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Are There Trends in Local Finance? A Comparative Look at Data and Normative Models of Local Government Finance[1]

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Abstract

There is little evidence of regional, let alone worldwide, trends in local finances, although trends within particular countries certainly exist. Given the path-dependent and context-specific nature of country experiences, one must be very careful both in categorizing the local finance systems found in different countries and in making cross-country empirical studies of local finances. In analyzing and comparing country experiences, it is important to be clear about the different (implicit or explicit) normative models to be found in the literature and exemplified in practice in different countries.

Key words: local finance, international comparisons, models of local finance

JEL Classification: H70, H77

[1] This is a slightly revised version of a paper presented at the 6th Symposium on Fiscal Federalism: Financing Local Governments, Barcelona, June 14–15, 2010 and published as "Local Finance: Trends and Issues," in *IEB's World Report on Fiscal Federalism '10* (Barcelona: Institut d'Economia de Barcelona, 2011), pp. 10-22. . I am grateful to other participants in the conference for their own presentations and in particular to Jorgen Lotz for pushing me to think through some aspects of the final section of the paper more carefully.

Seen from a great height—a "bird's-eye view," if you will—how local governments are financed may appear to be a rather small and unimportant issue, one that is easily lost from sight amidst the swirling clouds of international financial crises and the headline-claiming activities of national politicians and governments. Viewed from street level, however, down where people actually live, few aspects of the public sector have a more direct and tangible effect on the daily lives of citizens than the level and quality of local public services—and both the level and quality of such services are, arguably, dependent to a considerable extent upon how they are financed.

For the last two decades or so, fiscal decentralization in some form or other seems to have become a popular notion in many countries. International institutions have produced numerous reports on decentralization, academics have held conferences and written many books and papers on the subject, and politicians in many countries around the world have made endless speeches about it. But has all this talk led to much change in the local finance scene?

The first section of this paper offers a quick—and inevitably superficial—review of the (unsatisfactory) data on local finance around the world and suggests that, when viewed from on high, there do not appear to be any great universal or even region-wide trends in local government finance. On the other hand, within individual countries, one can identify country-specific trends, and, to a lesser extent, some trends in countries linked by history (such as the former French and British colonies in Africa or the central and eastern European countries that were formerly part of the Soviet bloc) and/or by geography and language, as in the Nordic countries and some other regional groups.

Since in many ways taxonomy is a critical step in organizing knowledge, the second section of the paper considers the question of whether the way in which one chooses to "cluster" country experience may not only reflect the questions one is pursuing, but also affect the answers one reaches.

The final and most speculative section of the paper suggests that considering country experiences in terms of the differing normative "models" (or "frameworks") of local government finance that prevail in the literature and to varying extents in different countries may offer a helpful approach to disentangling what has, and has not, been occurring in fiscal decentralization around the world.

1. Are There Any Trends in Local Finance?

Despite much talk about fiscal decentralization around the world in recent decades, it is not clear that much has actually changed. For example, Bahl and Wallace (2005, 91) conclude that, for countries for which data are available in the International Monetary Fund's Government Finance Statistics (GFS) database, the sub-national government share of both total government expenditure and taxation at the beginning of this century had changed little since the 1970s. At the beginning of the 21st century, as was the case three decades earlier, regional and local governments combined accounted for only about

11 percent of taxes and 13 percent of expenditures in developing countries. Although the comparable figures for OECD countries are higher—at about 18 percent of taxes and 33 percent of expenditures—these ratios too did not change perceptibly over this period.

Two clear conclusions emerge from this "high-level" look at the world:

- First, sub-national governments are much more important as both taxers and spenders in rich countries than they are in poor countries.
- Second, transfers are a far more important source of sub-national revenues in rich countries—where, on average, they finance over half of sub-national expenditures—than they are in poor countries, where they amount to less than a fifth of expenditures.

At first glance, these results may seem surprising. For example, Bahl and Wallace (2005, 93), like earlier studies of the determinants of cross-country variations in the expenditure decentralization ratio, find that higher income levels are significantly associated with greater decentralization. Nonetheless, during a period in which world income levels roughly doubled in both rich and poor countries, neither the tax nor the expenditure decentralization ratio seems to have been swept upward by rising incomes.[2] Instead, these ratios seem almost to be set in stone. Despite rising incomes, increasing urbanization, rising expectations and, in many countries, expanding democratization (or at least increased social mobilization), not to mention all the rhetoric and concern about decentralization, only a very small twitch in decentralization ratios can be detected.

Of course, the data on which this conclusion is based are far from satisfactory, as Bahl and Wallace (2005) recognize.[3] Yet even the more comprehensive and comparable data recently assembled for sub-central governments in OECD countries, although available in detail only for recent years, shows a similar lack of change. From 1995 to 2005, for instance, the average sub-central share of total revenue in OECD countries remained stable at around 17 percent, although there was a small but significant increase in the expenditure ratio from 31 percent to 33 percent over the period (Blochiger and Petzold 2009, 2).

