

WHITHER PROVINCES AND STATES?
THE CASE FOR AN HOURGLASS
MODEL OF FEDERALISM

ANWAR SHAH, CENTRE FOR PUBLIC ECONOMICS,
CHENGDU, CHINA,
AND WORLD BANK, WASHINGTON, DC, USA

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By Anwar Shah, Centre for Public Economics, Chengdu, China, and World
Bank, Washington, DC, USA

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Forum of Federations
700-325 Dalhousie
Ottawa, Ontario (Canada) K1N 7G2
p. 613-244-3360
forum@forumfed.org

Abstract

Globalization and the information revolution are profoundly influencing the division of powers within, across and beyond nation-states. These new economic imperatives empower global regimes that have democratic deficits. They also call for an hourglass model of federalism: that is, having strong central and local governments with provinces and states simply playing a coordinating role. This role is the opposite of the one in traditional federal constitutions such as those in the U.S. and Canada, which empower provinces and states but disempower local governments by treating them as creatures of provinces and states. These two mega changes have led to the diminished economic relevance of states and provinces – the intermediate order of government in many federal and unitary countries. These same changes have also increased the need for local governments to have more powers. Local governments are the primary agents of people and are also catalysts for change, the facilitators that improve economic and social outcomes for their residents. This role played by local governments is also critical to international competitiveness and growth as demonstrated by the experiences of China, Japan, Korea and the Nordic countries. Such an enhanced role for local governments is also shown to promote peace, order and good governance. However, constitutions from more than a century ago make such radical reforms difficult in some countries. In others with strong state or provincial governments run by feudal, military and industrial elites, such reforms may be unfeasible.

Keywords: federalism, fiscal federalism, local governance, municipalities, globalization, glocalization, government, intergovernmental, state and provincial governments, people empowerment, government accountability, good governance



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ANWAR SHAH, CENTRE FOR PUBLIC ECONOMICS, CHENGDU,
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Introduction: Why rethink fiscal federalism?

Globalization and the information revolution are profoundly influencing economic governance in both the industrial and the industrializing world. Globalization 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. These two revolutions 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). Globalization has also liberated markets and brought market discipline to governments. However, the recent global financial crisis has significantly shattered the common faith in the workings of free markets. Providing bailouts to markets has also endangered the fiscal health of governments around the globe while creating a crisis of public confidence in national politics and leadership. Changes in systems of governance will be needed to cope with these two revolutions. This paper sets out the special challenges in adapting multi-order governance to make it incentive compatible with the goal of “growth with equity and fiscal sustainability”.

Because of globalization, 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, environmental policy, telecommunications, and financial transactions (see Box 1) . Globalization is also making small open economies vulnerable to the whims of large hedge funds and polarizing the distribution of income in favour of skilled workers and regions with higher skills and access to information. Globalization widens income disparities within nations while improving average 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 globalization and the information revolution are also strengthening localization. They are empowering local governments and “beyond-government” service providers, such as neighbourhood associations, non-governmental non-profit and for-profit organizations, self-help groups and networks. These groups now exercise a broader role in improving economic and social outcomes at the local level through greater connectivity to markets and resources elsewhere. Localization is leading to citizen empowerment in some areas while simultaneously strengthening local elites in others.

Courchene has termed the overall effect of these changes “*glocalization*” (Courchene 1993, 2001). This term implies three things:

- 1) the growing role of global regimes
- 2) the growing role of local governments and beyond-government entities
- 3) the changing roles of national and subnational (provincial and 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
- from being intolerant of risk to allowing freedom to fail or succeed

Box 1. Glocalization: Emerging Rearrangements of Government Assignments

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.

Centralization: Social and environmental policy through international agreements; skills enhancement for international competitiveness; securing common economic union through bridging economic, social and digital divides within nations; social safety nets; oversight, financing of education, social services and technical assistance to subnational governments.

Localization and privatization: all regional and local functions.

Sources: Boadway and Shah, 2009

Recent global financial crises have hampered this change, but with improved macro stability in the future this 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 materialize because of political and institutional difficulties.

The three emerging trends resulting from this mega change in the shifting balance of powers within nations are these:

(a) The role of the central government is slowly changing from that of a managerial authority to a leadership role in a multi-centered government environment. Now the central government's major tasks are securing a common economic union by using economic and social risk management, and dealing with the economic and digital divide within nations.

(b) A steady erosion is taking place in the economic relevance of the role of the provinces (used as a short form of "provinces or states" in this paper—the second or intermediate tier).

(c) The role of local government in multi-order governance is being enhanced and redefined to serve as the primary agent of people providing oversight on shared rule and as a facilitator for network governance with the goal of economic and social advancement of its residents.

