CHAPTER - 3

FEDERAL FINANCE IN INDIA AND THE PLACE OF LOCAL BODIES

3.1.0 The Federal System Of Governance In India :

3.1.1 Under the Constitution enacted in 1950, India had opted for a ***Federal System of Governance, with Governments at three levels, the Central Government, the State Government and the Local Government***. The third level, though existing in the country since long, has attained the Constitutional status only recently, with the enactment of 73^{rd} and 74^{th} Constitutional Amendments in 1992. Since there are three layers of Government in the hierarchy, functioning in their respective jurisdictions, there is the need for creating such an optimum institutional arrangement which combines the advantages of Decentralization as well as of Economies of scale and externalities, which are generally associated with Centralized form of Government. Such an institutional arrangement cannot be permanent but has to undergo changes from time to time, with changes in Social, Political and Economic conditions in the Country. Despite division of Functions and Finances between different levels of Government under the Constitution, there is bound to be some over-lapping in taxation powers and expenditure patterns of different Governments. This needs Co-ordination and harmonization between functions and finances at different levels.

3.1.2 In every federation, different tiers of Government should have considerable autonomy and initiative to perform their functions, and raise and manage their resources, but some degree of Central regulation and control becomes necessary, to ensure Co-ordination and promote Macro Fiscal Stability. Complete Autonomy to the State Government and the Local Government, is inconceivable under the present Constitutional arrangements.

3.1.3 In the federal system of Governance, both on grounds of equity and efficiency, resources which are more elastic and productive, are generally assigned to the Central Government, while the states and the Local Governments are assigned larger responsibilities, more particularly in the area of Social and Economic Infrastructure, but with less elastic and less productive resources. The limited decentralization of taxation powers along with substantial functional decentralization and the concomitant spending responsibilities, creates a number of fiscal problems in the federal set-up. The most crucial fiscal problem is that which emanates from the mismatch between Expenditure responsibilities and Revenue Assignments, particularly at the State and the Local Level. Whereas, there are central and state lists of taxation in the Constitution, demarcating the areas of taxation of the Center and the States, more powers vest with the center because of the provision of concurrent list of Taxes which gives the center the prior right to levy Taxes contained in the list.

3.1.4 There is no Local List of Taxes which may empower the Local Bodies to levy specific taxes earmarked for them. The power of Local Bodies to levy taxes depends upon the discretion of the State Governments to transfer from the State list such taxes which are deemed to be appropriate, to be levied by Local Bodies and, therefore, are included in their taxation powers in the legislation enacted for their creation and functioning. Thus in the present Constitutional arrangements, the Local Bodies are at a disadvantage. They have been assigned lengthy lists of functions contained in schedules ***XIth*** and ***XII th*** of the Constitutional Amendment Act, but have to depend upon the State Government for Fiscal Decentralization. Our experience in the Post-Constitutional Amendment period shows that the State Governments have been very liberal and quick in transferring functions to Local Bodies but are very slow and sometimes reluctant, to transfer Revenue raising powers to them.

3.2.0 The Vertical And Horizontal Gaps :

3.2.1 The limited decentralization of taxation powers along with substantial decentralization of spending responsibilities creates the problem of Vertical Fiscal Gap. In addition to this, there are wide and increasing Horizontal Gaps between different States and different Local Bodies.

3.2.2 The framers of Indian Constitution could well visualize that there would be asymmetry or mismatch between Expenditure Responsibilities and Revenue Assignments, emanating from the Constitutional arrangements. Therefore, the Constitution has made a provision for the appointment of FC by the President of India, after every five years or earlier, to make recommendations to the President in respect of transfer of resources from the Center to the States, in the form of sharing of Central Tax Revenue between the Center and the States, and also in the form of Grants-in-Aid, to address the problems of vertical and horizontal imbalances. ***The Vertical Imbalances are mainly to be corrected through Revenue sharing, and Horizontal Imbalances mainly through Grants-in-Aid and also through Shareable Taxes.*** It is generally agreed that the system of fiscal transfers should satisfy the criteria of Adequacy, Autonomy, Economic Efficiency, Fiscal Discipline and Equity.

3.2.3 Whereas the Constitution has made arrangements for the transfer of resources from the Center to the States on the recommendations of the FC to be appointed after every five years, to recommend its awards in respect of transfers from the Center to the States, with a view to correcting vertical and horizontal imbalances, no such arrangement was provided for a long time in respect of transfer of resources from the Center and the States to Local Bodies, since the enactment of the Constitution. The transfer of funds from the State Government to Local Bodies therefore, remained unsystematic, ad-hoc, irregular, and discretionary, characterized by unpredictability and instability.

