

STATE FINANCE  
COMMISSIONS AND  
URBAN FISCAL  
DECENTRALIZATION  
IN INDIA

INDIA URBAN INITIATIVES

Prepared for

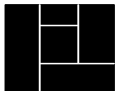


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## EXECUTIVE SUMMARY

Over the past few years, the Government of India (GOI) has become increasingly concerned with the slow pace of implementation of the Constitution (74th) Amendment Act, 1992, especially the provisions relating to fiscal decentralization (Schedule 12 and Article 243 Y of the Constitutional Amendment). Considering that fiscal decentralization is vital for empowering urban local bodies (ULBs), the GOI has mandated that the states and cities to ensure efficient implementation of the 74th Amendment under its newly launched Jawaharlal Nehru National Urban Renewal Mission (JN NURM).

Key to the fiscal relations between states and ULBs are the State Finance Commissions. The Urban Institute (Washington, D.C.), with support from the United States Agency for International Development/India (USAID India) has reviewed the performance of the State Finance Commissions (SFCs) in the context of the emerging decentralization framework. It has simultaneously reviewed the relevant work of the last two Central Finance Commissions on devolution for urban local bodies.

The study is in three parts. Part one looks at the constitutional mandate of the SFCs and SFC performance. Part two examines issues relating to the devolution of functions to ULBs in the larger context of “local demand” for decentralization. Part three extends the examination to the shifts that have taken place in the fiscal domain of ULBs. It also discusses the procedures adopted by the Central Finance Commissions for estimating the financial needs of ULBs together with the criteria for allocating the recommended sums for them.

### PERFORMANCE OF STATE FINANCE COMMISSIONS (SFCs)

The Constitutional amendment mandates that the SFCs recommend the principles for:

- ◆ the distribution between the state and local bodies of the net proceeds of taxes, duties, tolls and fees leviable by the state, and their *inter se* allocation between panchayats and urban local bodies;
- ◆ the determination of the taxes, duties, tolls, and fees that may be assigned to or appropriated by the local bodies;
- ◆ the grants-in-aid from the state consolidated fund to local bodies; and
- ◆ the measures needed to improve the financial position of the panchayats and urban local bodies.

This mandate is broad enough for each SFC to focus on crucial policy choices in establishing an approach to fiscal devolution. In practice, however, most states have merely replicated the Constitutional description of the tasks to be undertaken by SFCs without further guidance. Kerala and Tamil Nadu have broken new ground in mandating that their SFCs explore the potential for borrowing by the ULBs, develop criteria for sharing of costs of assets and

institutions transferred to ULBs, and provide guidance for more effective local financial management and accountability as well as state incentives that can support higher local resource mobilization.

There is a widespread perception that SFCs have not played a leadership role in supporting decentralization. There have been delays in constituting the SFCs. Some states have not constituted SFCs at all. The study shows that many important recommendations of the SFCs have not been accepted by the state governments. Other recommendations have been formally accepted but not implemented. The 12<sup>th</sup> Central Finance Commission criticized the lack of consistent SFC methodology in estimating urban local body resource needs. Clarification of how the resource gap is to be estimated and what norms are to be used is critical to the future usefulness of the SFC reports and the design of the state–local financial relationship.

#### *Key Decentralization Issues: Devolution of Functions*

The 74<sup>th</sup> Amendment provides for a schedule of functions (Schedule 12) that are considered appropriate for the ULBs. Many states have incorporated either all or some of the functions earmarked in Schedule 12 into the state municipal statutes. The key, however, lies in *de facto* transfer of functions to the ULBs: the evidence does not indicate that significant transfer of Schedule 12 functions to ULBs has occurred. Rather, the institutional arrangements that existed in the pre-Amendment period with regard to the division of functional responsibilities between the states and the ULBs have been continued. No mechanisms have been put in place for development authorities and the ULBs to coordinate the future development activities of cities and their environs. The result is that, notwithstanding Schedule 12, there is no role for ULBs in the formulation of Master Plans. The existence of parallel institutional arrangements is a major impediment to an efficient provision of urban services. It is fundamental to decentralization for ULBs to participate in planning decisions that affect their future development and future service responsibilities.

The principle of fiscal federalism as seen in the relationship between local citizens' contributions in terms of taxes, fees and levies to the services they get is, at best, weakly accepted. This view is borne out by recent surveys showing that local officials are unwilling to accept additional tax and fee authority in order to improve local service levels and in the ineffectiveness of past SFC incentive schemes designed to enhance local revenue mobilization. Local willingness to pay for better services is a crucial characteristic of decentralization and is one of the major obstacles to implementing the spirit of devolution as contained in the 74<sup>th</sup> Constitutional Amendment.

#### *Key Decentralization Issues: ULB Fiscal Powers and Revenue-Sharing*

The primary task of the SFCs under the Constitution is to design and structure a fiscal system that would meet the financial requirements of ULBs. The design of the fiscal system consists of (i) tax assignment or devolution to the ULBs, (ii) a revenue-sharing system, (iii) grants-in-aid for the ULBs, and (iv) agreement on management of critical assets, like publicly owned land and

infrastructure. The SFCs are expected to evolve a mix of revenue instruments that is appropriate for meeting the expenditure requirements of ULBs. This review suggests that:

- ◆ SFCs have not effected or recommended any change in the fiscal powers of ULBs; instead, they have exhorted ULBs to make better use of the fiscal powers they now possess.
- ◆ SFCs have given considerable attention to defining revenue-sharing arrangements between the states and ULBs by estimating the gap between what the ULBs generate from their own revenue-raising powers and what they need at some desirable or minimum service level. Estimating the revenue gap and developing a strategy for meeting the gap constitutes the centerpiece of SFC activity.

The estimation of revenue gap is done by using some form of a normative approach. However, norms vary as does the methodology used to estimate the gap. Moreover, far greater emphasis is placed on expenditure norms compared to revenue norms, where judgment as to the tax rates and fee schedules that local bodies should be able to afford is involved.

The attention devoted to resource gap analysis may have prevented SFCs from identifying other practical steps that states and ULBs can take together to enhance fiscal decentralization, such as reforms in property tax administration and sharing the proceeds of public land sales with ULBs.

The State Finance Commissions play a distinctive role in India's intergovernmental systems. In most federal countries, the quantum and form of state assistance to local governments is a political or quasi-political decision. In India, this decision is made by the SFCs, ostensibly non-political bodies. International experience suggests that a non-political, scientific approach to revenue-sharing formulae requires (i) clear political consensus on equalization goals, (ii) reliable data on local service levels and costs of service provision and local tax bases, and (iii) clearly defined revenue-sharing budget. In India, however, each SFC defines for itself the policy goals for revenue sharing as well as the methodology for estimating the allocations for ULBs. The result is that SFCs produce a divergent blend of technical analysis and their own fiscal norms that substitute for political consensus, rendering their recommendations, at best, of limited use.

### **ULBs AND THE CENTRAL FINANCE COMMISSION (CFCs)**

Article 280(3) (cc) of the Constitution requires the Central Finance Commission to make recommendations on the "measures needed to augment the Consolidated Fund of the State to supplement the resources of the municipalities in the state on the basis of the recommendations made by the Finance Commission of the state." The Eleventh Finance Commission (2000–2005) and the Twelfth Finance Commission (2005–2010) developed detailed criteria for allocating the recommended amounts for ULBs.

Review shows that the CFCs were unable to make use of the SFC reports on grounds of either the non-availability or non-usability of reports. Nor did the CFCs examine the adequacy of the methodologies adopted by the SFCs in assessing the revenue gap. As a substitute, the Eleventh



Finance Commission developed an “index of decentralization” that it applied for the purpose of strengthening the decentralization initiative. The Twelfth Finance Commission jettisoned the index on the grounds that most of the decentralization objectives had been achieved and substituted an “index of deprivation.”

Central government intervention via the institution of the Central Finance Commission (CFC) is exceptionally significant in reforming intergovernmental fiscal relations so that these are stable and predictable over the medium term. The decentralization initiative in India cannot be expected to be strengthened if it is not consistently supported by CFC policy.

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## INTRODUCTION

Fiscal decentralization in India is unfinished business. The 74<sup>th</sup> Amendment provides guidance as to the services that should be local responsibilities, but the list is discretionary. In practice, states have made very few modifications in functional assignments. Key urban functions either remain at the state level, or are allocated in an overlapping and unclear manner among state bodies, parastatal institutions, and urban local bodies.

On the income side of the budget, the 74<sup>th</sup> Amendment provides few guidelines as to how urban local bodies should be financed. This aspect of intergovernmental finance is left to states to decide, though programmes and schemes of the central government may offer incentives for particular reforms in tax design or revenue collection.

The 73<sup>rd</sup> and 74<sup>th</sup> Amendments provide for the creation of sub-national institutions—the State Finance Commissions (SFCs)—to help structure intergovernmental fiscal relations at the state level. In the breadth of their fiscal mandate, their intended independence from Government, and their constitutional role, State Finance Commissions (SFCs) are unlike sub-national fiscal institutions found elsewhere in the world. The SFCs are modeled after India's Central Finance Commission. In practice, however, the two institutions have evolved in very different directions. Whereas it has become conventional for Central Finance Commission recommendations to be adopted and implemented without modification at the national level, the track record of SFC recommendations is ambiguous. Many of their recommendations have been ignored or rejected by state governments; in at least one case (Maharashtra) the state government decided not to table the SFC report for the consideration of the legislature.