This paper is concerned with the potentials and perils associated with adaptive responses to these challenges especially in reshaping the role of provinces and local governments. The paper is organized as follows:

- "Empowering provinces and states" discusses the role of the provinces (states) and local governments under a traditional system of fiscal federalism.
- "Unshackling Local Governments" discusses the role of provinces (states) and local governments under a new vision of multi-order governance.
- "Empirical perspectives on the division of powers among provinces and local governments and implications for peace, order and good governance" draws the implications of alternative models for peace, order, good government and growth from cross-country and country case studies.
- The conclusion draws broader policy implications of this analysis.

Empowering provinces and states

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

Table 1. Governance Structure: 20th versus 21st Century

<i>20th century</i>	<i>21st century</i>
Centralized or provincialized	Globalized and localized
Central government that manages	Central government 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, <i>ultra vires</i> , “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 or provincial role	Ever-diminishing economic relevance of states or 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 centralization with revenue sharing and input-based conditional grants to finance subnational expenditures	Tax and expenditure decentralization with fiscal capacity equalization and output-based national minimum standards grants

Sources: Boadway and Shah, 2009

compact or alliance) among states or provinces, “each of which recognized the legitimacy of an overarching central government to make decisions on some matters that were formerly the exclusive responsibility of individual member states” as done in the USA (Inman, 2007:530). “Coming together” federalism 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 decentralize 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 their provinces. Federal countries broadly conform to one of two models: dual federalism or co-operative 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, the compact is between federal and provincial governments and both have separate and distinct responsibilities: local governments are typically creatures of the provinces. Canada, the United States, India and Pakistan practise this model. Under co-operative 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. Dual federalism also has the advantage of dealing with ethnic and linguistic conflicts if provinces are numerous and are small enough in geographic area and represent populations with relatively homogeneous characteristics. Smaller provinces may also have similar tastes and preferences for a menu of taxes and public services (as do cantons in Switzerland). If provinces are properly delineated as economic regions then they could also enhance the efficiency of the internal common market by exploiting economies of scale and scope. They also have the potential to deal with spillovers among municipalities and inequities among regions. Provincial governments can also

be responsive to citizen preferences if a provincial government is not captured by feudal, industrial and military elites. The absence of a well developed communication and transportation system and a lack of urbanization make provinces almost a necessity for countries that span a large geographic area.

However, the dual federalism model that empowers provinces has significant shortcomings.

“Tragedy of the Commons” Associated with Common Pool Resources. Under dual federalism, both the central government and the provinces compete to claim a larger share of the fixed national pie. This accentuates universalism and pork barrel politics. Dual federalism also can lead to a “tragedy of the commons” in which all federating units try to outdo each other in profligate spending and giveaways funded by 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. Empowerment of the provinces also leads to increased costs for the government treasuries 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, distracting them from their primary role of 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 small countries. Governments of New York, California, Ontario, Sao Paulo, Punjab, Sindh, Balochistan and the 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 such as Pakistan, where politics is dominated by feudal, military and industrial elites, this leads to complete alienation of governments from their people. This lack of accountability in governance is further accentuated by a lack of voice and exit options.

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 strait-jacket mandates with little resources and are kept under tight provincial reigns as is done in India and Pakistan. The empowered provincial

governments typically encourage local fragmentation in the interests of a high degree of intrusive controls. In India, there are 254,119 local governments that receive a pittance – a mere five per cent of national expenditures. Most of these expenditures go towards financing the salaries and allowances of civil servants and three million elected officials, with little left for delivering public services. In contrast, in China where the role of provinces is restricted and local governments are empowered, there are only 43,965 local governments accounting for 51.4 per cent of national expenditures (see Qiao and Shah, 2006).

Stifling any local innovations. Provinces and states often impose one-size-fits-all strait-jacket mandates that constrain local choices and stifle any innovative approaches. In Pakistan, provincial ordinances in 2000 required all local governments, small or large, to have 16 departments and a fixed number of positions. In the United States, outdated state laws rooted in unjustified distrust of local decision making have stifled action by successful cities. Many American municipalities are hindered from developing and implementing 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 any new or revised 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 also a direct interface with the centre. For this reason, the local governments of Shanghai, Beijing, Bangkok and Seoul are treated as provinces by China, Thailand and South Korea respectively. 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 the Internal Common Market. Empowered provinces also have the potential to create internal barriers to trade and factor mobility through residence requirements and by creating protective regulatory and trade barriers across provincial borders. Mature federations like the U.S. have circumvented these problems by including an interstate commerce clause in the constitution. These barriers, however, are formalized in the political and bureaucratic systems of India and Pakistan resulting in fragmented common economic union.

Increased Threats of Succession. Empowered provinces represent a potential threat to the political union especially in countries with ethnic,

linguistic and religious divides. A similar threat arises in countries such as Pakistan where there are a smaller number of provincial jurisdictions with one or more dominant provinces. Fiscal federalism literature shows that as a rule of thumb, all dual federalism models with fewer than 10 provincial jurisdictions are likely to face internal conflicts and potential political instability.

