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LOCAL TAXES AND LOCAL EXPENDITURES IN DEVELOPING COUNTRIES: STRENGTHENING THE WICKSELLIAN CONNECTION

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SUMMARY

Many countries are decentralizing in various ways. Decentralization is often intended at least partly to make government more efficient, flexible, and responsive. Many studies have evaluated the effects of decentralization on the provision of such services as health and education as well as on corruption, stability, and growth. Because what governments do and how well they do it is inseparably entangled with the question of how they are financed, this article outlines why and how a key element in a sound decentralization program should be to strengthen the linkage between local expenditures and local revenues—called here the Wicksellian Connection. Copyright © 2014 John Wiley & Sons, Ltd.

KEY WORDS—decentralization; local finance; benefit principle; user charges

INTRODUCTION

Many countries are decentralizing in various ways. Decentralization is often intended at least partly to make government more efficient, flexible, and responsive. Many studies have evaluated the effects of decentralization on the provision of such services as health and education as well as on corruption, stability, and growth. One lesson that has been learned is that what governments do and how well they do it is inseparably entangled with the question of how they are financed (Smoke, 2013). From the perspective of efficiency, a key element in decentralization should therefore be to strengthen the linkage between local expenditures and local revenues, which Breton (1996) labeled the Wicksellian Connection.[1] Although decentralization may of course be about more than efficiency, the focus here is essentially on how decentralization can most effectively improve the efficiency with which the public sector operates.

In an efficient local finance system, expenditure responsibilities would be matched with revenue resources, revenue capacities matched with political accountability, and benefit areas matched with financing areas. The services provided by the public sector are in effect thought of as being (so to speak) 'sold' to those who receive them, and the revenues yielded by such sales should be sufficient to pay for the cost of providing the service. In reality, of course, local governments operate in many different institutional settings, frequently act as 'agents' in delivering redistributive services financed by higher levels of government, usually offer some (excludable) services that are consumed by specific persons rather than jointly by the community as a whole and other services that 'spill over' local boundaries to varying degrees. Moreover, especially in developing countries, local governments often have little discretion with respect to either the services they offer or how they pay for them, and many local services are in the end paid for by someone other than local residents or the (overlapping but not identical) group of beneficiaries from local services.

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[1]'… Wicksell (1896) and Lindahl (1919) … recognized that if genuine links or connections were to emerge between revenue and expenditure decisions and if true demand functions were as a result to be revealed, the public (collective) provision of goods and services would be efficient…. I will henceforth call this connection the Wicksellian Connection (Breton, 1996, p.3).'

Some Wicksellian influence is evident in the decentralization literature. For example, a standard recommendation is that some local expenditure should be financed through user charges. Less frequently, local property taxes are sometimes supported in part as a sort of surrogate user charge through which residents who benefit from local services pay for those services.[2] Occasionally, a related argument is used to constrain localities from imposing taxes financing services benefiting residents when the taxes can be 'exported' to non-residents (Bird, 1993). A similarly 'split' view of the appropriate link between financing and service provision underlies the standard Pigouvian argument for intergovernmental transfers to compensate for external benefits provided to others than local residents from locally-provided services (Bird and Smart, 2002). However, such disparate ideas are seldom packaged as a whole and considered seriously as components of the revenue side of an appropriate Wicksellian local finance system. Moreover, the extent to which specific local revenues are or should be explicitly 'earmarked' to specific expenditures is seldom discussed. Indeed, earmarking seems to be almost as unpopular with experts in local finance as with budgeting experts at the national level.[3]

Theory and practice are thus often far apart when it comes to the relevance of the Wicksellian approach to local finance. In principle, for example, the optimal way to design a local tax system is first to determine the desired size and nature of local expenditures and then to put in place that tax (and transfer) system that faces local decision makers with incentives that will lead them to choose to finance precisely that package of expenditures. In reality, however, decisions on the two sides of the local budget are usually made independently, often with relatively little local input, and both local expenditures and local taxes are often largely determined by central authorities. The result is that not only are local expenditures little influenced by local revenue policy but that accountability at the local level is often both confused and confusing.