Such (unweighted) average figures conceal both critical details and considerable country-to-country variation. On the expenditure side, for example, while the share of sub-central expenditures in total government expenditure rose by more than 15 percent in Spain and by almost 10 percent in a few other countries (Czech Republic, Denmark, Finland, and Italy) between 1995 and 2005, it fell by 10 percent in Japan and by even more in Ireland (Blochliger and Petzold 2009, 29). On the revenue side, changes in the

[2] According to the World Bank database (available at http://data.worldbank.org/data-catalog), per capita GDP (in constant 2000 $US) between 1970 and 2000 rose by 199 percent in "rich" countries and by a smaller, but still respectable, 186 percent in "low and middle income" countries.

[3] Many empirical studies have been devoted to exploring the relationship between political federalism and fiscal decentralization. However, as Blume and Voigt (2008) show, the empirical measures used in most such studies capture only very specific aspects of the relevant institutional details and not necessarily the most important ones. Moreover, as Stegarescu (2004) demonstrates, the basic measures used in such studies can (and have) changed substantially in particular countries from year to year.

composition of revenues were equally varied from country to country, with Spain again leading the way in terms of the growth of sub-central taxes as a share of total taxes (also more than 15 percent), and Australia, Italy, and the Slovak Republic recording increases of more than 5 percent in tax decentralization. In contrast, the tax decentralization ratio declined by more than 5 percent in Norway, Turkey and also declined in seven other countries—including Canada (Blochiger and Petzold 2009, 31).

As other OECD work clearly shows, however, one must be particularly careful in interpreting revenue decentralization ratios. Traditionally, the local share of central taxes has been defined as sub-central tax revenue in OECD data, although from most relevant perspectives, the revenues received by sub-central governments from "tax sharing" are essentially equivalent to transfers and are not local "own" taxes in any meaningful sense (Blochliger and Rabesona 2009). In both Spain and Australia, for example, the big changes in the tax decentralization ratio mentioned above reflect major changes in tax sharing during the period (Charbit 2009, 13–14). In Australia, if the transfer of GST revenues to the states in 2000 is understood, as it should be, as a realignment of the way in which federal equalization transfers are financed, rather than as an extension of state taxing power, then Australia's tax decentralization ratio actually *decreased* slightly rather than increasing from 1995 to 2005 (Blochliger and Rabesona 2009, 7). On the other hand, since Spain really did devolve some limited taxing power—though not with respect to setting tax rates—to its Autonomous Communities (regions) when regional government financing was renegotiated in 2001, the tax decentralization ratio may more legitimately be considered to have increased in that country.

Depending on the approach one takes and the data, years, and countries one examines, one may sometimes reach a more positive conclusion. For example, Martinez-Vazquez and Timofeev (2009) assert that there has been a world trend towards fiscal decentralization, at least during the last two decades. Without in any way criticizing their careful study, an admittedly less rigorous consideration of a large number of detailed country studies suggests that perhaps the most striking conclusion one can draw from the evidence is not how similarly different countries in the world (or even any one region of the world) have acted in terms of decentralization, but rather how different they are—and are likely to remain.[4]

To this point, neither the data cited nor the discussion have distinguished local from regional finances. In the OECD, state or regional finances dominate in the federal (or effectively federal) countries—Australia, Belgium, Germany, Switzerland, Spain, the United States, Canada, and Mexico. On the other hand, local finances are much more important in Nordic countries (Denmark, Sweden, Norway, and Finland), as well as in Japan, Korea, Italy and several new "accession" countries in the European Union, such as the Czech and Slovak Republics and Poland (Blochliger and Petzold 2009, 31).

[4] See, for example, the wide variety of country case studies in the following sources: Bird, Ebel and Wallich (1995), Ter-Minassian (1997), Bird and Vaillancourt (1998), Rodden, Eskeland and Litvack (2003), World Bank (2005), Shah (2006), Bardhan and Mookherjee (2006), Smoke, Gomez and Peterson (2006), Wallack and Srinivasan (2006), Bird and Ebel (2007), and Martinez-Vazquez and Vaillancourt (2010).

This observation may point to one way in which we can perhaps begin to sort out what is going on, or not going on, in the complex and largely unknown world of local government finance— by considering not different income levels and regional factors as generic determinants of institutional structures and outcomes, but by considering more carefully the specifics of each particular country. The next section considers this point at more length.

First, however, it may be useful to consider briefly whether there may be trends in local finance in particular countries, even if such trends may be very different from those seen in other countries. The answer is definitely yes. Not only are there are trends in local finance in particular countries, there may even be cycles. Over Canada's first century, for example, the balance of power in public-sector finances first shifted to some extent from the provinces to the municipalities, then back to the provinces and then clearly to the federal government (Bird 1970, 1979). Since the 1970s, however, the provinces have again been clearly on the rise in terms of expenditure and, to a lesser extent, of taxes (Bird and Vaillancourt 2006). A somewhat similar tale may be told in the United States (Wallis 2000).

On the other hand, local governments in Canada have never again come even close to the importance they had in relative terms a century ago; they remain very much at the complete mercy of the provinces (Bird and Slack 1993). A somewhat similar evolutionary tale, but with interesting twists, can be told about much of Latin America, where the break-up of the heavily centralized Spanish empire (Centeno 2002) resulted in the emergence of much more centralized public sectors than in North America (Sokoloff and Zolt 2005)—even in countries that adopted formal federal constitutions (Diaz-Cayeros 2006).

