Chapter II

The Approach of the State Finance Commission

I. INTRODUCTION

1.1 Since the initiation of the process of restructuring of the rural and urban local bodies in Madhya Pradesh under the new legislations enacted in accordance with 73 and 74 constitutional amendments respectively, considerable progress has been made in the process of decentralisation and self governance in the state. The new legislations are intended to devolve powers, functions, responsibilities, authority and finances to local bodies in the state, with the ultimate objective of enabling them to function as autonomous institutions of self-government. The speed and commitment with which the state government has passed the conformity legislations, conducted elections and appointed the statutory bodies, are indications of the sincerity with which attempts have been made by the government to follow the constitutional mandates.

1.2 No federal system of government throughout the world envisages complete autonomy for any level of government in any country. In India it is the direct responsibility of the state government under the constitution to give such powers, authority and resources to local bodies which are essential for building up a viable and vibrant system of local self-government, within the parameters of the legislation enacted for the purpose.

1.3 Functional decentralisation will remain on paper, if a corresponding and commensurate financial devolution is not made to different territorial governments. The main task of the State Finance Commission (SFC) is to ensure that, given the distribution of functions and responsibilities by the state government to local bodies in accordance with constitutional provisions, adequate matching financial powers and funds are placed at their disposal, and that too without such constricting conditions, as would impinge upon their autonomy. The creation of the SFC under the Constitution has added a new
dimension to fiscal federalism and decentralization of public finances in the Indian federal system which is likely to undergo substantial changes in intergovernmental fiscal relations and transfers in accordance with the periodic recommendations of SFCs.

1.4 The first SFC has to function under severe constraints and difficult situation. It has no precedents, practices or guidelines to depend upon, while discharging its constitutional obligations. It had to face considerable difficulties in getting adequate and reliable data. Its recommendations, therefore, were hedged by a number of assumptions. The second SFC has the advantage of making a draft on the experience of the first SFC, its approach, its methodology, its constraints and its recommendations. The report of the first Commission may be considered as the bench-mark and the best launching pad for the second SFC to take up its exercise. In addition, the second SFC can draw upon the collective wisdom of the deliberations of the first FCs of other states. The second Commission may obtain building blocks from diverse sources, but the design of the building will be its own.

1.5 The tasks and functions of the SFC are contained in its Terms of Reference (TOR) which are, by and large, guided by the constitutional provisions and the requirements of the state. Given its tasks and within the framework of its TORs, the Commission, in the first instance, has proceeded to formulate its approach to the tasks assigned to it.

2. Decentralisation - The Keynote

2.1 The Commission believes that decentralisation does not imply merely creation of different levels of administration and delegation of some powers, functions and finances, but also implies evolving procedures, methods, techniques and organizing flows, communications, reciprocal interaction between different layers of the government. Democratic decentralisation implies devolution of decision-making powers to the people's institutions, in respect of functions and responsibilities assigned to them.
3. The Approach of the Commission

3.1 The systematic approach of the SFC has been to initially identify the functional responsibilities of different tiers of urban and rural local bodies. The principle of fiscal federalism also lends support to this approach that expenditure assignments should precede revenue assignments. The revenue considerations are, therefore, guided by expenditure requirements at different levels and cannot be worked out in advance of expenditure assignments. In fact, expenditure assignments are more decentralised than revenue collections.

4. Assessment of Expenditure Needs

4.1 The expenditure needs of local bodies flow from functions which they are expected to perform under respective legislations. This would necessitate the collection of information/data from local bodies regarding their expenditure on different functional heads for a certain period. Against the actual, the Commission has identified the normative standards of public/civic services and also the minimum level of basic services, and estimated the cost of providing such services by the local bodies. At the local level, we have to ensure a minimum standard of basic services, like water supply, primary health care, primary education, reasonably good roads, conservancy, etc. to the citizens throughout the country, so that no citizen shall suffer because of his/her choice of residential location. A pragmatic-normative approach should underlie such an exercise. The estimates of requirements of local bodies have to be made for basic and essential services. The expenditure requirements have been projected for five years period covering 2001-2006, based on average trend and also making allowance for the improvement of services and population growth.
5. The Scope of the Commission - An Integrated View of Devolution