We offer here no more than a preliminary exploration of these tangled and dark waters. The next section reviews several ways in which the Wicksellian connection between local services and revenues might be strengthened: (1) by changing the 'package' of local services; (2) by altering the 'package' of local revenues; and (3) by altering the way in which the two packages are tied together, although only the second of these points is discussed in any depth. Advances in technology in principle make a more rational local finance system along the lines discussed here more readily achievable even in developing countries. However, it remains far from clear that people (or politicians) in any country really want to face up to the economic realities of local finance. We conclude with a few reflections on why political economy makes it difficult to sell economic rationality when it comes to local government finance.

STRENGTHENING THE WICKSELLIAN CONNECTION

The basic conditions for a Wicksellian local government system are simple:

- First, give local governments the right things to do. Local governments should control an appropriate range of expenditure responsibilities: essentially, their task is to provide local services to local residents and businesses. Everyone should be clear exactly who is responsible for exactly what so that the role of local governments in serving local residents—as opposed, for example, to their role as agents of higher-level governments in delivering services financed by those governments—is clearly set out for all to see and to judge how satisfactorily they perform.
- Secondly, local governments need sufficient fiscal autonomy to do what they are supposed to do. Local governments should be able to exercise their responsibilities freely both in the sense that they (potentially) have access to sufficient resources to do so at an acceptable level and that they are not subject to detailed controls over what they do and how they do it, though of course they should be fully accountable in both administrative and political terms.
- Thirdly, local governments should not be directly engaged in redistributive policy. Their concern is solely to finance and deliver local services as efficiently and effectively as possible.[4]

[2]Although this approach is nicely developed in a seminal paper by Vickrey (1963) and discussed further in Netzer's (1966) important treatise, it has seldom surfaced subsequently in the voluminous literature on property taxation.
[3]For a discussion of the pros and cons of earmarking and the many varieties found in practice, see Bird and Jun (2007).
[4]Of course, their allocative decisions will affect distribution, but, as in the traditional fiscal federalism literature (Oates, 1972), adjusting for any undesired distributional impact arising from this or other causes should in principle be carried out by higher-level governments.

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In practice, none of these conditions is fully satisfied in any country, developed or developing. To some extent, this is inevitable. Consider, for example, the last point listed: if local governments are democratically responsive, they are inevitably in the business of redistribution to some extent (although their attempts to redistribute may be vitiated by the openness of their economies or the actions of higher-level governments). Nonetheless, it clarifies thinking to assume, as in the traditional public economics literature, that distribution policy is for the central government and the primary concern of local governments is to provide local services. In short, whatever is done to deal with distributive issues is dealt with—or not—essentially by the national government (even if some of the pains and pleasures meted out by that system happen to be delivered by local agents). Many conceptual and practical difficulties with the 'benefit model' of local government finance—for example, how to measure and adjust for inter-jurisdictional spillovers, the extent to which higher-level governments attempt through transfers and other means to bend local government decisions on local services to conform more closely with their own desires, and the almost universal lack of clear public understanding about who is responsible for what when it comes to such complex (and multi-level) products as the delivery of health or education services—are similarly left aside in this discussion. Life is never as neatly divided into 'local government' and 'the rest' as assumed here. Nonetheless, thinking about decentralization issues from this starting point provides an interesting and helpful perspective on how to approach decentralization issues in the messy world in which we actually live.

What local governments (should) do

The conventional wisdom of decentralization theory and practice has it that finance follows function (Bahl, 2002): one must know exactly what local governments are supposed to do before considering how best to finance them. From this perspective, the basic requirement for an efficient and effective Wicksellian local government can be thought of in terms of what may be called the 'matching principle.'

One dimension is 'vertical' matching: when local governments are acting as agents of higher-level governments in providing services, the primary financing responsibility should also be with those governments, as in the standard discussion of Pigouvian transfers intended to offset spatial mismatching of benefits and costs. Such transfers, like equalization transfers intended to place different jurisdictions in circumstances to be able to respond equally to incentives, should be carefully designed to ensure that, *at the margin*, the costs and benefits of local fiscal decisions are borne locally, while taking adequately into account such inter-jurisdictional spillovers as are deemed relevant (Bird and Smart, 2002). Consistent application of these rules with respect to both local revenues and transfers imposes a hard budget constraint on local decision makers and makes them more accountable for the consequences of their decisions. One reason such rules are seldom found in practice is owing to information problems. The more basic reason, however, is usually political. Neither local decision makers nor their constituents are happy to be subject to such a budget constraint. It is always easier and more pleasant to spend 'other people's money' in an unaccountable (and hence inevitably less responsible) fashion.

