

# PRINCIPLES AND THEORIES OF LOCAL GOVERNMENT

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*The role of local government is viewed in the context of the overall role of government per se. A particular advantage of local government lies in its ability to arrange for the provision of local public goods in line with local tastes and preferences. A number of arguments suggest that local governments should be assigned adequate powers of local taxation to finance their expenditure responsibilities rather than having to rely on central government grant.*

## Introduction

This article examines the nature of local government. We begin by considering the basis of government in general and show how the alternatives of government and anarchy can be seen in terms of a prisoners' dilemma game. The minimal role of the state is argued to be that of securing a co-operative outcome to this game. Further roles of the state in response to market failure, merit goods and redistribution are then discussed. Whilst local government can be argued to have roles in all these areas, the article focuses particular attention on local government's role in relation to market failure in the provision of local public goods. A major advantage of local government provision of local public goods lies in its ability to match local provision to local tastes and preferences in contrast with the uniformity expected under central government provision. The article discusses how the matching of local provision to local preferences is likely to be enhanced by migration as a result of the Tiebout effect. The finance of local provision is discussed and it is concluded that a system that provides local authorities with adequate powers of local taxation to finance their expenditure responsibilities is preferable to a system where local authorities depend upon central grants. We begin with a discussion of anarchy.

## The basis of government

In order to examine the basis of local government, it is helpful to begin by stepping back a pace and discussing the basis of any government, central or local. To discuss the basis of government it is, in turn, helpful to take a further step back and examine how humans would seek to satisfy their desires if there were no government at all. A particularly clear early perspective

on this question was provided by Franz Oppenheimer (1914). Oppenheimer argues that one can distinguish two alternative ways that humans satisfy their desires: 'These are work and robbery, one's own labour and the forcible appropriation of the labour of others' (Oppenheimer, 1914, p. 12; see also Höijer, 2004).

Oppenheimer argues that to get something one can either *make* it oneself (or make something else and exchange that for something one wants) or *take* the thing one wants by stealth or force. Getting things by making and exchange is labelled the 'economic means' by Oppenheimer (1914, p. 12) and getting things by taking them the 'political means'. He goes on to argue that, 'Whenever opportunity offers, and man possesses the power, he prefers political to economic means' (Oppenheimer, 1914, p. 22).<sup>1</sup> Although taking things rather than making them is individually rational, it leads to a poor outcome collectively. The possibility of taking things depends upon their being made in the first place, and if 'take' predominates there will not be much 'make', and the standard of living will be very low. Famously, Thomas Hobbes describes such a situation:

'Hereby it is manifest, that during the time men live without a common Power to keep them all in awe, they are in a condition which is called Warre; and such a warre, as is of every man against every man . . . In such a condition there is no place for Industry; because the fruit thereof is uncertain: and consequently no Culture of the Earth . . . no Arts; no Letters; no Society; and which is worst of all, continuall feare, and danger of violent death; And the life of man, solitary, poor, nasty, brutish, and short.'

(Hobbes, [1651] 1968, p. 188)<sup>2</sup>

Because such a war of every man against every man appears to be to no one's benefit one might

		Person B	
		Make things	Take things
Person A	Make things	6, 6	0, 10
	Take things	10, 0	3, 3

Figure 1: Law and order as a prisoners' dilemma game

wonder why it takes place. Game theory clarifies the problem. Hobbes's state of nature can be seen as the outcome of a prisoners' dilemma game played by members of society. It is worth spending a little time examining such a game.

Figure 1 shows a simple version of the prisoners' dilemma game, played between two persons: A and B. Both A and B can choose between a way of life restricted to making things (labelled make) or a way of life (labelled take) where some time is spent making things, but which is also supplemented by taking things.

The two choices of each of the two players combine to provide four possible combinations of action, which are set out in the four boxes of Figure 1. In the top left box neither A nor B steals. A and B are each able to get on with making things undisturbed by theft from the other. We score this as 6 for A and 6 for B. In the top right box, B is stealing from A, but A is not stealing back. B keeps what they make and adds to this by stealing from A. We score this 0 for A and 10 for B. Symmetrically in the bottom left box, A is stealing from B, but B is not stealing back. We score this 10 for A and 0 for B. Lastly, in the bottom right box, there is a situation of Hobbesian anarchy: A and B both steal from each other. We score this 3 for A and 3 for B.

Where are the players likely to end up? If there is only a small number of persons and they play this game repeatedly they may come to an agreement not to steal from each other, based on enlightened self-interest, that gives the best collective outcome (6, 6 = 12). However, with large numbers, at least beyond the size of a small tribe, narrow self-interest is likely to rule and the outcome is likely to be (steal, steal) the worst collective outcome (3, 3 = 6). There is therefore a clear role for the state in enforcing law and order and moving society from the bottom right box to the top left box.

