Chapter-II

APPROACH

2.1 The 73rd and 74th Constitutional amendments have transferred many subjects and functions to the rural and urban local bodies of the country. The responsibility for the provision of local public services is now predominantly vested with these local bodies. Indeed, increased decentralization can be expected to lead to an improvement in the level and quality of local services, better matching of local services to the preferences of the local citizens, and greater transparency and accountability. The basic thrust of the Constitutional amendments was to endow local bodies with adequate powers, responsibilities, and resources, to enable them to function as autonomous institutions of self government. As there can be no functional autonomy without financial autonomy, and as the revenue raising capacity of local bodies is limited, revenue transfers from the State Government to augment the resources of local bodies is necessary to enable them to provide adequate level of public services.

2.2 As a matter of fact, inter-governmental transfers are required to promote vertical balance, equalize horizontally, offset externalities and to take advantage of administrative efficiencies.

2.3 Vertical imbalances arise when there is a mismatch between the expenditure responsibilities of local body governments and their revenue raising powers. Owing to the Constitutional provisions, central and state governments have natural advantages over local governments in raising revenue as the relatively more productive sources of revenue are in the Union and State lists in the Seventh Schedule of the Constitution. On the other hand, local self governments have been entrusted with the responsibility of providing many types of public services, which results in the mismatch between the expenditure that such local governments are expected to incur and the resources locally available to them. The resulting gap must therefore be met by transferring resources from higher levels. It is to be noted that although local governments have access to various sources of revenue, the majority of these sources suffer from low yields.

2.4. Horizontal equalization is another justification for inter-governmental transfers, because of the disparities in fiscal capacities of local bodies. To the extent that local governments are left to rely exclusively on their own resources, there would be wide differences in the variety and standard of public services offered by these governments due to differences in their resource endowments and administrative capacities. Inter governmental transfers can be an appropriate mechanism to equalize such inter-jurisdictional differences in fiscal capacity of local governments. The justification for fiscal equalization rests on the concept of equal rights and equal treatment of all citizens in a country or state irrespective of where they may reside. Equalization through transfers is one approach through which differential access to public services and facilities can be narrowed down. However, achieving full equalization is an elusive goal not only because the magnitude of transfers required may be too large but also because of the difficulties in making an objective assessment of the fiscal capacity and fiscal needs of the local governments.

2.5 Another rationale for such transfers is to encourage local bodies to spend more on services which yield positive benefits extending beyond the jurisdiction of such local bodies and conversely discourage expenditure on services which may have a negative impact on neighbouring areas. Inter-governmental transfers are also justified on administrative grounds, as central and state governments are usually better placed to assess and collect taxes than local governments. It is therefore argued that it would be administratively more efficient to collect taxes at the central or state levels and then allocate the revenues to local governments in the form of transfers.

2.6 It is to be noted that steps to bring about vertical and horizontal equalization are not independent. The Union Finance Commission has generally recommended fiscal transfers from the central to state governments with a view to mitigating the vertical and horizontal imbalances simultaneously. Indeed, the exercise of vertical equalization is accompanied by efforts to bring about horizontal equalization which determines the inter-se distribution of funds among various state governments. This State Finance Commission has more or less adopted the approach of the Union Finance Commissions. In this connection, it is important to note that State Finance Commissions have been assigned a role that is somewhat different from the Union Finance Commissions. While the Union Finance Commission is to suggest devolution of funds between the centre and the states, the SFC is to recommend the assignment of specific taxes and duties of the state government to the local bodies, and also to determine the distribution of funds among different tiers of local bodies as well as their inter-se distribution.

2.7 In framing its award for the transfer of resources from the State Government to the local body governments, this Commission has made an attempt to adhere to the principles of equity, efficiency, autonomy and fiscal discipline. It is to be pointed out that due to the inadequacy of up-to-date and reliable data, the State Finance Commission has chosen to eschew the gap filling approach. As revenue gaps have not been estimated, the Commission has not recommended any grants for meeting revenue deficits. It has sought to devolve resources to rural and urban local bodies on the basis of their fiscal capacity and cost disadvantages in providing services. Fiscal capacity has been estimated by using proxies like per capita tax collections and per capita income in the primary sector net of mining and quarrying. Cost disadvantages have been taken into account by considering differential expenditure requirements arising from factors such as area, number of service recipients and O & M obligations.

2.8 The award of the Commission, consisting of transfer of revenues from the State Government to rural and urban local body governments, has been designed by appropriately structuring the horizontal and vertical dimensions of the transfers. The vertical dimension has been sought to be addressed by determining a divisible pool comprising of a certain percentage of the net collections of all taxes and duties of the State Government. The issue of horizontal balance has been addressed by recommending an allocation system which provides for transfers through tax sharing on the basis of objectively defined formula.

