4

Local-level Fiscal Decentralization

State Finance Commissions and Devolution

With the 73rd and 74th constitutional amendment, the structure of intergovernmental fiscal relations underwent necessary and significant changes following the statutory constitution of the State Finance Commissions (SFCs) in all the states (barring Mizoram, Nagaland and Meghalaya). These States have constituted several rounds of SFCs, and they have submitted their Reports (in Appendices 4A.1, 4A.2 and 4A.3, we have provided the details of SFCs in terms of their constitution and submission of Reports and actions taken); however, getting the fiscal system to catalyze effective public service delivery in a big way has not progressed to the extent one would have expected.

Often decentralization in India has been criticized on grounds of being only political and not enough in terms of administrative and fiscal devolutions (World Bank, 2000). This is primarily due to the fact that although local body elections in rural and urban areas of almost all major states have taken place and a three-tier system exists in the structure, yet there has been an inadequate transfer of functionaries and funds to the local bodies, giving them autonomy in the real sense. Devolution of functionaries is an important step towards administrative decentralization. It has been observed that devolution of functionaries is lagging behind devolution of functions and funds in all the states, excepting a few. Functionaries for all the 29 subjects enlisted in the Eleventh Schedule have been devolved only in Karnataka followed closely by Kerala. Table 4.1 gives the position of the major states regarding transfer of funds, functions and functionaries for the PRIs in rural areas. The table also shows that in West Bengal and Rajasthan while transfer of functions is hundred per cent, the states are lagging behind in terms of funds and functionaries.

Table 4.1: Status of devolution of subjects in the PRIs (as on 31 January 2004) as a percentage of total subject

State	Funds	Functions	Functionaries
Andhra Pradesh	17.24 (5)	58.62 (17)	6.90 (2)
Assam	–	100.00 (29)	–
Bihar	27.59 (8)	86.21 (20)	–
Chhattisgarh	34.48 (10)	100.00 (29)	31.03 (9)
Goa	20.69 (6)	20.69 (6)	–
Gujarat	51.72 (15)	51.72 (15)	51.72 (15)
Haryana	–	55.17 (16)	–
Himachal Pradesh	6.90 (2)	89.66 (26)	37.93 (11)
Karnataka	100.00 (29)	100.00 (29)	100.00 (29)
Kerala	89.66 (26)	89.66 (26)	89.66 (26)
Madhya Pradesh	34.48 (10)	79.31 (23)	31.03 (9)
Maharastra	62.07 (18)	62.07 (18)	62.07 (18)
Orissa	31.03 (9)	86.21 (25)	72.41 (21)
Punjab	–	24.14 (7)	–
Rajasthan	62.07 (18)	100.00 (29)	62.07 (18)
Tamil Nadu	–	100.00 (29)	–
Uttar Pradesh	13.79 (4)	41.38 (12)	20.69 (6)
Uttaranchal	–	37.93 (11)	37.93 (11)
West Bengal	41.38 (12)	100.00 (29)	41.38 (12)

Note: Figures in parenthesis are the absolute number of subjects.

Source: Ministry of Rural Development, Government of India.

However, even those states, namely Karnataka and West Bengal, where decentralization is believed to have struck firm roots, only a small fraction of the revenue of rural local bodies is raised by themselves. The dependence on transfers is high in most of the states and a large part of the expenditure gets determined by various tied transfers from the higher levels of governments leaving very little flexibility for the local government to implement their own programme. This is clear from Table 4.2. Apart from a few northern Indian states, status of own revenue generation for PRIs is dismal for the rest of the states. Among the fairly decentralized states, Kerala has a higher share of own revenue in total revenue. The ULBs are however situated in a better position than the PRIs.

Table 4.2: The share of own revenue of local bodies in total revenues: Major states (in per cent)

			PRIs			
States/year	**2002–03**	**2003–04**	**2004–05**	**2005–06**	**2006–07**	**2007–08**
Andhra Pradesh	22.8	19.7	20.4	18.6	20.5	19.4
Assam	1.5	0.8	0.7	0.5	0.5	0.9
Bihar	0.0	0.0	0.0	0.0	2.0	2.7
Chhattisgarh	3.8	3.6	3.1	2.1	1.5	1.0
Gujarat	1.6	1.6	2.5	1.5	1.6	2.0
Haryana	51.3	48.3	59.7	42.5	41.6	29.2
Himachal Pradesh	6.2	3.8	3.7	3.0	2.8	2.6
Jharkhand	1.8	1.7	1.9	0.4	0.2	1.7
Karnataka	1.5	2.4	1.6	1.7	1.8	2.8
Kerala	13.5	11.8	11.8	12.0	11.4	8.8
Madhya Pradesh	17.5	21.7	7.2	5.2	1.6	1.5
Maharashtra	5.9	7.8	6.2	4.9	4.8	4.9
Orissa	1.1	1.0	1.1	1.0	0.6	0.6
Punjab	31.3	34.8	34.2	23.4	15.7	20.2
Rajasthan	6.3	6.5	4.3	3.8	4.5	4.4
Tamil Nadu	9.5	7.7	7.9	8.3	8.0	6.1
Uttar Pradesh	4.6	3.6	3.5	2.9	3.7	3.7
Uttarakhand	8.5	10.4	10.2	7.0	5.4	0.1
West Bengal	5.0	5.7	5.9	3.7	4.8	0.0
			ULBs			
Andhra Pradesh	58.4	46.5	49.2	52.1	49.7	58.5
Assam	86.4	60.4	53.9	58.7	49.9	38.2
Bihar	80.5	75.4	50.4	24.1	17.9	14.6
Chhattisgarh	32.6	24.9	25.1	25.8	19.8	14.1
Gujarat	77.9	79.3	77.1	74.8	76.9	61.5
Haryana	83.7	74.4	76.7	54.1	57.8	33.5
Himachal Pradesh	41.3	58.0	53.5	57.1	47.8	0.0
Jharkhand	21.5	29.4	31.8	25.8	24.6	20.2
Karnataka	60.5	52.2	46.2	40.0	31.5	34.2
Kerala	40.9	40.9	37.4	39.1	39.7	39.5

Table 4.1 continued

Table 4.1 continued

Madhya Pradesh	22.4	20.8	15.5	13.2	10.9	11.6
Maharashtra	82.4	83.8	80.0	80.9	77.8	76.1
Orissa	6.5	6.6	8.8	8.5	6.7	4.5
Punjab	93.6	93.0	95.8	82.2	75.4	89.1
Rajasthan	33.5	30.4	32.8	38.9	37.1	39.5
Tamil Nadu	42.2	43.6	45.4	41.2	38.9	38.4
Uttar Pradesh	27.5	28.6	27.5	18.3	18.2	14.8
Uttarakhand	28.0	27.7	29.2	34.2	24.8	21.8
West Bengal	51.8	56.1	54.2	47.6	54.6	51.7

Source: fincomm.nic.in.

A study by Pethe and Lalvani (2008) revealed that the average PRIs' own revenues are below 1 per cent of the states' own revenue for 15 major states, and PRIs depend on their revenue requirements from upper tiers to the extent of 77.0 per cent. The study also noted that the shares allocated to various states by the Finance Commission from the funds set aside for PRIs do not seem to be in consonance with the incremental performance of these states in the arena of fiscal decentralization. Pethe and Lalvani (2008) tried to classify the states as per fiscal decentralization and buoyancy (Table 4.3). As per their estimates, only five states appear in the 'good' category, both in terms of their ranks in fiscal decentralization and buoyancy. This indicates that revenue efforts by the third tier have been very slow and the PRIs continue to depend heavily on the upper tiers of government for meeting their expenditure, especially through Union Finance Commissions. The terms of reference of Union Finance Commissions with regard to the local bodies, their recommendations, criteria and quantum of devolution to the local bodies are given in Appendix 4A.3. Despite these efforts, the lack of flexibility of finances at the local level still thwarts the degree of fiscal autonomy.