At present, there is general disillusionment with the performance of SFCs. They are held partially responsible for the slow progress in implementing the spirit of the 74<sup>th</sup> Amendment. The quality of SFC reports, the depth of analysis, and the qualifications of SFC members have been questioned by both the Eleventh and Twelfth Central Finance Commissions. However, it is also true that SFCs have been asked to examine some of the most difficult issues in fiscal federalism, for which there are no clear answers. They have inherited a methodology of analysis—revenue gap analysis—that when applied at the state level has produced wide inconsistencies between SFC policy recommendations and the reality of states' fiscal revenue constraints. This has led some states to disregard the revenue-sharing recommendations of SFCs or the SFCs to make ad hoc adjustments to their analytical methodologies in order to bring recommendations within financially feasible scope.

Meanwhile, by concentrating their efforts on developing revenue-sharing formulas, the SFCs have given short shrift to some of the critical issues of fiscal devolution, where expert analysis and reflection could be of significant benefit. These issues include identifying a workable approach to devolution of service functions, analyzing the implications for decentralization of local bodies' reluctance to take on new taxes or service fees to pay for expanded service responsibilities, the appropriateness of the “resource gap” methodology that underlies the current

approach to state–local financial relations, and practical ways to increase local revenue generation.

This Report examines both the performance of State Finance Commissions (SFCs) and the principal underlying fiscal decentralization issues, both those that have been dealt with and those that have escaped the attention of the SFCs. At the request of USAID, the Report uses the experience of three states—Karnataka, Maharashtra, and Rajasthan—against the broader background of decentralization to third tier urban local bodies in India.

The State Finance Commissions (SFCs) are institutions whose opportunity for impact thus far has been squandered. They have the potential of contributing significantly to any revival of policy interest in genuine fiscal decentralization to the local level. In most states, the third SFCs are scheduled to release their reports during the second half of 2006. A national workshop comparing and assessing their recommendations, in light of national and state policies toward decentralization, could rejuvenate the SFC, role as well as highlight common critical issues across states that would benefit from more informed public debate.

In view of the country’s unprecedented economic growth and projected growth in fiscal revenues, India has an opportunity over the next five years—the period covered by the third SFC recommendations—to decisively move ahead with (or reject) the spirit of the 74<sup>th</sup> Amendment.

## PART ONE

### EVOLUTION AND PERFORMANCE OF SFCs

#### Constitutional Mandate

The State Finance Commissions (SFCs) are established pursuant to the 73<sup>rd</sup> and 74<sup>th</sup> Constitutional Amendments. Each state government provides the Terms of Reference for its SFC.

Under the Constitution, SFCs are mandated to recommend the principles for:

- The distribution between the state and local bodies of the net proceeds of taxes, duties, tolls and fees leviable by the state, and the inter se allocation among different panchayats and urban local bodies.
- The determination of the taxes, duties, tolls, and fees that may be assigned to or appropriated by the local bodies;
- The grants-in-aid from the state consolidated fund to local bodies;
- The measures needed to improve the financial position of the panchayats and urban local bodies (ULBs).

The State Finance Commissions are to be constituted every five years, and their recommendations are to cover the subsequent five-year period. Currently, the third State Finance Commissions are completing reports, most of which are due in 2006. In the majority of cases, their recommendations are to take effect for the fiscal year commencing April 2006.

In practice, SFC reports have devoted most of their attention to the first mandate, i.e. the distribution of state revenue among local bodies, along with the analysis meant to provide an objective basis for this allocation. The SFC design as commonly interpreted provides a rather rigid framework for recommending revenue-sharing formulas. SFC reports are expected to come up with specific recommendations as to the total quantum of revenue that should be distributed from the state to local bodies over each year of the five-year period and how this amount should be allocated among different local bodies. SFC recommendations generally have not tied revenue sharing amounts to decisions about devolving additional services to the local level, leaving the linkage between ULB functions and ULB revenues poorly defined.

#### Terms of Reference

The Constitutional mandate for SFCs is broad enough that it would seem to invite states to tailor their Terms of Reference so that an SFC could focus on crucial policy choices likely to come before the state in establishing its approach to fiscal devolution. In practice, however, most states have merely reproduced the Constitutional description of the assignment to be undertaken by the

SFCs, as described above. The Terms of Reference in Rajasthan, for example, reproduce the wording of the 74<sup>th</sup> Amendment; the TORs for the third Rajasthan Finance Commission, established at the end of 2005, duplicate the TORs for the second Finance Commission, established more than five years earlier.

A few states have begun to give their SFCs more focused TORs that identify priority issues specific to the state's policymaking. Tamil Nadu and Kerala are two states that, in their TOR for the third State Finance Commissions, have elaborated the meaning of "suggest measures to improve the financial performance of local bodies" to give the SFCs more specific direction regarding their investigation. Kerala's TOR mandates the SFC to examine the "need to improve [local body] financial position with respect to" the following items, among others:<sup>1</sup>

- Scope for raising institutional finance through borrowing and to suggest a suitable framework and procedure for local bodies as well as borrowing limits.
- Need for sharing between state and local bodies the cost of maintenance of assets and institutions transferred to local governments.
- Steps necessary for efficient financial management with particular reference to efficiency in resource mobilization and economy in expenditures.
- Settlement of claims and dues of panchayats and municipalities vis-à-vis Governmental agencies.
- Procedures to be followed for smooth flow of funds to local self-governments and for ensuring proper financial accountability.
- Incentives for higher resource mobilization and efficiency in resource use of local bodies.
- Systems and procedures for monitoring of fiscal performance of local self-governments.

Tamil Nadu in its TOR to the State Finance Commission (Box 1) has identified some of the same issues.

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<sup>1</sup> Kerala Gazette, 22<sup>nd</sup> September 2004. [www.kerala.gov.in/sfc/fin30308.pdf](http://www.kerala.gov.in/sfc/fin30308.pdf)

**Box 1**

**Selected Terms of Reference  
Tamil Nadu Third Finance Commission**

The SFC will:

--Identify measures needed to improve financial position of local bodies taking into account, inter alia, level of debt, pension and interest payment liabilities, borrowing power.

--Identify measures needed to bring about greater efficiency in the functioning of local bodies in the mobilization and use of their resources in Local Self Government and suggestions on a well defined demarcation of functions of State Government vis-à-vis local bodies taking into account the prevailing levels of delegation of administrative, functional and financial powers to local bodies with reference to the functions enumerated in the Constitution of India and the concomitant State Legislation.

--Draw a monitorable fiscal reforms program aimed at reduction of excessive deficit of the local bodies and a scheme for providing an incentive to local bodies within the ambit of devolution mechanism linked to progress in implementing the said program taking into account the measures and the extent to which the local bodies have implemented such measures to exploit the available and the potential sources of their revenue and State Finance Commission and Central Finance Commission grants.

--Suggest possible new avenues for tapping resources in rural and urban local bodies keeping in mind local body tax structures in other States. In particular, the levy of user charges to attain the goals of covering operation and maintenance costs and capital costs for each item of service may be gone into together with suitable mechanisms to effectively realize these goals.

--Suggest measures after review of present system for assuring the accountability of the local bodies in utilizing the revenues raised or received from the State and Central Governments and other agencies and also the maintenance of local body records.

*Source: Issued 21 December 2004, [www.tn.gov.in/tsfc/tor.htm](http://www.tn.gov.in/tsfc/tor.htm)*

The activities specified in the TORs of the Tamil Nadu and Kerala SFCs go to the heart of issues that now require examination to complete fiscal decentralization to the third tier. However, adequate analysis of such issues exceeds the capacity of the Commissions, which in many states consist of only two permanent members operating without significant staff, for a limited period of time, and without the authority to commission expert studies. The Central Finance Commission has a budget for commissioning expert studies in areas that require focused analysis and data collection. States that assign their SFCs a central role in designing intergovernmental fiscal rules and institutions should also support expert analysis that can better inform decision-making.

### **Conventional Critique of State Finance Commissions**

There has evolved what might be called a “conventional critique” of State Finance Commissions (SFCs) and their interaction with state governments. The 11<sup>th</sup> and 12<sup>th</sup> Central Finance Commissions have expressed this critique most pointedly. The critique deals primarily with procedures followed in constituting SFCs, delays in submitting reports, lack of deference on the part of state government to key recommendations, lack of useful input by SFCs to the work of the Central Finance Commission, and the short time span that SFCs are in existence. In this section we summarize the main elements of this critique and offer a perspective on it.

**Delay in Constituting SFCs and Delays in Reports.** According to the Constitution, SFCs are to be constituted every five years. However, states have often delayed the formation of SFCs and, in at least one case, did not constitute it at all. SFCs frequently have had to be re-constituted to allow for resignations. Often, only the Chair and Secretary are appointed in a timely manner, with other members being appointed only at a later date or not at all.

The Twelfth Central Finance Commission (TFC) reported that out of 26 states, 19 states constituted their second SFC, of which 10 had submitted reports at the time of examination.<sup>2</sup> The second SFC reports for the three sample states for this study were delayed. In fact, the report of the second Maharashtra Finance Commission, though completed and submitted to the state government, was not submitted by the government to the state legislature, and thus remains outside the public domain.