5.1 To take a total view of development and disparities, it is essential that the SFC takes into account both plan and non-plan expenditure requirements of local bodies. In this context, an important question arises, whether the determination of the magnitude of plan funds and their allocation to the local bodies and their distribution among different categories of local bodies, should also be considered by the SFC? The Central Finance Commission constituted under Article 280, has to look after only non-plan revenue expenditure requirements of state governments. But the Constitutional amendment provisions do not draw any distinction between Plan and non-plan financial requirements of local bodies. In fact, at the local level, the distinction between plan and non-plan expenditure is blurred, since most of the local bodies do not maintain their plan and non-plan accounts separately. It would be in the fitness of things, if the SFC takes an integrated view of finances of local bodies, both in terms of development and maintenance of assets. It needs to be pointed out that functions of local bodies listed in schedules XI and XII, need both plan and non-plan expenditure.

5.2 The first SFCs in some states had included the devolution of both plan and non-plan funds in their schemes of devolution. But the first SFC of Madhya Pradesh had confined scope of its recommendations to only non-plan funds, leaving the allocation of plan funds to the State Planning Board. The TOR given to the second SFC limit the recommendations of the Commission to "not only balancing the receipts and expenditure on revenue account of both the state government, on the one hand, and the panchayats and municipalities, on the other, and also generation of surplus for capital investment and reducing fiscal deficit". The Commission is also required to make recommendations for the maintenance of capital assets created already and maintenance expenditure on plan schemes completed by 31st March, 2000. Despite the
need for taking up development and maintenance needs of local bodies by the same agency, the TOR set by the State Government limit the scope to revenue account which includes revenue receipts and revenue expenditure, and measures for balancing the two.

5.3  Once the expenditure estimates of existing as well as projected needs are made to provide certain minimum level of essential services to be rendered during a certain time-frame and also for improvement of such services in areas where minimum levels have been attained, the SFC would be required to recommend measures for better fiscal management, consistent with efficiency and economy in expenditure and also for the speedy, efficient and effective delivery system of services. The local bodies are required to implement in their respective areas a number of programmes/projects funded by outside agencies like the state, central government and foreign funding agencies. The SFC has also taken into account such agency functions of local bodies and expenditure incurred thereon, to take an integrated view of development of areas. It has to be examined whether consequent upon the constitutional amendments, the state government has transferred adequate funds as well as the services of employees along with transfer of a number of functions and activities to local bodies.

6. Design of Resource Transfers

6.1  Once the estimates of expenditure, existing as well as projected are made as per norms, the question of revenue mobilization, revenue assignments, design of transfers, becomes a critical element in providing resources to local bodies. The design of resource transfers will lay down certain principles relating to tax assignment, grants-in-aid and revenue sharing regime. However, the actual matching of expenditure needs with resource potential is largely dependent on revenue mobilisation effort of local bodies, both in respect of tax revenue and non-tax sources of revenue.
7. Dependence of Local Bodies on State Government for Devolution of Functions and Finances

7.1 Local bodies need adequate financial resources in order to discharge their expenditure responsibilities devolved upon them. There was no provision in the Constitution for a list of taxes and duties which could be levied by local bodies. The 73 and 74 constitutional amendments also do not make such a provision. The ultimate decision of authorising and assigning selective taxes to local bodies, continues to reside with the state legislature. The two constitutional amendments have kept the financial powers of local bodies within the jurisdiction of the state governments. Similar is the case regarding devolution of functions and responsibilities of local bodies.

7.2 A look at the provisions of the two amendments shows that these amendments have succeeded only in providing a long list of functions and responsibilities to be devolved to local bodies, without doing much in empowering local bodies with financial powers. In fact, paucity of funds constitutes a major constraint faced by local bodies in the state. The financial condition of local bodies, therefore, largely depends upon the state government transfers through tax sharing, assignment of revenues and various grants.