How the public sector becomes institutionalized and subsequently develops in any country reflects the shifting balance of ideas, interests, and institutions over time. Some factors, such as the ideological frameworks within which people understand and value such notions as equity, fairness, efficiency, and growth, are not inherently "national" in any meaningful sense. Indeed, ideas on such matters to a considerable extent may be thought of as "public knowledge"—at least among policy elites—and may hence influence policy in several countries or regions at once, either simultaneously or consecutively (through what may perhaps be called a kind of "demonstration effect").

Much the same is true with respect to the changing roles played in the political process by such economic and social interests as capital and labour, different regions within a country (centre vs. periphery, urban vs. rural, resource-rich vs. resource-poor, or simply rich vs. poor), as well as by different ethnic or linguistic groups and the extent to which they are regionally concentrated.[5] The expansion of world trade, for example, may lead to changes in political power in certain countries as some interests become stronger and others weaken; these changes may be reflected to some extent in the relative importance of different levels of government. Exposure to similar influences, however, whether

[5] For further exploration of this line of thinking, see Bird and Ebel (2007) and Bird, Vaillancourt and Edson-Roy (2009).

from intellectual or economic forces, need not and indeed usually will not lead to the same policy outcomes in all countries.

Outcomes may differ because the initial conditions prevailing in different countries exposed to similar shocks may be different, with the result that both the level and nature of their policy responses will differ, as will the consequences in terms of such measures as public-sector decentralization ratios.[6] One of the initial conditions that is often important in determining outcomes is the nature of the political and administrative institutions in place. At any point, countries can and do differ substantially with respect to the extent of democracy, the prevailing constitution (and its rigidity), the nature of the political system (party structure, parliamentary or presidential, etc.), and the degree and nature of public-sector decentralization in place, as well as the manner in which these various institutions interact in the formulation and implementation of tax and spending policy.

Even if all countries in a region are exposed to a uniform shock, uniform results are unlikely to emerge from the policy cauldron, with its different mixes of ingredients in each country. For example, Sokoloff and Zolt (2005) suggest that the greater initial political and economic decentralization of the English colonies in the Americas compared with the Spanish colonies may well have been a key factor in determining the better long-term economic performance of the former.

This is not to imply that all countries can or should follow the same evolutionary path, nor that other countries could or should follow the North American—or French, or Chinese—path in any particular respect. Indeed, countries almost certainly should not simply imitate others in approaching such key policy issues as fiscal decentralization.[7] These remarks are merely intended to suggest that the level of public-sector decentralization in any country, let alone the particular form that decentralization takes over time, as manifested for instance in the rise or decline of local fiscal autonomy, is best understood as resulting from a set of complex and interdependent policy decisions that occurred in a particular environment in historical time. History, by definition, takes time, and changes in historically shaped policy outcomes are unlikely to occur either quickly or universally.

Viewed from this perspective, it is not surprising that there appear to be few if any significant trends in local finance around the world, or even in particular regions. During the Second World War, for example, most of the now rich countries attained previously

[6] Consider the striking difference in the "transition paths" followed by the countries of central and eastern Europe towards decentralization following the break-up of the Soviet empire (Svejnar 2002). In most respects, these countries started with a similar institutional setup (Kornai 1992), but it quickly became apparent that they were decentralizing -- to the extent that they were -- in very different ways indeed (Bird, Ebel, and Wallich 1995).

[7] For an interesting early examination of the inappropriate adoption of foreign fiscal models and how this initial decision shapes subsequent developments in a particular policy area, consider the adoption of general sales taxes in various francophone African countries discussed in Hill (1977).

unachieved levels of both public-sector expansion and public-sector centralization.[8] Although the public sector in most of these countries for some years remained large and centralized, few grew much after the early 1970s (the end of *les trentes glorieuses*) and most (but not all) rich countries appear to have become less centralized over time to varying extents and in very different ways. Smoke and Gomez (2006) similarly stress the diversity of both the design and the outcome of decentralization in the regions (Asia and Latin America) that they examine. Indeed, the following excerpts from their interesting paper provide an appropriate end to this brief overview of trends in local finance:

> Contextually determined political dynamics, whatever specific features shape them, are key drivers of decentralization, and…historically based institutions and conditions heavily influence how decentralization unfolds… we have only a limited understanding of the specific forces that shape the pace and regularity of the process and how these affect decentralization policies and outcomes (p. 362).
>
> There is much more work to be done on understanding the historical path-dependent nature of the decentralization process. Specifically, it would be worthwhile to explore more formally the institutional mechanisms that represent and sustain the national and subnational political interests that ultimately define decentralization (p. 363).
>
> The study of decentralization is deeply fractured across disciplinary lines, yet it is clear that key elements have to come together for decentralization to work properly (p. 364).

Put another way, since no one ever fully understands what is going on in any country at any time very well, economists, who understandably often speak about trends in local finance in general solely from the perspective of their own discipline, are seldom in a position to speak with much authority. Indeed, even within the context of any particular country, any trends need to be understood and evaluated primarily in terms of the historical and political context as well as changes in economic conditions.

2. Comparing Countries: Pitfalls and Lessons

When faced with the need to make sense of the confusing cacophony that inevitably afflicts those who study data on local finance across countries or conduct comparative case studies of fiscal decentralization, a common, and sensible, approach is to attempt to array countries within some taxonomic structure in order to simplify the analysis and make it more comprehensible, either by comparing like with like or by fitting countries within some accepted normative or conceptual framework. This section comments briefly on two recent, and quite different, examples of this approach.

