government consumption, openness, number of procedures needed to open business, number of days needed to enforce contract, Freedom House index of political and civil rights, ethnical and religious fractionalisation. Estimation method in all regressions: OLS. Standard errors are heteroscedasticity robust.

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## Comments

It is indeed an honour for me to be a discussant on the Gustav Ranis Lecture organised by PIDE. Gustav Ranis has played an important role in the initial phase of development of Pakistan Institute of Development Economics (PIDE) as research institution. The Gustav Ranis lecture by Dr Anwar Shah is a philosophical thought provoking lecture. To be a discussant on this important lecture, I have tried to study all these philosophies. I congratulate Dr Shah for making this valuable contribution. As a student of development economics, my concerns are as follows:

The paper is providing an extensive review of literature on whether the multi-facet governments are functioning well or not? Whether you want to reduce the tiers of government? What is the role of provincial level governments? If we retain this tier of government what role it can play to get desired economic outcomes? The historical perspective presented in the paper informs us that initially small governments, small states prevailed. The greed for holding control of more and more countries and more and more space, led to wars and resulted in big governments and countries. Now we have to go back to the old localised system of governance. My concern here is: Was greed the only reason? How successful were these small governments? What were the weaknesses of the local level governments leading to their failure? Currently what is the experience of different countries opting for the local level governance? How far we can learn from these examples? This discussion is missing in the paper.

My second concern is: What is the role of level of economic development for the success of localised system of governance? It may be the case that If a country achieves certain level of economic growth and prosperity then involving more and more citizens in the decision making process may be more effective as compared to in the initial stages of economic development. What I would like to know from Dr Shah, because he is an authority in this area, that whether the initial economic conditions are important for the success of devolution of economic power or not.

Thirdly, what are the prerequisites like the capabilities and capacities of those who will be the decision makers so that we do not face the failure in this new experiment? What will be required in terms of resource base at the local level to translate power into actions? Unless there is financial backing the new form of governance will not be able to deliver. If you look into different districts of Pakistan, in terms of resources, in terms of income inequality, in terms of incidence of poverty, wide disparities exist. In some cases these disparities have been persistent over time. South Punjab has been the poorest of regions in Pakistan. Now what it will take to bring back those districts out of poverty; whether making them locally empowered will be sufficient or whether a resource transfer will be needed from somewhere, whether it is from the provincial level or directly from the federal level to empower them, to give them initial support to make the decisions so

that they can come out of this persistent poverty situation. The most important and effective local governments have been in terms of provision of education and health services. In addition, local governments have been effective wherever the capacity and the capability of the local decision makers is ensured. In Pakistan, the capacity and capability is critically lacking affecting the performance of local governments.

Next issue is what type and quality of institutions. Which institutions are critical for the success of experiment? This dimension is missing in this paper. Dr Shah is saying that the central system is not working and it is basically the failure of management. How we can improve this management system/management practices so that we do not have the failure of another system? This is important as the change from the centralised system to the local government will involve, initially, huge transactions costs. Who will bear that cost and how you can minimise it? These issues become critically important when you want to translate this idea, of moving away from the central government to the local government, into action.

Dr Shah has given the example of China. China has been studied and quoted widely these days. Chinese economic growth is not just that what is the form of government, a number of other factors or primary factors and implementation of incentive systems of production also played a critical role. Can we replicate it?

In terms of econometric results, I think, Dr Shah himself has some reservations. The data used are not explained. Given the methodology, it can not be claimed that Dr Shah's philosophy is supported. There are a number of insignificant coefficients. The estimation technique is also not appropriate.

Next issue is that the local governments can be very effective in some cases, and in some areas, and Dr Shah is focusing on control on expenditure. What about the revenue generation? What is the share of different level of local governments in terms of revenue generation and how much transfer would be required to improve performance economically and socially? That is an important issue.

Lastly, the local governments may be effective in terms of delivering some services but the role of the central government or the provincial government is also important in some areas. For example, in this era when the world is facing threats of climate change requiring global actions, how far the local governments will be effective in terms of generating incentives and to control disadvantage or disasters of climate change. It needs global action which require support from the central and provincial governments.

In the end, I would congratulate, Dr Shah for presenting this paper for Gustav Ranis Lecture and thank PIDE for giving me this opportunity.

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## Comments

This is a provocative and thought provoking paper. It is also particularly useful for those of us who mostly dwell on issues related to Pakistan's and do not focus on the big picture and new developments that are taking place elsewhere. I will first talk a little bit about some of the interesting concepts that have been presented in the paper and then relate it to the situation prevalent in Pakistan.

### **'Glocalisation': Relevance and Contradictions Within**

The first important issue that the paper raises is from a stream of literature referred as 'glocalisation'—integration of the local economy with the global. The impulse created by the information revolution and liberalisation of markets at the global level have come together in some parts of the world with sub-regional economies to create a new and dynamic developmental impulse. The possibility of reaping benefits at the local level of global opportunity would be directly proportional to the level of human capital and knowledge base that exists at whatever the level of disaggregation we wish to refer as 'local'.