3.2.4 It was as late as 1992 when the ***73rd and 74th Constitutional Amendments*** made provision for the creation of ***State Finance Commission*** in every state, after 5 years, charged with the responsibility of recommending devolution of resources from the state to the Local Bodies for correcting vertical and horizontal imbalances, through ***Tax Sharing and Grants-in-Aid. The SFC would also recommend measures for augmenting the resources of Local Bodies and for improving their capacity to perform functions more efficiently and effectively.***

3.2.5 In addition to the creation of ***SFC*** in every State, another important step taken in the direction of Fiscal Decentralization, has been the inclusion of an additional clause in section 4 relating to the terms of reference of the ***CFC,*** requiring the Commission to recommend "measures needed to augment the consolidated fund of the State to supplement the resources of ***Panchayats*** and ***ULBs*** in the state, on the recommendations of the ***SFC***". The inclusion of this clause in the ***TOR*** of the ***CFC,*** relating to devolution of funds from the Center to the States for supplementing the resources of Local Bodies, is a reflection of the growing recognition of the importance of Local Bodies in the Indian Public Finances and also of the growing concern of the whole country in the achievement of the Constitutional Goal of Decentralized Governance in the Country.

3.2.6 So far twelve ***CFCs*** have given their awards in terms of Constitutional requirements. Space does not permit to make a review of the recommendations of all the ***FCs*** in terms of their impact on Centre-State fiscal relations and also on Vertical and Horizontal Imbalances. We would concentrate on the recommendations of the ***XIth*** and ***XIIth FCs*** in respect of their impact on State Finances. But we may refer to the earlier FCs also while presenting a comparative picture of the devolution process in the Country.

3.3.0 Fiscal Transfers From Centre To The States :

3.3.1 Fiscal Transfers from the Centre to the states take place through a number of channels, the FC, the ***Planning Commission*** and through discretionary transfers of the ***Central Ministries*** in respect of a number of centrally sponsored schemes which have been increasing in numbers and variety, through the years. However, the major chunk of transfers to the states takes place on the recommendations of the ***CFC***. The amount transferred under the awards of the ***FCs*** constituted ***66% of the Total Transfers and 26% of Total Revenue of the States*** in the 1980s, though these shares declined to 49% and 25% respectively in the 1990s.

3.3.2 ***Fiscal Transfers from the Center to the States in India*** as percent of ***gross Revenue Receipts of the Center,*** disaggregated into different sources are presented in the **Table No.3.1**

3.3.3 The table shows that the ***Average Ratio of Total Transfers to Central Government Gross Revenue Receipts*** have remained round 38% during the ***VIIth*** and ***VIIIthFCs*** periods, but coming down to 35.79% during the ***XthFC*** period, going up to 40.33% during the ***IXthFC*** period, but coming down to 37.20% during the first two years of the ***XIthFC.*** The over-all size of transfers is determined by the availability of resources with the Central Government, after accounting for the relevant Expenditure requirements. This is the supply side of funds available for transfer.

3.3.4 ***As a Percentage of Grass Domestic Product (GDP) at Market Prices, Fiscal Transfers*** recorded a decline from the level of 5% during the ***VIIIth*** *FC* period to 4.8% and 4.1% respectively for the periods of ***IXth*** and ***XthFCs,*** increasing to 4.5% of the ***XIthFC*** and 5% of the ***XIIth FC.***

3.4.0 Impact Of Central Transfers On State Finances :

3.4.1 Fiscal Transfers, by enhancing the resource base of the states, have helped the states in containing their deficits. This has been empirically tested[1] by comparing the State Gross Fiscal Deficit with transfers and without transfers. During the 1980s, resource from the FCs awards helped the states to contain their Gross Fiscal Deficit by about 49.9%, which implies that in the absence of resource transfers, the Gross Fiscal Deficit of the States, on an average, would have almost doubled. However, in the 1990s the role of contribution to contain Gross Fiscal Deficit had declined to 47.5%. This was due to the fact that the decade of 1990s had witnessed considerable deterioration in the fiscal position of the States. The ***Combined Gross Fiscal Deficit*** of the states during 1990-98 averaged 2.9% of ***GDP*** which escalated to 4.3% in 1998-99, and further to 4.7% in 1999-2000. But the fact can not be denied that fiscal transfers to the states had helped the states, in varying degrees, in containing their fiscal deficits.