The delays in the formation of SFCs, their partial constitution, and delays in reporting have been carried over to the third State Finance Commissions:

- The third Maharashtra State Finance Commission was formed in January 2005. Only the Chair and Member Secretary were appointed at that time; three other members were supposed to be appointed separately. The TOR of the SFC calls for it to make its report available by 31 December 2005 for application over the five years commencing 1 April 2006.

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<sup>2</sup> Report of the Twelfth Finance Commission, p143. The findings are based on a review performed by NIRD.

However, the report has been delayed. The revised TOR called for delivery of the report by 30 June 2006.

- The third Rajasthan Finance Commission was formally constituted on 15 September 2005 with a mandate to submit its report by 15 March 2006. However, the SFC did not begin functioning until 15 December, by which time only the Chairman and Member Secretary had been appointed. The deadline for reporting has been extended to 31 December 2006. The third SFC issued, on short notice, an Interim Report dated February 2006, which extends the revenue sharing formula adopted by the second SFC, and modestly expands the revenue-sharing base. The interim recommendations were supposed to guide the state government revenue allocations for fiscal years 2005-06 (Revised Estimates) and 2006-07.

The pattern of delayed reporting appears to be common to most SFCs.

**Conflict of Timing with Central Finance Commission Report.** According to the Constitution as amended, the Central Finance Commission should recommend measures needed to augment the Consolidated Funds of different States, based on the recommendations and findings of the respective State Finance Commissions.

As both the Eleventh and Twelfth Central Finance Commissions have pointed out, the timing of SFC reports (as well as their inconsistent methodologies, see below) makes it impossible to carry out this mandate. The five-year period covered by the third SFC recommendations generally starts on 1 April 2006. Even if SFC reports were prepared in a timely manner, they would be unavailable for the Central Finance Commission to examine in preparation of its recommendations for the five years commencing 1 April 2005.

The mismatch of timing has led to recommendations that the cycle of SFC reports be adjusted to conform with the Central Finance Commission requirements. This would mean starting the fourth round of State Finance Commissions at an earlier date.

**Lack of State and Local Data.** Both the Eleventh and Twelfth Central Finance Commissions pointed out to the lack of 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 Central Finance Commission and State Finance Commission recommendations; borrowings by local bodies, etc.

The Eleventh Financial Commission earmarked Rs. 200 crores for the creation of a national database relating to local body finances. Six years later, the database remains in the process of creation. The report of the task force set up by Comptroller and Auditor General (C&AG) for establishing common reporting formats for urban local bodies has been accepted by the states. However, establishment of a functional database is far from reality.

The three State Finance Commissions interviewed as part of this Report also reported that their work was hampered by a lack of local financial data and lack of access even to the data examined by the previous SFCs.

The data void has led to recommendations that a permanent cell be created in state finance departments to support the work of the SFCs, and to collect and house state-local financial data on a regular basis. At present, each SFC starts *de novo*, without data and without support systems. Data collected and reported by the SFC cells would conform to standards established for national reporting of local financial information, and support national analysis of urban local body finances.

**Inconsistent Analytical Methodologies.** Central Finance Commissions have pointed out that State Finance Commission reports cannot be aggregated, and that states' requirements for supplementary financial assistance for local bodies cannot be compared, because of inconsistent methodologies that SFCs apply in estimating the resource gap. The way "resource gap" analysis is carried out is distinctive to India. The different SFCs have adopted widely varying, and often *ad hoc*, definitions of "resource gap." Successive SFCs in the same state often use different and contradictory definitions of resource gap. Within a single SFC report, the conceptual definition of resource gap is frequently followed by a short-cut quantification procedure that is inconsistent with the definition set out.

A good deal of this variation is inherent in the very concept of "resource gap" at the local level, which is subject to vastly different interpretations. Clarification of this issue is critical to the future usefulness of SFC reports—and, indeed, to the design of state–local financial relations throughout India. The issue is examined in Part Three of this report.

**Acceptance of SFC Reports and Recommendations by State Governments.** As the Twelfth Central Finance Commission point out, the convention has been established at the national level that the principal recommendations of Finance Commissions will be followed by government without modification. The recommendations of State Finance Commissions have not had the same reception. Many important recommendations have not been accepted by state government. Other recommendations have been formally "accepted" but not implemented. In at least one case, that of the second Maharashtra State Finance Commission, the state did not submit the SFC report to the legislature, and so the recommendations have not become part of the public record. In another case, that of the second Kerala State Finance Commission, the state received the report and submitted it to the legislature, but did not submit an Action Taken Report, indicating whether the recommendations were accepted or not, for almost three years.

The Twelfth Central Finance Commission has expressed the view that states should accept the recommendations of their SFCs, as has become standard practice at the national level. In fact, the Twelfth Finance Commission has gone so far as to declare that states' failure to implement SFC recommendations because of resource constraints "defeats the very purpose of constituting the SFCs." This conclusion appears paradoxical, in light of the Twelfth Central Finance



Commission's assessment about the poor quality of the State Finance Commission reports and the lack of adequate analysis to justify SFC recommendations. Where the state governments have failed to adopt SFC transfer recommendations, they typically have complained that the calculation of local "needs" does not take into account other needs that must be financed from the state budget and the overall budget constraints. The principle that revenue-sharing transfers should be calculated so as to fill the ULB revenue gap may discourage adequate attention to the state's budget constraint.

At some point, however, state-local financial policy must acknowledge resource constraints. A normative approach to the local resource gap almost always produces estimates of local "needs" that exceed the realistic capacity of government to finance. Blanket acceptance of SFC recommendations by state government, without analysis of financing capacity, would be irresponsible. Most of the recent SFCs have implicitly recognized this, and have trimmed their normative estimates of the resource gap to produce more "pragmatic" revenue-sharing recommendations after consultation with the state finance department.

It would be beneficial to publicly debate state-local finance policy if SFC reports are to enter the public domain. There can be no justification for refusing to release such reports, which are mandated by the Constitution, or for unreasonably delaying their release. Whether the convention that has evolved at the national level of accepting Finance Commission recommendations without modification should be followed at the state level is a different question. The quality of SFC reports to date has been spotty. Moreover, it is unclear why even well-prepared SFC recommendations should supplant political decision-making over such crucial matters as how much assistance to give to local governments and how to divide this assistance among different types of local bodies.

This issue goes to the heart of the future role of State Finance Commissions. Should the structure of intergovernmental financial relations be determined by an independent panel of experts operating for 12-18 months in each five-year period, or are these matters properly decided by state government, taking into account political objectives and state financial constraints, as well as SFC recommendations?<sup>3</sup> In the latter case, more attention should be given to disseminating and debating SFC recommendations, rather than simply accepting or rejecting them.

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<sup>3</sup> The role of independent expert commissions vs. general government in deciding fiscal transfer policy at national level is considered by Anwar Shah, "A Framework for Evaluating Alternate Institutional Arrangements for Fiscal Equalization Transfers," paper prepared for Government of Canada Experts' Panel on Fiscal Equalization (September, 2005).

## **PART TWO:**

### **KEY DECENTRALIZATION ISSUES: DEVOLUTION OF FUNCTIONS**

We now consider how SFCs and our sample states have addressed key issues of fiscal decentralization, starting with the devolution of functions. The picture that emerges is confusing. The strongest initiative on urban local body decentralization has been taken by the central government. States have been reluctant partners in the process, with many of them showing unwillingness to devolve responsibilities and revenue sources as contemplated by the 74<sup>th</sup> Amendment. Urban local bodies for the most part have expressed little desire to take on additional service responsibilities, have rejected efforts to transfer taxing authority to them, and have rarely made full use of the discretionary taxing authority now available to them.

How far fiscal decentralization can proceed without local “demand” for a greater role in financial self-governance is unclear. Recent national policy, as embodied in the JN NURM reforms, has been able to coax some states and municipalities to embrace a partial decentralization reform agenda and has increased local yields from property taxation. However, sustainable fiscal decentralization will require fuller commitment on the part of the states and the ULBs.

#### **Functional Domain of ULBs**

The 74<sup>th</sup> Amendment provides for a schedule of functions (Schedule 12) that is considered appropriate for the ULBs. The list, reproduced elsewhere, envisages that the ULBs should assume responsibility for such functions as planning for social and economic development, urban poverty alleviation, urban planning and regulation of land use, slum improvement, and urban forestry, in addition to their traditional role as entities for supplying basic infrastructure and services. The list is discretionary. It is the discretionary nature of the list that has led many to interpret that the re-allocation of Schedule 12 responsibilities between states and municipalities is a matter for the states to determine; given that the states in India are at different stages of development and given the uneven capacities of ULBs to undertake additional responsibilities, the incorporation of Schedule 12 functions and their de facto transfer will be an evolutionary and incremental process.

Historically, the functional domain of ULBs in India consisted of the provision of local public goods and services, including goods with merit characteristics. These comprised, in the main, public health including water supply, disposal of wastewater, solid waste collection and disposal, citywide roads and streets, street lighting, and other public amenities like parks and playgrounds. The Constitutional amendment sets out a vision to expand the scope of the role and functions of the ULBs (see Schedule 12), evoking in the process two sets of responses: one set visualizes the ULBs playing a larger role in India’s development process and consequently advocates the incorporation of Schedule 12 functions into state statutes and their de facto transfer to ULBs. The

second set suggests that the ULBs are not an appropriate level for taking on the developmental and redistributive role, further arguing that lack of appropriate capacities at the level of the ULBs deters them from effective assumption of such functions.