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[8] Peacock and Wiseman (1961) called this the “displacement effect.” There have been many subsequent studies of Wagner’s so-called “law” of state expansion—one of the better ones is a recent paper by Shelton (2007)—but most appear to reflect more econometric game-playing than either deep understanding of what the “law” means (Peacock and Scott 2000) or a serious examination of public-sector growth.

The first comes from a recent OECD study (Charbit 2009) analyzing the "tax-grants balance" in OECD countries. After neatly setting aside the conventional normative fiscal federalism framework with the (understated) observation that "in practice a variety of types of tax-grant systems are observed in OECD countries, which do not all follow these rules" (p. 3), the author proceeds to classify country systems into four different types, none of which can easily be related to the "optimal" model. Unfortunately, although there are many good and sensible observations in this paper, the suggested classification does not seem to be very useful.

One problem with this classification system it is that—perhaps influenced by the need to follow national political conventions in certain countries—the OECD first defines the tax-grant balance along three dimensions: autonomous tax, tax-sharing, and transfers. Since from the local finance perspective the last two of these categories are essentially synonymous – the centre gives; the sub-central sector receives--, the four country types the OECD study may for present purposes be reduced to three—those having low, medium, or high local fiscal autonomy.[9] However, even if one simplifies further and considers only the countries the study classes as "low" in sub-central fiscal autonomy (Germany, Mexico, Austria, Turkey, and the Czech Republic) vs. those classed as "high" (Sweden, Switzerland, Finland, Norway, France, and the United States), the author suggests that … each type constitutes a distinctly different model of sub-national government finance" (Charbit 2009, 6). However, grom the perspective of local finance it seems more accurate to say that distinctly different models of sub-national government finance are lumped together *within* each of these groups. In fact, as discussed in Section 3, there are probably at least three different "models" of local finance within each of the two categories—high- and low-autonomy the author discusses.

A second, quite different, example of the categorization problem is provided by a recent study by Martinez-Vazquez and Vaillancourt (2010a). In an attempt to pull together a coherent conclusion to a volume of (as usual) rather disparate case studies of decentralization in 15 very different developing countries, the authors interestingly chose to categorize the countries not by what they did, or what the effects were, but rather in terms of the "obstacles" they faced. This strategy is interesting, since there may indeed be much to learn about how to succeed by examining the anatomy of failure—that is, cases in which decentralization does not appear to have been particularly effective, at least in terms of the canonical fiscal federalism model.

What does this "taxonomy of failure" suggest? A first interesting observation is that it takes six categories to categorize only 15 countries in terms of the most important single obstacle encountered. Indeed, as the authors stress, each country faced its own peculiar

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[9] From some perspectives, of course, it may make sense to distinguish between tax-sharing and transfers. For example, recipient governments may prefer the former because it insulates them to some extent from discretionary budgetary policy and may, by giving them access to a more elastic tax base, increase the flow of funds they receive. However, in the present context the key point is simply that, with tax-sharing as with transfers, in most instances local governments cannot through their own efforts influence the amount of money they receive in any period.

combination of problems. The six categories of problems said to afflict decentralization are:

1. In Albania, Southern Sudan, Pakistan, and Peru, decentralization seems to have been designed to fail in the sense that there were fundamental flaws in the original plan, for instance, murky expenditure assignments or overwhelming transfer dependence.
2. In Laos, Bangladesh, and Congo DRC—though in quite different ways in each country—the key problem appears to have been weak central governments.
3. In Burkina Faso and Sierra Leone, the main obstacle was not so much the weakness of the central government as the effective resistance of particular groups—local elites and traditional power-holders—to decentralization.
4. In Cambodia and Madagascar, traditional hierarchical central structures—sometimes imposed or reinforced by colonial history—were simply too strong.
5. In Egypt and Ethiopia, despite rhetoric to the contrary, central governments in the end were not willing to lose political control.
6. In Yemen and Tanzania, what the authors consider "real" fiscal decentralization—the effective devolution of fiscal authority to sub-national governments—seems to have become lost in the search for some form of what the authors call "union-preserving federalism."

Martinez-Vazquez and Vaillancourt (2010a) draw a number of "lessons" from these studies of failure for countries that really want to achieve effective decentralization in the terms they understand it, that is, as effective devolution of decision-making power to sub-national governments. . Many of the lessons constitute sensible advice: for instance, if a country is unwilling or unable to accept that "decentralization" requires some elites and interests to give up power to others, decentralization is unlikely to work well.

More fundamentally, however, from the perspective of those interested not only in changing the world but also in understanding it, the real lesson from their interesting work is perhaps less the guidance it provides to would-be decentralizers than the fact that one can understand trends in sub-central finance in any country only in light of a full appreciation of the relevant environment—economic, political, social—and a deep understanding of why it is the way it is. From this perspective, since each "unit of study" is, by definition, different in important ways—political borders remain surprisingly "thick" even in an economically "globalized" world (Helliwell 1998)—lumping together disparate observations in the same analytical pot is perhaps unlikely to prove a fruitful approach to improving our understanding of decentralization.[10]

These comments are not intended to suggest that comparative studies are not both useful and necessary. On the contrary, it is always illuminating to consider how particular institutions function in any country from a comparative perspective. The comparative approach may be useful to policy-makers—as well as to scholars attempting to understand and evaluate their work—for several reasons:

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[10] As Deaton (2010) has recently re-emphasized, this same point also often raises serious questions about how to interpret many empirical studies based on cross-country statistical comparisons.