Diminished economic relevance of the intermediate order of government (provinces and states) under globalized governance. Finally and most importantly, globalization and the information revolution are working to make the economic role of provinces largely redundant. Globalization empowers supranational regimes and local governments at the expense of national and provincial governments. Globalization also implies that international competitiveness of a nation is decoupled from its resource base but directly linked to 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 the vagaries of the global system and social dumping by corporations to stay internationally competitive. National government also assumes a greater role in securing a common economic union. The provincial economic role, on the other hand, is on the wane as the information revolution makes possible national coordination and oversight over local governments and horizontal coordination at the local level through inter-local partnerships as is done in Finland. In view of the above pressures, state 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 countries and even on the rise in some, such as Germany, Pakistan and India. In Germany, the *Länder* have 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 two amendments to the Constitution that would have empowered local governments—the 73rd and 74th amendments. In Pakistan, the 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 adopt a smooth transition to such role reversals.

Unshackling Local Governments

Pressure to empower local governments is likely to grow. Central governments can grant this power or not, but in any case they will have to examine the likely consequences carefully.

Rethinking local government's role

Globalization and the information revolution have brought about a paradigm shift in the economic competitiveness of nations. The economic prosperity of a nation is now more closely linked to the knowledge, skills and information base of its citizens than to the country's resource endowments. It is increasingly recognized now that local governments, especially cities, are in a better position to spur economic growth by fostering a new knowledge-based economy. With the mobility of capital and deregulation of business, 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. The global financial crisis has diminished people's trust both in the market and in central governments as regulators of the financial system.

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 finance. One indication of this trend is that costly centralized services are now being replaced by competitive services at the local level. Closer to home, people are increasingly more likely to identify with local jurisdictions and to demand higher quality local services to improve their economic and social outcomes. But local governments with few exceptions (for example, China, Denmark and Finland) are prohibited from playing a leadership role in local economic development because of constraints imposed by higher orders of government. To reshape the role of local governments in order to conform to the new world economic order, one has to review both the theory of federalism and the federal practices of the past.

Models for roles of local governments

There are five perspectives on models of government and the roles and responsibilities of local government:

- traditional fiscal federalism
- new public management (NPM)
- public choice
- new institutional economics (NIE)
- network forms of local governance

The traditional fiscal 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).

Traditional fiscal federalism

The fiscal federalism approach is focused on internalizing the benefits and costs of providing services to each jurisdiction. It 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 (Boadway and Shah 2009 explain such a framework for the design of fiscal constitutions). Hence, one sees that in most federations, such as in Canada and the United States, local governments are creatures of state (intermediate order) governments. Both Canada and the U.S. practise *dual federalism*. In a few isolated instances, as in Brazil, they are equal partners with higher-level governments. This type of equal partnership takes place only under *co-operative federalism*, and in an exceptional case, Switzerland, local governments (cantons) 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 because their expansive role would come at the expense of the powers of the intermediate order of government. As globalization and the information revolution leads to a diminished economic relevance of the intermediate order of governments, these conflicts are accentuated. In this situation, the intermediate order governments have a tendency to play a more intrusive role at the local level to stay politically relevant. The traditional 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.

New public management (NPM)

Two interrelated criteria have emerged from the NPM literature in recent years. The first is a definition of what local governments should do and, the second is how they should do it better. These criteria argue that the role of public managers in local governments is to tap free resources of the community (such as goodwill and 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 mobilizing and facilitating a network of providers beyond local government. This environment, focused on creating public value, encourages innovation and experimentation up to a limit, namely the amount of tolerance of risk by 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.

Public choice

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 the people, they must have complete local autonomy in taxing and spending constrained only by provisions of direct democracy and they must be subject to competition within and beyond government. In the absence of these prerequisites, local governments will be inefficient and unresponsive to citizen preferences (Boyne 1998, Bailey 1999).

Neo-institutional economics (NIE)

Shah and Shah (2006) apply NIE principles in developing a framework for analyzing fiscal systems and local empowerment and for comparing mechanisms for local governance. This framework is helpful in designing multiple orders of government and in clarifying local government responsibilities in a broader framework of local governance. According to the NIE framework of 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 minimizing transaction costs for the principals.

The existing institutional framework does not permit such optimization, because the principals have bounded rationality. That is, the principals 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, 7). This has been described as “government as a runaway train.”

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 non-existent 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. The high costs of activism, historical and cultural factors, and mindsets by which people see few benefits, all 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.