Investigations undertaken as a part of this report suggest that:

- i. Most states have incorporated either all or some of the functions enumerated in Schedule 12 into the state municipal statutes. The key, however, lies in de facto transfer of functions to the ULBs, where the evidence does not indicate that any transfer of Schedule 12 functions to ULBs has occurred. Rather, the institutional arrangements that existed in the pre-Amendment period with regard to the division of functional responsibilities between the states and ULBs have been continued. Responsibility with respect to urban planning and regulation of land use, for example, continues to vest in state-level development authorities, with a minimal role for ULBs in implementing land use regulations. Moreover, appropriate coordination mechanisms have not been put in place for development authorities and the ULBs to coordinate the future development activities of cities and their environs.

The primary responsibility of development authorities is to formulate and implement Master Plans for cities. Drawing their powers from the Town and Country Planning Acts or specifically legislated Acts, the development authorities estimate the future requirement of lands for development (based on population and economic base forecasts), allocate lands to different uses, and prepare detailed zonal plans. The development authorities acquire, in stages, lands, develop them by building off-site infrastructure, and release the developed lands into the market by auctioning them to industries and trades or to cooperative and housing societies and the like. In due course, these lands are turned over to the ULBs for purposes of infrastructure maintenance.

At present, there is no role for ULBs in the formulation of Master Plans, even when these lands on the peripheries are required to be finally turned over to ULBs for maintenance. The ULBs have argued that lands that are transferred are often inadequately developed and serviced, and therefore, place a disproportionately large financial burden on them.

- ii. Provision and management of water supply presents another example where there are multiple institutional arrangements (Public Health Engineering Department [PHED], state-level and city-level parastatal bodies, and the ULBs), ostensibly with a clear division of responsibilities but without any practical mechanism for coordinating the activities of different institutions associated with water provision and management. In other spheres too, there are specialized agencies; e.g., for slum improvement, which often overlap with the functions of the ULBs.
- iii. There is an inadequate understanding of the role of ULBs vis-à-vis other government tiers in functions such as planning for social and economic development. These subjects are in the concurrent list of the Constitution.

- iv. The existence of parallel institutional arrangements is a major impediment to an efficient provision of urban services. In Rajasthan, the ULBs are reported to be performing only four functions for which there are no parallel arrangements: house tax collection, registration of births and deaths, solid waste collection, and removal of stray cattle. Apart from these narrow functional domains, parallel agencies exist for all functions that are notified for ULBs in the Rajasthan Municipalities Act. For roads alone, in addition to the Jaipur Municipal Corporation (JMC), the Housing Board, Jaipur Development Authority (JDA), Rajasthan Urban Infrastructure Development Corporation, and others operate within the JMC limits. In Karnataka, in addition to the State Government's Urban Development Department and the Directorate of Municipal Administration, the Karnataka Urban Water Supply and Drainage Board (KUWSDB), Karnataka Urban Infrastructure Development Finance Corporation (KUIDFC), Bangalore Metropolitan Regional Development Authority (BDA), Bangalore Water Supply and Sewerage Board (BWSSB), Karnataka Housing Board, Slum Clearance Board, and Bangalore Mass Rapid Transport, Ltd., all operate to deliver different services within urban areas.

The stated rationale for the development authorities and other parastatal institutions is that they are in a better position to take a longer view of development, particularly in matters relating to the preparation of Master Plans or prospecting for water outside the jurisdiction of cities. It is argued that the ULBs as service deliverers cannot devote adequate attention to developing longer-term perspectives and visions. It is also argued that, because of the professional orientation of parastatal institutions, they are in a better position to enforce fiscal discipline and use financial instruments such as cost recovery than are the ULBs. In practice, however, the functioning of development authorities and other similar agencies has been found to be far from satisfactory. They have not been able to control haphazard development on the periphery and on lands that are either notified for acquisition or acquired for development. Nor have they been able to effectively put in place cost recovery principles for charging for the services that they provide.

The question that arises is: why are functions that are supposedly local in character, particularly relating to land, housing and water, allocated to so many institutions and agencies? Land acquisition, land development, sale and lease of lands, and preparation of Master Plans including long-range urban planning and determination of land uses are specialized functions. These require expertise that is not available in most ULBs. The scale and complexity of urban planning could overwhelm the ULBs' primary function of service provision and maintenance if such functions were transferred to the ULBs.

In practice, therefore, it is unrealistic to simply transfer these functions to ULBs by a stroke of the pen. At the same time, it is fundamental to decentralization for ULBs to participate in the planning decisions that affect their future development and future service responsibilities. There are several prerequisites for achieving efficient functional performance at the level of ULBs:

- i. Clarity of functions and responsibilities between the different tiers of government and between various agencies and ULBs, not only at a broader policy level, but at the operational level;
- ii. Formal participation of ULBs in the preparation of Master Plans and determination of land uses and other land-related activities;
- iii. Enforcement of proposed land uses and regulation of land use to be a key responsibility of ULBs, with no role for developmental authorities;
- iv. Approval of Master Plans or Structure Plans by ULBs should be a requirement, although the formulation of such Plans may continue to be vested in the development authorities;
- v. Strong coordination mechanism between the state, parastatal and other institutions, and the ULBs in matters relating to city development and restructuring and provision of services.

### **Devolution of Functions in Sample States**

The record in our sample states of SFC recommendations and state responses regarding devolution of functions is instructive as to the wide variation in state approaches.

**Rajasthan.** Rajasthan lies at one extreme of the distribution of state–local functional responsibilities in India. Although the Rajasthan Municipalities Act identifies a list of 22 obligatory functions that every municipality shall perform, and another long list of 25 optional functions that a municipality may perform, in practice most local functions are either performed by a state agency or by overlapping state, parastatal, and local bodies.

The second State Finance Commission of Rajasthan noted that the financial position of municipalities makes them “unable to discharge their obligatory functions let aside the discretionary functions.” (p. 70) They found it infeasible to recommend devolution of new responsibilities to the local level. On the contrary, the financial difficulties of municipalities, exacerbated by the elimination of octroi, had obliged the state to assume a larger role in local service delivery.

The third Rajasthan State Finance Commission, as part of its background analysis, circulated a questionnaire this year to all local bodies asking if there were further functional responsibilities for which the local body wished to assume responsibility. The Chair of the SFC reported that *not a single urban local body identified a single functional responsibility that it wanted to take over*. The principal reason given for this reluctance was unwillingness to assume the financial costs of additional activity.

**Karnataka.** The first State Finance Commission of Karnataka took a strong position on functional devolution to the local level. It argued that the spirit of the 74<sup>th</sup> Amendment required that all functions listed in Schedule 12 be devolved exclusively to the local level:

If the true spirit of 74<sup>th</sup> Amendment to the Constitution is accepted, all the functions enumerated in the 12<sup>th</sup> Schedule of the 74<sup>th</sup> Amendment are expected to be performed by the municipal bodies and no other agency is constitutionally entitled to perform them.... We consider that the state government will have to respect the spirit of the 74<sup>th</sup> Amendment. Therefore, we recommend that all functions of urban development boards constituted in the state, and all town planning units operating in the state, should be brought under the jurisdiction of the respective municipal bodies. Even the functions of the Bangalore Development Authority and the Town Planning organization have to be transferred to Bangalore City Corporation. They cannot function independently hereafter.... This is the ultimate objective of 74<sup>th</sup> Amendment and should be respected.

Our recommendations [are] intended to remove dual control and multiplicity of agencies which have proliferated over the years and reduced ULBs to insignificance. (p. 37)

The state government ignored this part of the SFC's recommendations.

The second State Finance Commission of Karnataka backed away from sweeping recommendations about devolution of functional responsibilities. It implicitly assumed the continuation of existing institutions, while arguing for greater clarity in demarcation of the roles of different agencies and greater clarity and enforcement of the rules for interaction. However, it did not offer specific guidance as to how this could be accomplished at the operational level.

**Maharashtra.** Both state government officials and third SFC members argue that the 74<sup>th</sup> Amendment fails to take into account the wide differences in the capacities of urban local bodies and therefore fails to provide workable guidance on functional devolution. Mumbai is in a class by itself, capable of providing its own services. A smaller urban local body, in contrast, is unable to provide its own water supply and distribution system, so the state must do so.

As described by state officials, Maharashtra state agencies set standards for service delivery, then offer urban local bodies the choice of building and operating systems within their jurisdiction on their own or having the state do so. In the latter case, which is most common, ULBs are charged for costs. State officials consider this optional arrangement more realistic than a uniform devolution order.

**Conclusion.** The Terms of Reference of several of the third State Finance Commissions call for recommendations regarding clearer demarcation of institutional roles in urban settings (see Part One). It will be instructive to see the recommendations that are made and whether these are

supported by state government. Up to now, there have been lamentations about the lack of coordination and exhortations to improve coordination. What have been lacking are specific, mandatory guidelines for accomplishing coordination, starting with the critical functions of urban planning and urban development.

### **Fiscal Federalism and Local Willingness to Pay for Services**

Several of the SFC reports suggest that local officials and local citizens have not accepted the principle of fiscal federalism, which in the words of the second Karnataka Finance Commission holds that people should “see the relationship between their contributions in terms of taxes, fees, and levies to the services they get. By implication it amounts to making the people feel that they are paying for the services which they get.” SFC reports and surveys identify near universal opposition to new or optional local taxes, cost-recovery user fees at the local level, and even the principle that local service quality should be linked to local willingness to pay.

