

### CHAPTER - 3

#### REVIEW OF LITERATURE

The literature on local finance has its classical origin in the writings of Hicks (1959), Dalton (1922), Pigou (1932), Musgrave (1958), Due (1954), Johansen (1965) among others. These early writings mainly concentrated on the problems at an abstract level. The theoretical abstractions gave some insights into the problems while at the same time they missed the finer nuances. Later economists have based their studies on the classical format and then improved upon it.

The existing body of theoretical literature on the subject, however, does not appear to be developed to any appreciable degree. The reasons behind this are not far to seek. Firstly, local finance is a border line area between Economics and Political Science/Public Administration and strictly speaking, it has often more to do with the latter discipline. The people of Economics particularly the theoreticians and econometricians have not therefore treaded much ground in the field. About two decades ago Gramlich (1969) lamented that the area of state and local governments was relatively untouched by the model builders and the same observation also stands more or less valid for today. On the other hand, the non-economist researchers operating in this area generally keep their scope limited within the political aspects of local finance and seldom step beyond. Secondly, theoretical economists working in the said field are often targeted to some well-defined purposes (such as preparing reporting assignment related to some specific aspects of local finance) where they always do not get independent scope to construct any theoretical model, and even if they do, there are limits to over-burdening their empirical works with theoretical exercises.

Theoretical works on local finance are not only inadequate but these are also highly localised across the World. It may be observed that only a few

pockets of the academic world mostly originating in the developed countries like USA, UK and Australia are currently pursuing theoretical and empirical researches on local finance. Similar attempts in other countries are rather irregular, sporadic and limited on scale. Another observation regarding existing theories on local finance is that a great many of them deal with peripheral issues and not directly related with central themes of local finance i.e. revenue determination, role and impact of grant or any other issues linked up with financial performance of local government. For example, Grand (1975) attempts to identify some major sources of inequity between local authorities' fiscal operations and provide some suggestions for the theoretical formulation of a grants scheme to reduce or eliminate them. In another example, Dilorenzo (1982) examined the hypothesis that more income elastic tax structure (that causes increase in tax burdens without increasing tax rates) lead to higher levels of public expenditure because of 'fiscal illusion' (lower perceived tax rate leading to increased demand for local output). Similarly, Gramlich (1969) found that budget constraint has important bearing on the way such budgets respond to external forces such as movement in GNP, interest rates and federal grants. Longo (1981) theorised that property taxation causes fewer problems of interjurisdictional tax spill-overs than indirect taxes and therefore recommended for replacing existing greater reliance on indirect taxation (commodity tax) by that on property tax in case of Brazilian municipalities. It may be cited that such example of preponderance of indirect taxation in local tax package is rather exceptional for the Third World countries. All these examples suggest that a good number of existing theories on local finance are either peripheral to the subject of our study or they have little connection with local finance of the Third World.

Compared to the theories on local finance, country specific empirical or impressionistic studies are more in existence and are also widely diffused

across both developed and developing world. Now we turn to specific reviews of both theoretical and empirical literature which shed lights on the principal aspects of (i) determination of local revenues (ii) indispensability of local grant and (iii) effects of grants on local revenue/expenditure.

#### **A) Determination of Local Revenues**

Ability to finance local expenditure functions critically depends on the size and growth of local revenues. Any scheme to promote financial viability of local bodies must, therefore, involve proper identification of factors that determine local revenues. Conventional literature mostly deal with local revenues with reference to certain local units i.e. what are their problems of resource mobilisation and how these could be resolved. Since these treatments are specific to micro origin, a general and broad-based outlook cannot be developed from them particularly relating to what factors are of how much importance in affecting revenue growth.

Blair (1989), for example, recommends a set of policy options (based on the findings of a number of empirical studies) which aim at improving fiscal health of local governments in Bangladesh. But the work strictly conforms to the context of the country and there is hardly any theoretical interpretation of the factors that are likely to determine local revenues. The work, by and large, co-exists with some important gaps - (i) it does not pay attention to the prospect of tax diversification (ii) land development tax is over-emphasised in the analysis which is a locally based tax but collected centrally, (iii) moreover, it concentrates only on two rural local units and excludes Zila Parishad which is not only the highest tier of rural local government but is also accorded a newly defined place through the Ordinance of 1988. In this sense, the study seems to have been only partially purposeful.