- If other countries face similar problems, we can learn from examining how they have dealt with them.
- We can also learn from observing the outcomes of alternative solutions tried elsewhere.
- We can often learn a lot about the system in our own country by thinking about the similarities and differences between its situation and that in other countries.
- Comparative studies may help us to some extent to escape parochialism—the tendency to assume that local problems represent universal dilemmas and that local solutions constitute universal truths.
- And, perhaps most importantly, such studies may help us overcome the apparently endemic human belief that there must be a simple solution to complex problems that can be found somewhere else—that the grass is indeed greener on the other side of the fence.

Good comparative studies such as those in Martinez-Vazquez and Vaillancourt (2010a) and Smoke, Gomez, and Peterson (2006), are thus valuable not so much because they tell us how to do the right things or how to avoid doing the wrong things, but because they add, bit by bit, to our inadequate knowledge of the many dimensions of the decentralization puzzle in any particular country.

Comparisons, however, may also be misused. For example, it is all too easy to fall into the approach of picking one good feature from one country, and another one from another country, and proposing that both should be introduced in a third country without taking into account that from an institutional perspective, every country is a unique and to some extent organic unity. As Albert Hirschman (1967) once said, there are no such things as "side effects" when it comes to policy analysis: there are only effects.

To put this another way, in considering any policy change, one needs to take into account not only its intended or desired consequences (whether explicitly stated by the government or imputed by the analyst on the basis of some normative model)—for example, more efficient and effective provision of local public services—but *all* its consequences, direct and indirect, not only on that outcome but on all relevant outcomes, including political and other costs arising from deviations between the services provided in one locality and those in another.

The two exercises in country categorization summarized earlier in this section also demonstrate another important point. Such taxonomic exercises are generally motivated in part by the desire to reduce complex reality to a more tractable form that can be brought within the framework of some normative model. Implicitly, the model in both studies discussed earlier in this section appears to be that suggested by the conventional fiscal federalism approach, as modified to some extent in its "second-generation" formulation (Oates 2008). In both instances, however, the authors had to reach well beyond that model to grapple with the realities they faced.

In the OECD paper (Charbit 2009), for instance, perhaps for reasons of international politics, a rather artificial distinction is made between two types of intergovernmental

transfers—those in which the amount (and perhaps, in some instances, even the allocation to some extent) is determined by central tax collections and those in which the amount is determined by the normal budgetary process (or in some other way, as in the case of the traditional Canadian equalization formula). The potential relevance of this distinction to trends in local finance is not discussed, however. For example, different central tax bases for transfers may have substantially different elasticities and hence different implications for local finances. Similarly, different degrees of central discretion with respect to the level and distribution of transfer funds may affect local finances very differently.

In Martinez-Vazquez and Vaillancourt (2010a), as noted earlier with reference to Smoke and Gomez (2006), the authors recognize more clearly that the political and political economy elements that are so often critical to decentralization are not adequately encompassed within the traditional normative framework. As they (almost) put it at one point, there may be as many "visions of decentralization" (Martinez-Vazquez and Vaillancourt 2010a, 14) as there are players in the game. However, they do not suggest any alternative categorization that would help sort matters out.

As these examples suggest, it is surprisingly hard in most cases to tell either what the game is or who the players are without thinking about how best to model the "visions" of decentralization held in different countries. The next section takes a first look at this question.

3. "Models" of Local Government

Although most economists are presumably more familiar with "models" than with "visions," either word may fit the kind of normative frameworks sketched briefly in this final section.

Customarily, economists follow a four-step approach to policy issues:

- Step 1: Construct a "model" of what a good (optimal) public-sector structure should look like.
- Step 2: Examine the situation in question to see how it diverges from the model.
- Step 3: Propose changes that will transform "what is"—the imperfect reality of the current situation—into "what ought to be"—the perfect world of the initial normative model.
- Step 4: Since the correct answer has now been supplied and the rest is just a simple matter of political will to do the right thing and the competence to carry it through, most economists are then content to retire, satisfied, to their studies to wait for the next problem to come along.

Of course, this characterization is both facetious and undoubtedly unjust to many serious policy-oriented scholars. Nonetheless, it does seem fair to note that economists have not always paid enough attention to the critical question of why "what is" *is*—that is, why

certain administrative values, styles, and practices exist and persist in a particular environment.

When a reformer tries to implement a decentralization plan based on the conventional fiscal federalism model, as shown in studies like those summarized in Smoke and Gomez (2006) and Martinez-Vazquez and Vaillancourt (2010a), decentralization almost inevitably encounters unforeseen obstacles, traps, and dead-ends and outcomes are far from the postulated ideal. In addition to the need to pay more attention to the importance of both "path dependency" and "context specificity"—academic language for history and the current environment—this section suggests that there may be yet another "model-based" problem when it comes to understanding trends in local finance. Specifically, a number of quite different "models" of local finance appear to exist—some perhaps more in practice than in theory. To avoid a "dialogue of the deaf" between analysts and policy-makers discussing "decentralization"—itself a complex, many-faceted, and often ambiguous term—it is critical to ensure that everyone holds the same normative model of the appropriate role of local government and its role in the total policy picture.