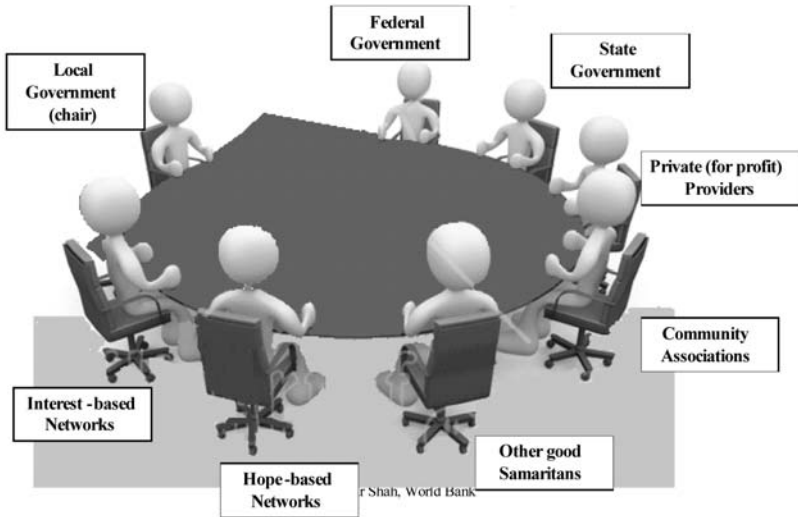
Network forms of local governance

Market and hierarchical mechanisms of governance for partnerships of multiple organizations both have high transaction costs and are perceived as unfeasible. Instead, a network mechanism 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 among partners with no formal institutional safeguards. Networks formed on the basis of shared interests (interest-based networks) can provide a stable form of governance. However, network membership should be limited to partners who can make significant resource contributions and there must be a balance of powers among members. Members of such networks interact frequently and see co-operation in one area as contingent on co-operation 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.

Local Government as a facilitator of Network Forms of Governance

Reshaping 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 used by various orders of government does not lead to service delivery that citizens expect. 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 unco-operative 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 strait-jacket mandates. They are given only limited home rule in their competencies. In this system of “federalism for the governments, by the governments, and of the governments,” local governments get crushed under a regime of intrusive controls by higher levels of governments. Citizens also have limited voice and exit options.

Table 1. The Role of a Local Government under the New Vision of Local Governance

<i>Old view: 20th century</i>	<i>New view: 21st century</i>
Based on residuality and local governments as wards of the state	Based on subsidiarity (see Table 1) and home rule
Based on principle of <i>ultra vires</i> (see Table 1)	Based on community governance
Focused on government	Focused on citizen-centred local governance
Agent of the central government	Primary agent for the citizens and leader and gatekeeper for shared rule
Intolerance of risk	Freedom to fail or succeed
Focus on government	Focus on governance with interactive direct democracy
Responsive and accountable to higher-level governments	Responsive and accountable to local voters; assumes leadership role in improving local governance
Direct provider of local services	Purchaser of local services
Focused on in-house provision	Facilitator of network mechanisms of local governance, coordinator of government providers and entities beyond government, mediator of conflicts, and developer of social capital
Focused on secrecy	Focused on letting the sunshine in; practices transparent governance
Has input controls	Recognizes that results matter
Internally dependent	Externally focused and competitive; is an ardent practitioner of alternative service
Closed and slow	Open, quick, and flexible
Has intolerance for risk	Innovates; takes risks within limits
Depends on central directives	Autonomous in taxing, spending, regulatory, and administrative decisions
Rules-driven	Has managerial flexibility and accountability for results
Bureaucratic and technocratic	Participatory; works to strengthen citizen voice and exit options through direct democracy provisions, citizens' charters, and performance budgeting
Coercive	Focused on earning trust, creating space for civic dialogue, serving the citizens and improving social outcomes
Fiscally irresponsible	Fiscally prudent; works better and costs less
Exclusive with elite capture	Inclusive and participatory
Overcomes market failures	Overcomes market and government failures
Boxed in a centralized system	Connected in a globalized and localized world

Sources: Shah and Shah (2006, 2007)

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. 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—together with pork-barrel politics—results in a “tragedy of the 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.

How can we reverse this trend and make governments responsive and accountable to citizens? The dominant solutions suggested in the literature are the following:

- implement the subsidiarity principle
- adopt the principle of fiscal equivalency
- create public value
- use results-based accountability and the minimization of transaction costs for citizens (as discussed earlier)

These solutions are useful but should be integrated into a broader framework of citizen-centered governance. They would create an incentive environment in the public sector that is compatible with a public sector focus on service delivery and bottom-up accountability. This citizen-centered governance should also be incentive-compatible with globalization. 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.

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

accountability and citizen empowerment. Formula based revenue-sharing arrangements, on the other hand, weaken government accountability to citizens.

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 inter-governmental system.

The two options are these:

- A. Local governments become the primary agent, subcontracting to local providers, provincial/regional (state), and federal or central government authorities and engaging networks and entities beyond government.
- B. Local, provincial/regional (state) and national governments function as independent agents.

Option A: Local governments become the primary agents of citizens. In this model, a local government serves three roles:

1. a purchaser of local services
2. a facilitator of networks of government providers and entities beyond government
3. a gatekeeper and overseer of province/state (intermediate order) and national governments for the responsibilities delegated to them

This model represents a fundamental shift in the division of powers from higher to local governments. It has important constitutional implications. Residual functions—those not assigned to central or provincial governments—remain with local governments. Provincial legislatures would not be directly elected and would simply be constituted as provincial councils from local government representatives (local mayors) to perform inter-municipal services. The provincial chief executive (governor) could either be directly elected or nominated by the central government subject to confirmation by the provincial legislature (provincial council). The provincial council would 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-fourths 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 harmonization 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: Different orders of government function 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 strictly follows function, 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. Globalization 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 globalization 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.