Table 4.3: Fiscal decentralization and revenue buoyancy matrix

		Fiscal decentralization	
		Good	**Not good**
Buoyancy	Good	(I) Kerala, Madhya Pradesh, Karnataka, Goa, Maharasthra	(II) Assam, Tamil Nadu, Punjab
	Not good	(III) Andhra Pradesh, Gujarat	(IV) Haryana, Orissa, West Bengal, Rajasthan, Uttar Pradesh

Source: Pethe and Lalvani (2008).

This chapter takes up the issues related to funds with special reference to the institutional mechanisms of local-level fiscal decentralization, in particular, the State Finance Commissions, for some of the selected states in India, namely Kerala, Karnataka and West Bengal. The next section discusses the rationale of setting up the State Finance Commission (SFC) and delves upon the legal and fiscal fiats of the SFCs to be followed by a critical analysis of the SFCs in Kerala, Karnataka and West Bengal. The last section gives a broader critique of the SFCs in general.

Interpreting the legal and fiscal fiats of SFC

The main thrust to form SFCs in the states was to rationalize the fiscal relations at the sub-national levels and set further norms and practices for periodic fiscal corrections and local governance. However, given the fact that a one-to-one correspondence between functional responsibilities and financial resources at various levels of government is a difficult proposition in a federation, the problem gets compounded with the ambiguity of the constitutional provisions, which does not clearly lay down the expenditure jurisdiction or a fiscal domain for the PRIs/ULBs. These are left to the state legislatures to enact and formulate according to the suitability of the states. The state legislature is expected, by law, to endow the Panchayats and Municipalities, with powers and authority as it may consider necessary to enable them to function as institutions of self-government. Moreover, such law may contain provisions for the devolution of powers upon Panchayats and Municipalities.

Under the new fiscal devolution system/framework, every state government is required to constitute a finance commission once in every five years and entrust it with the task of reviewing the financial position of local governments and making recommendations.

Articles 243I and 243Y define the responsibilities and tasks for the SFCs. These tasks may be chartered as follows:

(i) Review the finances of the local bodies in accordance with the functional responsibilities which include the preparation of plans for economic development and social justice.
(ii) Fix the size of the divisible pool taking into account the functional domain of the state, on the one hand, and that of the PRIs and urban local bodies (ULBs) on the other.
(iii) Evaluate the vertical gap at various levels taking into account the functional responsibilities on the one hand and tax assignments on the other.

(iv) Suggest measures for improving the financial position of panchayats and ULBs, which include revenue sharing and grant-in-aid.
(v) Design methods for the *inter se* distribution of the share of PRIs and ULBs on an equitable and efficient basis.
(vi) Make explicit the principles underlying the measures suggested.

However, a closer interpretation of these articles shows that the SFCs cannot perform their tasks independent of Articles 243G, 243H, 243J, 243ZD and 243ZE that relate to the administrative and political decentralization aspects. The Constitution (73rd and 74th) Amendment Act, 1992 and Article 280 (3)(c) have altered the erstwhile fiscal devolution system and framework between the states and municipalities as also between the centre and the states. The Union Finance Commission is now required to suggest measures to augment the consolidated fund of a state to supplement the resources of the local governments on the basis of the recommendations made by the finance commissions of states. With nearly two decades of enacting the 73rd and the 74th Constitutional Amendment Acts (CAAs), currently all states have submitted the third finance commission reports stating recommendations for financial devolution and chalking out formula models of revenue sharing and tax assignments/devolutions and are on way towards the fourth state commission reports. In practice, most SFC reports have devoted their attention to the distribution of state revenues among local bodies, along with the analysis meant to provide an objective basis for this allocation.

Analyzing the selected SFCs of India

As mentioned, in this section we review the recommendations of the three SFCs, namely Kerala, Karnataka and West Bengal. The administrative and political decentralization in Kerala and West Bengal has been quite strong, given the respective state history of strong local level bodies functioning even before the legislation of the PRIs/ULBs. In Karnataka however the process of decentralization gained momentum with the introduction of the 'concepts of efficiency and equity' in service delivery. Before we discuss the specific recommendations of the SFCs of these states, we give a brief overview of the fiscal position of the local bodies in these three states based on the data available from the Thirteenth Finance Commission. A look at Table 4.4 shows the level of fund utilization by the local bodies at the rural and the urban areas in these three states.

Table 4.4: Fund utilization of the local bodies

	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
			PRI			
Karnataka	94.5	94.4	94.5	94.8	93.9	94.6
Kerala	55.4	75.3	73.9	71.8	70.3	68.5
West Bengal	126.9	133.4	126.2	77.1	120.1	106.3
			ULB			
Karnataka	96.9	88.4	122.8	109.7	109.5	107.0
Kerala	71.5	87.9	82.9	88.5	102.9	105.8
West Bengal	109.0	105.6	117.4	119.0	119.3	125.2

Source: www.fincommindia.nic.in.

It has been already observed from Table 4.2 that the local bodies suffer from poor revenue resources. It is observed that the percentage of own revenue to total revenue is at very low levels, especially for the PRIs, indicating high level of dependence on transfers and grant-in-aids. For the ULBs however, there exists some resource generation for all the three states. This is explicable due to more avenues of tax assignments in the urban areas compared to the rural areas. The composition of revenue of the local bodies shown in Tables 4.5 and 4.6 reveals that it is heavily skewed by transfers.

Table 4.5: Revenue sharing and dependence of local bodies on higher governments for funds in PRIs

	As percentage of total revenue					
	2002–03	**2003–04**	**2004–05**	**2005–06**	**2006–07**	**2007–08**
			Karnataka			
Own revenue of which:	1.5	2.4	1.6	1.7	1.8	2.8
Tax revenue	1.5	2.4	1.6	1.7	1.8	2.8
Own non-tax	0.0	0.0	0.0	0.0	0.0	0.0
Central transfers	13.0	12.5	10.2	10.3	11.8	13.1
EFC/TFC	1.7	1.5	1.3	2.3	4.4	0.8
Assignments and devolution	83.8	83.6	87.0	85.7	82.0	83.3

Table 4.5 continued

Table 4.5 continued

Grant-in-aid from states	0.0	0.0	0.0	0.0	0.0	0.0
Kerala						
Own revenue of which:	13.5	11.8	11.8	12.0	11.4	8.8
Tax revenue	7.7	6.0	5.7	6.3	5.7	4.9
Own non-tax	5.9	5.8	6.0	5.7	5.7	3.9
Central transfers	11.5	10.5	11.5	9.7	8.9	10.3
EFC/TFC	4.4	3.5	3.1	7.9	7.2	6.5
Assignments and devolution	9.5	8.4	7.3	7.8	72.6	74.3
Grant-in-aid from states	61.1	65.9	66.3	62.6	0.0	0.0
West Bengal						
Own revenue of which:	5.0	5.7	5.9	3.7	4.8	0.0
Tax revenue	1.7	1.7	1.5	1.0	1.2	0.0
Own non-tax	3.3	4.0	4.4	2.7	3.7	0.0
Central transfers	48.4	46.5	45.7	47.5	38.0	42.8
EFC/TFC	4.1	3.3	5.0	6.4	12.3	8.1
Assignments and devolution	0.0	0.6	1.0	15.2	8.2	7.6
Grant-in-aid from states	39.8	39.1	36.6	24.9	32.9	26.6

Source: www.fincommindia.nic.in.