Whilst it is clear from this model that the enforcement of law and order by a government can be a good thing, the fact that something is a good thing is not always reason enough for it to happen – as the prisoners' dilemma game itself shows. We need to move from a normative theory about why government would be a good thing to a positive

theory of how government might come about. To fit in with the overall approach of economics, the explanation needs to be based on pursuit of self-interest. Olson (1993) has, comparatively recently, provided such a theory. He argues that an initial reaction to Hobbesian anarchy would be the formation of gangs of bandits – specialists in taking – and that these might rove from village to village plundering wherever they could find things to steal.

Once the bandits had stolen from a village they would move on to steal from another. Such a state of affairs forms the opening plot of the film *The Seven Samurai* and its western derivative – *The Magnificent Seven*. In these films (approximately speaking) the occupants of one village decide to get their own gang of bandits and reward them for staying at their village and repelling roving bandits. Are stationary bandits likely to be able to prevail over roving bandits? Olson argues that stationary bandits will have the advantage because they have an incentive to be less destructive of production than roving bandits and the superior returns will provide both a better return to stationary banditry and the means to finance superior force. Oppenheimer (1914, p. 26), who anticipated important elements of Olson's argument, compares the bear that destroys a hive in the process of robbing it with the bee-keeper who leaves the bees enough honey for the winter. In the same way, governments can promote greater economic development if they take a long-term view and exercise restraint in appropriating resources from citizens.

Olson argues that democracy provides a long-term assurance of security of property rights and the likelihood of a relatively low level of appropriation in comparison with autocracies, which often operate on relatively short time horizons and therefore have less incentive to think long term. 'The only societies where individual rights to property and contract are confidently expected to last across generations are the securely democratic societies' (Olson, 1993, p. 572). Because the government has the power to take from its people, the people may be reluctant to be too productive lest much of what they produce should be taken away from them. The government may promise not to engage in excessive

appropriation, but as they also have the power to take what they like, such promises may not be credible. Operating as a democracy may be a method for the government making a credible commitment not to renege on promises not to take too much.

The prime role of government is thus for it to be in power, either by taking power, or in the most developed version of government, by winning in an election. If it is to remain in power, the government will need to arm itself sufficiently to prevent violent takeover by a rival government, and will be able to gather more taxes if it encourages making rather than taking. It will therefore need to carry out the functions of a 'minimal state' by establishing a monopoly of violence (Weber, [1922] 1968) and enforcing property rights. In practice, however, modern governments rarely restrict themselves to the minimal state as outlined above. In the next section we consider the arguments for the extension of government into further roles.

### **Government beyond the minimal state**

The view that the government may be able to promote welfare by extending its activities beyond the minimal state outlined above requires a normative standpoint from which to make judgements on what constitutes a good arrangement of society. To this end, two value judgements proposed by the Italian economist and sociologist Vilfredo Pareto have been extremely influential. They were, first, that an individual is the best judge of their own welfare, and second, that any change that makes at least one person better off, without making anyone worse off, is an improvement (or Pareto improvement) (Pareto, [1906] 1971, p. 261). When all possible Pareto improvements have been made, the economy is said to be at a Pareto optimum.

The concept of the Pareto optimum does not immediately suggest an extended role for government. This is because, when joined with the first fundamental theorem of welfare economics, which states that competitive markets lead to a Pareto-optimal allocation of resources, the initial conclusion is that the market should be used for organising the economy (Stiglitz, 2000, p. 60). The intuition of this result is that voluntary exchange through the market leads to Pareto improvements and the operation of the market will allow all possible Pareto improvements to be made.

The market can be seen as a giant mechanism for voluntary exchange, and if all voluntary exchanges are carried out that people want to make it will then be impossible to make anyone better off without making someone worse off. For example, if I purchase something from a shop I will be better off in the sense that I would rather have my purchase than the money I paid. The shopkeeper is also assumed to be better off if they agree to the transaction.

Self-interest drives people to look for Pareto improvements and property rights allow each person to veto any exchange that does not make them better off. Thus, if I choose not to buy I am preventing myself from being made worse off.

Hence, the Paretian value judgements, combined with the first theorem of welfare economics, provide a powerful endorsement of the market as the basic means for organising the economy. If the government enforces property rights, it can leave the market to deliver a Pareto optimum.