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1. Kannon, Pillai Kaushaliya and Chander - Finance Commission Awards and fiscal stability in States-Economic & Political Weekly Jan 31, 2004.

3.4.2 The impact of fiscal transfers has also been examined in terms of (i) degree of fiscal decentralization which is measured as the share of the States Tax Revenue in the combined Tax Revenue of the Centre and the States. (ii) Fiscal autonomy which represents Share of States Own Tax Revenue in Total Revenue Receipts. (iii) Fiscal Devolution, which is worked out as composite Index of Fiscal Decentralization and Fiscal Autonomy. ***The study shows**** that Fiscal Devolution Co-efficient recorded an increase during 1980-81 and 2000-01, both on account of high degree of Autonomy and Decentralization.

3.4.3 Let us have a look at the ***Revenue Receipts of the States before and after transfers in terms of share in combined Revenue Receipts and also of their Expenditure in the Combined Expenditure.*** The **Table No. 3.2** presents this picture.

3.4.4 The table shows another impact of the Central Transfers on State Finances. The States get after transfers from the Center, a share in the range of 61 to 65% of the Combined Revenue Receipts of the States and the Centre. Their share in Combined Revenue Expenditure has been in the range of 56 to 58%. The states shares both in combined Revenue Receipts and combined Expenditure, have remained more or less stable. In terms of access to Revenue resources, before and after transfers, the position of the Centre and the State, is reversed, in favour of the States.

3.4.5 The impact of fiscal transfers seems to be greater when along with resource transfers, we take into account the fact that the FCs, more particularly the ***XI**th* and ***XII**th* ***Commissions***, in recent years, have been suggesting Fiscal Reforms for restructuring State Finances and also linking transfers with such reforms. The enactment of Fiscal Responsibility Act in 2003, can be considered as an important measure in this direction.

***** Ibid – EPW Jan 31, 2004

3.5.0 Horizontal Dimensions of Fiscal Transfers :

3.5.1 Though fiscal transfers have contributed to the reduction of over all deficit of States, the issue of horizontal fiscal inequalities is yet to be addressed by the FCs. The horizontal dimension of transfers relates to inter-se distribution among states. If all the States were similar in fiscal capacity and cost conditions, the equalization criteria would have been met by equal per capita transfers. But the actual position differs from the ideal. In the present dispensation of the FCs, Tax devolution plays the dual role of correcting vertical as well as horizontal imbalances. Grants-in-Aid are mainly intended for achieving a degree of equalization. This is why many of the better off States do not get grants under article 275, since they have Revenue Surplus after Tax Transfers. Grants are deemed to be more effective transfer instrument for State-Specific and Purpose-Specific targeting. Forces accentuating inter-regional disparities are so powerful in a market economy that it becomes difficult to correct these imbalances only through fiscal transfers. The problem needs to be tackled on other fronts also.

3.5.2 The ***XIth*** and ***XII^{t} FCs*** have considered Grants-in-Aid as a greater instrument of equalization compared to Tax Sharing and wanted to take away the role of equalizing from the Tax Sharing instrument. Therefore, in the devolution formula of the two Commissions, equity consideration dominates in Central Transfers through Grants-in-Aid. The **Table No. 3.3** presents the ***percent shares of Grants and Tax Sharing in Total Transfers recommended by the FCs.***

3.6.0 The Composition Of Transfers Recommended By The FC :

3.6.1 The **Table No. 3.4** presents the ***scheme of devolution of resources from the Centre to the State on the recommendations of the XIth and XIIthFCs and also the composition of total devolution by the XIIthFC for Madhya Pradesh and Chhattisgarh States:***