Now let us see the relevance of this particular model in our context. Obviously, the human capital base at the local level by and large is extremely weak. Thus the possibilities that exist in small town Germany or even in most South American countries are rarely prevalent, not only in Pakistan, but in the South Asian context in general. Secondly, in many ways Pakistan as a whole has not reaped the benefits of globalisation even at the aggregate level. FDI flows and trade integration in the region or beyond for Pakistan are below par when compared to other mainstream globalisers. This is in no way a critique of the concept, only an attempt to place ourselves in the larger scheme.

It is also pertinent to mention skepticism about some processes of globalisation itself; especially about the impact of global financial markets. The big picture at this point in time it is not very encouraging. A house is mortgaged in small town Kentucky or Louisiana in the US and a small Housing and Loans bank goes bust. A trillion dollars have to be injected by the central government to bail out that economy but even then the ripples of this catastrophe are felt across the global economy for years to come.

Dr Shah refers to the present financial crisis as an aberration in the relentless march towards globalisation. The other view is that these are recurring crisis and not aberrations with huge, economic as well as social costs, particularly for the poor.

### **Human Capital or Resource Based Development?**

Returning to the theme of glocalisation and the Pakistani context, it appears that Pakistan may be some notches behind the post modern glocalisation formulation mentioned in the paper. In fact one very interesting and important point is made in Table 1 in the paper that provincial competition actually happens on resource based extractive industries. Now that is a phase Pakistan is just beginning to enter after the passage of the

18th Amendment to the Constitution. In fact, some have argued that the economic aspect of the turmoil in Balochistan is based on the contest on the natural resource rents that the province is bestowed with. Moreover, globalisation has enhanced the rents to be reaped from these resources and all protagonists are aware of the possibilities. So rather than the human capital based resource, it is actually the extractive based resource which is something on which present day contentions of Pakistan are happening. These contentions will further intensify if Thar coal develops to its full potential in another province. The larger picture thus is that inter-provincial competition will have to be resolved through institutionalising mechanisms for resolving federal-provincial and inter-provincial contentions. As such, 'glocalisation' and its benefits seem distant from us.

### **Reduction in Transaction Costs vs. Reaping Economies of Scale**

The development model in this paper is in favour of sub-provincial or local government for the obvious reason that local governments reduce transaction costs so far as service delivery is concerned. At first glance, this is a truism as monitoring costs reduce at the local level and priorities for resource allocation are also best developed at that level. But as Dr Rehana Siddiqui rightly wonders what the institutional arrangements for this purpose will look like. True, the province is too large and entity and away from the people, so to speak, but the size of the districts in Pakistan are fairly large also. I happened to be travelling in Ms Hina Rabbani Khar's (Chair of this session) district, Muzaffargarh, a couple of months ago and to travel from one end of the district to the other takes more than four hours on fairly decent roads. If one travels that distance in Europe, one will cross two countries in that time. So the question I ask is what is the level of disaggregation where the 'local' begins for us? Is it the sub-district level or even further to the *deh* or *Mauza* level? Or create a level of government somewhere in between? Already we have three tiers within local government in Pakistan and we have done a lot of experimentation without reaping any spectacular developmental outcomes.

At the conceptual level, there is clearly a trade-off between is not only transaction cost reducing institutions and arrangements that allow the benefits economies of scale and scope to be reaped. There are two small points that have been made in the paper. One is a reference to state capture at the provincial level by the feudal military or industrial elite. We have seen in the last ten years that such captures are most prominent at the national or federal levels and also at the local level. Also, once capture at the local level occurs, it is very difficult to redress if there is local level 'autonomy'. At the provincial level there is a very different dynamic at play and many more stakeholders who tend to create some semblance of a balance.

One useful illustration of different tiers pitching in with their respective advantages in a developmental effort is of India's Rural Employment Guarantee Act (NREGA). NREGA has a three tier model of both financing as well as execution as well as verification across the federal government, the state government and the local government. And so far it has worked well in India, where social and institutional structures are more similar to us than elsewhere. Now are such arrangements possible in our institutional milieu? We need to explore but to take out one tier, i.e. the provincial, is neither useful nor perhaps desirable.

**Province or District: Historical Trajectory of Federalism in Pakistan**

Another very interesting and important point that the paper raises is that provinces in a federal set up have a holding together function. This could not be truer in Pakistan today given the 18th Amendment and the NFC Award than it ever was. In fact by going ‘federal-local’ during the martial law regimes, we may have had some reduction in economic transaction costs but it increased political transaction costs to the point that the country was tearing at it seems. So another question that we need to ask is how far can we divert from historical trajectories? It is easy to say that we move from one model of governance to another but in many ways we are structurally bound by our political history—which is that provinces are important middle level tiers so far as the ethnic and linguistic conception of identities are concerned.

On the whole, this is a very useful paper and I enjoyed reading it and has prompted me to ask and share a number of questions.

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