Property rights have a key role to play in delivering a Pareto optimum. They are the mechanism that guards against persons being made worse off. Thus, for example, theft must be prevented because it does not deliver a Pareto improvement – the thief makes himself or herself better off but only by making the victim worse off.<sup>3</sup>

As noted, the above argument only supports a 'minimal state' role for the government. The argument for further government activity then comes under three possible headings. First, there is the argument that the market may fail for a number of possible reasons. Second, there is the 'merit goods' argument that the market is successfully delivering what people want, but that what people want may not necessarily be what is best for them. Third, there is the argument that the government has the power to take resources from some and give to others and so may decide to do so. We discuss these briefly in turn under the headings market failure, merit goods, and redistribution.

#### *Market failure*

The role of government in this view is seen as the correction of 'market failure'. The state intervenes to make corrections where the market fails. There is, however, an important caveat to this argument. Since the 1970s there has been increasing awareness that 'market failure' need not necessarily imply 'government success', though these ideas have a long history (Sidgwick, 1887; Coase, 1964). George Stigler (1970) likens awarding roles to government on the basis of market failure to the example of a Roman Emperor judging a music competition for which there were two contestants. After the Emperor heard the first contestant he immediately awarded the prize to the second (Olson, 1987, pp. 94–95). Despite this criticism, market failure arguments are widely used to define the role of government and we adopt the approach here.

There are a number of ways in which the market may fail. The market may fail due to lack of competition, due to the existence of public goods or externalities, due to information problems and incomplete markets or there may be macroeconomic problems in the form of unemployment or inflation (Stiglitz, 2000, p. 85). Most of these market failures lead towards arguments

for intervention by the national government and we will not pursue them in detail here. However, public goods in the form of local public goods are usually taken to be the main justification for local government activity (King, 1984, p. 6) so it is worth outlining their nature.

Public goods are goods that are both non-rival and non-excludable. Classically, national defence is such a good. Non-rivalness is a form of economy of scale (Olson, 1986, p. 121) in the sense that providing, for example, a nuclear deterrent for everybody in the nation is no more expensive than providing it for just one person. Centralised provision is therefore cheaper (McKinnon and Nechyba, 1997, p. 5). Non-excludability means that it is impossible, or too costly, to exclude anyone who does not pay for receiving the good, and non-excludability, working in combination with non-rivalness means that people are likely to attempt to free-ride on the efforts of others in providing public goods and as a result there is under-provision by the market.

### *Merit goods*

The argument for government intervention in the market in the case of merit goods is based on a denial of the Paretian value judgement that an individual is the best judge of their own welfare. For example, children are often thought to need to have their choices corrected, either by their parents, or a paternalistic state. In the case of merit goods, the government intervenes to 'correct' individual choices. Richard Musgrave introduced the idea of merit goods and included in this category such goods as subsidised low-cost housing and free education (Musgrave, 1959, p. 13).

Merit goods can be provided either by national or local government. However, the concept of merit goods is philosophically problematic in a democracy as those same individuals who, according to the merit goods concept do not know what is best for them, may also have the job of choosing the government in a democracy. As the inventor of the concept himself warns, 'The concept of merit or demerit goods, to be sure, must be viewed with caution because it may serve as a vehicle for totalitarian rule' (Musgrave and Musgrave, 1989, p. 58). The final role for governments is in redistribution, which we now discuss.

### *Redistribution*

One important reason that intervention by the government in the distribution of income and wealth may be beneficial is if the distribution of income is itself a form of public good (Friedman, 1962, chapter 2). Private charity can address much of the problem of a distribution of income and wealth that people may see as undesirable, but the level of redistribution

it achieves may be suboptimal as a result of some individuals free-riding on the charitable efforts of others. The government may therefore have a role in the use of its powers to enforce contributions to redistribution.

Donors may desire that redistribution be in the form of specific goods such as education rather than cash if they view equity in the form of categories of inequality (Tobin, 1970), and in such cases it may be difficult to disentangle merit goods arguments, public goods arguments and redistribution arguments.

Another important motivation for government redistribution derives not from normative judgements about improving equity but rather from the simple ability, as outlined above, of governments to *take*. Such taking is likely to be driven by a desire to receive, and in a democracy the relevant desires will be those of the median voter. Politicians may therefore offer redistributive policies (albeit often suitably concealed by cover stories) in return for middle-class votes (Stigler, 1970; Tullock, 1997).

Such redistribution may often not be in the direction that egalitarian arguments would advocate: 'Most public expenditure on the social services in Britain (and elsewhere) is thus distributed in a manner that broadly favours the "higher" social groups, whether higher is defined in terms of income or occupation' (Le Grand, 1982, p. 128). Redistribution is likely to occur at the level of local government as well as national government, although at the local level a jurisdiction with a high taste for redistribution is likely to be constrained by the danger of the loss of contributors to the redistribution by outward migration combined with the encouragement of inward migration of potential recipients.