Local government derives its authority from these sources:

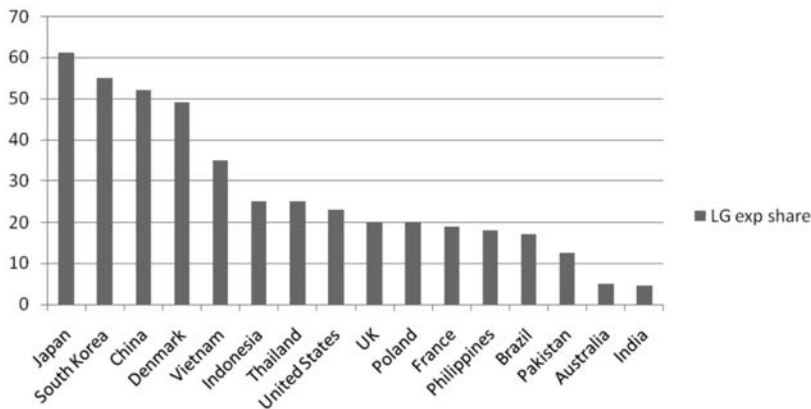
- national constitutions in Brazil, Denmark, France, Germany, Korea, the Netherlands, and Sweden

- state constitutions in Australia, Switzerland, and the United States
- national legislation in the United Kingdom and New Zealand
- provincial legislation in Canada and Pakistan
- 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 the local government share of consolidated public sector expenditures. According to this indicator, Japan, South Korea, China and Denmark are the leaders; Indonesia, Thailand, the U.S., the UK, Poland, France, Philippines, and Brazil are in the mid range; Pakistan, Australia and India are in the lowest range. Using another indicator, local government share of GDP, Denmark stands out, claiming about 50 percent of total expenditures for its local government—accounting for about 30 percent of GDP. Among the industrial countries, Australia is an outlier with local expenditures accounting for less than three percent of GDP.

Figure 1 .The rising tide of local governance - 2010



The relative importance of local government is quite small and the local government role in local economic development is quite weak in Australia (“roads and rubbish” only), India (largely ornamental), Pakistan, France and the 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 the UK and

France. Local governments are relatively more important and play a moderate role in local economic development in Japan, Germany, Canada, the U.S. 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 the 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 roles in local economic development. Local governments below the provincial level employ 89% of the public workforce and command 51% 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. The Nordic countries, Switzerland and China appear to have a local government role more consistent with the demands of new world economic order. In these countries, intermediate orders of government have a limited role (China) or no role (Nordic countries).

Some lessons

Historical evolution and the current practice of local governance are 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 the 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 recognize 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 Moio, 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 importantly, 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. Globalization and the information revolution are reinforcing those conceptual perspectives on a catalytic role for local governments. This view is also grounded in the history of industrial nations especially in the Nordic countries and ancient civilizations 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 governments. This trend continued unabated until globalization and the information revolution highlighted the weaknesses of centralized rule for improving the quality of life and social outcomes. The new vision of local governance (Table 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-centered 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 unshackles its local governments and prospers

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% 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 the poverty headcount rate from 31% in 1978 to less than 2% 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 commands an 89% share of public sector employment and a 51% share of consolidated public expenditures. Other than defence, debt and foreign affairs, all of which are the exclusive domain of the central government, 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. The provincial role is largely limited to agriculture and providing coordination and oversight of local governments on behalf of the central government. Thus China, while having a unitary constitution, bears a resemblance to an hour-glass model of federalism. There is strict government accountability to citizens at all orders through a 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 incorporate: (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.

Sources: Qiao and Shah, 2006

**Empirical perspectives on alternate models of division
of powers among provinces and local governments:
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 a leaner role for 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, decentralization of government authority to local government is more important than decentralization to the intermediate tiers such as provinces or states.

For our analysis we group countries according to the roles assumed by provincial and local governments. Provincial 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 Ivanyna and Shah, forthcoming). With a few notable exceptions, data shows that strong and fair local governance is usually associated with weak provincial/state governments (see Annex Table 1) and strong provincial/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's 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 provincial/state governments do better than countries with strong provincial/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 provincial/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 isolates 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 provincial/state government helps only in 1 out of 12 cases while it hurts in 4 out of 12 cases. Thus while the data limitations prevent us from more thorough empirical analysis of these choices, the results presented here provide some 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.

Conclusion

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 centralized and provincialized 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 the 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 their own sources or they can piggyback on central tax bases. The underlying principle is that to strengthen local government accountability to local residents, finance should follow function. In addition, inter-governmental 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 the 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 the people or appointed by the central government subject to confirmation by the provincial council. The provincial council would determine policies on inter-local functions and also provide oversight on the provincial executive — headed by the provincial governor — that implements these mandates. Such a framework minimizes costs of intergovernmental coordination while reducing transaction 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 minimizing internal conflicts while promoting good governance and growth. The paper has, however, recognized 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 materialize 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 a few exceptions and these are found mostly in the 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.