Another important dimension of matching is 'horizontal' matching: matching as closely as possible those who benefit with those who pay and with those to whom the relevant political decision makers are politically accountable. When there are local variations in tastes and costs, there are efficiency gains from carrying out public sector activities in as decentralized a fashion as possible, so the basic rule of efficient expenditure assignment is to assign each function to the lowest level of government consistent with its efficient performance (Oates, 1972).[5] Strictly speaking, this rule implies that the only services that should be provided centrally are those that satisfy one or more of three conditions: (1) there are no significant differences in demands in different localities; (2) there are substantial spillovers between jurisdictions that cannot be efficiently handled in some other way (e.g. by contracting with other public or private sector agencies, by redrawing boundaries, or by grant design); (3) the additional costs of local administration are sufficiently higher to outweigh its advantages. Although the allocation of functions to local governments varies considerably from country to country and some functions (such as street maintenance) are local everywhere, few, if any, countries come close to satisfying these criteria in reality. Nonetheless, the benefit model of local finance, in which local governments provide services for the last (marginal) units for which recipients are

[5]This is similar to the well-known 'subsidiarity' principle in the European Union.

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willing to pay a price or charge that is just equal to the benefit they receive, remains central to achieving effective, efficient, and accountable local government.

In practice, as discussed in the succeeding text, it is often difficult to design an appropriate pricing policy for some local public services. Moreover, implementing efficient pricing in the local public sector is seldom politically appealing—especially when, as often happens, efficient user charges require people to pay for services, which in the past were supplied for free.[6] But even when local service pricing is not possible or is not desirable (e.g. because it would be too costly to administer) local expenditures and revenues can be linked by matching service benefit areas to the spatial dimension of the financing sources. Taxes levied by local governments to finance local services should fall exclusively on local residents and on those non-residents who benefit from such services. Unless there is a clear public purpose rationale for financing part or all of the cost by transfers from higher levels of government, local services should be financed solely by local taxes and charges. For governments to be accountable to their citizens, it is important that everyone know as precisely as possible who pays for exactly what and why.[7]

The first step is to establish clear lines of responsibility and accountability. Clarity of assignment in terms of specifying exactly what services each governmental agency is responsible for delivering is only part of the story. Clarity must be matched by accountability (e.g. through democracy and transparency) as well as by authority in terms of the ability to manage expenditures and to determine revenues (within limits, as discussed below). Full clarity in expenditure assignment may simply not be possible—for instance, because the level and type of local services is inextricably related to services provided by other governments as when local roads are networked with other (provincial, national) roads or when water and other environmental services have strong regional linkages. Even when a service is exclusively local, the relevant policy and regulatory framework may be established at higher levels of government, which may, for example, impose higher standards of service provision than local citizens want or are willing to pay for. Clarity is easier to ask for than to deliver. But if public service delivery is to be efficient, it must be as clear as possible to all exactly who is responsible for doing precisely what.

One argument for decentralization is that coordination (or cartelization, or monopoly, depending on one's perspective) is less likely to deliver the goods—or, more precisely, to deliver the right goods in the right quantities to the right people —than more competitive suppliers responding to price signals. Because even the best-designed decentralized public sector is unlikely to be perfectly competitive, decentralized outcomes are seldom optimal in the technical economic sense. What seems to be undesirable duplication or overlapping of functions may sometimes provide useful redundancy in a complex system facing changing conditions (Landau, 1969). Sometimes, however, duplication and confusion may be wasteful and call for intergovernmental coordination. The answer to such problems is seldom to replace local services by centralized provision but rather to design intergovernmental fiscal relations to minimize coordination problems while continuing to work at the difficult (and likely never-ending) task of establishing effective and preferably cooperative coordinating institutions, beginning with as transparent a local finance system as possible with all relevant decision makers facing hard budget constraints.[8] An additional benefit from well-designed decentralization is that a set of diverse suppliers providing clearly specified and publicly accountable services is more likely to come up with new and better ways of providing public services than more centralized alternatives (Oates, 1999).