To begin with, it is important to distinguish two distinct theoretical models. One is the canonical fiscal federalism model as set out notably by Oates (1972).[11] Within the broad structure of this model, at least three significant "sub-models" may be discerned, as discussed below. To begin, however, we shall consider the distinct "administrative federalism" model sketched in Rattsø (2002) and set out in more in detail in some of the country cases found in Dafflon (2002) and Kim and Lotz (2008). Although Oates (2005) suggests that this model is of little use with respect to most of the interesting issues in fiscal federalism, this dismissal seems mistaken. In fact, two variants of this model—which for convenience are distinguished here as territorial administration (Model 1) and administrative federalism (Model 2)—appear to accord more closely to both the normative framework and the systems existing in a wide variety of countries than do any of the variants (Models 3-5) of the canonical model.

Model 1. Territorial Administration

Experience in a wide variety of countries suggests strongly that many have neither any tradition of, or experience with, the "electoral and fiscal autonomy" that (Oates 2005, 358) considers an essential ingredient of fiscal federalism as he understands it. In the territorial administration "model" found in many such countries, local governments are essentially viewed simply as the local manifestation of central administration—as it were, local lines in the central budget. Sometimes such governments have limited

[11] For an earlier review of this model, see Bird et al. (2003). The various approaches to "second-generation" fiscal federalism, insightfully discussed in Oates (2005, 2008) and Weingast (2006), are not considered here. From the present perspective, these approaches can all be seen as (useful) extensions of the canonical model to encompass more explicit treatments of information asymmetry and various aspects of political economy. Similarly, the quite different "public choice" perspective associated with Brennan and Buchanan (1980) is not discussed here. A brief consideration of some of the literature mentioned in this note may be found in Bird (2009) and Smart and Bird (2009).)

powers to impose fees. However, their main role is simply to act as a channel for central funds devoted to carrying out centrally directed functions at the local level. Often, the number, qualifications, and salaries of all "local" officials are also set centrally. In short, local governments are little more than "deconcentrated" central government offices.

In the many countries around the world in which both experience and expectations are along these lines, it is not surprising that most attempts to decentralize in terms of giving local governments responsibility and authority for real decision-making have failed. Of the six obstacles to decentralization mentioned by Martinez-Vazquez and Vaillancourt (2010a), this failure in two-thirds of the cases they consider[12] may at least in part be attributed to the dominance in reality (and perhaps also expectation) of what could be characterized as a sort of "territorial administration" model.

Moreover, a problem with the OECD (Charbit 2009) categorization scheme noted earlier also becomes apparent. In the Soviet-era model, local governments had no significant existence apart from their role as the local face of state power (Kornai 1992). Not surprisingly, even some countries that are now in the European Union continue to hew fairly closely to this model. A recent detailed study of the Czech and Slovak Republics, for example, shows clearly that, despite considerable rhetoric about "local self-government," especially in the Czech case, both attitudes to and the administration of local government finance still largely reflect the role of local governments as arms of the state public administration (Bryson, Smith, and Cornia 2009). That no one could possibly characterize Mexican local governments in this way (see Giugale and Webb 2000), even though the two countries are classified in the same category by the OECD (Charbit 2009) illustrates why that approach to classification is not useful.

The point to be emphasized, however, is that if a country (implicitly or explicitly) thinks Model 1—deconcentration—is "right" for it, there is probably little point in urging "devolutionist" (local autonomy) reforms on it. Moreover, evaluating the success (or not) of whatever decentralization (by their lights) that they undertake in terms of what is, from their perspective, the largely inappropriate standard of the canonical fiscal federalism model is unlikely to prove useful. One may do so if one wishes: but why should anyone in the country concerned listen?

Model 2. Administrative Federalism

Such problems are not confined solely to ex-Soviet countries or to poor countries. Indeed, an important variant of this model is evident in northern Europe in the form of

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[12] Martinez-Vazquez and Vaillancourt (2010a) identify traditional hierarchical rule (Cambodia, Madagascar), central governments unwilling to give up control (Egypt, Ethiopia), murky expenditure assignments and undue transfer dependence (Albania, Southern Sudan, Pakistan, and Peru), and effective resistance of elites and power-holders (Sierra Leone and Burkina Faso). In contrast, in two of the cases they consider—Yemen and Tanzania—the canonical model fails essentially for the opposite reason, because it does not easily encompass what has elsewhere been called the "federal finance" model (Bird and Chen 1995)—a model that comes closest to Model 5 discussed below.

the "administrative federalism" model (Model 2). Under this approach, the "welfare state" is in effect administered by an integrated system under which central and sub-central governments, although distinct and with different constituencies and responsibilities, nonetheless work almost as one. In countries like Sweden and Denmark, for example, most redistributive spending is financed by both central grants and local taxes but locally administered.[13]

In contrast to Model 1, however, under Model 2 local governments have both incentives and freedom to experiment to some extent with new services and new ways of delivering services. Potential problems arising from information asymmetry and differing incentives are assumed to be largely dealt with through an institutionalized structure of central and local cooperation that ensures, in effect, that each level of government is seeking to achieve the same objectives and acting on the basis of the same information. In such circumstances, the commitment failures that motivate so much research on fiscal federalism are unlikely to be a serious problem, since local authorities are generally both directly regulated with respect to many aspects of local service provision and subject to budgetary regulations that ensure they cannot expect to obtain a bailout by increasing spending.

