



Working Paper No. 1

Roles of Central and Local Government in Joint Problems



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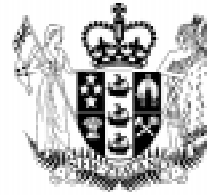
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Roles of Central and Local Government in Joint Problems

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Summary

Some of the most difficult public policy issues call for joint or co-ordinated action by both central government and local government. If such issues are to be addressed effectively and efficiently, the relationship between the parties needs to be based on a clear, accurate and shared understanding of the relative status and respective roles of each. This paper seeks to establish a framework on which such an understanding might be based.

The paper integrates a political economy analysis of the roles and relationships of central and local government in New Zealand, and an economic analysis of the various kinds of “goods” – public private and mixed. The paper makes a case that central government and local government should not be regarded as “tiers” in a vertical hierarchical relationship, but as operating alongside each other. It concludes that in addressing joint problems central government and local authorities should in general not enter into purchase agreements for the supply of outputs by the latter in a principal/agent relationship, but should instead co-operate through arrangements that respect the autonomy of the parties.

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Contents

INTRODUCTION.....	3
THE STRUCTURE OF GOVERNMENT	3
FRAMEWORK FOR ANALYSIS.....	4
DIFFERENT KINDS OF GOODS DEFINED	4
PUBLIC GOODS	5
PRIVATE GOODS	6
MERIT GOODS	6
PROVISION OF PUBLIC AND MERIT GOODS	6
PRINCIPLES FOR THE PROVISION OF DIFFERENT GOODS.....	7
MIXED GOODS AS CRITICAL ISSUES	7
CONCLUSION.....	9
APPENDIX 1: EXAMPLES OF DIFFERENT KINDS OF GOODS.....	10

Introduction

Some of the most difficult public policy issues call for joint or co-ordinated action by both central government and local government – for example, the issues which the Strengthening Families and Safer Communities programmes seek to address.¹ If such issues are to be addressed effectively and efficiently the relationship between the parties needs to be based on a clear, accurate and shared understanding of the relative status and respective roles of each. This paper, prepared by the State Services Commission (SSC), seeks to establish a framework on which such an understanding might be based. To that end, it sets out to identify:

- considerations that are relevant to the allocation of functions as between central government and local government; and
- the issues that arise when functions involve both central government and local government.

This paper first locates local authorities within the wider constitutional and governmental contexts. An analytical framework is then constructed. This framework introduces the considerations deemed relevant to the division of functions as between local and central government and translates them into principles. Issues arise, however, when both local and central government have functions in relation to the same problem. The paper concludes with an examination of those issues.

The Structure of Government

Local government is an institution comprising a number of separate and autonomous organisations (local authorities²) in a political system over which Parliament is supreme. Parliament provides the authority for both central and local government and the constraints within which each institution and its constituent organisations function.

The distinction between Parliament and central government is fundamental, but is sometimes overlooked. This oversight may have originated in earlier times when the distinction between the two was somewhat blurred. This blurring could have led to the assumptions that central government possesses authority over local government or that local authorities are properly regarded as agents of central government.

Such assumptions are not consistent with the true constitutional position or with the law. Constitutionally central government seeks to interpret the political preferences of the national community and acts to meet them, within the laws made by Parliament. Similarly, under the local government legislation, local authorities seek to interpret the political preferences of their local communities and act to meet them, within their Parliamentary mandate. Ministers generally have no more power to direct local authorities, or to veto their decisions, than they have those powers in relation to firms or citizens. Local authorities are creatures of Parliament but they are not creatures of central government. The most significant differences

¹ These issues involve the voluntary and private sectors also.

² There are two main types of local authority: regional councils and territorial authorities (comprising city and district councils) but the differences between them are not relevant for the purpose of this analysis.

between central government and local authorities, apart from scale, are that they serve different communities with potentially different interests and that they perform largely – but not wholly – different functions. In a constitutional sense they are better regarded as co-existing side by side rather than hierarchically.³

Framework for Analysis

An analytical framework captures, in one place, different sets of information that, when put together, can be used to view problems systematically so that one or more solutions can be derived. The central problem for which the framework below has been designed is the optimal allocation of functions between central and local government. Two sets of theoretical information will be drawn upon – political and economic. Political theory gives us an understanding of the capacities of the actors to which functions might be allocated. Economic theory gives us an understanding of what is to be allocated (responsibility for providing “goods”) and of the different types of these goods. The combination of the two sets of information points to who should provide what, and to whom.⁴ The question of who should produce, as distinct from provide, goods is a separate and subordinate question that falls outside this discussion.