Ahmed (1989), on the basis of his study of four Pourashavas, found that the potential resources of these urban bodies are under-exploited whereas their rapid urbanisation process calls for increased mobilisation of these resources. Apparently, the study did not bring into analysis some important factors having significant bearing upon success in resource mobilisation i.e. identification of revenue variables particularly revenue collection effort or willingness and the forces underlying it, revenue impact of grants, significance and scope of further devolution of revenues etc. The short-term and long-term measures recommended to upgrade the resource position of local bodies also do not appear to be fairly comprehensive.

Mandal (1987) enquires about effectiveness of municipal finance in mobilisation of local resources, based on a case study of five municipal towns of Bangladesh. Though the study is limited in scope, draws heavily on secondary sources and lacks sufficient depth of enquiry, it deserves credit for deviating from traditional approach to similar enquiries in the context of Bangladesh particularly through adopting some quantitative techniques. Moreover, the study dwells, albeit briefly, on the matter of local revenue determination which is a crucial aspect of local finance. Another positive contribution of the study takes the form of suggestion for introducing revenue incentive mechanism on the basis of rewarding higher and penalising lower revenue effort by respectively delivering higher and lower amount of grants. However, on the whole, the study suffers from the following imperfections :- (I) It gives us an incomplete picture of revenue determinants as it does not include income and assessment variables. Analysis of cited determinants is also not elaborate. (II) Insignificant regression results with respect to 'local revenues' impact upon per capita value-added is explained by the fact that internal revenue is entirely used up for administrative and maintenance purposes and the surplus, if there is any, is used for supporting works programme which have lower contributions to income - generating activities.

Concretely speaking, this statement does not reflect realities as it misrepresents the expenditure Table (7) of the study. It appears from the Table that expenditure composition does not unilaterally favour over-head/maintenance heads since a sizable portion of local fund is also devoted to programme head like road development, human resource development (public health, sanitation), works programme etc. which have both direct or indirect positive effects upon local income and economy. It may be recalled here that management of income-generating enterprises is not a direct responsibility of any local government in Bangladesh. These bodies are assigned with selected number of service or welfare-oriented functions many of which have potentials of contributing to local income i.e. marketing facilities of a road project augmenting local production. Indications to this effect are available in a number of studies (Bahl, 1983 ; Asaduzzaman, 1985).

Other studies relating to local finance in Bangladesh i.e. Schroeder and Muniruzzaman (1982), Chowdhury (1987), Asaduzzaman (1986), Saqui and Mokabber (1989) also avoided theoretical approach to analysis and there was no attempt to delineate the revenue determinants in a systematic manner.

Empirical studies specific to other countries are too numerous to be cited here. But among them, Philippine-based work of Bahl and Miller (ed. 1983) and U.K. based study of Foster et. al. (ed. 1980) are worth mentioning for their appreciable thrust on theoretical exposition. The principal guiding objective common to both is to design a set of appropriate policy packages towards strengthening financial position of the respective local governments, basing on the objective assessment of the prevailing situation. In this process, model relating to expenditure is constructed in both the studies. But none of them considered the theoretical and empirical perspectives of comprehensive revenue determinants package along with an articulation of their relative weightages. Believably, such an attempt could have laid down a more scientific basis of attacking the problem of local fiscal crises.

Internationally comparable literature on local finance also does not seem to be much concerned with the theory of local revenue determination. This category of works does not claim any large number and remarkable ones among them are by Hye (ed. 1985), Mathews (ed. 1977) and Davey (1983). Hye (ed. 1985) affords us an understanding of the practices of local finance in several developing countries i.e. Bangladesh, India, Philippines, Nepal and Sri Lanka. But the depth of insight it provides does not appear to be adequate perceptibly for the reason that the country papers were mostly written on the basis of impressions and secondary materials. Moreover, the nature of analysis is more political than economic as the issue of local resource mobilisation was viewed in relation to decentralisation. There is no systematic attempt to delineate revenue growth variables and the impact of grant upon revenues is also not studied.