Table 4.6: Revenue sharing and dependence of local bodies on higher governments for funds in ULBs

	As percentage of total revenue					
	2002–03	**2003–04**	**2004–05**	**2005–06**	**2006–07**	**2007–08**
Karnataka						
Own revenue of which	60.5	52.2	46.2	40.0	31.5	34.2
Tax revenue	37.8	31.3	22.1	21.8	18.9	18.5

Table 4.6 continued

Table 4.6 continued

Own non-tax	22.7	20.8	24.1	18.2	12.6	15.6
Central transfers	5.7	5.7	7.9	1.6	0.9	6.3
EFC/TFC	0.4	1.2	4.3	3.0	6.9	2.3
Assignments and devolution	32.7	40.6	41.6	55.3	60.7	57.3
Grant-in-aid from States	0.0	0.0	0.0	0.0	0.0	0.0
Kerala						
Own revenue of which:	40.9	40.9	37.4	39.1	39.7	39.5
Tax revenue	28.4	26.9	24.5	25.1	24.7	23.7
Own non-tax	12.5	14.0	12.9	13.9	15.0	15.8
Central transfers	6.3	5.5	6.0	5.3	3.8	5.2
EFC/TFC	2.7	2.7	2.5	4.7	4.6	4.1
Assignments and devolution	0.1	0.1	0.0	0.0	0.5	0.5
Grant-in-aid from states	40.3	40.9	53.9	50.4	0.0	0.0
West Bengal						
Own revenue of which:	51.8	56.1	54.2	47.6	54.6	51.7
Tax revenue	29.2	28.9	29.5	24.5	25.6	23.5
Own non-tax	22.6	27.2	24.7	23.1	29.0	28.2
Central transfers	0.0	0.0	0.0	0.0	0.0	0.0
EFC/TFC	2.1	3.2	2.6	2.5	4.5	4.2
Assignments and devolution	11.7	12.9	12.0	15.5	13.8	16.4
Grant-in-aid from states	34.5	27.8	31.2	34.4	27.1	27.7

Source: www.fincommindia.nic.in.

Among the three states considered, Kerala has been hailed as a model of decentralization for others. Yet Table 4.7 shows that in education-specific transfers to local bodies from the states, figures are quite low. However, under compensation and assignment devolution to local bodies, Kerala ranks among the highest. In fact Kerala is the only state where almost more than one-third of the total plan funds are transferred as untied funds to local bodies. The service-specific transfers are generally part of various plan schemes and are mostly of tied nature. Since the requirements of Kerala are different from other states, tied grants serve little purpose (Chakraborty et al., 2009). In Kerala, the education and health requirements need 'second generation measures' as the human development indicators are comparable to many of the developed countries. The state decentralization model with pro-social sector public policy stance is often held responsible for Kerala's achievements.

Karnataka on the other hand shows highest education-specific transfers to the PRIs. Table 4.7 suggests that although Karnataka has had a degree of fiscal devolution in education, health seems to lag behind. The state finance accounts record no transfers to local bodies in this account. Apart from the education-specific expenditures, although less than Kerala, Karnataka also has considerable transfers to local bodies under compensation and assignment devolution. As criticized normally, West Bengal figures do show a lower degree of fiscal devolution. It has often been critiqued of the West Bengal decentralization model that political decentralization has been of the highest form, whereas it has lagged behind in fiscal decentralization. Table 4.7 shows that there have been transfers under compensation and assignment devolution in West Bengal but to a substantially low degree. Further, the West Bengal finance accounts do not show any local body transfers from state under education or health categories. In fact the state's main expenditure is on the salary and wages account.

Clearly there exist problems when it comes to fiscal devolution in the states. Although Kerala shows relatively better performance, yet fiscal decentralization is yet to be achieved fully if the own source revenue (OSR) mobilization and other fiscal requirements are considered. The SFCs were mandated to look into these problems within the states and providing guidance to achieve higher degrees of fiscal decentralization. In this section, the recommendations of each SFCs are analyzed keeping in mind the limited fiscal autonomy enjoyed by the states.

Table 4.7: Education and health-specific fiscal transfers from state to local bodies

	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
Kerala						
Transfers to local bodies on education						
As percentage of revenue expenditure	0.65	0.55	0.49	0.47	0.52	0.40
As percentage of education expenditure	3.22	2.76	2.59	2.52	2.77	2.20

Table 4.7 continued

Table 4.7 continued

Transfers to local bodies on health						
As percentage of revenue expenditure	0.10	0.14	0.07	0.06	0.06	0.05
As percentage of health expenditure	2.03	2.70	1.34	1.10	1.04	1.06
Transfers as compensation and assignments to local bodies (PRIs and ULBs combine)	0.39	0.47	–0.02	0.00	9.18	8.43
Total transfers to Local Self Self-Ggovernments (LSGs) as percentage of social sector expenditure with Compensation and assignments	3.35	3.60	1.59	1.65	31.35	28.40
Total transfers to LSGs as percentage of total revenue expenditure	1.15	1.17	0.54	0.53	9.75	8.89
Karnataka						
Transfers to local bodies on education						
As percentage of revenue expenditure	12.35	11.68	11.29	12.70	12.42	12.92
As percentage of education expenditure	65.17	66.00	63.53	73.61	72.82	70.88
Transfers as compensation and assignments to local bodies (PRIs and ULBs combine)	3.05	2.95	3.26	4.13	4.90	5.15
Total transfers to LSGs as percentage of social sector expenditure with Compensation and assignments	45.79	44.72	46.19	53.04	52.96	51.46

Table 4.7 continued

Table 4.7 continued

Total transfers to LSGs as percentage of total revenue expenditure	15.40	14.63	14.54	16.83	17.32	18.07
West Bengal						
Transfers as compensation and assignments to local bodies (PRIs and ULBs combine)	1.00	1.00	0.90	1.07	1.10	1.12
Total transfers to LSGs as percentage of social sector expenditure with Compensation and assignments	3.05	3.21	2.92	3.41	3.30	3.20
Total transfers to LSGs as percentage of total revenue expenditure	1.00	1.00	0.90	1.07	1.10	1.12

Source: State Finance Accounts, 2007–08, GoI.

To start with, both WBSFC and Karnataka SFC take a total view of their development needs and financial requirements. West Bengal's first state finance commission had an approach of treating the resources required as entitlements on tax revenue which seemed to be rational approach given the constitutional mandate to promote institutions of self-government (Article 243G) and autonomous planned efforts (243ZD). The SFC noted that the entitlements suggested 'are only a redeployment of funds which are now being spent for the districts already' (WBSFC, 1995). The annual allocations to gram panchayats (GPs) included, besides entitlements, grant-in-aid and their own funds, which also included donations from the public. On the other hand, Karnataka SFC adopted sort of a pragmatic-normative approach, which indicated that the choice of residence of a person should not affect his/her access to the minimum level of essential public/civic services. Like WBSFC, it also takes a totalitarian approach towards finance and development and recommended a share of the state's own revenue to be allocated to the local self-governments. Karnataka SFC emphasized on ensuring a minimum standard of basic services at the local level and its projected financial requirements accounted for both non-plan and plan expenditure. For Kerala, the recommendations of the finance commission also related to tax sharing and included rationalization of tax structures to improve fiscal health of the Panchayat institutions. It recommended a revision in number of taxes besides adding several new taxes at the local levels. In fact, some states have begun to give their SFCs more focused TORs that identify key issues specific to the state's requirements. Kerala has been a forerunner in this sense. In its TOR for the current finance commission, it has worked upon measures of resource mobilization of its own. The specific recommendations of the Three SFCs are discussed below in a summarized form:

Karnataka SFCs recommendations

The standardized system of decentralization in Karnataka came into existence only after the 73rd Constitutional Amendment (1992) through the Karnataka Panchayati Raj Act (1993). It provided for a three-tier structure of rural local government at zilla (district), taluk and gram (village) levels. As of now, there are 27 zilla panchayats (ZPs), 175 taluk panchayats (TPs) and 5,659 gram panchayats (GPs) in Karnataka. All the three levels are vested with executive authority. The first tier of decentralized government, the GPs, included a group of five to seven villages with population coverage of 5,000–7,000. Salient features of decentralization in Karnataka are given in Table 4.8.

Table 4.8: Salient features of decentralization in Karnataka

Population	**52 million**
Rural local governments	5,870
Zilla parishads	27
Block panchayats	175
Gram panchayats	5,659
Total elected number, rural governments	84,886, 44% women
Devolution of subjects to panchayats	All 29 subjects
Channeling of public expenditure through panchayats	About 20%

Source: World Bank, 2004.