The Rajasthan Finance Commissions have employed some of the most colorful language in describing voter and politician resistance to local taxes, but the view has been shared by SFCs in other states, as indicated below:

The Commission, during its visits to the districts, heard majority of [political representatives] expressing their view against any fresh taxes at the local level, in view of their proximity to the voters. They were also against any assignment of taxes, as they were finding it difficult to collect the local taxes already levied by them. (First Rajasthan Finance Commission report, p. 114)

While the functional responsibilities of Municipal bodies increased several times (due to growth), inflating their resource needs, their performance has been dismal on augmentation of revenues to carry out these functions. Even the statutory avenues of raising resources remain unexploited or under exploited, because the elected bodies no longer muster courage to levy taxes under their powers, which may be commensurate with the level of services they wish to provide (Second Rajasthan Finance Commission report, p. 70)

Growth in local own-source revenue is necessary to ensure financial responsibility at the local level, as fundamental condition of efficient federalism. ULBs have not been able to do this, both because of limited revenue sources, and because of resistance of taxpayer-voters further compounded by past dependency culture... (First Karnataka Finance Commission report, p. 40)

This view of politicians’ and voters’ attitudes has been borne out by recent surveys and the response to SFC incentive schemes. A study conducted by the third SFC in Rajasthan found that urban local bodies make essentially no use of the optional list of taxes under their authority. The SFC’s survey of urban local bodies found that local officials would entertain levying only one

optional fee or tax, an electricity surcharge, and that only if the surcharge was billed and collected by the Electricity Corporation, with revenues turned over to the municipality.

Recent SFC reports in different states have come up with a number of incentive schemes intended to mobilize additional own-source revenue from municipalities, but none have produced the desired results. The second Karnataka Finance Commission proposed a complicated system that would award Panchayat Raj Institutions (PRIs) for enhanced revenue collection, and would be extended to ULBs if successful. It was unsuccessful and has not been used for ULBs. Upon recommendation of the second Rajasthan Finance Commission, the state adopted a one-for-one revenue match for municipalities (other than municipal corporations) that mobilized revenue from new sources. None of the money set aside for this purpose has been expended, because no municipality has tapped new revenue sources. Even the incentive grants provided to local bodies by the Eleventh Central Finance Commission could not be utilized in full, because local bodies (as well as states) failed to provide their matching shares.

**Conclusion.** The disconnect between urban services demand and local willingness to pay for services is a prominent characteristic of Indian decentralization. The TORs of several third State Finance Commissions call for the SFCs to examine this issue and propose workable measures to tighten the connection between service delivery and taxpayer-user payments, in light of past state experience as well as experience elsewhere. It will be valuable to monitor and highlight the SFC recommendations, due for release over the next six months.

Local dependency upon states for revenue transfers as well as service delivery stands as one of the greatest obstacles to implementing the spirit of devolution contained in the 74<sup>th</sup> Amendment.



## **PART THREE:**

### **KEY DECENTRALIZATION ISSUES: ULB FISCAL POWERS AND REVENUE SHARING**

#### **Fiscal Powers of Urban Local Bodies (ULBs)**

The fiscal powers of ULBs have typically comprised property taxes (49); a tax on the entry of goods into a local area for consumption, use, and sale, known as octroi (52); advertisement taxes (55); taxes on non-motorized vehicles (57); entertainment taxes (55); taxes on animals and boats (58); and taxes on professions, trades, callings and employment (60)<sup>4</sup>. The general postulate underlying the assignment of fiscal powers is that the revenue yields from these taxes should be adequate to meet the operational expenditures of ULBs; however, given the relative inflexibility and low buoyancy of many of these taxes and the difficulty in adjusting local tax rates, state governments have traditionally used a system of grants-in-aid and a tax-sharing arrangement for bridging the revenue gap faced by the ULBs. In addition to grants and tax sharing, the state governments utilize the instrument of specific-purpose grants, often extensively, for advancing state-level goals and mandates. It is important to note that unlike in center–state fiscal relations, which are clearly set out, the state Municipal Acts do not provide for transfers to ULBs or do so under specific circumstances. Transfers are thus determined in an ad hoc manner.

The primary task of the SFCs under the Constitution is to design and structure a fiscal system that would meet the financial requirements of ULBs. The design of the fiscal system consists of (i) tax assignment or devolution to the ULBs, (ii) a revenue-sharing system, and (iii) grants-in-aid for ULBs. The SFCs are expected to develop a mix of these revenue instruments that is appropriate for meeting the expenditure requirements of ULBs and to address two questions: what should the ULBs do to improve their finances? and what should the states do to improve and augment the finances of ULBs?

Reviews of the recommendations made by the SFCs suggest that:

- i. SFCs have not effected any change in the fiscal powers of ULBs, nor have they recommended such changes. The SFCs have emphasized the need to better use the fiscal powers that the ULBs are endowed with under the existing statutes. The SFCs have, in particular, placed emphasis on the reform of property taxation together with a charging mechanism for services.

To this point, however, SFC recommendations regarding ULB taxation and charging policy have consisted mostly of exhortations to better local fiscal management. The recommendations do not have the same specificity regarding institutional implementation as SFC recommendations for state revenue sharing. In fact, the only operational

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<sup>4</sup> The numbers in parenthesis represent the numbers given in the State list.

consequence thus far has been to influence SFC revenue-sharing recommendations, taking into account SFC calculations as to how much revenue ULBs “should” be able to generate from own sources.

The municipal officials interviewed for this study stated that their tax and user fee policies are not influenced by SFC reports.

- ii. SFCs have paid considerable attention and space to defining revenue-sharing arrangements between the states and ULBs, by focusing on three issues:
  - a. What (which state-level taxes and other revenue components) should be shared between the states and the ULBs?
  - b. What should be the share of state-level revenues assigned to the ULBs?
  - c. What should be the criteria for allocating the recommended share among ULBs of different sizes?

States have addressed these issues in highly divergent ways. On the first issue, namely the taxes or other revenues that should be shared, two primary models emerge from the reports of the SFCs.

- a. Pool all state-level tax receipts for purposes of sharing, either on a gross or net basis;
- b. Share individual taxes with ULBs, by either determining a percentage share for ULBs or assigning specific amounts to them.

### **Fiscal Base ULBs of Sample States**

The position with respect to the revenue-sharing base in the three states is given in Table 1. Annex 1 summarizes SFC revenue-sharing recommendations for all Indian states. In general, the SFCs have promoted pooled revenue sharing, rather than tax-by-tax sharing, and state policies have moved in this direction. This represents an important simplification of revenue-sharing policy that also promotes greater stability of shared amounts.

**Table 1**  
**Revenue Sharing with ULBs as Recommended in Sample States**

<i>Karnataka</i>	θ	5.4% of the <i>total non-loan gross own-revenue receipts</i> for meeting the plan and non-plan requirements.
<i>Maharashtra</i>	θ	25% to 100% of entertainment taxes collected from municipalities of different grades, 25% of vehicle tax and 10% of profession tax.
<i>Rajasthan</i>	θ	2.18% of the <i>net proceeds of State taxes</i> ; the division of these proceeds between rural and urban should be in the ratio of 3.4:1.

*Source: First State Finance Commission Reports*

<i>Karnataka</i>	θ	8% of <i>total non-loan gross own-revenue receipts</i> .
<i>Rajasthan</i>	θ	2.25% of the <i>net proceeds of State taxes</i> ; (excluding entertainment taxes); 15% share in entertainment tax for ULBs.

*Source: Second State Finance Commission Reports (Maharashtra second SFC Report was not tabled and recommendations are not known)*

The criteria for allocating the recommended shares among ULBs also differ with each SFC. The first State Finance Commission of Karnataka suggested that two general indicators, viz., population and backwardness as measured by illiteracy rates and service-level shortfalls be used for allocating the recommended shares between ULBs. The second State Finance Commission continued with these general criteria (using different indicators) but recommended the creation of a small fund for dealing with common problems of ULBs like computerization, creation of databases, studies and surveys.

The first Rajasthan Finance Commission allocated ULB revenue-sharing entitlements according to population size and resource potential of ULBs as well as indicators of management capacity. The second Finance Commission relied on population criterion alone, noting that reliable data on other relevant indicators were not available. The Maharashtra State Finance Commission, on the other hand, recommended specific amounts of different taxes for each class of ULBs.

- iii. For assessing the financial needs of the ULBs, a key exercise has been to estimate the revenue gap, i.e., the gap between what the ULBs generate (or should generate) from their own revenue-raising powers, and what they need at some desirable or minimum

service levels. Indeed, estimating the revenue gap and developing a strategy for meeting the gap constitute the centerpiece of SFC activity.

Revenue-gap analysis in India is conducted in a distinctive and highly complex manner. Annex 2 discusses the methodology and its appropriateness. Estimation of a revenue gap has several requirements: there should be standards/norms of services to serve as benchmarks for determining the financial requirements of ULBs. Similarly, there should be norms and standards for local revenue-raising capacity.

The estimation of revenue gap by SFCs has followed very different routes. The Rajasthan SFC has utilized service norms as recommended by a Committee that submitted its report in 1963; the Maharashtra SFC estimated the gap separately for each service by using norms recommended by different agencies; for example the Ministry of Surface Transport for maintenance and repair of roads, the State Public Works Department for maintenance of buildings, and so on.