The above arguments provide reasons for the extension of government beyond the minimal state. There are normative arguments relating to correcting market failure and also normative arguments based on more direct value judgements in relation to merit good arguments about the desirability of certain goods, and in relation to the desirability of distributional equity. Aside from such normative arguments, there is also reason to believe that the state will engage in redistribution in return for the votes of recipients.

The above reasons for the extension of government are often set out under the three broad headings first proposed by Musgrave (1959). These headings are the *allocation* of resources, the *distribution* of income and wealth, and the *stabilisation* of the macroeconomy. Of these roles, stabilisation and redistribution are generally seen as mainly roles for central government, and the key normative role for local government is seen to be in the allocation of resources, particularly in the finance of local public goods (King, 1984, p. 6). In the following discussion of

the need for local government, we focus on the allocation of resources, and specifically on local public goods.<sup>4</sup>

### The need for local government

As noted, the clearest rationale for the existence of local government is as a solution to the problem of local public goods. Whilst many public goods such as defence, are national in extent, other public goods such as local parks, street lighting and refuse collection, have a more limited geographical extent or benefit area.

The major advantage of local government is that it allows the local public goods and services it provides to be adjusted to suit the tastes and the preferences of local residents. As pointed out by Alex de Tocqueville, this variation in local provision contrasts with the uniformity likely to arise from centralised provision. 'In great centralized nations the legislator is obliged to give a character of uniformity to the laws, which does not always suit the diversity of customs and of districts' (Tocqueville, [1838] 1945, Vol. 1, p. 163, cited in Oates, 1972, p. 31).

John Stuart Mill argued: 'The very object of having local representation is in order that those who have any interest in common, which they do not share with the general body of their countrymen, may manage that joint interest by themselves' (Mill [1861] 1991, p. 415, cited in Sharpe, 1970, p. 155). More recently, Wallace Oates formally stated the essential advantage of decentralisation as follows:

'For a public good – the consumption of which is defined over geographical subsets of the total population [and for which there are not cost advantages to central provision] – it will always be more efficient (or at least as efficient) for local government to provide the [locally preferred] levels of output for their respective jurisdictions than for central government to provide any specified and uniform level of output across all jurisdictions.'

(Oates, 1972, p. 35)

The implication for design of local government structures is that local government jurisdictions should be based on the benefit areas of local public goods (Oates, 2005, p. 351). Because benefit areas for different local public goods do not generally coincide, this principle does not lead to a particularly tidy design. Either there should be a multiplicity of single-purpose local governments with boundaries defined by the extent of the local public goods they provide, or local governments should be multi-functional, with boundaries defined as a compromise between a range of different local public goods (Tullock, 1969).

Should local governments be large or small? Arguments based on economies of scale might at first seem to suggest that larger units of local

government might be more production efficient. However, the existence of local public goods only provides a rationale for local government *finance* of public goods rather than local government *production*, and where economies of scale exist, small local governments can enjoy economies of scale by using private contractors (Ostrom *et al.*, 1961; Tullock, 1969). Small local governments are likely to be better at solving the problem that the right local public goods are produced and go to the right people. In addition, the accuracy with which local authorities are able to match their residents' preferences for local public goods is likely to be enhanced by the Tiebout effect. In Tiebout's model, local residents can seek a more precise match between their preferences and local provision by voting with their feet (Tiebout, 1956). They can migrate to the local authority that provides the combination of local public goods that is closest to their preferences.

If a view is taken over which responsibilities should be allocated to which levels of government on the basis of the geographical extents of the benefit areas of the range of local public goods, there is then the question of financing these responsibilities. This relates to the tax assignment question.<sup>5</sup> One solution is to assign adequate taxation powers to central and local government with the objective of securing a close match between benefit area, tax area and electoral area. Olson (1969) calls this the principle of fiscal equivalence. Bird (1999) expresses the idea as follows:

'Multitiered governments in principle work best when taxes and the benefits of public spending are as closely related as possible when, that is, the citizen–voter–consumers residing in a particular political jurisdiction both pay for what they get from the public sector and get what they pay for.'

(Bird, 1999)

When different levels of government each have adequate taxation powers to pay for the expenditure responsibilities allocated to them there is said to be a state of 'vertical fiscal balance'. In practice there is vertical imbalance in most countries with a consequent need for a significant level of grant funding from central to local government to make up the shortfall in local funding (Ahmad and Craig, 1997; Bird and Tarasov, 2004, p. 77).