3.6.2 The **Table No. 3.4** shows that in its scheme of devolution, the ***XIIthFC*** has reduced ***the Percent Share of Tax Sharing in Total Transfers*** from 86.53% of the ***XIthFC*** to 81.31%, by raising the weight of efficiency factors and lowering that of the equalization criteria. The instrument of Tax Sharing is deployed to a larger extent for reducing vertical imbalances, arising out of insufficiency of taxation powers of States relative to their Expenditure responsibilities and relying more on grants for reducing horizontal imbalances between States. The percentage share of grants has been increased from 13.47 of the ***XI^th^FC*** to 18.87 of the ***XII^th^FC***. Among the Grants-in-Aid, the share of Non-Plan Revenue Deficit grant has been reduced from 8.13% of Total Transfers to 7.52%, because of the application of certain norms for estimating Revenue Deficits of State Governments. The share of grants for the up-gradation of certain Social-Economic Services has been raised from 3.04% of the ***XI^th^FC*** to 8.04% of the ***XII^th^FC.*** Also the share of grants to States for supplementing the resources of Local Bodies has been raised from 2.3 to 3.31% of total transfers recommended by the FC, modifying the formula for devolution to the States, so as to give greater weightage to the factor of deprivation in the provision of water supply and sanitation, and dropping the criterion of index of decentralization of the ***XI^th^FC.***

3.7.0 The Composition Of Transfers To Madhya Pradesh And Chhattisgarh :

3.7.1 Let us have a look at the composition of Total Transfers to ***MP*** and ***Chhattisgarh*** as recommended by the ***XI^th^*** & ***XII^th^ FCs***. Table given in the previous section also presents this picture. In both the States, the Share of Tax Sharing in Total Transfers is higher than that of the whole Country, as recommended by the ***XI ^th^***and ***XII^th^FCs***. The share of ***MP*** is 88.90% and that of Chhattisgarh is 89.12%, but the share of grants is lower in both the States 11.10% in ***MP*** and 10.88% for Chhattisgarh, much lower than that of the whole Country, 18.87%. This is due to the fact that both the States do not get any Non-Plan Revenue Deficit Grants, which account for 7.52% of total devolution recommended by the ***XII^th^FC***. After taking into account the transfer of Shares in Tax Revenue of the Centre, both the states have post-devolution Revenue Surplus. Hence no grants on this score are recommended by the ***XII^th^FC***. The Revenue Gap Projected by both the Governments were reduced by the estimates made by the FC, to Rs 7256 crores in respect of ***MP*** from Rs 61740 crores, as estimated by MP Government. The deficit projected by the ***XII^th^*** comes to 15.96% of that which is projected by the State Government. In the case of Chhattisgarh, the Pre-Devolution Non-Plan Revenue Deficit of Rs 8695 crores made by the State Government was reduced by ***XIIthFC*** to Rs 1353 crores which work out to 15.56% of state projection. After taking into account Tax Sharing of Rs 41180.59 crores to ***MP*** and Rs 16285.76 crores to ***Chhattisgarh,*** both the States would have Revenue Surpluses. No grants have been recommended for both the states on this account. Projections of Revenue Deficits of both the states are such higher than amounts estimated by the FC. This is due to over-estimation of Revenue Expenditure and under estimation of Revenue Receipts. The shares of grants for upgradation of certain services are lower in respect of both the States, 6.73% for MP and 7.03% for ***Chhattisgarh***, as against 8.04% for the whole country recommended by the ***XIIthFC.*** Both the states do not get any grant for health and education. The share of grants for Local Bodies is 4.37% for ***MP*** and 3.85% for ***Chhattisgarh,*** higher than 3.31% for the ***Whole Country.***

3.8.0 The Scheme Of Devolution Of The XIIth Finance Commission :

3.8.1 It would not be out of place to present here the scheme of devolution recommended by the ***XIIthFC*** and the extent of its departure from that of the ***XIthFC***. In some respects the scheme represents a notable departure from the ***XIthFC*** scheme.

3.8.2 The Main Points Of The Scheme Are Given Below :

(i) The share of States in net proceeds of Shareable Taxes of the Centre, has been enhanced from 29.5% of the ***XIthFC*** to 30.5% by the ***XIIth FC***.

(ii) The limit of Revenue Transfer to the States, as percent of gross Revenue Receipts of the centre, has been raised from 37.5%, as recommended by the ***XIthFC*** to 38% by the ***XIIthFC.***

(iii) Change in the formula for Tax devolution, with reallocation of weight in favour of population and efficiency factor, and dropping out of factors, the ***Index of Infrastructure***, used by the ***XIthFC.***

(iv) Application of norms in the assessment of non-plan Revenue Gap of the States for determining grants to states left with Non-Plan Revenue Deficits, after taking into account tax devolution.

(v) Applying the equalization principle to provide grants for education, health and some other services to such States which are relatively deficient in their Revenue Capacity, provided they maintain their annual Expenditure on these heads at the current level.

