CHAPTER II

THEORY OF LOCAL FINANCES

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2.1 INTRODUCTION:

The present study deals with the finances of Sangola Nagarpalika, which is a local government in the federal system of finance in India.

The theories of public finance as also expenditure mainly deal with the expenditure and taxation aspects of a national government rather than the local governments. The only theory which exclusively deals with the expenditure side of the local governments was presented by **Charles Tiebout.** We present below the gist of his theory followed by a discussion of functions and areas of financing various local governments in India.

2.2 THEORY OF LOCAL EXPENDITURE BY TIEBOUT:

Musgrave and Samuelsons work in public finance is the recent development in the field of "Applied Economic Theory". The two writers agree that no "market-type" solution exists to determine the level of expenditure on public goods.

The above discussion should not be applied to local expenditure. Charles M.Tiebout presents a solution for the level of expenditure for local public goods, which

reflects the preferences of the population more adequately than they can be reflected at the national level.

Theoretical Issue:

Samuelson defines public goods as collective consumption goods (xn+1, xn+2, ... xn+n), which all enjoy in common inthe sense that each individual's consumption of such good leads to no deduction from any other individuals consumption of that good, so that $xn+j = x^{i}_{n}+j$ simultaneously for each and every i th individual and each collective good. Many goods that appear to lack the attributes of public goods may properly be considered public goods if consumption is defined by external economies. The public goods is defined as the one which should be produced but for which there is no feasible method of charging the consumers. This definition allows for the objections of Enke and Margolis. This definition, however, does not remove any of the problems faced by Musgrave and Samuelson.

The main problem concerns the mechanism by which consumer voters register their preference for public goods. Both Musgrave and Samuelson show that in the vertically additive nature of voluntary demand curves, this problem has only a conceptual solution. There is no mechanism to force the consumer voter to state his true preferences. This problem can be solved through the political mechanism. This objective on the expenditure side is then combined

with an ability-to-pay principle on the revenue side,giving us our current budget, yet, in terms of satisfactory theory of public finance, it would be desirable:

(1) to force the voter to reveal his preference,

(2) to be able to satisfy them in the same sense that private goods market does; and

(3) to tax him accordingly.

Local Expenditure:

Msugrave and Samuelson have assumed that expenditures are handled at the central government level. The provision of governmental services as Police and Fire, Hospitals, Courts and education do not necessarily involve federal activity. However, many of these goods are provided by local governments. The important point is that the often neglected local expenditures are significant. The consumer voter may be viewed as picking that community, which best satisfies his preference pattern for public goods. This is an assumption about reality in the extreme model that follows the patterns are assumed to be absolutely fixed. The greater the number of communities and thne greater the variance among them, the closer the consumer will come to fully realizing his preference position.

A Local Government Model:

The implications of the preceding argument may be shown by postulating an extreme model. Here, the following assumptions are made:

(1) Consumer voters are fully mobile and will move at that community where their preference patterns which are set and best defined;

(2) Consumer voters are assumed to have full knowledge of differences among revenue and expenditure patterns and to react to these differences;

(3) There are large number of communities in which the consumer voters may choose to live;

(4) Restrictions due to employment opportunities are not considered. It may be assumed that all persons are living on dividend income;

(5) Public services supplied exhibit no external economies or diseconomies between communities;

(6) For every pattern of community services set by city manager who follows the preferences of the older residents of the community, there is an optimal community size, in the same sense that the average cost curve has a minimum for one firm but can be reproduced by another. There is seemingly no reason why duplicate community cannot exist. The assumption that some factor is fixed explains why it is not possible for the community in question to double its size by growth;

(7) The last assumption is that the communities below the optimum size seek to attract new residents to lower average costs. This assumption needs to be amplified. The case of the city that is too large and tries to get rid of residents is more difficult to imagine. Every resident who goes to the suburbs gets better schools and more parks. It is against the pattern the city has to offer. Moving or failing to move replaces the usual market test of willingness to buy a good and reveals the consumer voters' demand for public goods.

Comparison Model:

It is interesting to contrast the results of the preceding model with those of an even more severe model in order to see how these results differ from the normal market results. It is convenient to look at this severe model by developing its private market counterpart.