Mathews (ed. 1977) highlights some theoretical and conceptual issues on state and local taxation accompanied with international comparisons on the subject involving 4 developed countries - Canada, USA, FRG and Australia. Though the theoretical part deals with some issues relevant for both developed and developing countries, but it does not any way cover the aspect of revenue determination.

Davey (1983), while presenting an overview of various alternative revenue instruments employed across the Third World, appraises selected revenues (property tax, income tax, goods and services tax, land tax) in the light of their four attributes i.e. adequacy and elasticity, equity, administrative capacity and political acceptability. These discussions have very little to offer in the form of revenue determinants because none of these attributes excepting adequacy and elasticity have any direct connections with revenue growth. Thus a systematic presentation of the revenue determinants remains beyond the scope of the book. In particular, the collection aspect which is an important variable is utterly ignored.

A relatively systematic theoretical analysis of the revenue determinants is made by Schroeder - Dalton (1986). While reviewing the growth characteristics of local revenue sources in the Third World, they demonstrate, in the form of an equation, that local revenue is a function of (i) population (ii) income (iii) tax base (iv) assessment (v) tax rate and (vi) collection rate. While non-discretionary factors (population and income) influence revenue elasticity, the six revenue determinants as a whole determine revenue buoyancy. The model appears to have covered almost all the basic revenue determinants representing an integration of all the inter-related variables in one formulation. To be specific, on population will depend per capita income and both these factors will determine tax base. On this base will be imposed the tax rate (in case of holding tax, the rate will be fixed on assessment variable) leading to determination of final tax liability, the collection of which will depend on the collection rate. Thus the six variables make a compact whole. This study, nevertheless, suffers from a number of weaknesses :- (i) firstly, all revenue determinants are not equally important -- some are more and some are less. A knowledge of such differential importance may be instrumental in designing an appropriate revenue promoting policy. The said work, however, does not establish the relative importance of individual revenue determinants on the basis of empirical estimation. (ii) collection rate is a crucial determinants of local revenues and success in this will depend on wide ranging factors. This aspect is not highlighted in the study. (iii) the specified variables determine revenues under a given equilibrium of revenue devolution and therefore there is a limit to which they may affect revenue growth. A breakthrough in this regard may be achieved through enhanced decentralisation of revenue powers. This is, indeed, an external factor of revenue determination which is not covered by the study.

This external aspect of revenue determination was treated by Sharpe (1981). In his introductory appraisal of fiscal crises of West European local govern-

ments, he stressed the point that higher level of governments generally tend to retain bulk of elastic and easily collectible revenues, releasing few of them for local authorities. Level of revenue devolution has, therefore, some relation with revenue determination. This aspect was however not substantiated by factual data nor was it detailed particularly in the context of Third World.

#### **B) Indispensability of Local Grants**

It is widely acknowledged that grant is indispensable for local government either for filling up resource gap or supporting local projects with spillover benefits or for any other purposes. But academic exercises to focus on such roles of grant is very few and far between. A theoretical perspective of the essentiality of grant for financing local programmes with spill-over effects may be found in the works of Oates (1972), Break (1980) and Ashwe (1986) among others. The case of grants as a necessary instrument for filling up resources gap at the sub-national level, on the other hand, is considered by the Indian Finance Commission Report (1984) and Kerala Municipal Finance Commission Report (1976).<sup>\*</sup> Other purposes for which grant may be needed most are reviewed by Schroeder (1987). This brief introduction precedes a critical discussion on the literature.