(vi) Providing grants for the maintenance of roads and bridges, heritage conservation, State Specific needs, needs of Local Bodies and requirement of calamity relief, on a larger scale.

(vii) Grants to Local Bodies have been substantially enlarged, by modifying the formula for their allocation to states, taking into account the deprivation index in the provision of drinking water and sanitation, dropping the index of decentralization as one of the criteria as used by the ***XIthFC.***

3.8.3 The share of each State in the Tax Devolution is to be determined by the following criteria in **Table No. 3.5** ***evolved by the XIIthFC Juxtaposed along with this, is the formula of the XIthFC for the purpose of comparison***.

3.8.4 The instrument of Tax Devolution has been used, both for vertical and horizontal aspects of transfers, but the role of this instrument has been reduced for correcting horizontal imbalances, compared to the scheme of allocation of the ***XIthFC***. The percentage weight of income distance has been reduced from 62.5% to 50%, and the role of index of infrastructure has been dropped. The relative weight of population has been increased from 10% of the ***XIthFC*** to 25% of the ***XIIthFC.*** The weight of area has been increased from 7.5% to 10%. Greater weight has been assigned to Tax Effort.

3.8.5 ***The ranks of first five states in the inter-se shares of states in the net proceeds of shareable union taxes, as per the criteria of the XIth and XIIthFCs,*** are presented in the **Table No. 3.6.**

3.8.6 Though as per both the FCs, the states in the range of first five ranks in terms of their **inter-se** shares in the total shareable net proceeds of Central Taxes are the same, but they are with changed ranks and changed percent shares. Among the five States, U.P., Bihar, M.P. are comparatively less developed, the other two States, Andhra Pradesh and West Bengal are reckoned amongst the relatively developed States. The percent shares of five states in the scheme of devolution of the ***XIIthFC*** have been reduced. The gainers according to the ***XIIthFC,*** compared to the ***XIthFC*** are ***Gujarat, Haryana, Jammu & Kashmir, Maharashtra, Punjab, Orissa,*** and some smaller states like ***Manipur, Sikkim, Meghalaya.*** The greater beneficiaries are the relatively developed states like ***Maharashtra, Punjab, Haryana and Gujarat.***

3.8.7 For reducing ***Horizontal Imbalances***, we have to depend on other measures along with fiscal transfers in the form of ***Tax Sharing and Grants-in-Aid.*** The FC can use the instrument of Grants-in-Aid for the development of Social Services, to a much larger extent than at present.

3.9.0 Weaknesses Of The Existing System Of Transfers In The Federal Set Up Of India :

3.9.1 The present system of transfers suffers from some deficiencies which are briefly discussed below :-

(i) Multiplicity of transfer channels, each presenting its own formula/criteria for allocation. The integrity of Constitutional scheme requires that all Revenue Transfers be mediated through the FC. The present dichotomy of Plan and Non-Plan Revenue Transfers should go. The plethora of centrally sponsored schemes should also go. The Planning Commission may recommend only transfers for meeting capital requirements of the States. There seems to be little evidence of movement in this direction. At present multiplicity of objectives to be pursued simultaneously by multiplicity of transfer channels, cancel out their effects in some cases.

(ii) Despite generous transfers made by the FCs through tax devolution and grants, disparities in Revenue Capacity of the states remain pretty large. The Per Capita Revenue of Bihar as assessed by the ***XIIthFC*** together with state's Share in Central Taxes and grants recommended for 2005-10 is only about 40% of that of ***Haryana*** and ***Kerala.*** The situation does not seem to have changed much even under the ***XIIth FC,*** compared to that of ***XIthFC.*** The coefficient of variation in normatively derived per Capita Revenue has gone up among the major States of India. The equalization principle seems to have been given inadequate place, despite increase in the proportion of grants in the distribution formula.

(iii) The fiscal restructuring scheme setting targets for the deficits seem to be unduly restrictive and may prove to be counter-productive. Uniform targets for all the states, irrespective of their level of development and requirements, may not be implemented.

(iv) Debt relief scheme is linked with restructuring. This violates the basic tenets of fiscal federalism. Single minded pursuit of fiscal correction to get the benefit of debt relief, may have disastrous implications for those states which require huge investments to build up their Physical and Social Infrastructure. Some of these states will have to reduce their development Expenditure, both Revenue and Capital, to adhere to the tight schedule of restructuring.

(v) Local Bodies have not been given adequate space in the devolution scheme of the FCs. Their allocations fall short of requirements.