On the other hand, experience elsewhere suggests that commitment problems clearly do arise in decentralized systems like those of the United States and Canada, which again makes one wonder about the utility of a classification system like the one used in the OECD study (Charbit 2009), which places the United States and Sweden in the same category. Moreover, such problems have been an important reason why decentralization has encountered serious obstacles in many countries, as illustrated by the "design flaws" identified by Martinez-Vazquez and Vaillancourt (2010a).[14] Countries such as Denmark may be sufficiently small and homogeneous and have a sufficiently generally agreed-upon set of values that central governments do not have to worry much about whether local governments will not do what they "should" (from the perspective of the central government). At the same time, local governments in these countries are sufficiently integrated into the decision-making process that they do not feel unduly oppressed and directed from above. Few other countries may be so fortunate, but the point is that those working in this Model 2 framework often have rather confused and confusing exchanges with those who, like most economists, approach decentralization from the conventional fiscal federalism framework.[15]

The "conventional" fiscal federalism model itself is by no means simple. Quite apart from the ongoing evolution of various so-called "second-generation" fiscal federalism

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[13] See the papers on the Nordic countries (Denmark, Finland, Norway, Sweden) in Kim and Lotz (2008) as well as the papers presented at a subsequent Copenhagen workshop in 2009.

[14] See also Rodden, Ekesland, and Litvack (2003).

[15] For further reflections along this line, see Smart and Bird (2009), which stresses the importance of simultaneously considering the design and implementation of both intergovernmental transfers and local taxes. In addition, as Borge (2010) notes, in a fuller treatment of local finance "models," it is also important to consider regulatory provisions, both those related to the control of local services and the more general "fiscal rules" often used to constrain local deficits and borrowing.

approaches,[16] at least three distinct "models" of local finance lurk within the conventional framework. For discussion purposes, we shall call them the benefit model (Model 3), the agency model (Model 4), and the autonomy model (Model 5). Of course, these labels and the distinctions drawn between these models are rather arbitrary, since the elements discussed here are often intermingled both in the literature and in practice.[17]

Model 3. Benefit Model

Perhaps the simplest, if perhaps the least common model is Model 3, which might perhaps be called the local business model. Tiebout (1956) in a sense started this line of thinking by treating localities as competing firms. However, his "local firms" sold only pure public goods that were enjoyed equally by all local residents. In reality, many of the goods and services provided by local governments are essentially "private" and should, in principle, be paid for strictly by those who benefit directly from them.

Combining these lines of thought, Bird (2001) draws an analogy between a local government and a business that provides services to consumers (residents) who must pay for what they receive. What this approach suggests is that the first rule of local finance should be "Wherever possible, charge," since it is both equitable and efficient for the direct recipients of benefits, whether residents, businesses, or properties, to pay for what they get, provided, of course, that the correct (roughly, marginal cost) price is charged. Only thus will the right amounts and types of service be provided to the right people—that is, those willing to pay for them.

Considered somewhat more broadly, this approach can be recast as a strict benefit model of local finance, under which the basic requirement for efficient and effective local government is the matching principle, whereby expenditure responsibilities are matched with revenue resources, revenue capacities matched with political accountability, and, in particular, benefit areas matched with financing areas.[18]

As Bird (1993) notes, this approach has strong implications for the appropriate local financing structure, in particular that localities should be constrained from "exporting taxes." For example, as Bird (2003) argues, while businesses should pay property taxes, they should not be subject to higher effective property tax rates than residents, since such

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[16] See note 12 above.

[17] As Jorgen Lotz has pointed out in a personal communication, many of the elements singled out in the discussion of the next three models may also properly be considered in the context of Model 2. In Denmark, for example, the high degree of equalization in effect makes the local personal income tax (the marginal source of finance for welfare services) a benefit tax, thus discouraging inefficiency or "gold-plating" in local service delivery because such "excess" costs will be directly reflected in higher local taxes. Since local governments in all countries may differ considerably in the efficiency with which they produce services, ssome version of the "benefit" argument can play a useful role within almost any normative framework.

[18] Set out explicitly in Olson (1969), this "fiscal equivalence" approach is also central to Bird et al. (2003).

discriminatory taxation will undesirably bias business investment decisions.[19] If there is a benefit case for heavier business taxation, the best way to impose such taxes is probably through a relatively neutral tax along the lines of the (unpopular) IRAP, a regional (and local) tax on business in Italy.[20]

Model 3 in effect focuses on the appropriate level and structure of local revenue systems. In doing so, three strong assumptions are implicitly made:

- First, local governments have an appropriate range of expenditure responsibilities—providing local services to local residents and businesses. In other words, the obscurities, contradictions, and even impossibilities that, as Martinez-Vazquez and Vaillancourt (2010a) emphasize, are often to be found in practice have all been resolved. Who is to do what is clear to all.
- Second, local governments are permitted to exercise these responsibilities freely both in the sense that they have (potentially) access to sufficient resources and that they are not subject to detailed controls over what they do and how they do it. Of course, this does not mean that they are not subject to the constraints imposed by both administrative and political accountability.
- Third, local governments are not directly concerned with redistributive policy.