The UK has a high level of vertical fiscal imbalance, with local authorities heavily dependent on central grant, and this reduces local autonomy and accountability (Bird and Tarasov, 2004; Watt, 2004; Stegarescu, 2005). Currently about 75% of local government revenue expenditure is funded through the centre through grant and distributed non-domestic rates, and only 25% funded locally through council tax (ODPM, 2004, p. 6). High levels of grant funding lead central government in the direction of attempting centralised micro-management, as witnessed under the current best value and

comprehensive performance management systems. These systems suffer from the information problems that are inherent in central planning (Hayek, 1945). High central funding also reduces the importance of local elections, contributing to poor turnout, and places the system of grant allocation and its assessment of needs under great strain as the system is responsible for the majority of the funding local authorities receive (Watt, 2002, pp. 249–250).

Vertical fiscal imbalance can also lead to a common pool problem as a result of services to local residents being paid for by non-residents through central transfers (Weingast *et al.*, 1981). A version of the prisoners' dilemma can occur where local authorities may prefer a system where finance is decentralised for all, but individually do not have an incentive to abstain from fishing in the common pool of central finance (Inman, 2003).

High grant levels can also generate the problem of local authorities operating under a soft budget constraint (Kornai *et al.*, 2003). Central government may be unable to commit credibly to a policy of no bailout of local authorities that get into budgetary difficulties, as they may fear being blamed for high local tax increases and may feel obliged to supplement grant funding to prevent this. Qian and Roland (1998) develop a model showing that decentralisation of taxation powers to local government can be an effective means of avoiding this problem.

Lastly, Brennan and Buchanan (1980, pp. 182–183), in their 'Leviathan' model of government growth, argue that financing local governments by central grant rather than local taxes enables a cartel to be set up between local governments where a system of competing local taxes is replaced by a uniform central tax. The effect is to reduce competition between local governments and may thereby allow them to expand provision above the optimum level.

All these arguments suggest that the design of a system of local government should not leave local governments dependent on a high level of grant but that instead they should be allocated adequate powers to raise their own revenue through local taxes.

One way of addressing the problem of high grant levels would be to re-examine the allocation of functions to local government. If, as is currently being debated, education were moved out of the hands of local authorities and instead were directly funded by central government this would reduce the proportion of central grant in local government funding. If the change were combined with the introduction of a voucher finance scheme the move would be decentralising rather than centralising, but such a move does not seem to be politically feasible at present. In education, and in social services, those who deplore any element of 'postcode lottery' stand in opposition to the arguments for local choice. Again, in both education and social services, voucher funding could provide decentralisation of choice to

the level of individuals, whilst largely avoiding a postcode lottery effect.

## Conclusions

This paper has argued that an understanding of the role of local government stems from an understanding of the overall role of government. The fundamental contribution of government is in the establishment of both law and order and the secure property rights that allow the market to operate. Any government with control of law and order also clearly has the power to redistribute resources according to its wishes, and whilst a democratic government will exercise restraint in this activity in comparison with autocracy, it is nevertheless likely to engage in redistribution, not least in response to the desires of the median voter. Governments also extend their role beyond the minimum state by acting to correct market failure and intervening to increase provision of merit goods.

Whilst local government can engage in some redistribution and provision of merit goods, it is argued that the key function of local government is in the provision of local public goods matched as closely as possible to local tastes and preferences. Small local authorities enable a close fit between local provision and local tastes, and the precision is enhanced by the Tiebout effect whereby persons may migrate to the locality that most matches their preferences.

Ideally local authorities should be established so that local residents both pay for and vote to decide on the local public goods they receive. Such a system provides clear local accountability and avoids the need for central control and the information problems it is likely to involve. Currently in the UK there is a high dependency on central grants, and it is argued that this leads to a number of problems, including attempts at central micro-management and excessive strain on the grant system.

1. See also Usher (1992, pp. 78–79) and Khaldūn ([1377] 2005, p. 151): 'Each one will stretch out his hand for whatever he needs and try simply to take it, since injustice and aggressiveness are in the animal nature'.
2. See also Khaldūn ([1377] 2005, p. 47): 'People need someone to exercise a restraining influence and keep them apart, for aggressiveness and injustice are in the animal nature of man'.
3. Likewise, murder, in the absence of the victim's consent, does not deliver a Pareto improvement.
4. Some of the ideas presented here are examined in more length in Watt (1996, chapter 1).
5. See Shah (1994, p. 2) for discussion of the allocation of responsibilities between governments and the assignment of taxes between governments.

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