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ANNEX TABLES AND FIGURES

Table 1: Countries grouped by strength of local and state governments

strong SG	ETH, NPL, MYS, MEX, VEN, IND, AUS, ARG, BIH, PAK, BEL, SDN	AUT, DEU, BRA	USA, CAN
weak SG	rest of the world	TZA BOL ECU KOS KGZ EST BGR ALB PHL URY NZL SRM TJK LUX TWA PER PRT KAZ SVK ZAF BLR IRL CZE ESP MNG ROM UZB LTU	LTU, NLD, LVA POL UKR NGA GBR HUN RUS CUB GEO FRA IDN COL CHE JPN ITA KOR ISL NOR FIN SWE CHN DNK
	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 of own local expenditures is more than 10% of general government expenditures, fair LG - the share is between 5% and 10%, weak LG - the share is less than 5%

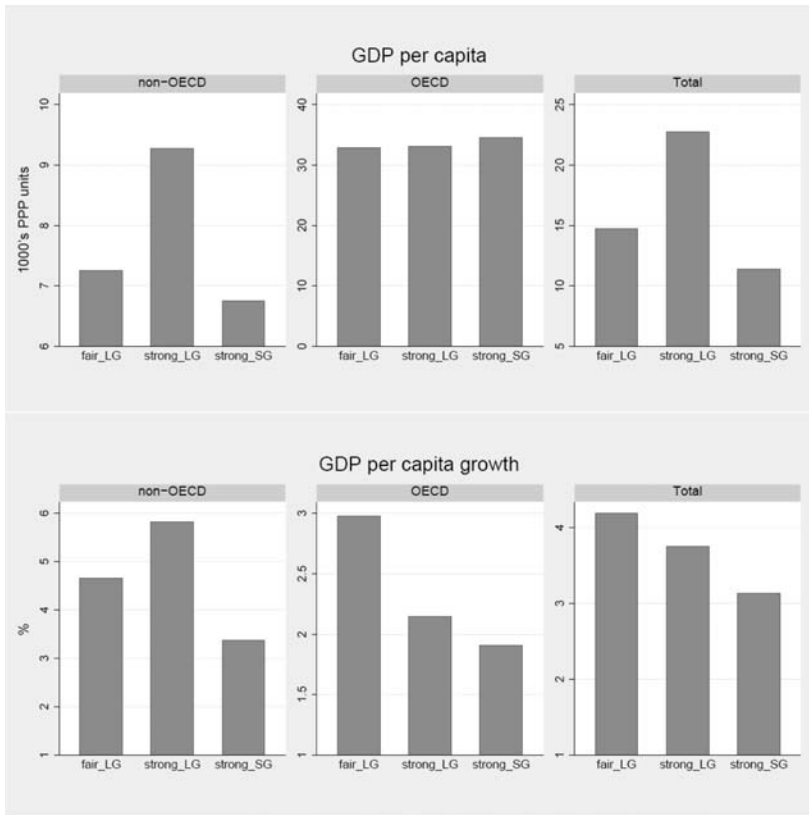


Figure 1: State governments vs. local governments: Comparing averages

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

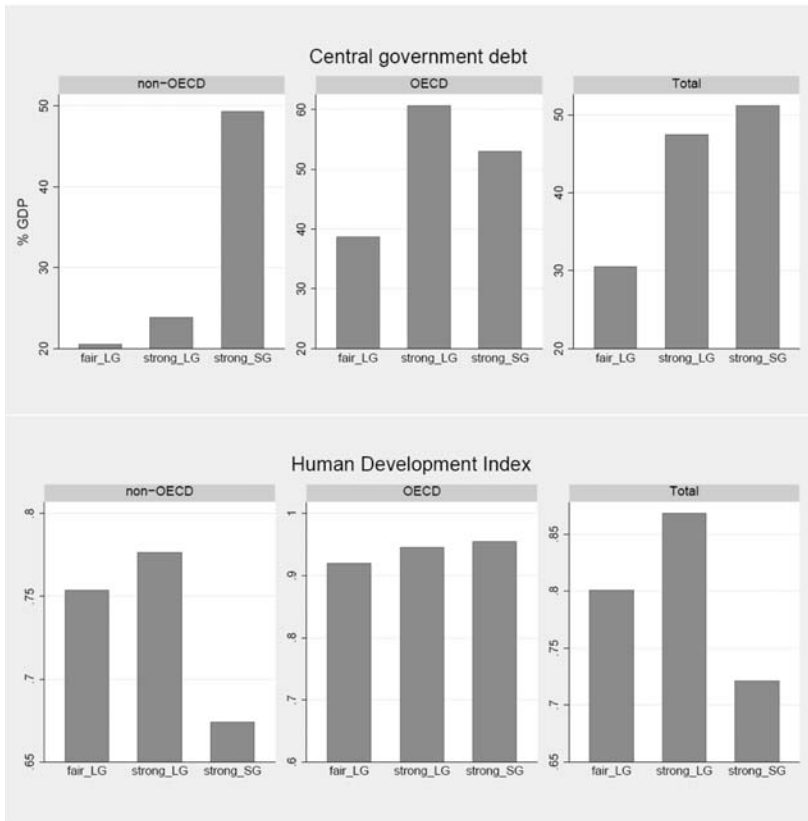


Figure 2: State governments vs. local governments: Comparing averages

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

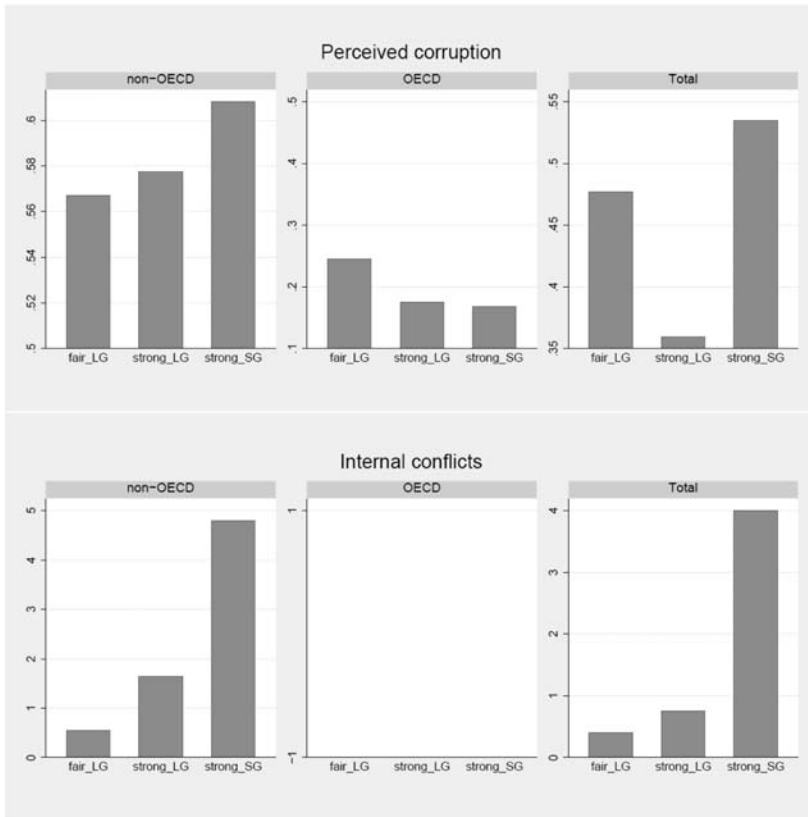


Figure 3: State governments vs. local governments: Comparing averages

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

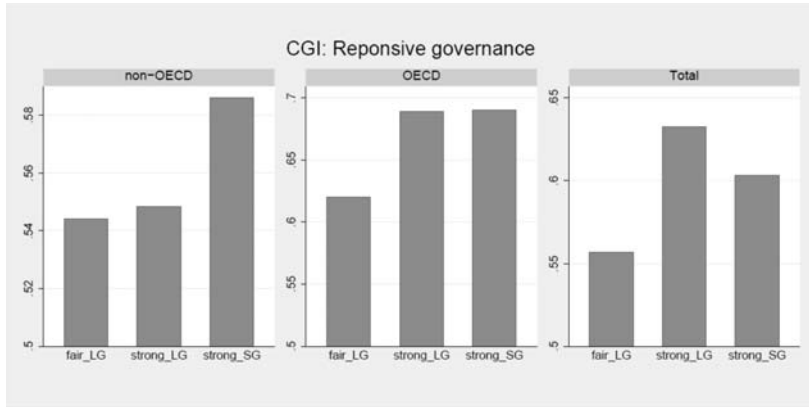


Figure 4: Citizen Centric Governance Indicator: Responsive Governance (source: basic data from Ivanyma and Shah, 2009)