The 73rd amendment also directs the GP to convene a meeting of the gram sabha (village assembly) at least once in six months, thereby making the village assembly an integral part of the decentralization process. Though the three tiers were expected to be independent of each other, in actual practice, there exists a hierarchical structure with TPs having a supervisory role over GPs and ZPs supervising both GPs and TPs. The recommendations for improving the process of fiscal decentralization in Karnataka identified by Rao et al. (2004) is given in Box 4.1.

The state had a spate of growth in the knowledge-based industries including software industry, development of educational and urban infrastructure, which was supplemented by a pragmatic stance in relation to governance and decentralization. This has been reinforced by innovative policy recommendations on fiscal devolution from the first two Finance Commissions.

Box 4.1: Enhancing fiscal decentralization in Karnataka: Recommendations

The prevailing system in Karnataka has been essentially 'top-down' with the state government transferring schemes along with the employees for selected functions, with an inherent assurance to protect their salaries, hierarchy and promotional possibilities. The World Bank study, therefore, proposes reform in four broad areas – functional assignment, augmenting revenues, intergovernmental transfers and public spending at the local levels.

Functional assignment: overlapping and consolidation

(i) Consolidation and rationalization of large number of central, state and district sector schemes into broad categories.
(ii) Clarity in the role of the implementing agencies in order to check misappropriation.
(iii) Strengthening accountability of the employees to the local bodies.

Augmenting revenues: reforms in policies and institutions

(i) Grant of more fiscal autonomy to the ZPs and TPs.
(ii) More significant role for GPs in the overall scheme of fiscal decentralization.
(iii) Enhancing the revenue productivity of the GPs.
(iv) Enhancing tax enforcement at the GP level.
(v) Assignment of new taxing powers.
(vi) Redesigning of the tax system.

Issues in intergovernmental transfers:

(i) Over-dependence on transfers.
(ii) Determining the requirements of the different types and tiers of local governments.
(iii) Importing allocative flexibility and autonomy.
(iv) Enhancing the role of GPs in public service provision.
(v) Building up an information base for better design.

Box 4.1 continued

Box 4.1 continued

Improving efficiency in public spending at local levels:

(i) The GPs should be assigned important schemes and activities that benefit the majority of residents so that more expenditure is incurred at the GP level.
(ii) Transfers to the GPs must be linked to the local priorities.
(iii) The overall distribution of expenditures among the GPs should be made more equitable.

Source: Rao et al., 2004; World Bank, 2002.

Table 4.9: Fiscal devolution framework for local governments in Karnataka

Level of devolution	1st SFC frame work	2nd SFC frame work
1st level devolution Local governments Share in state's resources.	36 per cent of non-loan gross own Revenue receipts (NLGORA)	40 per cent of non loan gross own Revenue receipts (NLGORR)
2nd level devolution Division of resources between urban and rural local government	Based on five indicators Population 33.3% Area 33.3% Backwardness indicators Illiteracy rate 11.11% Population per Hospital bed 11.11% Road length Per sq. km. 11.12% Total weightage of backwardness Index 33.34% Total 100.00% Application of these indicators resulted into 85% share to PRIs and 15 % to ULBs– that is 85% of 36 = 30.60% 15% of 36 = 5.40% Thus PRIs share came to: 30.60% of NLGORR municipal bodies- 5.40% of NLGORR	Based on same five indicators Population 30% Area 30% Backwardness indicators Illiteracy rate 15% SC and ST population 15% Persons per hospital bed 10% Total weightage of Backwardness index 40% Total 100% Application of these weightage indicators resulted into 80: 20 sharing between PRI and municipal bodies that is – 80% of 40 = 32% of NLGORR 20% of 40 = 8% of NLGORR Thus, PRI share came to: 32% of NLGORR ULBs – 8% of NLGORR

Table 4.9 continued

Table 4.9 continued

3rd level devolution/ sharing of funds among different tiers of rural and urban local governments Part A – Panchayats Part B – Municipal bodies	40% Zilla panchayat 35% Taluka panchayat 25% Gram panchayat 100% (30.60% of NLGORR) This formula was not accepted by the state government, as there was high ratio of committed expenditure, that is, salary. As a result, actual allocation took place on basis of salary expenditure only.	– The committed expenditure to be earmarked first out of the amount (32% of NLGORR) available to PRIs – Block grants to the gram panchayats at the rate of ₹3.50 lacs per gram panchayats to be deducted next from the above amount – Block grant to increase every year by ₹25 thousand per village – ₹100 million to be deducted next from balance for giving incentive grant – Remaining amount to be shared by ZP and TP in the ration of 65:35
4th level devolution/ sharing of funds among different urban local governments	Composite index made up of five weighted indicators for inter-reallocation among urban local governments Population 33.3% Area 33.3% Backwardness indicators – Illiteracy 11.11% – Population per bed 11.11% – Road length per sq. km 11.12 Total 33.4%	Two weighted indicators for *inter se* allocation among urban local governments Population 67% Illiteracy 33% Total 100% 2nd SFC dropped other indicators like area, SC and ST population and population per hospital beds as 2001 data was not available and it felt that 1991 data should not be applied.

Source: Compiled from Joshi, 2006.

While the First State Finance Commission (FSFC) was set up in 1994 and submitted its report in 1996, and the Second State Finance Commission (SSFC) was set up in October 2000 and submitted its report in December 2002, the third finance commission was set up in 2006 and delayed submission of its report. The recommendations of the first two commissions have been laid down in Table 4.9. All the commissions have recommended for a sound framework for fiscal devolution.

West Bengal SFCs recommendations

West Bengal has illustrated a continuing strong commitment to devolution based upon a high degree of political certainty resulting from over more than 30 years of control by the CPI(M)-led Left Front Government with a well-embedded political structure at the local level. The state government has enacted a range of innovative legislations designed to strengthen the local-level bodies. This includes the Chairperson in Council (Cabinet style) system, coordinated local planning mechanisms and the basis of a systematic fiscal framework. The Government of West Bengal has consistently supported the empowerment of local government. The state's urban and rural local government system has been successfully functioning with regular elections and devolution of powers for more than three decades. The state has also led other states in India in developing a legislative framework for decentralized local government, with separate Municipal Corporation Acts for large urban local authorities, a progressive West Bengal Municipal Act, 1993 governing the municipalities and the West Bengal Panchayats Act, 1973 for the various levels of rural local bodies in the state. The major problem of the Panchayati Raj system in West Bengal is low level of fiscal autonomy of the local level government. The organizational structure of the third-tier system in West Bengal is given in Table 4.10.

Table 4.10: Third-tier system of West Bengal

	West Bengal
Zilla parishads	16
Block panchayats	340
Gram panchayats	3314

Source: State Finance Commission Report, West Bengal.

The state has been facing fiscal crisis for a long period of time and that has impacted upon the funds of the local governments as well. In the pre-SFC periods, urban local authorities used to derive revenue from government grants, property tax and other assigned taxes such as entertainment tax, motor vehicle tax, etc. Despite having the delegated power to raise revenues, urban local authorities in West Bengal have largely depended upon government grants to meet their establishment costs. The entire salary payments and 80 per cent of the dearness subvention are provided by the state government together with a significant portion of pension dues. These have led to a situation in which urban local authorities have become complacent about their own resource mobilization and consequently, civic services are often poor. In relation to expenditure, the single largest expenditure head is salary and wages, which generally accounts for nearly 60 per cent of expenditure. Urban local authorities, thus, rely heavily on government grants, plan funds and development schemes to fund the necessary infrastructure works. Studies have repeatedly shown that urban local authorities are capable of significantly increasing their own revenues and easing the pressure on the state for funds. Rural local authorities have three major sources of revenue: schematic funds, untied funds from the centre and funds from the state. Although PRIs are empowered to collect certain local taxes and levy user charges, they are essentially grant-dependent and experience poor local revenue collection. However, Table 4.11 shows that the own source revenue (OSR) collection by the PRIs in West Bengal has increased marginally over the last few years. It also shows that the lowest tier, that is the GP, collects the major share (almost 60 per cent) of own source revenue when compared to the other two tiers of the Panchayat. However, over the years, it is observed that the highest tier (ZP) has gained in its share of collection at the cost of the lowest ring (GP) of the panchayat. Simultaneously, Table 4.12 shows an increase in the grants to ULBs, with a marginal rise in OSR in absolute terms.