8. The Extent of Exploitation of Resources by Local Bodies

8.1 The SFC has examined the financial resources of local bodies for a specific period, classified into tax revenue and non-tax revenue, and also the extent of devolution of resources from the state government. The main sources of revenue are (i) own locally generated revenues, both tax and non-tax; (ii) resource transfers from higher level governments, particularly the state government, which include assignment of revenue and grants-in-aid, both general and specific; (iii) borrowings. Fiscal autonomy largely depends upon the extent to which own resources are raised by the local bodies. It is a fact that level of resources that can be raised locally is restricted by narrow economic base of local areas. But the reluctance of local bodies to tax people and poor administrative capacity at the local level, also account for the poor financial position of local bodies. It has to be examined empirically by the
SFC as to what extent local bodies have exploited their own resources and also to what extent power to levy taxes and introduce changes in rates of taxes, is restricted by the state government. In a federal set-up some restrictions are inevitable. A highly decentralised tax system may distort the allocation of mobile resources or factors of production and stand in the way of creation of a domestic common market. Since self-effort to raise resources may be one of the criteria for determining devolution of resources from the state government to local bodies, the SFC has made efforts to collect such data from local bodies and also ascertain reasons for poor performance on this front.

9. Estimation of Revenue Gap

9.1 The determination of the size of revenue gap of local bodies is the most crucial input to developing the fiscal package for local bodies in the state. The revenue gap measures the difference between the revenue expenditure and the own resources of local bodies. But for measuring the future financial needs, the revenue gap is considered as the difference between expenditure needs and revenue raising capacity of local bodies on the basis of certain norms and standards. The revenue gap would determine the devolution of resources from the state government to local bodies.

9.2 The major limitation in this respect that the Commission has faced is the non-availability of over time data regarding revenue and expenditure of local bodies in the state. The fiscal data relating to local finances provided by the XI Finance Commission in its report, is too aggregated and does not give breakdowns of revenue and expenditure into individual components. The level of expenditure does not indicate the level of services, since we do not know the performance of services in terms of their quality. Despite these limitations, we have decided to analyse the macro level data provided by the XI Finance Commission, in the absence of any other source from which macro level data might be available.

9.3 The more reliable method would be collection of data and information from local bodies through questionnaires designed for the purpose. But in this
regard, we are constrained in our approach to estimate the revenue gap, because of the inability of the local bodies to supply us data in the manner in which we needed. However, this method would be more reliable to make projections of future needs and revenue receipts. One of the objectives of micro-level approach is to capture the financial strengths and weaknesses of local bodies and use the results for estimating future requirements.

10. Determination of the size of the divisible pool

10.1 One of the important tasks of the SFC is to determine the size of the divisible pool and the principles regarding the determination of divisible pool, taking into account the functional domain of the state government, on the one hand, and that of local bodies on the other. The major instruments provided in the scheme of transfers to local bodies are revenue sharing and grants-in-aid. This divisible pool consists of three components - share in tax revenue, assignment of revenue from certain taxes and grants-in-aid.

10.2 In the pre-constitutional amendment regime, transfer to local bodies were dominated by grants which promoted dependency syndrome. Now, the place of grants is gradually being taken by tax sharing and assigned revenue for discharging functions, for equalization of regional development and for ensuring minimum level of basic services. Revenue sharing may be either in the form of share of specific taxes levied and collected by the state government or a consolidated share in the gross/net proceeds of the state government.

10.3 The provisions regarding the TOR of the SFC do not restrict sharing revenue to any specified taxes or duties, levied and collected by the state government. In other words, the SFC is not obliged to confine its recommendations in respect of revenue sharing to certain specific taxes and duties. In case, the SFC decides, it may link the devolution of funds from the state government to local bodies, to the totality of state revenues rather than revenue from specific taxes or duties. The first FC of Madhya Pradesh, after making a review of the financial position of the state government and also of local bodies, had recommended that a certain percent of gross proceeds of entire tax and non-tax
revenue of the state government, be transferred to local bodies, according to the criteria laid down by the Commission. The approach of the second SFC in this regard has been mainly guided by its TOR and the Constitutional provisions.

### 11. The fiscal package

11.1 The primary objective of the constitutional amendment is to bring about an improvement in the delivery and performance of services rendered by local bodies. The aim of fiscal package is to ensure the achievement of this objective. The SFC has adopted the following steps essential for developing such a package:

i) Review the macro economic environment within which local bodies operate in the state.

ii) Undertake an appraisal of the finances of local bodies.

iii) Estimate the revenue gap, separately for rural and urban local bodies.

iv) Determine the fiscal package for financing future expenditure.

v) Determine the size of divisible pool consisting of share in own tax revenue of the state, assignment of revenue and grants-in-aid.

vi) Evolve criteria for determining the share of rural and urban local bodies in the divisible pool.

vii) Allocate the total share of rural local bodies among Gram Panchayats, Janapad Panchayats and Zila Panchayats, and total share of urban local bodies amongst city corporations, municipal councils and nagar panchayats, on the basis of a well-conceived criteria.

viii) Evolve well-defined criteria for determining grants-in-aid and their \textit{inter-se} distribution among different types of local bodies. The Commission has explored the possibility of evolving suitable conditionalities linked with grants-in-aid, in the interest of efficiency, productivity and sound fiscal management.

