CHAPTER - 8

APPROACHES TO GRANTS DISTRIBUTION

Though the typology of grants varies widely across countries, most of such grants may be conveniently grouped under two broad purposive categories -- equity approach and growth approach.

A) Equity Approach to Grants

Theories of Public Finance are often concerned with the concepts of 'vertical' and 'horizontal' equity (For example, see Break, 1980). Vertical equity virtually signifies a transfer of resources from higher to lower level of government for redressing the latter's fiscal gap. Since this aspect has already been covered by preceding analyses, we now turn to a discussion of horizontal equity which is otherwise known as equity approach to grants distribution. The latter presupposes a more favourable treatment of the poor, needy and backward localities. Deficit grant, equalisation grant, compensatory grant and to some extent block or adhoc grant bear features of such grant. Under equity approach, the purpose is to equalise local governments' differential financial capacity of producing local public goods and services, by covering their respective deficit between per capita expenditure needs (E) and own revenue (R) strength. The estimate of expenditure needs and local revenue strength may be actual (if necessary data is available) or assumed as ideal or standard data. Per capita expenditure needs being equivalent to quantity of per capita local services (Q) multiplied by their unit costs (C), financial deficit (D) may be defined as

$$D = Q.C - R$$

$$\text{or } D = E - R$$

Reflecting the need for distributing grant in accordance with this approach, the Layfield Committee Report of England (1976) also advocated for grant size

to be in the order of difference between spending needs and local revenue capability.

i)   **Expenditure Needs** :- Population is the most widely used indicator of expenditure needs.   This variable is a major factor in the distribution of rate support grant in Britain and in Bangladesh it provides the two-third basis for grant distribution for some levels of local government.   This indicator appears to be a close approximation to needs estimate as the expenditure need generally varies directly with the number of population.   In some cases, this variation in expenditure needs is more than proportionate i.e. fire fighting or crime policing services are increasingly needed in a thickly-populated habitation.   Population criterion, however, does not take into account the 'economy of scale' resulting from higher density of population.   Moreover, this criterion shows a bias for thickly-populated urban centres and as a result, better municipal services therein may perpetuate the trend of rural-urban migration.

Area is a better index of local expenditure needs for sparsely-populated rural bodies having significant diseconomy of scale.   In Philippines and Bangladesh, area is used as a partial determinant of inter-governmental transfers.   But on the whole, area is not a perfect indicator like population because population, being direct consumers of local services, add to local expenditure needs more than anything else.   For similar reason, other non-population criteria (i.e. road mileage, number of vehicles etc.) are seldom in use.   Unit cost of local services or the price of inputs used in producing them is an important determinant of expenditure needs but indexation of grant to local price-level is an uncommon practice.

When a grantor authority intends to give weightage to more than one of the above indicators, then formula method is adopted (i.e. population 70%, area 30% or the ratio being 50 : 50 and so on).

ii) **Local Revenue Capacity :** For calculating local budget deficit, local revenue capacity is an important variable. Necessary local income data are, however, seldom available in the developing countries.

An ideal deficit grant is to be disbursed on the basis of expenditure needs variable discounted by expenditure capacity variable as discussed above. But practical situation more often marks a deviation from above when grant is allocated according to only one criterion instead of two. In Philippines, Tunisia, Columbia and Turkey, for example, grant is distributed only on the basis of some expenditure needs criteria (i.e. population, land area etc.) whereas the basis is expenditure capacity (per capita personal income) for certain grants in Brazil and India. But the fact remains that when allocated only on the basis expenditure needs criterion with no recognition of expenditure capacity differences, grants are not likely to equalise fiscal capacity. We can explain this by Figure 13.

In Figure 13, we compare among three hypothetical local bodies - A, B and C. On the basis of only expenditure needs criterion, C emerges as the largest claimant to grants followed by B and A. If, however, grant distribution is weighted by both expenditure needs and capacity variables then entitlement to grants will be in the reverse order i.e. A highest, B next highest and C lowest. The latter provides the basis of an ideal deficit grant. Thus equalisation or deficit covering objective will be perfectly served if both expenditure needs and expenditure capacities are taken into account for distributing grants.