Charging for local services

Financing local services through appropriate user fees provides not only the funds to supply such services but also information on which services should be provided, in what quantity and quality, and to whom. Good user charges improve the efficiency with which scarce public resources are employed, thus giving people more of what they

[6]It is not surprising that, as Zetland (2013) reports, surveys frequently show that, even when it comes to something as simple as paying for water, many customers would prefer a policy of subsidies (e.g. for water-saving devices) and regulations (e.g. on watering lawns) to paying for what they use.
[7]When other governments pay, local governments should be accountable to those governments (and their wider constituencies) with respect to how they spend those funds. How to design and implement such 'dual accountability'— downwards to service beneficiaries (local voters) and upward to higher-level governments (paymasters)—is a complex, context-specific issue not further discussed here.
[8]When appropriate, private as well as public agencies may be used to deliver services, although again this question is not pursued here.

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want (and are willing to pay for) instead of what someone else decides they should have. The first rule of sensible local finance is thus 'Wherever possible, charge.' The main economic rationale for pricing local public services is not to produce revenue but to promote economic efficiency. When people are not explicitly charged for consuming a service, the implied value they will rationally attach to the last unit they use is approximately zero. When no charge is imposed for a service, more of it is consumed than people would be willing to pay if faced with the real costs of providing the service. Under-pricing—the free (or subsidized) provision of services—results not only in over-consumption but often also in subsequent ill-advised investment. For example, when subsidized roads become crowded, the political pressure to widen them becomes greater. Over-investment in under-priced facilities may sometimes lead to corruption; but it always leads to inefficient use of scarce public resources. It is the 'black hole' of local government finance—something goes in but nothing of equal value to society comes out. Good user charges can avoid such waste.

The level and structure of existing user fees leaves much to be desired even in such highly developed and 'benefit' oriented systems as Switzerland's local governments (Dafflon and Daguet, 2012). Water rates, for example, are sometimes independent of the volume of water consumed. Because the marginal cost of additional consumption is zero, the result is over-consumption. Even when water consumption is metered, if declining block rates are used, as is common, prices may be less than marginal cost for large water consumers—thus favoring those with large lawns and backyard swimming pools. The even more common 'postage stamp pricing' approach (uniform everywhere) to public prices almost never makes economic sense. Both distance from the source of supply and the time of use should be taken into account in setting charges—as should, of course, the administrative and enforcement costs of any pricing system.

Determining the proper domain and design of user charges can be challenging. The economically efficient price for any good or service is that which would be charged in a perfectly competitive market, that is, one in which there are many buyers and many sellers, all of whom have full information not only about the price and cost of the item in question but also about all possible substitute and complementary products.[9] Even in the absence of these conditions, we allow private markets to distribute such essentials of life as food and shelter for the most part. However, we take such problems more seriously in the public sector in part because the fundamental rationale for many public sector activities is that some or all of the conditions required to achieve market efficiency are violated. For instance, 'publicness' (joint consumption) is considered a dominant characteristic; non-priced externalities are significant; excludability is not feasible; scale and sunk cost factors result in monopoly provision; or distributional concerns dominate. Some combinations of these problems preclude charging; others make it difficult to design effective (approximate) charging systems for public services; all these factors cause difficulties in designing appropriate user charges in the real world. Any charge may produce (some) revenue; but only well-designed charges will also improve socially-relevant economic outcomes.

Defining costs properly is neither technically simple nor politically easy. Both a clear legal framework and a well-designed and well-implemented accounting system are needed (Dafflon and Daguet, 2012): few developing countries have either. Moreover, even the best accounting costs are not the same as economic costs and even if the needed information is available, pricing public services correctly is not simple. The common practice of setting prices at average costs rather than marginal costs results in inefficient utilization. Another approach is average incremental cost pricing, under which costs are allocated to a particular incremental decision with respect to providing a service (e.g. the level of investment in road maintenance) and an appropriate share of the cost is then assigned to users in proportion to their usage. For example, when a vehicle enters a highway at a particular time, the costs attributable to this decision may be broken down into those arising from the addition of one vehicle at this time at this place (congestion), those attributable to the place (building the highway to its particular specifications), and those attributable to the trip (wear and tear on the road). An approximation to an efficient pricing system might combine a time penalty at peak times, appropriate charges for cost recovery for road use (wear and tear, which is exponentially related to vehicle axle-weight, as well as accidents, which are related to driving records), and perhaps some sort of access charge (vehicle license) to recover the fixed cost of highways. These charges could be

[9]This assumes that prices are adjusted to reflect all external costs and benefits and that—as Wicksell (1896) emphasized—a satisfactorily 'just' initial distribution exists. Of course, it never does; but we are assuming a very simplified world here in an effort to understand more clearly how to structure an efficient local government finance system.