The first Karnataka SFC used what it called a pragmatic normative approach, arguing that any person living in Karnataka should get a minimum of essential public/civic services for which it identified normative standards pertaining to core services and recommended that revenue sharing be designed to raise the existing physical levels of those services to these levels over a period of five years.

In sum, some form of a “normative approach” has been used by the SFCs in estimating the revenue gap. However, norms vary and so also their application for estimating the requirements. A study performed by NIPFP for the Eleventh Central Finance Commission found that the normative aggregate revenue gap of ULBs at that time ranged from Rs. 6.9 million crores to Rs. 32.6 million crores, depending on which of several sets of commonly cited standards was applied for expenditure norms. Moreover, far greater emphasis has been placed on expenditure norms compared to revenue norms. A revenue norm involves judgment as to the tax rates and fee schedules that local bodies “should” be able to afford, given their revenue sources, not just today but for the next five years, for which economic conditions have to be projected. Generally, SFCs have concluded that municipal governments should be raising more own-source revenue—representing a divergence between expert opinion and local political opinion, as summarized in the previous section.

- iv. The SFCs have only rarely made recommendations regarding the degree of autonomy that the ULBs should have in matters relating to setting tax rates and charges, tax exemption policies, sharing in revenues from urban land and asset sales, or accessing capital markets for infrastructure finance. Some of these broader topics have been included for the first time in TORs for the third SFCs of selected states.

SFC reports have had greater impact when focused on specific institutional arrangements at state level that can be changed by state government decision.

- In Karnataka, the second SFC criticized the practice of deducting at source the amounts owed by ULBs to state institutions, like Karnataka Power Transmission Corporation and Karnataka Urban Water Supply and Drainage Board, before calculating the divisible pool available for local revenue sharing. This practice eliminated the linkage between individual ULB debts and revenue-sharing offsets—in effect subsidizing heavily indebted ULBs’ transfer amounts at the expense of other ULBs. It recommended a change in policy, so that individual ULB revenue entitlements were calculated first, then sums to be deducted at source were subtracted from each ULB’s transfer amount. The change in policy has been accepted by the state. It has had substantial impact on the allocation of transfer amounts, since roughly one third of all transfer payments are deducted at source. The new policy more effectively links individual ULB financial management to transfer deduction.
- In Rajasthan, successive SFCs have pointed out that state law requires that 15% of the proceeds of land sales by Urban Development Authorities and Urban Investment Trusts be turned over to the municipal governments that will have responsibility for service provision in the developed areas. However, these payments were not being made, and no accounting was provided to local authorities. The state has recently revised the law, so that a portion of the revenue generated from land sales is paid directly to the state, along with a public accounting of the disposition of proceeds, including verification that the 15% share was paid to the respective ULB. Income from land sales has now become the single largest element of own-source budget revenue in Jaipur, as a result of this clarification and enforcement.

**Conclusions.** State Finance Commissions play a distinctive role in Indian intergovernmental fiscal relations. In most federal countries, state aid to local governments is an avowedly political decision, made by state legislatures in conjunction with the state executive authority. India has tried to take this decision out of politics, by placing it in the hands of SFC technical experts who are supposed to use scientific methods to determine revenue-sharing policy and other aspects of intergovernmental finance. Some other countries have followed this approach, most particularly Australia and Canada, which also have had the equivalents of State Finance Commissions.<sup>5</sup>

The Australian and Canadian experience is summarized in Annex 3 of this report. Their experience helps clarify the choices to be made about future SFC design in India. A non-political, “scientific” approach to revenue-sharing formulas requires (i) clear political consensus

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<sup>5</sup> India in fact adopted the Finance Commission approach based largely on Australian experience. A delegation visited Australia to examine how national and local finance commissions functioned, before India’s Constitutional language was adopted.

as to what equalization goals should be achieved; (ii) abundant and reliable data on local service levels, local costs of service provision, and local tax bases; (iii) a clearly defined aggregate revenue-sharing budget; and (iv) a very substantial technical staff to carry out analysis.

Australia meets these conditions. The country has evolved a clear national political consensus in favor of full equalization of local fiscal capacity. States' local finance commissions engage in strictly defined efforts, using common methodologies, to translate the commitment to fiscal capacity equalization into revenue sharing formulas that achieve full equalization, taking into account local variations in tax base and costs of service provision, as well as the level of funding available for revenue sharing. The local finance commission conducts a purely technical, professional exercise.

Canada formerly had national and provincial policies that called for full equalization of fiscal capacity, and also utilized local finance commissions to define revenue-sharing formulas that would achieve this outcome. In recent years, however, Canada has explicitly abandoned the goal of full fiscal equalization. Most provinces have dissolved their local finance commissions, whose mandate was to calculate the revenue-sharing formula that would achieve this outcome. Canada has replaced local fiscal equalization grants with an incentive grant scheme intended to boost local infrastructure investment while stimulating economic growth and urban efficiency.

India has retained the State Finance Commission structure, but each SFC has been left to define for itself both the policy goals of revenue-sharing and the methodology to be used to estimate ULB allocations. The result is that SFCs produce a divergent blend of technical analysis and their own fiscal norms that substitute for political consensus. It is perhaps to be expected that state governments have not adopted SFC recommendations automatically, but instead have chosen those elements that fit their political, financial, and managerial agendas.

### **ULBs and the Central Finance Commission (CFC)**

In addition to the incorporation of Section IX A on Municipalities into the Constitution, Article 280 concerning the mandate of the Central Finance Commission (CFC) was also amended, requiring the Central Finance Commissions (CFCs) to make recommendations on the “measure needed to augment the Consolidated Fund of a State to supplement the resources of the Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.” Pursuant to this provision, the Eleventh Central Finance Commission (EFC) recommended a sum of Rs. 2000 crores for the ULBs, while the Twelfth Central Finance Commission (TFC) raised the share of ULBs to Rs. 5000 crores. The two successive Commissions made important observations on two aspects: (i) composition of the SFCs and (ii) the approach and methodology adopted by the SFCs in assessing the revenue gap. The two CFCs developed and applied detailed criteria for allocating the recommended amounts for ULBs. Several points concerning the approach of the two CFCs deserve to be underlined:

### **Non-Use of the Reports of the SFCs**

The CFCs were not able to make use of the reports of the SFCs in the framing of their recommendations. The stated reasons were the non-availability of the reports and incompatibility of methodologies. What is important to note is that the CFCs made no attempt to comment on the adequacy of the methodology adopted by the SFCs in assessing the revenue gap even when reports were in public domain. On a general plane, however, the CFCs have noted that better results would have been obtained if the SFCs had followed the methodology that is used by them. The following quotes from the report of the Twelfth Finance Commission are relevant here:

If the SFCs follow the procedure adopted by the central finance commission for transfer of resources from the centre to the states, their reports would contain an estimation and analysis of the finances of the state government as well as the local bodies at the pre-and post-transfer stages along with a quantification of the revenues that could be generated additionally by the local bodies by adopting the measures recommended therein. The gaps that may still remain would then constitute the basis for the measures to be recommended by the central finance commission.

While estimating the resource gap, the SFCs should follow a normative approach in the assessment of revenues and expenditure rather than make forecasts based on historical trends. Per capita norms for revenue generation must take into account the data relating to the tax bases and the avenues for raising non tax income by the municipalities and the panchayats, assuming reasonable buoyancies and the scope for additional resource mobilization. Per capita expenditure norms could be evolved on the basis of the average expenditure incurred by some of the best performing municipalities and panchayats in the provision of core services. The gap between the aggregate revenue and the aggregate expenditure calculated in this manner, after adjusting for the resource transfers recommended by the SFCs, will provide the basis for the approach of the central finance commission.

## Absence of Purpose in the Criteria for Allocating Funds for ULBs

The Eleventh Central Finance Commission (EFC) developed a complex formula for the allocation of Rs. 2000 crores for ULBs. The formula comprised the following indicators:

**Table 2**

### Criteria for Allocating Funds to ULBs

<b>Indicators</b>	<b>Weight</b>
Urban population	40%
Geographical area	10%
Distance from highest average per capita Gross State Domestic Product	20%
Own revenue efforts of ULBs, using state's own revenue as an indicator	5%
Own revenue efforts of ULBs, using Gross State Domestic Product as an indicator	5%
Index of decentralization	20%

*Source: Report of Eleventh Finance Commission, New Delhi (2000-05)*

Of particular relevance is the “index of decentralization,” which the EFC stated had the purpose of using fiscal allocations to strengthen the decentralization initiative, as envisaged under the Amendment.<sup>6</sup> The TFC, however, jettisoned this indicator, saying that most of the decentralization objectives had been achieved. It substituted an “index of deprivation.” The index of deprivation is based on intra-state disparities in drinking water and sanitation.

Central government intervention *via* the institution of the Central Finance Commission (CFC) is exceptionally significant in reforming intergovernmental fiscal relations so that these are stable and predictable over at least the medium term. Decentralization in India cannot be expected to be strengthened if it is not consistently supported by CFC policy.

<sup>6</sup> The “index of decentralization” illustrates a paradoxical aspect of the fiscal incentives built into revenue-sharing formulas in India. The revenue-sharing weights are described as incentives intended to encourage certain behavior (in this case decentralization of functions, management responsibilities and revenues to local level), but the weights are constructed solely on the basis of past behavior, and therefore take the form of rewards for past decisions. No provision is made for increasing future state and local revenue allocations if states improve their decentralization index measures. In fact, since the Twelfth Central Finance Commission abandoned the decentralization index, any state that modified its decentralization behavior in response to the Eleventh CFC's revenue-sharing weights would have gone unrewarded.