B) Growth Approach to Grants

One basic problem with equity oriented grant is its alleged non-stimulative role with regard to local resource mobilisation. When the national policy is to sustain or improve local revenue effort rather than sanctioning unconditional deficit grants, then revenue growth oriented or revenue stimulative grant is

Figure - 13

<u>EQUITY   APPROACH TO GRANTS DISTRIBUTION</u>
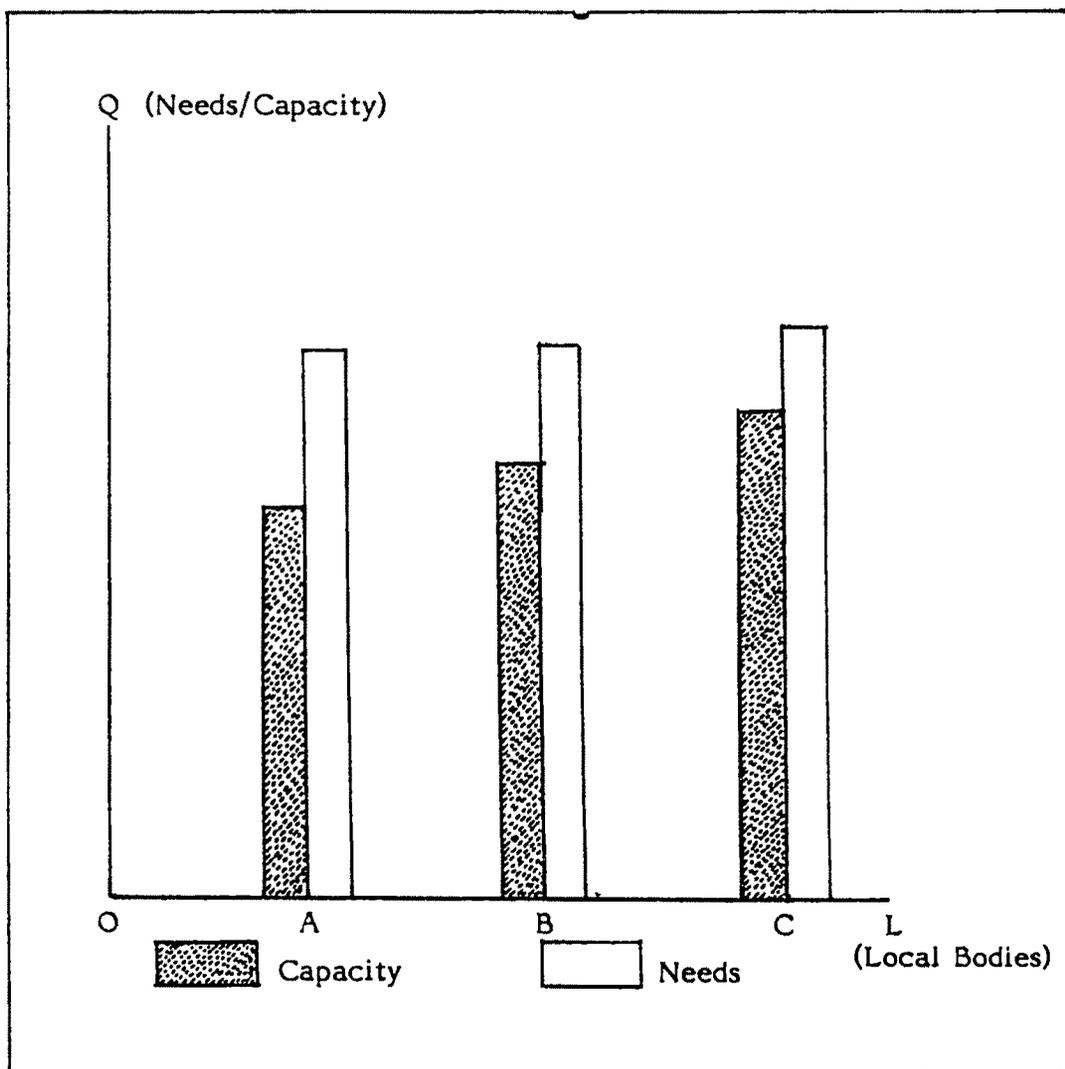
specially important. Since different types of such grants have already been discussed in Chapter 6, this need not be repeated here.