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collected in part from vehicles (vehicle license), in part from vehicle use (gasoline taxes; tolls), and in part from drivers (drivers' licenses) perhaps with variations by class (e.g. trucks vs. cars). Such a system is hardly ideal marginal cost pricing, but it may be as close as a particular country can come. Few if any local governments in developing countries are equipped to develop such systems on their own, but help may perhaps be available from such sources as other governments, external aid agencies, or the private sector (businesses, non-government organizations, and community groups).[10]

Many other pragmatic compromises—variable block pricing, multi-part tariffs, and so on—have been developed in different contexts and may sometimes be useful ways to introduce quasi-marginal cost pricing conducive to more efficient local public service decisions. Often, however, even rough approximations to appropriate user charges require information that is hard to obtain. Every road could be a toll road but the cost of collecting all those tolls—both the administrative and compliance cost and the related social cost of added congestion—means that such charging makes no sense. However, with modern technology, it is possible to establish time-sensitive and place-sensitive pricing for many public services even in developing countries. The costs of such systems are declining so rapidly that governments engaged in decentralization should consider carefully the expanded pricing options now available.[11]

Even if the 'right' price (or something close to it) can be worked out, it may prove too politically costly to adopt. If people pay for identifiable public services that they consume, and no one receives a service without paying for it or pays without receiving a service, some might perceive the outcome to be fair. The rich do not, as a rule, pay more or less for bread or milk than the poor. Why should they pay more or less for a building permit or a fishing license? Nonetheless, the most common objection to proposals to expand or reform public sector pricing is that doing so would be unfair and regressive. However, trying to rectify fundamental distributional problems by inefficiently pricing scarce local resources is a bad idea that at best may produce a little more equity at a high price in efficiency terms. Undesirable distributional effects from particular changes are better offset by compensating increases in transfer payments or by such devices as letting users access services through smart cards (on mobile phones?) with low-income users receiving an initial credit, thus simultaneously achieving universality (everyone has the same card) and targeting (those who need it have free or subsidized access). Second-best approaches to redistribution through distorting price signals may sometimes be necessary in developing countries attempting to rectify huge inequalities with limited technical and administrative resources, but one must always be careful not to pervert efficient and effective local government service provision in the process.

Local government taxes

Beyond user charges, two basic principles of assigning revenues to local governments may be suggested. First, 'own-source' revenues should ideally be sufficient to enable at least the richest such governments to finance from their own resources all locally-provided services primarily benefiting local residents (Bird, 1993).[12] Second, to the extent possible, local revenues should be collected only from local residents, preferably in relation to the perceived benefits they receive from local services. Revenues from other sources (including local business activities) should similarly match the benefits they receive from local services.

When the direct use made of services by specific individuals can be measured, such services should be priced, if it can be carried out at a reasonable cost. In some instances, however, when services like water and sewerage connections are provided to specific locations, it often makes sense to pay for at least the access costs of such services through charges related to relevant characteristics of properties (such as size of lot, frontage, or building height) or to property values. Other services (or components of services) such as arterial streets, utility lines, and public transit as well as major parks and recreation facilities may be 'area-specific' in the sense of being most accessible to those

[10]For example, when water distribution was made a local government responsibility in Colombia, most municipal governments managed surprisingly well by partnering with a variety of institutions and groups (Fiszbein, 1997).
[11]Of course, the result of such consideration need not always be to adopt the new technology; see, for example, the interesting discussion of water metering in England in Zetland (2013).
[12]This rule follows from the previous prescriptions confining local governments to providing local services, imposing charges where possible on service beneficiaries (whether local residents or not), and designing central transfers so that they compensate properly for spillovers and ensure the desired degree of equalization and redistribution.