Oates (1972) assesses the roles of grants in achieving an efficient use of resources and equitable distribution of income under a federal system of governance. As one of his remarkable contributions, he argued that the Pigovian model of unit subsidy in individual case may well apply to the case of local grants when spent for projects with spill-over effects. He also answered the criticisms against Pigovian theory and held on to his view that despite some problems associated with the theory, it could still serve as the basis of the theory of local grants. In this process, Oates justified grant on the basis of inter-jurisdictional spill-over argument. In another scholastic attempt, he also showed that owing

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\* Kerala is a State within India.

to openness of local economies, problems of taxation are more acute at the local level than at the centre and on this plea, he recommended a greater central part in revenue collection adjusted with increasing role of grant and revenue-sharing. This is, indeed, a controversial issue as it goes against the spirit of decentralisation and on this account, its applicability to the Third World tends to be limited. Moreover, in the strict sense, the case of more grant to compensate for the loss of local revenue does not reflect the indispensability of grant. Another limitation of Oates' work is that he did not highlight the resource gap argument which is perhaps more important a factor in explaining the need for local grants particularly in a resource-poor developing economy.

Break (1980) makes critical reviews of various state and local grants in a multi-tier system of government. His approach to evaluating the role of grant seems to be more or less balanced and impartial as he duly focuses on both merits and demerits of grants. He states, though use of grant seems compelling, the case of grant rests to a large extent on second best, rather than first best consideration - better alternatives may exist in principle, but grant appears to be the best feasible means of attaining various fiscal and economic goals. He postulates that the rationale of grant is to meet three deficiencies of a federal system - (i) healing economic inefficiencies stemming from spill-over effects (ii) correcting various fiscal imbalances. (iii) redressing unmet needs of lower income people. Break's perception about essentiality of grant appears to be more broad-based than that of Oates. Particularly, an elaborate analysis of spill-over theory of grant goes to the credit of Break. But his theoretical contributions mainly confine to this aspect only and his similar treatment of other strands of economic rationale for grants is not at all remarkable.

Ashwe (1986), in his treatise on fiscal federalism in Nigeria, envisaged various economic rationales for grant including the aspects of spill-overs, fiscal (resource) gap and fiscal equity. Expressing his positive vision of spill-over argument, he iterated that despite limitations to the applicability of Pigovian principles, there is a compelling theoretical case for the use of grants based on efficiency. While interpreting this matter, he made some marginal contributions to the existing theory. He also appreciates the need for local grant for covering the fiscal gaps that originate from the mismatch between increasing spending liabilities and relatively static revenue authorities. The over-all analysis on various rationales of grant, nevertheless, lacks sufficient elaboration.

It appears from the review of existing literature that there has been more theoretical works and theories are more developed regarding the spill-over argument of grant in comparison to resource gap filling case of the same. The latter is more represented in the empirical works both at macro and micro level.

The role of grant in filling up resource gap is reflected in the Indian Eighth Finance Commission Report, 1982 (1984). It pleaded the case for central grants to state governments on several grounds, of which one important one was to cover the resource gap of these governments. The Commission made projections of revenue deficits for eleven states for the years from 1984-85 to 1988-89. These deficits survived even after making allowances for devolution of taxes. This leaves an indication that notwithstanding all-out efforts to mobilise resources locally, the revenue gap of state or local government is a likely case and this gap is to be redressed by grants.

In another work namely Kerala Municipal Finance Commission Report (1976), annual resource gap for urban local governments of the state was calculated at about Rs. 98.10 millions. To cover this gap, The Commission recommended six measures which include provision of grant in addition to other non-grant

measures to strengthen local finance. This means that non-grant measures are not enough to bridge this gap and for this purpose grant is needed most to supplement them. In this manner, the above two study reports came out with the crucial findings that the role of grant to bridge the resource gap of local bodies is indispensable. But as the reports had well-defined purposes to achieve and these purposes were served by operating within the limited periphery of empiricism, there was no attempt to enrich the analysis with theoretical exposition nor to diversify the rationale of grants. The findings suggest that the role of grant depends on the existing rigidities in the structure of local economies. The issue of externality reinforces the argument for grant.

Schroeder's (1987) comparative study of inter-governmental grants (with focuses on their various implications) in four Asian nations devotes an abridged coverage to the theory of grants. In this section he simply gives an account of purposes for which grants may be needed. All these are, in fact, notional arguments in favour of grants and there is no endeavour to substantiate grant as an essential element of local finance on the basis of pure theory or empirical analysis.