## CONCLUSIONS AND RECOMMENDATIONS

Fiscal decentralization is a key component of the urban reform agenda under the newly launched Jawaharlal Nehru National Urban Reform Mission (JN NURM). States, however, continue to set the framework for urban local finance. Rejuvenation of the State Finance Commissions can help modernize state–local financial relations to make a reality of urban local body decentralization.

This report recommends as next steps that:

- 1) The Ministry of Urban Development convene a national workshop in early 2007 that would compare and assess SFC recommendations, in light of national and state policies toward decentralization. In most states, the third SFC reports are due for release by the end of 2006. A national workshop would allow national and state policymakers to examine the fiscal reform agendas that are being advanced at state level and to consider the extent to which these are consistent with national priorities.
- 2) In preparation for the workshop, or as a separate body of work, a summary be compiled of different SFCs' recommendations with respect to some of the specific challenges facing state–local fiscal relations, such as:
  - State control of ULB borrowing, including the framework for local borrowing and the establishment of borrowing limits;
  - Steps for sharing the cost of maintenance of assets and institutions transferred to local government;
  - New matching grant proposals by states designed to increase local resource mobilization or increase local government expenditure efficiency;
  - The methodologies used by different SFCs to calculate the resource gap for ULBs, and the manner in which these are translated into proposals for revenue sharing.

Some states have these matters specifically identified in the terms of reference of the third SFCs, and the opportunity exists for sharing lessons learned in adopting new measures.

- 3) An analysis be undertaken of the effective design of state grants-in-aid to ULBs. One of the paradoxes revealed in this report is that ULBs in general do not want more revenue-raising or expenditure authority from their states. This weak demand for fiscal decentralization stems partly from ULBs' dependence on the states for general revenue transfers. Other studies have shown that general transfers tend to substitute for ULBs' own-source revenues; that is, that states generate less own-source revenue when they receive general transfers. A reform of states' transfer programs to more effectively encourage local revenue mobilization that is converted into local service improvements is a pre-requisite for effective fiscal decentralization.

- 4) SFCs recommend additional fiscal strategies for capturing part of the economic growth that comes from urbanization. JN NURM and most SFCs recommend translating gains in property values through property taxation and property tax reform that ties taxes more closely to property values. A supplement to property taxation that has significant potential, but has not been put to noticeable use in India because of institutional fragmentation of responsibilities, is to capture the increased value of publicly owned lands for new infrastructure development. Establishing principles for sharing revenues from land sales with the ULBs would improve their capacity for financing needed infrastructure investments. The report notes that Rajasthan recently acted to enforce such a policy for sharing land sale revenues between municipalities and Urban Development Authorities.
- 5) States' resource gap analysis be modernized. The principal activity of the SFCs is to recommend a formula for sharing state revenues with the ULBs. This activity requires estimating the resource gap, i.e., the gap between what the ULBs are able to generate from their own revenue sources and what they need in order to fulfill their functional responsibilities. To estimate the resource gap, norms are required for local service outputs, local service expenditures, and local revenue generation.

On the expenditure side, the Zakaria Committee (1963) norms have enjoyed countrywide acceptability for decades, but have become obsolete for reasons of technological changes in infrastructure development and shifts in the pattern of design. If resource gap analysis is to be continued, the service delivery expectations of ULBs and estimates of the costs of providing this level of service should be updated. At the same time, it needs to be recognized that, in the context of decentralization, ULBs start from very different levels of current performance and that improvement in performance is the foremost priority.

- 6) Future Central Finance Commissions restore an Index of Decentralization as a weighting element in allocating funds to ULBs. The Eleventh Finance Commission established a formula for fiscal allocations to ULBs that included an index of decentralization, which contained such items as decentralization of functions, management responsibilities, and revenues to local level, together with completion of SFC reports. This weighting element was jettisoned by the Twelfth Finance Commission on the ground that most of the decentralization objectives had been achieved. Consistent support by the CFC will be critical to future decentralization. Rewarding states and ULBs fiscally through a decentralization index provides a vehicle for addressing gaps in implementation of the 74th Amendment.
- 7) The SFC role be restored to prominence. The role assigned by the Constitution to State Finance Commissions is distinctive to India. It creates the opportunity to examine, from outside, every five years, the fundamental structure of state–local fiscal relations. To do this requires that the Commission contain independent fiscal experts and that SFCs engage in public discussion of their recommendations.

## ANNEX 1

### Revenue-Sharing Packages (As Recommended by First and Second State Finance Commissions)

State	Recommended Shares (First State Finance Commission)	Recommended Shares (Second State Finance Commission)
Andhra Pradesh	39.24% of state tax and non-tax revenue to all local bodies.	40.92% of state tax and non-tax revenue to all bodies, both rural and urban bodies, 9.67% is allocated to municipalities.
Assam	2% of state tax for local bodies, both rural and urban. (The share of urban local bodies has not been specified).	
Himachal Pradesh	An amount equal to Rs.12.2 crores as grants in lieu of octroi for 1996/97, to rise to Rs.17.9 crores in 2000/01 and CSS grants to accrue to municipalities.	An amount equal to Rs.19.66 crores as development grants for the year 2002/03, with a 10% mark-up to neutralize inflation, rising to Rs.28.79 crores by 2006/07, and CSS grants to accrue to municipalities.
Karnataka	5.4% of the total non-loan gross own revenue receipts for meeting the plan and non-plan requirements.	8% of non-loan gross own revenue receipts for municipalities.
Kerala	1% of state revenues (excluding from certain sources) be transferred to local bodies as non-statutory non-plan grants distributed between the rural and urban local bodies in proportion to their population.	
Madhya Pradesh	8.67% of the tax and non-tax revenues of state government.	1.07% of divisible pool of state own tax revenue.
Maharashtra	25% to 100% of entertainment taxes collected from municipalities of different grades, 25% of vehicle tax and 10% of profession tax are recommended shares for local bodies.	

State	Recommended Shares (First State Finance Commission)	Recommended Shares (Second State Finance Commission)
Orissa	Rs.179.5 crores is the projected transfer (grant) to urban local bodies between 1998/99 and 2004/05. (The deficit of Rs.1,378 crores between the estimated income and expenditure and an additional requirement of Rs.381.48 crores for improvement of core civic services should be met by the Eleventh Finance Commission.	4 per cent of net tax proceeds of all state taxes to be devolved to all local bodies.
Punjab	20% of the net proceed for five taxes namely, stamp duty, motor vehicle tax, electricity duty, entertainment tax, and cinematograph shows should be transferred to municipalities, and the projected gap of Rs.322 crores should be met by the Central Finance Commission.	4 per cent of net tax proceeds of all state taxes to be devolved to all local bodies.

*Source: Taken from Om Prakash Mathur, 2001. Approach to State-Municipal Fiscal Relations. National Institute of Public Finance and Policy, New Delhi*

## ANNEX 2

### **Revenue Sharing and the ULB Resource Gap: Finance Commission Methodology**

The principal activity of a State Finance Commission is to recommend a formula for sharing state revenues with local bodies (see Annex 1). The greatest part of a typical SFC report is devoted to analysis that supports the recommended revenue-sharing formula. This work is undertaken pursuant to the Constitutional mandate to “recommend the distribution between the State and Local Bodies of the net proceeds of taxes, fees, etc., leviable by the State and the inter-se allocation between different panchayats and urban local bodies.”

Traditionally, State Finance Commissions, like the Central Finance Commission, have adopted a variant of “resource gap” analysis in addressing the revenue sharing question.

In resource gap analysis, as applied in India, revenue-sharing recommendations are arrived at through the following steps:

1. An estimate is made of (aggregate) local body expenditures required to meet assumed service standards or expenditure-growth standards.
2. An estimate is made of the own-source revenues that local bodies (in the aggregate) “should” generate if they make appropriate use of taxing and fee authority.
3. The aggregate “vertical gap” is estimated by subtracting normative own-source revenues (Step 2 above) from normative expenditures (Step 1).
4. The aggregate “vertical gap” for local bodies is targeted for closure through sharing of certain state revenues. Or, alternatively, a target may be set as to the proportion of the vertical gap that will be closed. This calculation yields the divisible pool available for revenue sharing.
5. The divisible pool is apportioned between panchayats and urban local bodies employing a set of weights (rural vs. urban population plus special weighting factors).
6. The amount calculated as the urban portion of the divisible pool is further allocated among ULBs using another set of weights.

This method of calculating revenue-sharing entitlements has a number of deficiencies. It is immensely complex and unstable, as successive SFCs change the weighting factors and the normative standards for both expenditures and own-source revenues. Despite the complexity, the key amounts assumed for Steps 1 and 2 are essentially arbitrary. A study performed by NIPFP for

the Eleventh Central Finance Commission found that the “normative gap” of ULBs at that time ranged from Rs. 6.9 million crores to Rs 32.6 million crores depending on which of several sets of commonly cited standards was employed for expenditure norms.

Expenditure norms have been estimated by such devices as estimating the cost of meeting physical standards of service delivery (e.g., liters per capita per day of water supply, distance between street lights, and number of sweepers per 1000 population); extrapolation of past spending growth adjusted for new functional assignments; or, as the Twelfth Central Finance Commission recommended, adopting the per capita service expenditure figures of rural and urban bodies generally regarded as high performing. Norms have to be applied to the entire universe of highly varied local bodies in order to come up with an aggregate expenditure estimate.