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nearby. Because the value people attach to such services should be reflected in property values, a suitable form of financing may again be a value-based property tax. Still, other services may provide city-wide or even region-wide benefits: again, such benefits should affect property values and an appropriate form of financing would again appear to be a property tax.[13]

Because the cost of providing local services may differ widely from business to business, it is less clear that property-based taxation is the optimal form of financing business-related services, not least because their employees (who enjoy lunch in the local park), their customers (who benefit from locally-provided business inputs like streets), and their owners (who similarly benefit from cost-reducing local services) are not always residents of the locality. In addition to business-related services that may indirectly benefit non-residents, non-residents may benefit directly from locally-provided services when they visit a locality as commuters (working but not living there), as tourists (presumably enjoying locally-provided amenities), or simply as visitors coming to shop, to dine, or for some form of entertainment or recreation. Although some of the cost of providing services to non-residents may be recouped through user charges and taxes on business, a case may sometimes be made for additional specific forms of taxation on non-residents, although from the perspective of efficiency, it is also important, as in the case of taxing business in general, to be sure that the taxes and charges imposed on such non-voting beneficiaries are not excessive.

A key question to ask about local revenues from the benefit perspective concerns the possibility of undesirable tax exporting—negative spillovers to non-residents such as (1) commuters (non-resident labor), (2) tourists and other visitors (non-resident consumers), (3) non-resident owners of local businesses (external capital), and (4) non-resident consumers of city exports (e.g. financial services). On the other hand, non-residents may gain from the joy of living next to the amenities of a city (even if they don't use them—option demand) so another important question is the extent to which tax exporting matches possible offsetting benefits from local services. Local taxes on sales may for example tax visitors as well. Taxes on hotels and entertainment would similarly catch this group, whereas a payroll tax would tax non-resident commuters as well as most residents.[14]

Budgeting and accountability

Unless local governments are able to alter the level and composition of their revenues at the margin, neither local autonomy or local accountability is meaningful. Local governments should not only have access to those revenue sources that they are best equipped to exploit—such as residential property taxes and user charges for local services—but should be permitted and encouraged to exploit these sources. If intergovernmental fiscal structures are properly designed, this should not be a problem (Bird and Smart, 2002). Accountability works in part through electoral democracy. If local electors do not like what their local government does, or does not do, they can (try to) throw the rascals out at the next election. If they do not do so, local electors should, in a properly designed system, bear the consequences of their inaction. The freedom to make mistakes, and to bear the consequences of one's mistakes, is an important component of local autonomy in any country. If those who fail to collect local taxes or to spend revenues efficiently are bailed out by discretionary transfers, the rascals may not be thrown out but rather re-elected for their success in obtaining a larger share of other people's money. Countries that have an inappropriate intergovernmental fiscal structure are likely to have more problems in managing decentralization and less satisfactory policy outcomes.

Accountability requires not just good information about what local governments do and how they pay for it. It also requires that such information is sufficiently understandable so that at least a critical margin of voters can understand what is really going on. Much has been said recently about the important connections between fiscal transparency, public participation, and accountability (Khagram *et al.*, 2013). Brazil, for example, has done much to make public budgeting more transparent especially at the municipal level, with the clear result of increasing both popular participation in budgeting and accountability in fiscal decision making (Alves and Heller, 2013).

[13]Another suitable source of finance may in some instances be a development charge or other form of (pre or post) 'value capture' (Smolka, 2013).
[14]Bird (2006) argues that the best way to tax local business from a benefit perspective is through a tax based on the business's use of all inputs including 'local government services to business', with the best approximation to such a tax base being business value-added.

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An important issue is the extent to which particular local government revenues should be earmarked to particular expenditures. The basic principle is simple: when charges and taxes are imposed on beneficiaries, whether as individuals or as members of specific groups (drivers, area residents, etc.), those revenues should be earmarked to those expenditures and those expenditures—abstracting from any externality-financing transfers—should be financed only from those revenues. There is no place for cross-subsidization in the Wicksellian world. There is also no place for the common practice of 'nominal' earmarking in which some levy is rationalized as financing an activity but has no marginal effect on the level of that activity. Although there are well-known limitations to the extent to which extensive earmarking is consistent with sound budgetary practice, the introduction of more explicit budgetary links between user charges and benefit taxes and the expenditures they are supposed to finance is an important component of a more Wicksellian local government finance system.[15]

Local governments may attempt to extract revenues from sources for which they are not accountable, thus obviating the basic efficiency argument for their existence. The local public is more likely to applaud than to deplore moves in this direction. It is therefore important to limit local government access to taxes that fall mainly on nonresidents—such as most natural resource levies, corporate income taxes, pre-retail stage sales taxes, and, to some extent, even nonresidential real property taxes.[16] One approach is to establish a uniform set of tax bases for local governments (perhaps different for different categories such as big cities, small towns, and rural areas), with a limited amount of rate flexibility being permitted in order to provide room for local effort while restraining unproductive competition and unwarranted exploitation. If inappropriate tax bases are assigned, wasteful competition and undesirable tax exporting are likely to result. As always, the role of the central government in establishing the rules of the local fiscal game as well as in taking care of redistribution is central to the establishment of a more Wicksellian approach to local finance.