First assume that there are no public goods, only the private ones. The preferences for these goods can be expressed as one of 'n' patterns. Let a law be passed that all persons living in any one of the communities shall spend their money in the particular pattern described for that community by law. Given one earlier assumption (1) through (5), it follows that if the consumers move to the community whose law happens to fit their preference patterns,

they will be at their optimum. The 'n' communities, in turn, will then send their buyers to market to purchase the goods for consumer voters in their community. This is simply a lumping together of all similar tastes for the purpose of making joint purchases. The allocation of resources will be the same as it would be if normal market forces operated. The conceptual experiment is the equivalent of substituting the city manager for the broker or the middleman.

Now turn the argument around and consider only the public goods. Assume with Musgrave that the costs of additional services are constant. Further assume that a doubling of the population means doubling of the amount of services required. Let the number of communities be infinite and let each announce a different pattern of expenditure on public goods. Define an empty community as one that fails to satisfy anybody's preference pattern. Given these assumptions, including the earlier assumptions (1) through (5), the consumer voters will move to that community which exactly satisfies their preferences. This must be true, since a 'one person community' is allowed. The sum of the demands of the 'n' communities reflects the demand for local public services. In this model, the demand is exactly the same as it would be if it were determined by normal market forces.

Unless some sociological variable is introduced, this may reduce the solution of the problem of allocating

public goods to the trite one, of making each person his own municipal government. Hence, this model is not even a first approximation of reality. It is presented to show the assumptions needed in a model of local government expenditures, which yields the same optimal allocation that a private market would.

Local Government Model Re-Examined:

The first model, described by the first five assumptions together with assumptions 6 and 7, falls short of this optimum. Two related points need to be mentioned to show the allocative results of this model:

(1) Changes in the cost of one of the public services will cause changes in the quantity produced;

(2) The cost of moving from community should be recognized.

The distinction should not be blown out of proportion. Actually, the cost of registering demand comes through the introduction of space into the economy. Yet, space affects the allocation not only of resources supplied by local governments. But of those supplied by the private market as well. Every time, available resources or production techniques change, a new location becomes optimal for the firm. In fact, Koopmans has stated that the nature of the assignment problem is such that in a space economy with transports costs, there is no general equilibrium solution

as set by market forces.

Thus, the problems stated by this model are not unique. They have their counterpart in the private market we are maximising within the framework of the resources available. If production functions show constant returns to scale, with generally diminishing factor returns, and if indifference curves are regularly convex, an optimal solution is possible. On the production side, it is assumed that communities are forced to keep production costs at a minimum. Both trips take the consumer to market. There is no way in which consumer can avoid revealing his preferences in a spatial economy. Spatial mobility provides the local, public goods counterpart to the private market's shopping trip.

External Economies and Mobility:

Relaxing assumption (5) has some interesting implications. There are obvious external economies and diseconomies between communities. In cases in which the external economies and diseconomies are of sufficient importance, some form of integration may be indicated. In real life, the diseconomies are minimized, insofar as communities reflecting the same socio-economic preferences are contiguous.

Assumption (1) and (2) should be checked against reality. Consumer voters do not have perfect knowledge and set preferences nor are they perfectly mobile. The general

disdain with which proposals to integrate municipalities are met, seems to reflect, in part, the fear that local revenue expenditure patterns will be lost as communities are merged into a metropolitan area.

Policy Implication:

The preceding analysis has policy implications for municipal integration, provision for mobility and set local revenue and expenditure patterns.

On the usual economic welfare grounds, municipal integration is justified only if more of any service is forthcoming at he same total cost and without reduction of any other service. A general reduction of costs along with a reduction in one or more of the services provided cannot be justified on economic grounds, unless the social welfare function is known. For example, those who argue for a metropolitan Police force instead of local Police, cannot prove their case on purely economic grounds. If one of the communities were to receive less Police protection after integration than it received before, integration could be objected to as a violation of consumers' choice.

Policies that promote residential mobility and increase the knowledge of the consumer voter will improve the allocation of government expenditure in the same sense

that mobility among jobs and knowledge relevant to the location of industry and labour improve the allocation of private resources.

Finally, one can raise the normative question whether local government should have a fixed revenue expenditure pattern in a large, dynamic metropolis. This may be impossible. Perhaps, it could more appropriately be considered by rural and suburban communities.

Conclusion:

It is the contention of Samuelsons' article that for a substantial portion of collective or public goods, this problem does have a conceptual solution. If consumer voters are fully mobile, the appropriate local governments whose revenue expenditure are set, are adopted by the consumer-voters, while the solution may not be perfect because of the institutional rigidities. This does not invalidate its importance. The solution is the best that can be obtained given preferences and resource endowments.