Political theory and empirical observation tell us that citizens have preferences about outcomes, and elect sets of decision-makers to pursue them on the citizens’ behalf. Different sets of decision-makers are responsible to different communities of citizens for seeking their desired outcomes and avoiding or minimising undesired ones.⁵

Activities and outputs make goods. A good is something that is valued or wanted by somebody. A good, or a bundle of goods, results in one or more outcomes. An economic taxonomy can also be used to identify the different types of goods.

Different Kinds of Goods Defined

There are two main kinds of goods: *public goods* and *private goods*. These categories are ideals or archetypes, inasmuch as there are very few, if any, pure public goods; that is, most goods are mixed public and private goods in varying proportions. Each good belongs somewhere on a continuum from “pure public” to “pure private”. The conceptual distinction between them is, however, useful for analytical purposes.

³ Although there can be particular exceptions in practice.

⁴ This discussion does not go into problems of preference revelation, or market or government failure. Its conclusions are not dependent on assumptions about how such problems are best dealt with. It does, however, make the conventional assumption that governmental activity should be consistent with the goals of efficiency (allocative, productive and dynamic) and equity.

⁵ Taxes are an example of an undesired but unavoidable outcome for the taxpayer – a “bad”, to be weighed against the benefits (“goods”) they enable.

Public Goods

Pure public goods have two defining characteristics: they are *non-excludable* and consumption of them is *non-rivalrous*. Non-excludability means that people cannot be prevented from enjoying them⁶. Non-rivalry means that one person's use or "consumption" of the good is not at the expense of anyone else's.⁷ Public health is an example of a fairly pure public good; where there is a high standard of public health people cannot be prevented from enjoying its benefits, and each individual's enjoyment of the good is not at the expense of anyone else's.

The benefits of public goods can be realised at different geographical scales: pure *local public goods* are goods whose benefits are confined to specific geographic areas⁸, while the benefits of pure *national public goods* are realised at the level of the nation. For reasons of efficiency and equity, the cost of a public good should be borne within the political jurisdiction where the good is provided and enjoyed. This proposition, which is known as *fiscal equivalence*,⁹ means in practice that people outside the political jurisdiction, who do not bear the costs or enjoy the benefits of a good, do not get a vote on its provision or funding; and conversely, those within the political jurisdiction, who bear the costs and enjoy the benefits, have the political say.^{10 11}

Excludability assumes the existence of regulation – laws – and (usually) property rights. What is excludable may also depend on the available technology. For example, pay TV depends on a coded signal that can be decoded only if the viewer has a decoder, for which the user must pay. Before the technology became available, viewers could not be excluded from watching any broadcast programme without paying the owner of the programme. Now pay TV is commonplace. Recent and continuing technological developments in metering and billing, including reducing their cost, increase the excludability of previously non-excludable goods. Consequently some goods that were formerly public goods have become potentially private goods, and more will become so in the future. The use of roads in some jurisdictions (e.g. Singapore) provides an example.¹²

⁶ Or in some cases that people cannot avoid enjoying them, whether they wish to or not; for example, the defence of the realm.

⁷ Non-rivalry disappears, however, when "congestion" occurs (e.g. when a park becomes full of people, or when several people want to borrow the same public library book at the same time).

⁸ Practical considerations restrict the scope to draw local government boundaries precisely around areas of benefit, or to establish a separate local authority for every local public good. Hence the existence of multi-purpose local authorities whose boundaries represent compromises among a number of considerations, including presumed economies of scale.

⁹ The proposition "no taxation without representation" expresses a similar principle.

¹⁰ The term *community of interest* expresses a similar concept.

¹¹ *Spillovers* - also called *externalities* - occur when costs or benefits cross boundaries. Spillovers represent departures from fiscal equivalence. Although spillovers may be unintended and undesired, in particular cases they may not be worth doing anything about.

¹² See *Electronic Road Pricing* (ERP) discussion: Singapore Government website, <http://www.lta.gov.sg/erp/abouterp.htm>.

Private Goods

In contrast to public goods, the consumption of private goods is:

- rivalrous (one person's consumption of a private good impinges on the ability of another to consume that good), and so it may be efficient to charge consumers so that the right amount is produced and it is consumed by those who value it most; and
- excludable (people can be excluded from consumption), and so it will be possible to charge consumers.

Club goods are a variant of private goods. Club goods are provided by a voluntary club to its members. Within the club, consumption of the club good by members is non-rival¹³ and non-excludable but non-members are excluded from enjoying it. In these ways a club good differs from a purely individual private good.

Examples of different kinds of goods are provided in Appendix 1.