THE POLITICAL ECONOMY OF THE WICKSELLIAN APPROACH TO LOCAL FINANCE

This article emphasizes the importance of the Wicksellian Connection—the tightness of the connection between decisions on public spending and on its financing—in determining whether local public policy decisions are right in the sense of being in accordance with citizens' wishes. The more closely spending and taxing decisions are linked by being made by the same body at the same time, the better government will function in its economic manifestation as a provider of services. If countries want to improve the efficiency with which local governments spend, they should be careful to ensure that the conditions under which those governments operate are more conducive to such spending.

Local governments must not only be willing and capable of focusing on such matters but also prepared to break the golden chain of transfer dependency and make—and largely finance—their own decisions (Breton, 2004).[17] This vision of mayors and councils throughout the land marching arm in arm on regional and national capitals to demand less money in transfers and more revenue-raising power of their own is far from the present reality in most countries. The outstretched municipal hand is more common than the upraised municipal fist. But the question is important. The local level is where public sector efficiency is most directly relevant to daily life. If local governments are to be efficiently run, they need to be essentially self-controlled, and to be self-controlled, they need to be self-financed at the margin rather than dependent on the largesse of others.

Even the most empowered local governments cannot be expected to act efficiently and responsibly in the interests of their residents unless the intergovernmental fiscal structure is properly designed and monitored to fully account for the external benefits and costs of local actions. Similarly, unless the essential information on who pays what for what and why is not only transparent but publicized so that the information is easily accessible to and adequately understood at least by the critical few among the local public it is unlikely that even the best-run and best-governed locality will make all fiscal decisions in a socially efficient way.

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[15]A more detailed discussion of the pros and cons of earmarking may be found in Bird and Jun (2007). .

[16]An appropriate rule with respect to property taxes might be to require uniform taxation of residential and non-residential properties (Bird *et al*., 2012).

[17]As always, what is critical is local decision making at the margin: infra-marginal intergovernmental transfers for equalization purposes, like externality-compensating transfers at the margin, are fully compatible with the Wicksellian approach.

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In the complex metropolitan regions in which much economic and population growth is occurring in developing countries, whether or not there is an adequate overreaching metropolitan governance structure—which there seldom is (Bird and Slack, 2013)—the political advantages of providing services with 'other people's money' are so great and the technical difficulties of evaluating and pricing many public services so important that even exceptionally strong intergovernmental, reporting, and accountability structures may not result in greatly improved public sector efficiency. Combined with the capacity deficiencies in many small localities, achieving the ideal Wicksellian local government model may seem unachievable. Nonetheless, even in the poorest areas in most countries much could be done to establish stronger Wicksellian Connection between taxes and expenditures at the local level. The first step—admittedly, one many developing countries do not seem interested in taking—is to establish such key elements to any well-designed decentralization reform as (1) an improved information base available to local officials and citizens; (2) better technical support (e.g. in establishing good pricing systems); and (3) an appropriate local equalization transfer system to induce localities to focus more on efficient provision of services at least cost.

Citizens in many countries appear to be less than fully satisfied with their governments. Most, however, seem to attribute bad outcomes to the unfit crowd in charge rather than to flaws in the design of the ship of state. However, outcomes depend as much or more on the way in which policies are decided than on the policies themselves, regardless of which particular set of politicians and officials came up with them. The ways that different countries 'do' politics—like the ways they structure local finance (Bird, 2011)—have largely been inherited from the past, and hence shaped in part by what was then technologically feasible. Until recently, for example, only people in the very smallest communities were able to decide for themselves about most things in the political sphere even when they were free to do so. The only way to conduct public business in a large democratic country was through representative democracy. Even the best representative democracy—seldom found in the world—although perhaps more conducive to reflective rather than emotive decisions and more likely to take a longer view than more direct democracy is always messy in operation and produces results that will be unsatisfactory to some.