Table 4.11: Tier-wise OSR collection panchayats as worked out by the Third State Finance Commission, West Bengal (₹ in crore)

Year	Gram panchayat			Panchayat samiti	Zilla parishad	All tiers
	Non-tax	Tax	Total			
2002–03	14.17	15.7	29.87	7.26	6.12	43.25
2003–04	16.15	15.41	31.56	9.45	14.24	55.25
2004–05	18	20.08	38.08	12.09	13.01	63.18
2005–06	23.93	41.37	65.3	16.68	15.24	97.22
2006–07	25.95	32.4	58.35	15.92	22.2	96.47
Percentage share of OSR collection by each tier (%)						
2002–03	32.8	36.3	69.1	16.8	14.2	100.0
2003–04	29.2	27.9	57.1	17.1	25.8	100.0
2004–05	28.5	31.8	60.3	19.1	20.6	100.0
2005–06	24.6	42.6	67.2	17.2	15.7	100.0
2006–07	26.9	33.6	60.5	16.5	23.0	100.0

Source: Third SFC Report, Government of West Bengal.

Table 4.12: Revenue earned from the profession tax and grants to the ULBs (₹ in crores)

Year	2002–03	2003–04	2004–05	2005–06
Revenue collection on other taxes on income and expenditure	230.51	229.76	237.43	264.41
Grants to ULBs	0	5.24	9.09	9.62

Source: Ibid.

As the SFCs were set up in the state, the devolution framework was also recommended by individual SFCs. All the three SFCs so far have recommended formulas to strengthen the decentralization mechanism. The Third Finance Commission of West Bengal was constituted in 2006 and submitted its report in 2008 and has also stressed on the need for increased revenue mobilization, especially for the PRIs at the GP levels. It has also recommended for a progressive increase of the 'untied' fund allocation at the minimum rate of 12 per cent per annum on a cumulative basis for the subsequent four financial years. 20 per cent of 'untied' fund may be utilized for maintenance of assets by the Local Self-governments (LSGs). This concept of 'untied entitlement for devolution of funds' has been an innovative approach of the West Bengal government. The FSFC recommended 16 per cent of total tax collected as devolution to local governments in state as an 'untied entitlement' which has been largely retained in the following Second and Third Commission's recommendations. All the three SFCs are of the opinion that the concept of untied fund is most necessary for strengthening grass-roots level democracy and will lead to participative democracy. The commissions felt strongly that only funds of untied nature would provide local government to carry out development schemes drawn by them to meet their felt needs. The Third Commission also felt that the streamlined and rigid centrally sponsored projects have cut and dried framework, which does not permit modifications to suit the local requirements. In the next section, we discuss about the devolution framework as suggested by the finance commissions of the state. At the PRI level, the vertical allocation formula is given in Table 4.13. The fiscal devolution framework as suggested by the First, Second and Third Finance Commissions are discussed in Table 4.14.

Table 4.13: Vertical allocation in PRIs of West Bengal (in per cent)

Vertical level	FSFC	SSFC	TSFC
Zilla parishads	30	20	12
All panchayat samitis together	20	20	18
All gram panchayats together	50	60	70

Source: SFC, West Bengal.

Table 4.14: Fiscal devolution framework of West Bengal

Level of devolution	1st SFC framework	2nd SFC framework	3rd SFC framework
1st level devolution local governments share in state's resources.	16% of total taxes collected by the state in a financial year to the local governments as 'untied entitlement'.	16% of total taxes collected by the state in a financial year to the local governments as 'untied entitlement'. Subject to minimum amount of ₹7,000 million.	16% of total taxes collected by the state in a financial year to the local governments as 'untied entitlement'. Subject to minimum amount of ₹8,000 million constituting around 5% of the state's own net tax revenue for the year 2008–09. Additional recommendation of a progressive increase of the 'untied' fund allocation at the minimum rate of 12% p.a. on a cumulative basis for the subsequent four financial years.
2nd level devolution division of resources between districts.	Based on six indicators Population 50.0% Area 10.0% Illiteracy rate 10.0% Backward population 10.0% Rural population 10.0% Inverse ratio of per 10.0% capita bank deposit (including PAC working capital) Total 100.00%	Based on eight indicators Population 50.0% Density of population 7.0% Illiterate population 7.0% SC population and 8.0% Minority population ST population 7.0% Rural population 7.0% Infant mortality 7.0% Per capita net district Domestic product (NDDP) at constant price 7.0% Total 100.00%	SC population (PSCi) 0.25 (or 25%) 2) ST population (PSTi) 0.50 (or 50%) 3) Minority population (PMi) 0.25 (25%) 4) Rural population (PRPi) 0.1 (10%)

Table 4.14 Continued

Table 4.14 Continued

3rd level devolution/ sharing of funds among rural and urban local governments	On the basis of population under three categories: District municipal fund District panchayat fund District special area fund (for the areas not falling under municipal or panchayat category)	On the basis of proportion of rural and urban population in the district: District municipal fund District panchayat fund (after setting aside 0.4% amount from district's allocation for hilly areas)	On the basis of proportion of rural and urban population in the ratio 24:76 with allocation of 0.726% of the total 'untied' fund of the state as entitlement to the hill areas.
4th level devolution/ sharing of funds among different tiers of local governments A – Among urban local governments (intra-ULG allocation of district municipal fund)	On the basis of a further set of weighted population and socioeconomic measures (population, literacy, scheduled caste/tribe, population density, length of kutcha drains, etc.).	Based on five indicators: Population 50.0% Density of population 12.5% SC and ST population as per 1991 census 12.5% Non-literates 12.5% Length of Kutcha drains in municipalities 12.5%	Based on seven indicators: Population 50% Backward population Segments 3.8% Female non-literates 12% incidence of poverty 12% Proportion of un-surfaced roads 4% Weakness in service provision 4% Sparseness of population (inverse of population density) 4% Incentive support for ULBs 10.2%
4th level devolution/ sharing of funds among different tiers of local governments B – Among rural local government	Zilla parishads 30.0% Panchayat samitis 20.0% Gram panchayats 50.0%	Zilla parishads 20.0% Panchayat samitis 20.0% Gram panchayats 60.0%	Zilla parishads 12% Panchayat samitis 18% Gram panchayats 70%

Source: 1st, 2nd and 3rd Finance Commission Reports of West Bengal.

The Third State Finance Commission has taken up some additional indicators for fund devolution. It differs from the earlier commissions in the sense that it takes into account the backwardness of areas in terms of female illiteracy, food insecurity and hunger indexes, human development index and availability of safe drinking water and also takes into account the proportion of marginal workers at the GP level as one of the factors/indicators of fund devolution.

The recommendation of SFCs of West Bengal in terms of devolution has considerably reduced arbitrariness in the devolution. It guarantees a non-discretionary assured grant for each PRI that could be spent according to the priorities set by themselves, even though the dependence of PRIs on grants would continue in West Bengal. Yet another notable development is that the SFC made it a point that any scheme of devolution of resources from the state level to local bodies should be from the pool of state's own taxes instead of individual tax-based sharing, since growth of individual taxes vary considerably from year to year.