C) Formula based Grants

Sometimes, there is an attempt to give weightage to both of the above approaches by adopting a package formula i.e. 50% grant for covering deficit and 50% on revenue effort basis or the ratio being 70 : 30 and so on. Obviously, such conflicting purposes are likely to cancel each other's effect and thereby the very purposes of grant system may be defeated. So grant distribution should adhere to a single approach (equity or growth) depending upon the policy of grantor government.

Empirical Findings

In Bangladesh, the objectives of grants are not the same at all levels of government. As regards our studied local bodies, the grant system seems to have some similarity with equity-oriented deficit grant. Because for these bodies, grants are distributed on the basis of expenditure needs criteria (i.e. population and land area for the rural Union Parishad and only population for the urban Pourashava). In neither cases, however, there is coverage of expenditure capacity variables, mainly due to non-availability of local income statistics. This is rather an imperfection for the so-called equity approach to grants.

In order to examine if the declared population basis of grant distribution is really carried out by the actual distribution programme, a simple correlation test was developed between population and development grants variables and the results appear in Table 18.

Table 18 affirms that ex-post distribution of development grants in the local bodies is made on the basis of population as borne out by the significant correlation results of both total and per capita grants in both the local units.

Table - 18

CORRELATIONS BETWEEN DEVELOPMENT GRANTS AND POPULATION SIZE IN TWO LOCAL BODIES

Local Units	Total Grant	Per capita Grant	N
1. Manikganj Pourashava	.81 (4.9)*	.81 (5.03)*	15
2. Kaultia Union Parishad	.84 (4.67)*	.77 (3.61)*	11

N.B. :   i.   Figures in the parentheses give T-Statistics

ii.   Star marks denote significance at .05 level.

iii. Population and grant data in Table 1 and Annexure 2.

Pertaining to another crucial aspect - if the grant distribution is biased for any particular local body i.e. urban Pourashava, Table 18 does not provide any decisive answer. The same way, however, be derived from Table 19 regarding per capita grants.

The bias of local grants in favour of urban local government is quite apparent from Table 19. It exhibits that on the average, one Taka per capita grant for the rural Union Parishad is matched against similar grants of Tk. 8.38 for the urban Pourashava. Such pro-urban bias of local grant, however, does not imply a redistribution of national funds from rural to urban area because the urban localities in Bangladesh, as Bahl (1983) observed, contribute more to national taxes than their rural counterparts.

Table - 19

PER CAPITA AND REAL PER CAPITA GRANTS IN
TWO LOCAL BODIES (IN TAKA)

Year	Manikganj Pourashava		Kaultia Union Parishad	
	Per capita	Real per capita	Per capita	Real per capita
1973-74	3.07	-	-	-
1974-75	3.23	1.93	-	-
1975-76	3.97	4.43	-	-
1976-77	2.75	2.69	-	-
1977-78	8.33	7.40	1.03	.91
1978-79	11.51	10.63	0.93	.86
1979-80	7.83	6.61	0.56	.47
1980-81	40.06	35.60	1.36	1.21
1981-82	10.99	9.45	1.55	1.33
1982-83	9.63	8.76	0.91	.83
1983-84	31.49	28.71	4.55	4.15
1984-85	25.39	22.88	4.99	4.50
1985-86	37.86	34.47	4.66	4.24
1986-87	65.48	60.82	4.21	3.91
1987-88	57.63	-	3.21	-
Mean	21.28	18.03	2.54	2.24

N.B. : Per capita grant is related to total grants.