Merit Goods

A government may decide to provide access to a good as if it were wholly or partly a public good, even if the good concerned has the natural properties (rivalry and excludability) of a private good. For example, a government may provide free or subsidised access to certain services, such as education or recreational facilities, to every person who meets certain criteria. Governments do this because they consider that the good concerned has some socially meritorious feature, and that it would be under-consumed if each consumer faced the true cost. Such goods are called merit goods, and they are provided as if they were wholly or partly public goods (whether national or local).

Provision of Public and Merit Goods

Two of the ways in which a public or merit good can be provided are:

- the good can be purchased in the market, or produced, by the government (local or national) and provided to citizens at below cost, or even at a zero price. The cost to the government has to be recouped by taxation; and
- regulation can be put in place to compel parties other than the government to produce the good and to bear, or pass on, part or all of the cost.

Either approach involves the exercise of coercive power. The only institution in our society that has legitimate coercive power is government, by virtue of laws made by or under the authority of Parliament.¹⁴

¹³ Up to the point where congestion occurs (a club will often also provide ordinary private goods to its members.)

¹⁴ However, the voluntary and private sectors can and do provide some public goods through charitable or sponsored activities that do not involve exercising coercive power.

Principles for the Provision of Different Goods

Applying the proposition of fiscal equivalence – i.e. the boundaries of the costs and benefits of governmental activities should coincide – to the various kinds of goods leads to the following further propositions about the provision¹⁵ of different kinds of goods:

- the provision of national public goods should be the responsibility of central government;
- the provision of local public goods should be the responsibility of local government;
- the provision of merit goods should be the responsibility of the government – national or local – which judges the good to be meritorious, to the extent that it judges it to be meritorious; and
- the provision of club goods and of individual private goods should be left to clubs and individuals, without the involvement of central or local government.

Mixed Goods as Critical Issues

However, the most challenging social policy issues are complex and multi-faceted. They are not amenable to solution by simple provision of simple public goods, or they would no doubt have been solved already. Interventions to address them effectively and efficiently will require complex combinations and mixtures of goods to be designed and provided. To design and provide these will call for joint or co-ordinated action among decision-makers, drawing on information that is uncertain, incomplete, and difficult to obtain and analyse. Unlike financial information, information about the problems of people is inherently difficult to record and aggregate, and loses much of its meaning when it is aggregated. Policies that seek to address these problems need to be designed and applied in ways that recognise these information problems. Often the fine detail of policy will need to be tailored to specific local and personal circumstances as perceived by the service providers, and to be informed by their individual experience and professional knowledge.

In many cases interventions will involve both central government and local government in some relationship. If the relationship between the parties is not based on appropriate principles, or is not well-structured, there is a risk that the required goods will be under-provided or inefficiently provided, or both.

The term ‘purchase paradigm’ refers to one of the current dominant means of central government provision of goods. In such cases the Crown (through a central government agency) contracts to purchase outputs from another party (for example, a firm) as supplier. The supplier agrees to provide the outputs (which may be physical goods, or services, or a combination) to the purchaser’s specification as to quantity, quality, cost, timeliness, location of delivery, and price. The specification is so designed that the outputs, when delivered, will meet the purchaser’s outcome objective.

¹⁵ Whether by purchase, production, or regulation.

Roles of Central and Local Government in Joint Problems

In the language of agency theory, the parties to a purchase contract enter an agency relationship in which the purchaser is the principal and the supplier is the agent. Agency theory deals with the problem of aligning the behaviour of the agent with the interests of the principal.¹⁶ The supplier's responsibility is to fulfil the terms of the contract. Provided they are fulfilled, the actual outcome is not the supplier's responsibility.

There is always a risk that the contracted outputs do not lead to the intended outcome. That risk – policy risk – may not be of concern, or even of interest, to the supplier¹⁷. Policy risk belongs to the purchaser. Potential sources of policy risk include:

- the output specification is incomplete in some respect that turns out to matter;
- a mistake in specification arising from an inadequate understanding of causes and effects; and
- circumstances change so that the specification becomes inappropriate.

Policy risk increases as the complexity of the policy problem increases.

There is also a risk that the agent does not behave in accordance with the interests of the principal. This risk – agency risk – is greater where the contracted output is complex, and it is difficult for the principal to be sure whether the agent is actually supplying the contracted output to the agreed specification.