Apart from this, there were significant changes in the planning process at the district level. Earlier, the district plans consisted mostly of departmental schemes drawn up by the departments, may be with the participation of lower tier officials of the departments, but independently of the elected bodies. The role of the three-tier Panchayats in the district plan largely consisted of utilization of funds provided to them for poverty alleviation programmes or as untied funds. The integration of planning at the district level was more of a formality before the SFC came. The new entitlement scheme recommended by SFC has provided the elected bodies with considerable funds to pursue their own priorities through the plans they can draw up. The flexibility of district plans thus increased considerably.[1]

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1 Against the backdrop of local level fiscal decentralization in West Bengal, an MIT study by Chattopadhyay and Duflo (2001) has measured the impact of feminization of governance at local level on the outcomes of decentralization with data collected from a survey of all investments in local public goods made by the village councils in one district in West Bengal. They find that women leaders of village councils invest more in infrastructure, like drinking water, fuel and roads, which is relevant to the needs of rural women, and that village women are more likely to participate in the policymaking process if the leader of their village council is a woman. However, without direct evidence on the nature of women's preferences relative to those of men's and since women's reservation in the leadership positions in local government was not linked to the distribution of women in the village, this study does not quite address how local democracy affects the underrepresented groups in the village to implement their desired outcomes (Bardhan, 2002). However, placing women in leadership position in governance at the local level can change the expenditure decisions of the local bodies and in turn changes the types of public good investments at local level more corresponding to the revealed preferences ('voice') by women (Stern, and Nicholas, 2002).

Kerala SFCs recommendations

Though it was only in 1991 that Kerala (like the rest of India) came to have elected bodies at the district level, the civil conditions of the state have been ideal for democratic decentralization reforms for a longer period. Widespread literacy, sharply reduced deprivation and absolute poverty, good health performance, successfully carried out land reforms, powerful class and mass organizations, etc. have acted in synergy for Kerala as an ideal state for introduction of participatory local democracy.

Popularly known as the 'Kerala Model', the state has demonstrated how appropriate redistribution strategies can meet the basic needs for citizens despite low levels of economic development. However, Kerala has failed to translate high social sector achievements into comparable achievements in the material production sectors. This has resulted in economic stagnation of the state, growing unemployment and an acute fiscal crisis, thereby raising questions about the sustainability of the 'Kerala Model'. Democratic decentralization, intended to accelerate economic growth and to create a new model of growth with equity, has been the political response to the stagnating economy of the state in the form of 'People's campaign for Decentralized Planning'.[2] All 1,214 local governments in Kerala – municipalities and the three tiers of rural local government, i.e. district, block and gram panchayats – were given new functions and powers of decision-making and were granted discretionary budgeting authority over 35–40 per cent of the state's developmental expenditures. The campaign, however, attempted more than just devolution of resources and functions. Local governments were not only charged with designing and implementing their own development plans, they were mandated to do so through an elaborate series of participatory exercises in which citizens were given a direct role in shaping policies and projects (Isaac and Franke, 2000).

In Kerala, the usual sequence of decentralization has been reversed; financial devolution preceded functional devolution. In 1996, 35–40 per cent of the outlay of the Ninth Five Year Plan was devolved to local self-government institutions. This financial devolution took place without the recommendation of the State Finance Commission of Kerala. Given the low level of administrative capacity at the newly created third tier and the lack of experience of newly elected members of local bodies, the reversal of sequence of decentralization tended to create disequilibrium during plan implementation. However, complementary reforms

2 In 1996, a coalition (Left Democratic Front) of left parties returned to power in the state of Kerala and immediately fulfilled one of its most important campaign pledges by launching the 'People's Campaign for Decentralized Planning' (Isaac and Franke, 2000).

undertaken by State government has created conditions for successful devolution. For instance, quite contrary to the rest of India where financial devolution took the form of schemes (tied in nature), in Kerala 75–80 per cent of devolution has been in the form of untied grant-in-aid. Thus, the nature of financial devolution in Kerala encourages maximum fiscal autonomy to the local governments.[3]

The measures undertaken by government subsequent to the 73rd and 74th constitutional amendments, to institutionalize the process of decentralized planning and governance in Kerala are shown in Box 4.2.

The Kerala state government has also enacted a range of innovative legislations designed to strengthen the local level bodies soon after the 73rd and 74th CAAs. Kerala has been among the pioneers in setting strong examples of political and administrative decentralization and how such changes can have positive impacts upon the entire human development indicators. However, even in Kerala, there has been a situation of overdependence on funds from higher levels of governments. Kerala has been a state that has been transferring one-third of its planned investments to the local self-governments. This exemplifies the dependence of local bodies on the state government funds. Despite the fact that the fifth state finance commission is in progress and fourth state finance commissions have already submitted reports and also ATR statements on the recommendations of the previous reports, yet the financial health of the local bodies provides a gloomy image. The salient features of the decentralization process in Kerala are summarized in Table 4.15.

Box 4.2: Institutionalizing the process of democratic decentralization in Kerala

1. **Devolution of plan outlay**: 35 to 40 per cent of the state's Ninth Plan (1997–2000) outlay was devolved to the local self-governments for projects and programmes drawn up by them. The initiation of the People's Plan Campaign (PPC) and the appointment of the Committee for Decentralization of Power (the Sen Committee) followed, to facilitate the process.

Box 4.2 continued

[3] Thus going by the traditional literature, Kerala's decentralization takes the form of 'devolution' as opposed to the moderate 'deconcentration' or an essentially right wing 'delegation'. Here, authority is transferred to autonomous or semi-autonomous local governments, giving them powers to plan, make decisions, raise revenues, employ staff, and monitor activities. In the Kerala people's campaign, devolution was used as the administrative mechanism of decentralization, but the international significance lies in Kerala's attempt to make devolution large-scale, democratic, participatory, activist, egalitarian, empowering, self-reflective, self-reliant and sustainable.

Box 4.2 continued

2. **Institutional and structural changes**: Following the Sen Committee's report, 44 state legislations affecting various line department functions (education, health, drinking water, etc.) and parastatal were amended to broaden the entitlements and powers of local bodies. Also, institutions such as the ombudsman, the Appellate Tribunals and the State Development Council were created to make the decentralization process more effective and sustainable.
3. **Comprehensive area plan**: The outlay for the comprehensive area plan prepared by each local body comprised of the grant-in-aid, integrated with different state and centrally sponsored schemes, own revenue surplus of the local bodies, loans from financial institutions, etc.
4. **Automatic sanction for allocations**: 1997–98 onwards, automatic sanction was given to all plan and non-plan allocations to local bodies through the state budget.
5. **Mid-term auditing**: Besides the usual local fund departmental audit, a performance audit was also undertaken. The gram sabha (village assembly) also went for a 'social audit' that brought out people's view on the administrative system. These measures were meant to introduce accountability, promote monitoring and mid-term correction.
6. **Modification of criteria for fund distribution**: Instead of only population, a composite index of entitlement (indicators were, geographical area of the local body, area under paddy, houses without sanitation facilities and electricity and population) was used for distribution of plan grant-in-aid since 1998–99.

Source: World Bank (2004) and Isaac and Franke (2000).

Table 4.15: Salient features of decentralization in Kerala

	Kerala
Population	31 million
Rural local governments	1,157
Zilla parishads	14
Block panchayats	53 municipalities
Gram panchayats	991
Total elected number, rural governments	12,117; 33% women
Devolution of subjects to panchayats	All 29 functions but functionaries and funds devolved for only 15 functions
Channeling of public expenditure through panchayats	About 30% of plan expenditure and 18% of total state budgets

Source: World Bank (2004).

Among all the SFCs, the Third State Finance Commission report has stressed mostly on tax devolution to the local bodies and mobilization of funds by the local bodies. Even the Third Kerala State Finance Commission has felt the strong need for the LSGs to be able to handle funds with greater freedom subject to state monitoring. Although Kerala has had a history of highest devolution of finances to the local levels, yet more untied funds are necessary for Kerala to embark on the path of the second stage of achievements of human development indicators.

However, Kerala's experience in fiscal decentralization has been substantially different from the rest of the states. Some of the features are stated below:

(i) The local governments at the village level and the municipal level have been given the right to collect certain 'own' taxes, viz. property tax, profession tax, entertainment tax and advertisement tax. In addition, the state government fully or partly shares its land tax, motor vehicle tax and tax on registration of property. The local governments are given the freedom to fix tariffs and levy user charges without reference to the state government.