Norms for own-source revenue are, if anything, more arbitrary. They involve judgment as to the tax rates and fee schedules that local bodies “should” be able to afford, given their revenue sources, not just today but for the next five years, for which economic conditions have to be projected.

The divisible pool arrived at in Step 4 is then allocated to individual local bodies through a series of weights that qualitatively are intended to take into account such factors as backwardness, poverty, variations in local fiscal capacity, incentives for own-source revenue mobilization and many, many more. Each generation of SFCs and CFC tends to introduce a different set of allocation weights, sometimes as many as 12 different weighting factors. No calculation is made as to how the individual weights affect each other or how far the combined set of weights goes toward eliminating horizontal differences with respect to any of the factors.

At the end of the sequence of analysis, SFCs generally find that the normative resource gap greatly exceeds the state’s capacity to compensate, given its own fiscal limitations. A “pragmatic” adjustment then is made to bring revenue sharing costs into line with state financing constraints.

One feature of this methodology is that it never comes to terms with the key question: how much equalization across ULBs should be promoted by state and central revenue sharing and how should equalization be measured—in terms of equalized fiscal capacity, equalized per capita expenditures, equalized service outputs, or other standard?

The first Karnataka SFC is the only SFC in our universe to have explicitly connected revenue-sharing weights to expected outcomes. It argued that by creating a weighting system that compensated backward ULBs and providing incentives for service improvements, basic service levels of ULBs should rise to a uniform minimum level, throughout the state, within the five-year period of the formula’s implementation. As the second Karnataka SFC pointed out, however, equalization in practice was not achieved, and many of the service level indicators could not even be measured. No other SFC has adopted specific equalization targets.

**Conclusion.** The entire procedure used to devise revenue sharing formulas, which can consume the effort of SFCs, needs to be re-examined. It would be far simpler, more transparent, and more stable if states were simply to decide what portion of revenues they will share with local bodies and the principles that should govern allocation. These would seem to be inherently political decisions. The belief that they can be decided “objectively” through technical resource gap analysis may be an illusion. At most, SFCs can quantify the allocations implied by a clear statement of policy objectives.

Many states are moving in the direction of simpler rules for revenue sharing. Although SFCs may go through the lengthy routine of normative analysis, in the end their recommendations for revenue sharing increasingly are based on a straightforward percentage target that only incrementally modifies current practice. The first Karnataka Finance Commission recommended sharing 35% of net state revenues with local bodies. The second Karnataka Finance Commission, after finding that the local body share during the previous five years had actually averaged 36.8%, recommended that the local share be increased to 40% to take into account increased local functions. The state has accepted this recommendation as a target to be achieved incrementally. It implies sharing 8% of net state revenues with urban local bodies, the remainder being allocated to panchayats (or for expenditures on their behalf).

## ANNEX 3

### SFC Experience in Australia and Canada

Historically, two countries—Australia and Canada—have used institutions and revenue-sharing methodologies that most closely approximate the approach taken in India. Both countries have used variants of State Finance Commissions. Both have developed revenue-sharing formulas based on standardized resource gaps. However, in recent years the two countries’ systems have evolved in very different directions. Their experience sheds light on the choices to be made about the role that SFCs should play in India.

**Australia’s State Grant Commissions.** The State Grant Commissions of Australia exist to implement a national policy of full horizontal fiscal equalization. “Fiscal equalization” is defined to mean that, within a state, every local body can provide its citizens with the same service outputs as all other municipalities making the same tax effort. Fiscal equalization within a state is embedded within a national grant system designed to achieve fiscal equality between states, as well. The funds used by states for local equalization are financed through national grants.

Australia has come as close as possible to objectively quantifying fiscal differentials for purposes of revenue sharing. Its approach reveals how much data and analysis are required and how precisely equalization components must be defined to make this process work successfully, and how isolated from the political arena the technical analysis becomes.

Allocation of state funds among local bodies is intended to cover the standardized fiscal gap, defined as:

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$$\begin{aligned} & \text{Standardized Expenditure Requirement} \\ & \textit{Minus} \text{ Standardized Own-Source Revenue (at average tax effort)} \\ & \textit{Equals} \text{ Standardized Resource Gap to Be Covered by Grant} \end{aligned}$$


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At state level, the Australian system takes the amount of financing available for gap filling to be determined exogenously by national grant policy. The state receives a determined amount of federal grant, which it distributes among local bodies so as to achieve fiscal equalization. The State Grant Commission also takes the average level of local tax effort as given. It is the actual average tax effort of local bodies, weighted by each type of tax and fee.

The State Grant Commission then iteratively calculates the cost of different levels of local service provision until it identifies service levels for which standardized expenditure for all municipalities in the state minus standardized own-source revenue just equals the magnitude of the grant provided for fiscal equalization. In this approach, the potential for mismatch between the



“resource gap” and state funding constraints is eliminated.<sup>7</sup> This is possible because starting differentials in local fiscal capacity are relatively small and the funds available for fiscal equalization are relatively generous.

The State Grant Commission employs a large permanent staff to make these calculations. In Victoria State, the standardized expenditure component is estimated on the basis of the cost of providing precisely defined service outputs for each of nine different local service functions, taking into account 14 different types of cost factors (e.g., local wages for white collar workers, local wages for construction labor, materials costs) differently weighted for each service function. The result is a technical tour de force, but also a black box of calculations so complex that the results are not transparent even to fiscal specialists.

Australia’s system could not be replicated in India. The required data on local service levels and local service costs do not exist. The number of local bodies in an Indian state vastly exceeds the number found in an Australian state. The production function of public services (i.e., the mix of skilled labor, capital and other inputs used to produce public services) is far more variable between local bodies than in Australia.

Australia’s experience is instructive primarily because it represents the logical extrapolation of one interpretation of the role of State Finance Commissions: that they should be able to calculate objectively local resource gaps that must be removed to equalize fiscal capacity. It demonstrates just how demanding the requirements are for this role to be performed literally and how far removed the resulting exercise is from regular politics.

## **Canada**

Canada in the past also embraced the principle of full fiscal equalization under the Representative Tax System at both national level (for grants to provinces) and provincial level (for grants to local bodies). However, in recent years both the federal government and provincial governments have moved away from full equalization as a policy goal. In October 2004, the federal government announced that starting with Fiscal Year 2004-05, Parliament would determine the amount of funding to be used for equalization purposes. The policy target of attaining 100% equalization was dropped.

Provinces had moved earlier to eliminate total fiscal equalization at local level. This was done primarily on the grounds of financial feasibility, but also because it was feared that fiscal equalization encouraged inefficient urbanization. In Canada, the principal beneficiaries of fiscal equalization transfers were very small towns, whose costs of service delivery were high because of inefficiencies of scale.

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<sup>7</sup> See Victoria Grants Commission Information Paper (2005) at [www.doi.vic.gov.au/doielect.nsf](http://www.doi.vic.gov.au/doielect.nsf). Also, Commonwealth of Australia, *History of the Commonwealth Grants Commission* (Canberra: Government Printing Office, 1995).

Grant reform in Saskatchewan illustrates the shift in policy. Like the federal government, Saskatchewan first capped the amount of funds available for equalization at an amount legislated annually by Parliament. By 1997-98, the legislatively approved funding for equalization had declined to the point where it was sufficient to remove only 16.45% of the fiscal disparities between urban local bodies in the province. At that point, the Province froze the total grant amount as well as individual grant allocations, effectively eliminating future equalization transfers. Because technical calculations of equalization transfer amounts would not be needed in the future, the Province also did away with the Local Finance Commission that recommended equalization transfer formulas. Most other provinces likewise have disbanded their Local Finance Commissions, in favor of openly political decisions about grant policy.

The provinces generally have moved away from fiscal equalization in favor of incentive grants. The province of British Columbia, for example, now will pay 25% of the cost of local public works investment in water supply, wastewater removal and treatment, and road projects. The shift in grant design reflects an explicit choice to use state funds to spur local investment levels, economic growth and efficient urbanization rather than compensate local governments for high costs of service provision or low tax bases. Only the poorest Canadian provinces have retained local equalization grants.

## ANNEX 4

### Twelfth Schedule

1. Urban planning including town planning.
2. Regulation of land-use and construction of buildings.
3. Planning for economic and social development.
4. Roads and bridges.
5. Water supply for domestic, industrial and, commercial purposes.
6. Public health, sanitation conservancy and solid waste management.
7. Fire services.
8. Urban forestry protection of the environment and promotion of ecological aspects.
9. Safeguarding the interests of weaker sections of society, including the handicapped and mentally retarded.
10. Slum improvement and up-gradation.
11. Urban poverty alleviation.
12. Provision of urban amenities and facilities such as parks, gardens, playgrounds.
13. Promotion of cultural, educational and aesthetic aspects.
14. Burials and burial grounds; cremations, cremation grounds and electric crematoriums.
15. Cattle ponds; prevention of cruelty to animals.
16. Vital statistics including registration of births and deaths.
17. Public amenities including street lighting, parking lots, bus stops and public conveniences.
18. Regulation of slaughterhouses and tanneries.

## REFERENCES

### Reports of the State Finance Commissions

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Eleventh Finance Commission (2000 to 2005)  
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