Now, however, in a world in which everyone everywhere will—or so it seems—soon have a mobile phone, it may soon be technologically feasible for everyone to be able to vote on anything at any time—if one wants to follow this path. There may be good reasons why one should not do so. But the apparent deep distrust of many in the elite (of all countries) about the ability of ordinary people to decide what is best for them is not such a reason. Some seem to think that if 'the people' are allowed to decide policies they will act emotionally, irrationally, and often against their own long-term interests. People are indeed rationally ignorant with respect to most public policy issues. Few would be willing to put in the hard work on all sides necessary to make real power-sharing work even with technological advances that may, at least in the best of circumstances (which are, to repeat, unlikely to exist in most developing countries) allow us both to generate the needed information and to make it easily available to all relatively cheaply. The decision process in what one might call a 'full' democracy will not only likely be both excessively slow and inefficient but also prone to being controlled by a self-selected few. Even if the process worked perfectly, more widespread and direct political participation, like more transparency, will make the life of governments more difficult and may bring to the surface fundamental disagreements on norms that will increase rather than reduce conflict. The result might be less growth and more redistribution, or the opposite.

There are thus many reasons for being cautious about increasing local democracy. Still, as Churchill once said, democracy may be the worst of all governments except for all the rest. Much the same may perhaps be said of more participatory democracy at the local level. Introducing much stronger market elements than are now present in the public sector of most countries is now technologically feasible as well as economically desirable. Doing the same in political markets is also more feasible and may be desirable. Sharing power is always a scary exercise, especially for those who now have the power. However, perhaps the time is approaching when countries will have to consider which 19th century sage was right: the one who said there is a fool born every minute, implying that people are best seen as suckers to be fooled or sheep to be fleeced (or at least led)? Or the one who said you can fool all of the people some of the time and some of the people all of the time, but you cannot fool all of the people all of the time?[18] No one

[18]The first 'sage' is usually said to be P. T. Barnum, a famed American showman, and the second is usually said to be Abraham Lincoln, although in fact neither saying can be accurately attributed—unlike the Churchill remark cited earlier, which is discussed in depth by Lindert (2003).

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can readily answer such questions in any country. Nonetheless, restructuring local government finance to establish a strong Wicksellian connection may not only be a good way to make local government more flexible, efficient, and responsive but also to ensure that decentralizing to even foolish local governments will not cause undue harm to innocent bystanders.

However, a basic problem with the Wicksellian approach is that few want to hear unpleasant truths like users should pay, and redistribution through mispricing local public services is almost always a bad idea. Sweetening such bad news sufficiently to make it politically palatable is not easy. For local government finances to move in this direction, as they must if many of the decentralization reforms in train around the world are to produce the desired results, someone has to be willing and able not only to deliver the bad news but to persuade people that the message is real and needs to be dealt with. Public policy, like medicine, cannot be practiced solely in the laboratory: it requires close and seldom simple engagement with patients and their families (policy makers and their constituents). Those favoring decentralization could perhaps learn some useful lessons from such medical protocols as the ABCDE approach about how to tell bad news to patients: advance preparation; build good relationships; communicate well; deal empathetically with reactions; encourage and validate emotions while correcting distortions.[19]

Decentralization has produced some favorable results in some countries, but it has failed to do so in others.[20] Thinking through more carefully what can and should be done by decentralizing public sector activities, how to ensure that decentralization produces the desired results, and how to market such unpopular ideas as the beneficial effects of paying for what you get may perhaps result in achieving better outcomes in some instances. However, it is difficult to be optimistic. Few politicians in any country are likely to risk their futures by being the messengers delivering the bad news associated with establishing a stronger Wicksellian connection in local finance: not only should people they pay for what they get but, provided the central government is doing whatever its citizens want in terms of redistribution, it is also a good thing for them to do so.

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[19]This is a slight modification of a protocol suggested by Rabow and McPhee (1999).

[20]For examples, see the numerous case studies contained in such books as Ter-Minassian (1997), Bird and Vaillancourt (2011), World Bank (2005), Bardhan and Mookherjee (2006), Smoke *et al*. (2006), Martinez-Vazquez and Vaillancourt (2011), and Brosio and Jimenez (2012).

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