(ii) The second remarkable feature of fiscal decentralization in the state is the transfer of plan funds to local governments. One-third of the plan resources, which are mostly borrowings, are earmarked for local governments with the urban and rural areas getting shares equivalent to their population and among the rural local governments, the village local government getting 70 per cent. The grant is practically untied and gives freedom to the local governments to plan and prepare their own development programmes. The entire money is investible and local government-wise allocation is passed along with the state budget and every single rupee is devolved according to a formula without any political or executive discretion whatsoever.

Given this, the devolution framework of the state has been different from the rest of the Indian states. The third finance commission of the state in its report has mostly followed the same devolution pattern as recommended by the previous SFCs. However, it has made some digressions from the basic conceptual framework in the sense that the Third SFC has recommended for more autonomy to the LSGs as the role of SFCs in Kerala has transgressed from being a mere service provider and implementation of state and central schemes to that of planning, formulating and developing newer and more efficient ways to become an active partner of the state in its economic development endeavour.

Therefore the SFC recommended a major portion of state taxes to be devolved to the LSGs mainly for three purposes:

(i) To augment their own resources to meet their traditional functions;
(ii) To maintain the services and institutions transferred to them; and
(iii) To extend and develop those institutions.

The framework suggested by the Third SFC is as follows:

(i) 25 per cent of the State's total tax revenue to be transferred to LSGs. This is to be subsequently increased at a rate of 10 per cent annually.
(ii) Following the second state finance commission's recommendations, the ratio assigned for the four functions are given as: (a) 3.5 per cent of the amount for traditional expenditure; (b) 5.5 per cent maintenance and (c) rest of the amount for expanding and developing services and institutions transferred to LSGs.
(iii) The funds would be transferred directly to four bank accounts for each LSG into traditional function expenditure, maintenance expenditure, developing services and institutions (plan funds to local bodies) and for agency functions like state and centrally sponsored schemes, pensions flows, etc.

However, Kerala has often been criticized on the grounds of having financial devolution before functional devolution that has led to quite a few imbalances in drawing up plans for efficient service deliveries and better management of funds. Further, the devolution of large amount of plan resources took away the interest of local governments in collecting their own resources and built up a large dependence on the plan grants. Local governments are empowered to collect an array of taxes, tolls and fees and to improve their revenue by maximizing the collection. The problem with Kerala local governments was of continuous fixed flow of funds despite severe financial constraints that have affected the local government's willingness of own revenue mobilization.

Critique of SFCs

Finally given these three State Finance Commissions, the performance of other SFCs have also had not been without criticism. A general 'conventional critique' of the SFCs has evolved over the years which point to certain commonalities in the functioning of the SFCs. They can be summed up as follows:

The 13th Union Finance Commission which recently released its reports noted critically the procedures followed in constituting SFCs, delays in submitting reports, lack of deference on the part of state government to act on key recommendations, substantial lacking in the quality of the SFC reports in terms of providing recommendations to the work of the Union Finance Commission and the short time span that SFCs are in existence. We discuss some of the main points here.

Delay in constituting SFCs and consequent delays in report submission

The 13th Union Finance Commission notes that although according to the Constitution, SFCs are to be constituted every five years, states have often delayed the formation of SFCs and, in at least one case, did not constitute it at all for substantial period of time. In one state, the SFC report for the period 2005–06 to 2009–10 was submitted to the state government as late as 31 January 2009. The State Government is yet to finalize its report for the action taken. In the interregnum, the recommendations of the previous State Finance Commissions are being implemented. Moreover, SFCs need to be re-constituted periodically as mandated in the Constitution to allow for continuity in transfers in an objective manner. Delays in the formation of SFCs, their partial constitution and delays in reporting naturally gets carried over to the next State Finance Commissions and thereby evolves a problem of synchronicity with the Union Finance commissions. The 13th Union Finance Commission notes that there remains an urgent need to ensure that SFCs are appointed on time and the period covered by SFCs remains synchronous with the Union Finance Commissions.

Quality of SFC reports

The 13th Union Finance Commission criticized the SFCs for delivering patchy reports. Although it had been recommended that SFCs collect data in the formats suggested by it, the advice was not strictly followed by most of the states. The non-availability of data at the local level still remains a problem for some of the states. Despite recommendations made by both the Eleventh and Twelfth Finance Commissions to collect information and relevant data on most aspects of state–local finances, including details on transfers and grants from states to local bodies; details on the intergovernmental assignment of functions, changes therein and related expenditures; the status of implementation of the previous Union Finance Commission and State Finance Commission recommendations; borrowings by local bodies, etc., there remains a lacuna in this aspect. Although funds had been earmarked to this purpose by the Union Finance Commissions and efforts have begun, it has not been reflected in the reports as yet. Union Finance Commissions have also criticized the SFCs from the point of view of adopting differential methodologies which often result in non-aggregation of the reports. Moreover, the states' requirements for supplementary financial assistance for local bodies cannot be compared because of inconsistent methodologies that SFCs apply in estimating the resource gap which results in further complications.

Policy suggestions and way ahead

The review so far done on SFCs identifies few key policy options for the local level decentralization and the way ahead in strengthening the role of SFCs. The most important lesson from the review is that the untied nature of grants to the local level would increase the flexibility of finances at the local level to respond to the local needs. Arbitrariness and ad hoc-ism in fiscal devolution of local body grants should be reduced, promoting the judicious use of specific purpose grants. Finally, databases need to be updated, maintained and harmonized with state-level treasury management systems to enable SFCs to make better judgment vis-à-vis fiscal decentralization and service delivery needs.

Appendix 4A.1: First SFC reports: Dates of constitution, report submission and action taken

State	Date of constitution of SFC	Date of submission of SFC report	Date of submission of ATR	Period covered by SFC
Andhra Pradesh	22.6.1994	31.5.1997	29.11.1997	1997–98 to 1999–2000
Arunachal Pradesh	21.5.2003	6.6.2003	3.7.2003	2003–04 to 2005–06
Assam	23.6.1995	29.2.1996	18.3.1996	1996–97 to 2000–01
Bihar	23.4.1994/2.6.1999*	Not submitted	Not submitted	–
Chattisgarh	22.8.2003	Not submitted	–	–
Goa	1.4.1999	5.6.1999	12.11.2001	2000–01 to 2004–05
Gujarat	15.9.1994	RLBs-13.7.1998, ULBs Oct., 1998	Submitted	1996–97 to 2000–01
Haryana	31.5.1994	31.3.1997	1.9.2000	1997–98 to 2000–01
Himachal Pradesh	23.4.1994	30.11.96	5.2.1997	1996–97 to 2000–01
Jammu & Kashmir	24.4.2001	May, 2003	Not submitted	2004–05 (Interim)
Jharkhand	28.01.2004	Not submitted		Not specified

Appendix 4A.1 Continued

Appendix 4A.1 Continued

Karnataka	10.6.1994	RLBs-5.8.1996, ULBs 30.1.1996	31.3.1997	1997–98 to 2001–02
Kerala	23.4.1994	29.2.1996	13.3.1997	1996–97 to 2000–01
Madhya Pradesh	17.8.1994	20.7.1996	20.7.1996	1996–97 to 2000–01
Maharashtra	23.4.1994	31.1.1997	5.3.1999	1996–97 to 2000–01 #
Manipur	22.4.1994/31.5.1996	December, 1996	28.7.1997	1996–97 to 2000–01
Meghalaya	SFC not yet constituted	73rd Amendment not applicable as traditional Local Institution of Self-government exists in these States		
Mizoram	SFC not yet constituted			
Nagaland	SFC not yet constituted			
Orissa	21.11.1996/ 24.8.1998 *	30.12.1998	9.7.1999	1998–99 to 2004–05 $
Punjab	July, 1994	31.12.1995	13.9.1996	1996–97 to 2000–01
Rajasthan	23.4.1994	31.12.1995	16.3.1996	1995–96 to 1999–2000
Sikkim	23.4.1997/ 22.7.1998 *	16.08.1999	June, 2000	2000–01 to 2004–05
Tamil Nadu	23.4.1994	29.11.1996	28.4.1997	1997–98 to 2001–02
Tripura	RLBs-23.4.1994,	RLBs-12.1.1996,	RLBs-O 1.04.1997	RLBs-Jan.1996. Jan. 2001
	ULBs-19.8.1996	ULBs-17.9.1999	ULBs-27.11.2000	ULBs-1999-00 to 2003–04
Uttar Pradesh	22.10.1994	26.12.1996	20.1.1998	1996–97 to 2000–01

Appendix 4A.1 Continued

Appendix 4A.1 Continued

Uttaranchal	31.1.2001	2002	3.7.2004	2001–02 to 2005–06
West Bengal	30.5.1994	27.11.1995	22.7.1996	1996–97 to 2000–01

Notes: * – Date of reconstitution. In case of Gujarat, the SFC report on RLBs was submitted prior to the reconstitution of the SFC.
– As per the ATR, the SFC recommendations shall be effective from 1.4.1999.
$ – Though SFC was asked to submit the report covering a period of five years with effect from 1.4.1998, its report covers the period from 1998–99 to 2004–05.