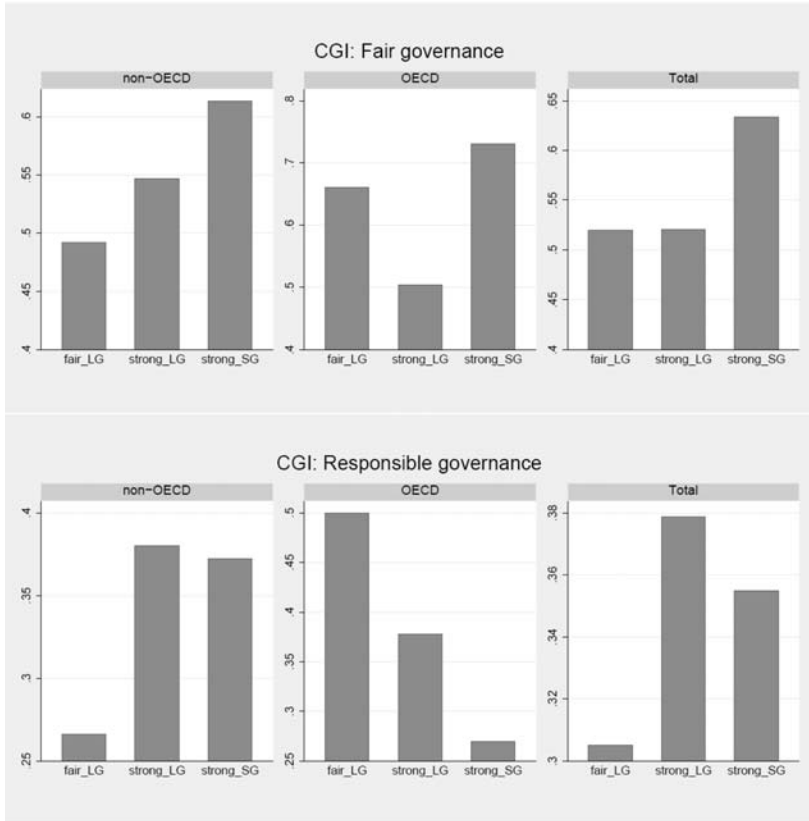


Figure 5: State governments vs. local governments: Comparing averages

Note Definitions: *Fair governance* – 2005-2008, datasource – Ivanyna and Shah [2009];
Responsible governance – 2005-2008, datasource – Ivanyna and Shah [2009].

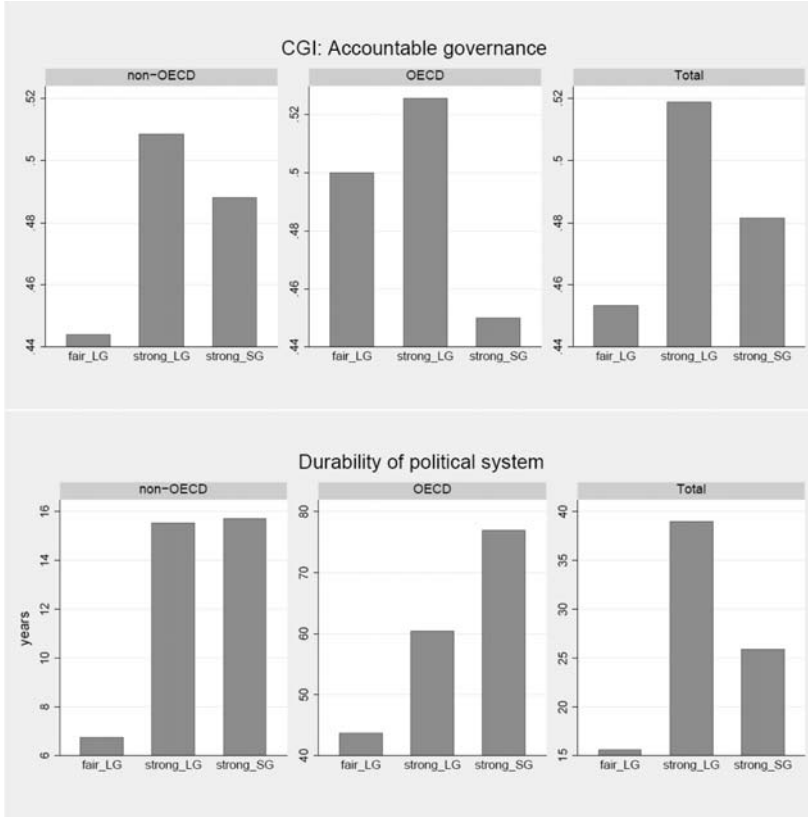


Figure 6: State governments vs. local governments: Comparing averages

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

	(i)	(ii)	(iii)	(iv)	(v)	(vi)
dep. variable	<i>gdp_cap</i>	<i>gdp_growth</i>	<i>debt</i>	<i>hdi</i>	<i>corr</i>	<i>confl</i>
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% level, ** - significant at 5% level, *** - significant at 1% level. Years analyzed in all regressions - 1999-2008. Dependent variables: *gdp_cap* - GDP per capita, *gdp_growth* - GDP per capita 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 fractionalization. Estimation method in all regressions: OLS. Standard errors are heteroscedasticity robust.

Table 3: State vs. local governments: regressions

	(i)	(ii)	(iii)	(iv)	(v)	(vi)
dep. variable	<i>cgi</i>	<i>r-ve gov</i>	<i>fair gov</i>	<i>r-le gov</i>	<i>acc.gov</i>	<i>dur</i>
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% level, ** - significant at 5% level, *** - significant at 1% level. Years analyzed in all regressions - 1999-2008. Dependent variables: *cgi* - Citizen-centric Governance Indicator, *r-ve gov* - Responsive 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, ethnic and religious fractionalization. Estimation method in all regressions: OLS. Standard errors are heteroscedasticity robust.