2.9 The sharing of taxes by origin on the basis of the existing statutory provisions and also executive decisions has been prevalent since long. The taxes presently falling under this category are motor vehicles tax, entertainment tax, land revenue and local rate. Under this approach, local bodies, receive an amount based on collections of the concerned tax within their geographical boundaries. It would be pertinent to point out that the State Government determines the tax rate and the tax base for these taxes and that the local bodies are not in a position to influence the amount of revenue coming from such sources. The taxes are in fact collected by the State Government machinery and then are to be devolved to local bodies as transfers on the basis of the existing legal provisions and executive decisions. The derivation based tax sharing, therefore, does not allow much scope for local government autonomy. More importantly, such tax sharing arrangements are usually counter equalizing since local governments with larger tax bases will benefit from larger transfers. Thus, the Commission favours the discontinuation of this system and recommends its replacement by global sharing of all State taxes on the basis of objectively defined formula.

2.10 Formula based transfers make use of objective quantitative criteria to determine the allocation of the divisible pool of revenues among local governments. This approach provides the State Government with a mechanism to promote equity, efficiency, autonomy and fiscal discipline. It also provides for greater transparency and certainty in the distribution of resources. However, the design of the formula depends very largely on the availability of reliable and adequate data. Since virtually no data base is being maintained by rural local bodies and as the information base of the urban bodies is also extremely limited, this Commission faced considerable difficulty in formulating its award on the basis of this approach. But as formula based transfers are generally accepted as the best means of sharing taxes between different levels of government, the Commission decided to follow this approach on the basis of the information made available by the concerned government departments. It has accordingly made use of criteria such as population, area, district per capita income, urban infrastructure facilities, and per capita tax collections. While doing so, the Commission strongly urges both the State and local body governments to develop a proper data base within a definite time frame covering at least their revenue and capital receipts, revenue and capital expenditures, infrastructure facilities available within their jurisdiction, population, and area, as well as information pertaining to various development indicators.

2.11 It is to be stressed that local body finances cannot be viewed in isolation and must be considered as a part of the overall fiscal system comprising of the finances of the Central as well as the State Government. The terms of reference have mandated that the Commission shall, among other considerations, be guided by the objectives of balancing the revenue accounts of the State Government as well as local bodies, and by the resources of the State Government and the demands thereon. The Commission has, therefore, attempted to balance the fiscal requirements of the local bodies with that of the State Government. Keeping in view the extremely difficult and precarious financial position of the State Government, the Commission has attempted to keep the magnitude of transfers within the fiscal capacity of the State Government after taking into account the basic requirements of the local bodies. In any case, the State Government may project the financial requirements of local bodies on the basis of this report, while submitting its memorandum to the Twelfth Finance Commission. Rural and urban local governments must appreciate that the transfers recommended by the Commission are meant to supplement and not substitute their existing sources of revenues and that determined and sustained efforts have to be made by them to raise their own tax and non-tax revenues from all sources. This will not only enable them to provide certain minimum levels of public services but will also engender greater fiscal discipline by linking expenditures to resource mobilization.

2.12 The Commission observes that the devolution of resources from the State Government to the local body governments can play only a limited role in facilitating the provision of public services to citizens. Improvements in quantity and quality of public services and facilities provided by local bodies can take place only when they become fully functional in the manner envisaged by the 73rd and 74th Constitutional amendments. It is, therefore, imperative that the decentralization process be taken to its logical conclusion and that all the schemes being predominantly implemented within the jurisdiction of local bodies be transferred to them alongwith the available manpower and budgetary support. As the rural local bodies have recently been constituted, the transfer of schemes alongwith staff and funds may be done in a phased manner within a given time frame. In this connection it is imperative that an elaborate capacity building exercise be undertaken at the local level to enable the local body staff to successfully execute their responsibilities. With a view to effecting functional autonomy and encouraging decision making at the grass root levels, transfer of funds to local bodies should not be entirely tied or conditional in nature. Rather, it would be advisable to adopt funding patterns that consists of an appropriate balance of tied and untied funds, the composition of the funding pattern being determined by the objectives of the programmes and schemes. At the same time, the existing legal provisions and rules empowering the State Government to intervene in areas relating to the own tax and non tax revenues of local bodies should be reviewed so as to provide local bodies adequate freedom to determine tax rates, tax bases, and decide on issues which have vital implications for their finances.