

CHAPTER - 1

INTRODUCTION

A) Statement of the Problems

Local governments across the world are often constrained with financial problems. Though such problems very much exist in the developed countries like those in Western Europe (Sharpe, 1981), they are particularly acute in the developing Third World. The nature of problems is however commonly related with growing imbalance between expenditure needs and spending capacity of local public sector. On the one hand, local functional liabilities go on rising mainly under effect of progressive devolution of statutory functions and inflating demand for local goods and services induced by population growth. Local revenue strength, on the other hand, does not appreciate at the similar pace. There are several reasons for this. Firstly, central/national government allocates to local governments taxes which are less elastic (capacity to vary automatically in response to non-discretionary factors i.e. income and population growth) than the national revenues. Secondly, such local taxes are also not buoyant (responsiveness of revenues with respect to both non-discretionary forces cited above and discretionary measures i.e. base, rate etc.) like national taxes, for increases in their bases or rates are seldom allowed by the higher government. Thirdly, for various reasons, local revenue effort operates at a lower level for which holding taxes are assessed below the legal standard and taxes in general are not collected to the fullest extent of legal tax liability. All these factors account for a slow growth of local revenues which may remain static or even may decrease if considered in real terms. There is, however a strong ground for local revenues to bear a part of incremental financial burden. This burden can be successfully borne if systematic approach to mobilisation of local revenues is followed through

proper identification of local revenue determinants along with a measurement of their relative weightages. Without this attempt, designing of any revenue promotional policy is likely to be less than perfect.

To bridge the existing gap between local expenditure needs and local revenues, grant is often used as an essential financial instrument. But it is a matter of theoretical interest to consider how much a local government should rely on higher government of grants. One extreme case may be 100% local revenues with no grant while the other extreme may be 100% grant with no local revenues. In between these two extremes there is the third possibility of various combinations of both own-source revenue and grant. It is, therefore, necessary to sort out the question as to which of these three alternative solutions is practicable and desirable for a local government. In other words, this exercise presupposes a systematic enquiry into if the role of grant is indispensable in local finance and if yes, then how much should it be relied upon i.e. if there are constraints to exclusive or excessive dependence upon local grants.

Grant may also have far-reaching effects upon local revenues and expenditures - positive or negative depending upon the character or size of grant. Theoretically, general purpose grant may replace local revenue while matching grant may stimulate it. Though revenue stimulation is a critically necessary element for the grant programme in the resource-poor developing countries, revenue stimulative purpose cannot be better served under the system of matching grant. A search for a better alternative of revenue stimulative grant has therefore been a matter of academic interest across the world. Similarly, merit or productivity of local expenditure is likely to have some relations with the volume of grant. Local grants, therefore, are to be administered in full awareness of their implications, otherwise such grants may accentuate local financial crises instead of playing a desirable role.

Like other Third World nations, Bangladesh also experiences above nature of financial problems in its local public sector. Here, generally speaking, local resources mobilised are far below the level of expenditure requirement (Ahmed, 1989). Local revenues are less elastic, and these grow only at a modest rate, Buoyancy coefficient of such revenues is also remarkably low. For example, the Model Tax Schedule, 1961 for Union Parishad was revised only in 1982 and the rates applicable to such taxes have not yet been changed. Similarly, the model tax schedule and rates for Pourashavas were revised in 1985 after 25 years of their first enactment. Tax collection efficiency is miserably low for the local bodies in general (Schroeder, 1983). The sum total of these factors is that local revenues are never collected at full potentials. To meet own revenue-expenditure gap, grants are channelled to local bodies. But dependence on grants, at some levels of local government is not only substantial, but also goes on mounting in terms of its share to total revenues. Such grants, because of their substantial volume and unconditional nature, are not probably without any implications for local revenue effort and expenditure pattern.

The above-mentioned problems relating to local government of the Third World in general and Bangladesh in particular provide the background of this study.

B) Objectives of the Study

This study aims to accord theoretical and empirical treatments to selected aspects of local finance. Specifically, the principal objectives are to -

- i) review the determinants of local revenues and measure their relative importance.

- ii) determine the appropriate role of grants in local finance i.e. if grant is indispensable and if it is, then what its extent is.
- iii) Consider the possible effects of grant on local resource mobilisation.
- iv) analyse the likely impacts of grant on local expenditure.
- v) recommend policy prescriptions towards improving financial viability of local governments in Bangladesh.

C) Hypotheses of the Study

The main hypotheses of the study are as follows :

- i) The cost of local services or the local expenditure needs cannot be fully covered by the revenues mobilised locally. This discrepancy is to be covered by local grants, which may cost independence of local bodies.
- ii) National revenues are more buoyant than local revenues.
- iii) Local grant is indispensable but there are limits to exclusive or over-dependence upon grant.
- iv) Expenditure propensity of grant is higher than that of local revenues.

D) Methodological Approach to the Study

Characteristically, this study is a blend of theory and empiricism, since some of the theoretical issues on local finance are judged in the light of empirical findings. Such empirical data were mostly collected from micro origin. Two local bodies - one urban Pourashava and another rural Union Parishad, both within

the vicinity of Dhaka city - were selected purposively to economise time and cost. The author personally visited these bodies to collect micro data. Official and representative functionaries of these bodies were interviewed. But more important method was survey of budget papers and other relevant official documents. Poor and unsystematic maintenance of records posed a formidable problem at this stage and therefore extreme care and caution had to be applied for cleaning raw data. Data available in Manikganj Pourashava covered 15 years (1973-74 to 1987-88) while it was 11 years for Kaultia Union Parishad (1977-78 to 1987-88). These data were gathered during the second half of 1988.

Cross section financial data used in regression analyses for selected local bodies were derived from secondary sources. The latter source also provided macro statistics related to local finance in Bangladesh. Furthermore, secondary data in the context of Third World local finance were also consulted.

E) Theoretical Base of the Study

In conformity with the objectives set out above, this study probes into the selected aspects which are connected with the policy of improving financial viability of local government in Bangladesh. In dealing with them separately, efforts were made, wherever it was possible, to base the analysis on some theoretical foundation.

For reviewing relative importance of revenue determinants (Chapter 4), Schroeder-Dalton (1986) model of six variables was adopted as the theoretical basis because these variables are all pertinent determinants of local revenues.

In Chapter 5, the works of Oates (1972), Break (1980) and Ashwe (1986) founded on the theory of Pigou (1932) provide a theoretical basis for justifying grant for financing local projects with spillover effects.

In examining the grant's effects on local revenues (Chapter 6), we depended on the theoretical work of Spahn (1977) who graphically analysed possible effects of general purpose grant and matching grant on local revenues.

Marshall's (1961) Law of Diminishing Marginal Productivity lies at the root of the optimum quantity theory of grants as proposed in the study (Chapter 7)

The above-mentioned theories on local finance were judged in the light of empirical findings, with an end to make marginal contributions to such theories or develop them.