Those who are tempted to compare this model with competitive private model may be disappointed. Those who compare the reality described by this model with the reality of the competitive model, given the degree of monopoly, friction may find that local government represents a sector where the allocation of public goods need not take a backseat to the private sector.

2.3 FUNCTIONS AND FINANCING OF VARIOUS LOCAL GOVERNMENTS:

The local body is an integral part of the national administrative machinery. The local government creates new democratic leaders. It provides facilities like primary-education, control of epidemics, drainage, water-supply, streetlighting, etc., to the people. The origin of the local government can be found in the old self-governing villages panchayats in India and the ancient Greek city states.

The local government does not face economic problems sharply in comparison with the State and Central Government. The local body is always in contact with the people. So, it faces many difficulties. After all, the principles and problems of the local finance are almost similar to the principles and problems of the state and federal finances.

The local bodies are dependent on the state government in their financial matters. The financial position of the local bodies is almost poor. They always deserve a sympathetic treatment on the part of the state governments, particularly in view of the performance of their ever increasing functions in the community. Different states have different types of local bodies with different functions to perform. Some of the large cities have municipal corporations. The local government is different from the improvement trusts and development authorities in several metropolitan towns.

In most states, there are village panchayats, which have special functions assigned to them and have their own sources of income. The main local bodies may be classified into the following categories:

(1) Village Panchayats,

(2) District Boards,

(3) Municipalities and Municipal Corporations.

The village panchayat is an elected body which may cover one, two or more smaller villages. The village panchayat is the foundation of our democratic form of government. The village panchayats help people in involving in the national politics. The village panchayats have been given powers to impose taxes. These are property-tax, taxes on trades, vehicle-tax, theatre-tax, etc. The more widely adopted taxes by the village panchayats are: (1) the general property tax, (2) taxes on land revenue or rent on land, (3) profession-tax, and (4) tax on animals and vehicles. The main functions of village panchhayat include the provision of judicial services, social and community servies and economic services for the local people. The village panchayats provide protection to the life and property of the people residing within their jurisdiction. They also perform the duty of registration of births and deaths in their villages. The village panchayat, at present, include the construction of panchayat-ghar repairs and maintenance of wells for drinking

water, construction of buildings for primary schools, etc. Under the system of decentralized planning, the functions of the village panchayat are likely to expand in future.

The territorial jurisdiction of District Local Board is generally a revenue district. The state governments have usurped some of the functions of the district boards. For example, the responsibility of providing primary education is transferred to ad-hoc boards. Some of the State departments have entered in the education, medical services, etc., which are the functions of the local bodies. Some of the village panchayats have assumed responsibility for performing certain functions which were earlier performed by the district boards. The district boards derive a substantial portion of their revenue from the government grant-in-aid. The various taxes, fines and fees, etc., are the other sources of their revenue. The district boards deal with the functions which are neither of local nature nor do they cover the whole state either.

The municipalities are the local bodies created for urban areas to look after the local affairs like sanitation, public health, lighting of urban roads, etc. The standard patterns of municipalities in India is a council elected by the municipal voters and a President thereof elected by the council.

The functions of the municipalities may be divided

into the following two parts: (1) obligatory, and (2) optional or non-obligatory functions. The sources of revenue available to the municipalities are not fully tapped. Their revenue is inadequate in relation to the growth in their expenditure.

The municipal corporations are set up in big cities. They are important in comparison with the municipalities. Sometimes an administrative officer is appointed by the concerned state government or the central government. The corporations perform important functions like providing education upto middle or secondary level, sanitation, water-supply, drainage, etc. The municipal corporations impose taxes. They are: (1) tax on buildings, (2) taxes on goods particularly octroi and terminal taxes, (3) personal taxes on professions, trades and property, pilgrim tax, (4) taxes on vehicles, (5) theatre tax, (6) advertisement tax, and (7) water tax.

Finances of Local Bodies:

(1) Taxation: The local government levy a number of taxes such as property, profession, animals, octroi, etc. There are no particular taxes which are particularly allowed to local bodies;

(2) Share of Taxes: These taxes are imposed and collected by state governments and proceeds of which are shared by them with the local bodies, for example, motor

vehicle tax, entertainment-tax.

(3) Grant-in-Aid: These grants are not important in the local bodies' revenue, although the larger grants are given mainly for education, medical and public health purposes out of the grants for goods.

(4) Non-tax Revenue: It consists of the fees, fines and incomes obtained from some public undertakings as tramways, buses and distribution of electricity, etc.

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