### **C) Effects of Grants upon Local Revenues/Expenditures**

Studies relating to impacts of grants on local taxes and expenditures are relatively scarce. Mcmillan (1981) observed that the effect of grants upon the fiscal behaviour of the recipients has not been more extensively investigated and therefore pleaded for further works in the area. Though he was mainly concerned with the case of Australia and Canada, his observation regarding relative shortage of grant's impact-based studies is equally true for developing countries like Bangladesh. This is revealed by a critical evaluation of the literature related to this field.

Bahl (1983) conducted a thorough enquiry into the grant system of Bangladesh. This is basically an evaluative study of the grant system pointing to a set of suitable policy measures. It also indicates some policy choices pertinent to designing grants system; the most important choice is related to trade-off between a relief and development orientation of the grants system. This study, however, did not cover an analysis of grants effects upon local revenues or expenditure which are key elements for complete evaluation of any grants programme. It is particularly important for a country like Bangladesh where most of the grants are in the category of unconditional general purpose grant which has, at least in theory, potentials to replace local revenues. Furthermore, the study recommended for inserting revenue effort criteria in grants allocation formula but it did not spell out how such a revenue stimulative grant can be practically evolved.

Schroeder (1983) reviews the finances of Zila Parishads and Union Parishads of Bangladesh both of which are rural local bodies. In this attempt the regression impact of various independent variables upon own revenues were measured. As a part of this, the effect of inter-governmental grants on resource mobilisation was tested through inserting per capital Zila Parishad normal and Rural Works Programme grants in the estimating equations. The results do not suggest any clear-cut relationship between grant and revenue. The explanation for such nature of findings is not, however, backed with adequate theoretical analysis.

Spahn's (1977) work is a relatively comprehensive theoretical analysis on possible effects of various types of grants upon local resource mobilisation. He graphically demonstrates how general purpose grant is likely to substitute local revenue and matching grant may stimulate it. He also tested the regression impact of general grants upon state-local taxation by using empirical data from Australia and found the results in the direction of his hypothesis. But the major

limitation of the study is the absence of any elaboration of ideal conditions in which the substitutive role of general grant is likely to hold good. In fact, these conditions are significant for the reason that the revenue effect of general grant may be other than substitutive if these conditions do not operate.

Mieszkowski and Stein (1983) reviewed trends in the national total of the expenditures of state and local governments in the United States for the period of 1929-82. Their findings reveal that the growth of federal grants has a positive role in the growth of these expenditures and that even after making allowances for the price and income effects and grants, a large positive residual remains which is partly explainable by the growth in school-age population. The positive impact of grant upon local expenditure also necessarily implies the former's similar impact upon local revenues which is a typical case of matching grant. Information about the typology of grant and their differential impacts upon local revenues, nevertheless, remains behind the analysis. Grant's impact upon local expenditure is tested through regression method but that even does not make any difference between different varieties of grant. Explanations of grant's positive impact upon expenditure do not include the issue if expenditure propensity of grant is higher than that of local revenues. In this regard, there is simply a passing reference to Gramlich's (1977) findings of higher expenditure propensity of grant relative to local revenues which is rather a normal case. But the study itself does not focus on this supply side factor as having influences upon local expenditures.

The above review of literature on local finance makes the following points clear :-

- a) Local finance is relatively a neglected area for the theoreticians. Particularly the works on local finance in Bangladesh suffer from conspicuous deficiency of theoretical expositions.

- ii) It appears that available literature on the subject leaves some gaps in areas directly linked up with financial performance of local government. These include quantitative estimation of relative importance of various revenue determinants, conceptualising a macro framework of revenue stimulative grant, considering an optimum (quantity) theory of grants, higher expenditure propensity of grants relative to local revenues etc. This study aspires to cover all these gaps while recommending, as an end product, a package of theoretically sound and practically feasible policies towards improving financial viability of local governments of the Third World in general and Bangladesh in particular.