Source: RBI (Development Research Group) Report, Government of India, Finance Commission Reports (various reports)

Appendix 4A.2: Second SFC reports: Dates of constitution, report submission and action taken

State	Date of constitution of SFC	Date of submission of SFC report	Date of submission of ATR	Period covered by SFC
Andhra Pradesh	8.12.1998	19.08.2002	31.3.2003	2000–01 to 2004–05
Arunachal Pradesh	Not constituted			
Assam	18.4.2001	18.08.2003	Not submitted	2001–02 to 2005–06
Bihar	June,1999	RLB – September, 2001	Not submitted	
		ULB – January, 2003	Not submitted	
Chattisgarh	Not constituted			
Goa	Not constituted			
Gujarat	19.11.2003	Not submitted		2005–06 to 2009–10
Haryana	6.9.2000	Not submitted		2001–02 to 2005–06

Appendix 4A.2 Continued

Appendix 4A.2 Continued

Himachal Pradesh	25.5.1998	24.10.2002	24.06.2003	2002–03 to 2006–07
Jammu & Kashmir	Not constituted			
Jharkhand	Not constituted			
Karnataka	October, 2000	December, 2002	Not submitted	2003–04 to 2007–08
Kerala	23.06.1999	January, 2001	Not submitted	2000–01 to 2005–06
Madhya Pradesh	17.06.1999	July, 2003	Not submitted	2001–02 to 2005–06
Maharashtra	22.06.1999	30.3.2002	Not submitted	2001–02 to 2005–06
Manipur	03.01.2003	Submitted	Not submitted	2001–02 to 2005–06
Meghalaya				
Mizoram				
Nagaland				
Orissa	5.6.2003	25.10.2003	Not submitted	2005–06 to 2009–10
Punjab	September, 2000	15.2.2002	08.06.2002	2001–02 to 2005–06
Rajasthan	07.05.1999	30.08.200 I	26.03.2002	2000–01 to 2004–05
Sikkim	July, 2003	Not submitted		*
Tamil Nadu	2.12.1999	21.5.2001	8.5.2002	2002–03 to 2006–07
Tripura	29.10.1999	10.4.2003	Not submitted	2003–04 to 2007–08
Uttar Pradesh	February, 2000	June, 2002	30.04.2004	2001–02 to 2005–06
Uttaranchal	Not constituted			
West Bengal	14.7.2000	6.2.2002	Not submitted	2001–02 to 2005–06

Appendix 4A.2 Continued

Constitution of Third SFCs				
Rajasthan	15-09-2005	February, 2008		2005–06 to 2009–10
Tamil Nadu	14-12-2004	September, 2006	May, 2007	2007–08 to 2011–12

Notes: * – No specific period of coverage has been prescribed.

Source: RBI (Development Research Group) Report, Government of India Finance Commission Reports and selected State Finance Commission Reports (various reports).

Appendix 4A.3: Central Finance Commissions and local bodies

Item	Tenth Finance Commission	Eleventh Finance Commission	Twelfth Finance Commission	Thirteenth Finance Commission
Terms of reference relating to local bodies	–	To make recommendations on the measures needed to augment the consolidated funds of the states to supplement the resources of the panchayats and the municipalities on the basis of the recommendations of the State Finance Commissions (SFCs).	To make recommendations on the measures needed to augment the consolidated funds of the states to supplement the resources of the panchayats and the municipalities on the basis of the recommendations of the State Finance Commissions (SFCs).	To make recommendations on the measures needed to augment the consolidated fund of a state to supplement the resources of the panchayats and municipalities in the states on the basis of the recommendations made by the State Finance Commissions (SFCs).
Recommendations	Recommended ₹100 per capita for rural population as per the 1971 census for the panchayats and ₹1,000 crore for the municipalities for the five year period covered by the finance commission.	Recommended a total grant of ₹1,600 crore for the panchayats and ₹400 crore for the municipalities for each of the five years starting from the financial year 2000–01.	Recommended a sum of ₹25,000 crore for the period 2005–10 as grant-in-aid to augment the consolidated fund of the states to supplement the resources of the municipalities and the panchayats. This amount may be divided between the panchayats and the municipalities in the ratio 80:20, i.e. ₹20,000 crore for the PRIs and ₹5,000 crore for the municipalities.	Recommended a sum of ₹20,000 crore for the PRIs and ₹5,000 crore for municipalities for the five year period starting 2005–06.
Criteria for distribution of grant among states	The amount recommended for the urban local bodies has to be distributed amongst the states on the basis of the interstate ratio of slum population derived from urban population figures as per 1971 census.	• Population: 40% • Distance from highest per capita income: 20% • Revenue effort: 10% – Geographical area: 10% • Index of decentralization: 20%	• Population: 40% • Distance from highest per capita income: 20% • Revenue effort: 20% – With respect to own revenue of states: 10% – With respect to GSDP: 10% – Geographical area: 10% • Index of deprivation: 10%	• Population: 40% • Distance from highest per capita income: 20% • Revenue effort: – With respect to state's own revenue: 10% – With respect to GSDP: 10% – Geographical area: 10% • Index of deprivation: 10%

Appendix 4A.3 Continued

Appendix 4A.3 Continued

Conditions	• These amounts should be additionally over and above the amounts flowing to the local bodies from state governments. • The state governments were required to prepare suitable schemes with detailed guidelines for the utilization of the grants • The local bodies should be required to provide suitable matching contributions by raising resources. • The grant is not intended for expenditure on salaries and wages.	• These amounts should be over and above the normal flow of funds to the local bodies from the states and the amounts that would flow from the implementation of SFC recommendations • The amounts indicated for maintenance of accounts and audit and for development of database, would be the first charge on the grant recommended by EFC and would be released by the concerned ministries of the Government of India, after the arrangements suggested by EFC have become operational. The remaining amount should be utilized for maintenance of core civic services by the local bodies, on the principles indicated in the EFC report.	• Of the grants allocated for panchayats, priority should be given to expenditure on the O&M costs of water supply and sanitation. • At least 50% of the grant-in-aid provided to each state for the urban local bodies should be earmarked for the scheme of solid waste management through public-private partnership. • States may assess the requirement of each local body in building data base and maintenance of accounts and earmark funds accordingly out of the total allocation recommended by TFC. • It is for the state concerned to distribute the grants recommended for the state among the local bodies including those in the excluded areas in a fair and just manner. • No conditionality over and above those recommended by TFC need to be imposed by the Central Government for releasing the grant-in-aid.	• Of the grant for PRIs be utilized to improve service delivery in respect of water supply and sanitation schemes subject to their recovering at least 50% of the recurring cost in the form of user charges. • At least 50% of the grants provided to each state for ULBs should be earmarked for solid waste management through public–private partnership. • States should create data bases and maintenance of accounts by local bodies and part of their support be earmarked by the state governments for this purpose FC-XII made a number of recommendations with regard to the constitution, composition, mode and methodology of working of SFCs aimed at improving their functioning. • No additional conditionality over and above those of Twelfth Finance Commission as it acts as binding upon the performance and utilization of funds.

Source: Central Finance Commission Reports.