In practice, all three of these assumptions are generally breached to some extent in almost all countries. For example, at least in democracies, if local governments are actually governments—politically responsive bodies—they are, almost by definition, going to be in the business of redistribution to some extent, whether or not these attempts are vitiated by the openness of their economies. Similarly, in most countries, central governments attempt to some extent to bend local government decisions to accord with national policy objectives. Finally, some degree of spillovers of both local expenditures and taxes are almost inevitable.

Model 4. Agency Model

Model 4 accepts the failure of the first and second of the assumptions just mentioned. In this approach, which dominates much of the literature on grants as well as many empirical fiscal federalism studies, local governments are largely viewed as agents to whom central governments have delegated certain functions. Given the (presumed) information asymmetry inherent in agency relationships, with local information dominating central knowledge, analysts thus face the "mechanism design" task of developing an incentive-compatible combination of intergovernmental transfers and local taxing power that will maximize social welfare—usually taken to be synonymous with national (rather than local) welfare.

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[19] An exception might be to the extent that higher business taxes may constitute a way to tax the 'rents' that firms may reap from agglomeration economies, particularly in metropolitan areas, but even in this case, a more general form of business taxation, like that next discussed in the text, is preferable.

[20] This line of argument appears to have had some influence on recent revisions of local business tax systems in both Japan and France.

This approach has not only produced a rich theoretical and empirical literature, but also helps one understand and attempt to improve the many real-world situations in which the underlying assumptions prevail—that is, that local and central knowledge and interests differ and that the level of national welfare may be improved by improving the extent to which central (and, it is often apparently assumed, benevolent) interests prevail.[21] In many ways, this model provides, as the literature demonstrates, a useful normative framework for analysis of intergovernmental fiscal relations.

However, Model 4 is unlikely to provide a perfect fit to reality in any country. For example, it is subject to some important caveats when it comes to applying it in "truly federal" countries—that is, countries in which it is not appropriate to assume that the "centre rules" (Bird and Chen 1998, Bird and Tassonyi 2001). It is also arguably only really appropriate for countries in which both national and local democracy are 'full' governments in the sense that not only are governments at all levels accountable to their citizens, but citizens are also relatively well informed about what is going on. That is, a certain degree of "fiscal transparency" is necessary for this approach to be a useful approximation to reality (Bird 2000). Unfortunately, as Martinez-Vazquez and Vaillancourt (2010a) and others have shown, such conditions do not exist in many developing countries. It is perhaps therefore legitimate to wonder whether conclusions based on this framework have much to tell us about how to improve policy outcomes in such countries.

Model 5. Local Autonomy

Finally, there is also a Model 5, which represents complete local autonomy, at least in key respects. At the extreme, under this model, local governments are free to do what they want, how they want, and when they want. At first glance this model—though in some ways close to Tiebout (1956)—may appear to make little sense, since such governments would then in effect be little "countries" and hence not "local" in the sense of being subordinated to some national rules and government. A more realistic version, however, is to think of a federal country in which state—and perhaps even local—governments have clearly defined spheres of absolute authority that cannot be abolished, cancelled, or directly controlled by central governments. In this "federal finance" model of local self-government, localities would presumably be free to do as they wished in terms of taxing and spending for their citizens. Under the right conditions, the result should be welfare-maximizing . These conditions include a framework that ensures that the actions of one local government will not infringe unduly on the freedom of other local governments (no tax exporting, no internal barriers to trade, etc.) nor on areas for which the central government has primary responsibility, and that local governments have adequate information and appropriate incentives (local accountability, fiscal

[21] An important initial paper along this line was Musgrave (1961); for some further discussion, see Bird and Smart (2002, 2010), and Smart and Bird (2010).

responsibility), and so on. In this context, the task of the policy analyst in effect becomes one of designing the constitution, thus moving the discussion to another level.[22]

4. Final thoughts on the use of models

In the federal countries of North America, both public discussion and public policy towards fiscal federalism often wobble somewhat uneasily between Model 4 and Model 5 with respect to federal-state (province) relations. In many U.S. states, similar discussions—and policy confusion—may sometimes be seen at the state-local level. In Canada, on the other hand, provincial-municipal relations are firmly in the Model 4 mode for the most part (Bird and Tassonyi 2003).

This characterization of the Canadian and American cases may of course itself be considered by some to be a caricature. But perhaps the most appropriate way to conclude these preliminary reflections is to emphasize that the point is not so much whether this or that model (or mixture of elements from the different models sketched above) is "right" either in general or in any particular context or even by discussing whether the particular set of "models" listed here is either complete or correct. In all likelihood, it is not. The aim here is simply to underline the importance of ensuring that those engaged in dialogue about local finance issues in any country are as clear as possible about both their own normative assumptions about what is "right" and those of others in the discussion.

Clearing the air in this sense is unlikely to be a simple or easy task, either conceptually or in practice. Nonetheless, doing so may, in at least some instances, lead to more meaningful and ultimately productive discussions than seems to have been the case so far in most countries in which debates on decentralization are currently under way.

[22] Brennan and Buchanan (1980) explicitly approach the issue from this perspective, although they adopt a strong Leviathan model of governments at all levels.

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