Beyond those difficulties associated with complexity a problem arises where the agent is also the agent of another principal and the two principals have differing interests. In such a case the agent faces a conflict of interest. This problem arises where central government contracts with a local authority to purchase outputs from the latter, through an arrangement that makes the local authority an agent of central government. A local authority is already the agent of a different principal – namely, its own local community. The local community's interests are not identical with those of central government and the national community, any more than an individual's interests are identical with the interests of his or her local community. A local authority which becomes an agent of central government therefore places itself in a potential conflict of interest, between the differing interests of two principals, to the possible prejudice of its citizens' interests.¹⁸ In principle, therefore, central government and local authorities should seek to avoid entering that kind of relationship.^{19 20}

There are two further reasons why local authorities should generally eschew contracts with central government or other parties for the supply of outputs, other than through a local

¹⁶ In a purely commercial relationship the purchaser's outcome objective may be a matter of indifference to the supplier; any interest in that objective is more likely to be associated with prospects of future business than with a concern for the objective *per se*.

¹⁷ Provided, of course, that the purchaser still pays in full and on time.

¹⁸ English local authorities act in many matters as agents of central government, and substantial conflicts of interest and unclear accountabilities are among the results.

¹⁹ However the desirability of following this principle might need to be weighed against other considerations such as existing commitments, what is practicable in the particular circumstances, and so forth.

²⁰ It would equally be undesirable for Parliament to legislate them into that kind of relationship.

authority trading enterprise. The powers and governance arrangements of local authorities are designed to be optimal for the provision of local public goods. They are not optimal for the management of the commercial risks that necessarily attach to contracts for the supply of outputs. Moreover, by reason of the fact that it possesses coercive powers, a local authority is not in a position of competitive neutrality with other actual or potential suppliers. These are the reasons for the enactment of the local authority trading enterprise legislation in the first place.

Where a problem calls for action by both central government and a local authority, the two should first identify the objectives they have in common in relation to the problem. They should then seek co-operative and collaborative arrangements with each other, and possibly with voluntary organisations²¹, towards meeting the common objectives. In such arrangements none of the parties is subordinated to any of the others; rather, a joint venture or partnership is established in which each party commits to perform its agreed role to attain the shared objectives. The precise form and content of such arrangements, and their documentation, will of course vary case by case, and will depend on what is to be sought and how.

Conclusion

The analysis in this paper leads to the following conclusions:

- the provision of national public goods should be the responsibility of central government;
- the provision of local public goods should be the responsibility of local government;
- the provision of merit goods should be the responsibility of the government – national or local – which judges the good to be meritorious, to the extent that it judges it to be meritorious;
- the provision of club goods and of individual private goods should be left to clubs and individuals, without the involvement of central or local government; and
- the provision of mixed goods should generally be undertaken within co-operative arrangements that respect the autonomy of the parties - whether central government agencies, local authorities, or voluntary organisations - vis-à-vis each other, and not within purchase agreements in which the parties assume hierarchical principal/agent relationships.

The last point, translated from the language of “goods”, means that, where central government and local authorities encounter a common problem, they should pursue their common objectives by joint or co-ordinated action as equal partners, with responsibility to their respective principals.

²¹ “Clubs” are generally voluntary organisations.

Appendix 1: Examples of Different Kinds of Goods

Two examples might help to illustrate the distinctions between different kinds of goods. The first example is hypothetical. The quality of water supplied for domestic use might be subject to national legislation to assure a minimum standard for public health reasons, so as to mitigate the risk of very serious water-borne diseases such as typhoid. That standard of quality is a national public good. A local authority might decide to use its powers to regulate a higher standard in its jurisdiction, so as to mitigate the risk of less serious disease, such as cryptosporidium. The additional increment of quality is a local public good. The households in a small community in that jurisdiction might form a community water supply association,²² which is essentially a club, to provide them with water, and the association might decide to observe a still higher standard of quality, perhaps in colour or taste. This additional increment is a club good. Finally, a household in the association might decide to filter or distil the water provided by the association so as to obtain a higher standard yet, or as insurance against failure somewhere in the system. This final increment is a pure private good.

The second example is empirical. Under the Resource Management Act 1991, specified standards of environmental quality may be mandated throughout New Zealand²³; these standards are national public goods. The Act also allows local authorities to adopt policies in their jurisdictions, not inconsistent with national standards, that occupy interstices between the national standards. These interstitial policies regulate matters not already regulated by national standards and mandate standards that are local public goods.²⁴

The two examples are different in that the first involves different levels of standards and the second involves different domains to which standards are applied. However, the examples are similar in that in neither case is joint or co-ordinated action by different decision-makers required.

In reality few goods are purely public or private, purely national or local, purely individual or club. Merit goods are a mixture of public and private goods, and many public goods are a mixture of national and local public goods.

²² Under the Companies Act 1993 and section 50A of the Land Act 1948.

²³ For example, in the Coastal Policy Statement issued in 1994.

²⁴ Individuals and organisations might of course choose to observe higher standards still, as individual or club private goods.