### 12. Beyond the fiscal package

12.1 The SFC has made an attempt in the direction of restructuring and rationalizing the local tax structure, with a view to making it more simple,
equitable, elastic and productive, giving less scope for evasion, and ensuring better tax compliance. To create sense of fiscal responsibility and give them a stake in the cost-effectiveness of expenditure, it is necessary to devolve adequate taxation powers to local bodies. If local bodies show some tangible results by way of benefits of expenditure, people may be willing to bear the burden of higher taxation and their taxable capacity may expand. Burdening the people without benefits can never be the answer. The vicious circle of low benefits, low taxation and back to low benefits, needs to be broken. Moreover, the dictum "You pay and I spend" may often result in fiscal profligacy, militating against sound financial policy and also accountability.

12.2 The efficiency of the fiscal package can be significantly enhanced, if it is accompanied by supplementary measures for improving the finances of local bodies. These measures relate to:-

i) The adequacy and efficiency of the administrative structure of local bodies.

ii) Appropriateness of the system of municipal accounting.

iii) Soundness of the system of audit.

iv) Soundness of the existing system of property taxation.

v) Feasibility of privatization of certain local services and activities.

vi) Reforms in tax and non-tax structure of local bodies.

13. Restructuring of state government finances

13.1 The whole exercise of devolution of resources from the state government to local bodies has been attempted against the background of financial position of the state government and the need for balancing receipts and expenditure on revenue account and reducing fiscal deficits. An evaluation of state government finances and their projections in the next five years, has been an essential exercise of the SFC. Such an evaluation has been normative in character.

13.2 The capacity of the funding agency and its economic health has been one of the major considerations which the Commission has kept in view while
evolving the scheme of devolution of resources and designing the fiscal package.

14. Conclusion

14.1 The SFC has highlighted a number of issues with which it has attempted to grapple with in its deliberations. These issues, by and large, emerge from the terms of reference set by the State Government and the constitutional obligations. The Commission has also delineated its approach to tackle these issues. The Commission is charged with the responsibility of recommending measures for building up the financial capability at the local level, with a view to ensuring fiscal autonomy, both by strengthening the financial base and by augmenting resources. But at the same time the Commission is also expected to suggest some checks and balances and a system of accountability to be instituted at the local level, to check financial profligacy. Gap filling transfers will discourage mobilization of own resources by local bodies. The dependency syndrome needs to be checked. Too much protection leads to syndrome of "never-maturing" infant.

14.2 While keeping itself within the parameters of the TOR and the limitations of state finances, the Commission has recommended measures which will permit better implementation of programmes and schemes and also permit greater scope for autonomy.

14.3 A systematic approach of the SFC has been to initially identify the functional responsibilities of local bodies and then estimate the financial requirements on a normative basis, estimate the revenue gap and recommend a scheme of devolution of resources from the state government to local bodies - a devolution which is adequate under the given circumstances, is predictable and stable, realistic and transparent and conforms, as far as possible, to the principles of public finance. The Commission has laid down a well-conceived criteria for inter-se distribution of the divisible pool among different category
of local bodies, taking care of need for reducing regional disparities. It has also
laid down the principles of tax assignment, revenue sharing and grant
mechanism, besides reviewing the financial position of local bodies and
suggesting measures for the augmentation of their resources. The Commission
has also suggested measures regarding proper budgetary procedures and
control and audit of accounts. The purpose of making explicit the principles on
the basis of which recommendations have been made, is to know the rationale
of specific recommendations and also to explain as to how far these principles
have been incorporated in its recommendations. At best, these principles can
provide a point of reference and a norm for evaluation.

14.4 The SFC has also examined the possibilities of privatization of certain local
services, to ensure cost-effectiveness and efficient delivery of such services.

14.5 The manner in which suggestions given by the Commission in respect of
issues discussed and approach evolved to tackle such issues, are implemented
will determine the journey on the road to effective and sound system of
decentralization and self-government.

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