(vi) Despite the weights given to relative poverty measured by distance of per capita income from the advanced states in the devolution formula, the cumulative effect has been that ends up with bias against poorer states. By and large, the richer states have been the major beneficiaries of transfers. No FC has so far succeeded in evolving a truly normative approach.

3.10.0 Devolution Of Resources To Local Bodies :

3.10.1 As already pointed out in an earlier section of this Chapter, till the enactment of 73 and 74 Constitutional amendments, no Constitutional arrangement existed in respect of transfer of resources from the centre and the states to the Local Bodies. In the federal finance system of the country, Local Bodies remained ignored. The creation of ***SFC*** in every state after every five years, and the inclusion of devolution of resources from the centre to the States for supplementing the resources of Local Bodies, in the terms of reference of the ***CFC,*** are the two major steps taken in recent years in the direction of fiscal decentralization in the Country.

3.10.2 Since article 280 was amended before the expiry of the terms of the ***XthFC,*** the Commission suo motto made some recommendations for transfer of funds from the Centre to the States for Local Bodies, despite the fact that it was not included in the TOR of the Commission. It had recommended a grant of Rs 1000 crores for ***ULBs*** to be distributed among states on the basis of inter-State ratio of slum population on the basis of 1971 census, and a grant of Rs 100 per capita of rural population as per 1971 census, for ***Panchayats***.

3.10.3 It was for the first time that the ***XIthFC*** was required as per its Terms of Reference, to suggest measures to augment the Consolidated Fund of the states, to enable them to supplement the resources of Local Bodies, on the recommendations of the **SFC.** But the ***XIthFC*** made its own assessment of the requirements of Local Bodies, since the recommendations of the ***SFCs*** were not available either because they had not been constituted by that time or they were yet to submit their reports. The experience of ***XIthFC*** in this regard has been disappointing when it observes in relation to the first generation reports of the ***SFCs,*** "Many of the reports of ***SFCs*** have not addressed to the specific items listed in Article 243(I) and 243(Y) nor have they provided a clear idea of powers, authority and responsibilities entrusted to Local Bodies. Many of these reports do not clearly indicate the principles formulated for sharing and assignment of states taxes, duties, tolls, fees, grants-in-aid". (Para 8.11 of ***XIth FC***). The recommendations of the ***SFCs*** thus could not provide the basis for the recommendations of the ***XIthFC***. In view of limitations and deficiencies of the reports of the ***SFCs,*** the ***XIth***FC had gone to the extent of recommending an amendment in the Constitution, to delete the words "on the recommendation of the State Finance commission". We do not agree with this recommendation of the ***XIthFC.*** It is a reasonable provision, an anti-thesis of the "up-down" approach and an expression of the commitment of the primacy of the Local Bodies. This provision, therefore, needs to be retained. The State Governments have to ensure that the reports of their respective ***SFCs*** are made available to the ***CFC*** in time, much earlier to making its recommendations, at least 6 months. It is a Constitutional obligation which the State Governments have to adhere to and implement.

3.10.4 Despite limitations, the ***XIthFC*** had recommended adhoc amount of Rs 8000 crores for ***Rural Local Bodies*** and Rs 2000 crores for ***Municipalities*** during its award period. It also mandated certain activities like ***Maintenance of Accounts and Development of Database***, as first charge on its grants. The remaining amount was to be used for the ***Maintenance of Core Services***. The ***XIIthFC*** has reported that out of Rs 200 crores for the creation of data base, only Rs 93 crores could be utilized, and out of allocation of Rs 483 crores for maintenance of accounts, only Rs 113 crores could be utilized, utilization being hardly 30% of allocation.

3.10.5 The ***XIIthFC*** has recommended a sum of Rs 25,000 crores as grants for Local Bodies. The amount works out to be 1.24% of the shareable Tax Revenue and 0.9% of Gross Revenue Receipts of the Centre, as estimated by the Commission for the period 2005-10. The amount of Rs 25,000 crores is to allocated between ***PRIs*** and ***ULBs*** in the ratio of 80:20, allocating Rs 20,000 crores to the ***PRIs*** and Rs 5,000 crores to the ***ULBs***, a substantial increase over the amount recommended by the ***XIthFC.***

3.10.6 For working ***out the inter-se allocation of grants among the states, the XIth and XIIthFCs have suggested the criteria according to*** **Table No. 3.7**, ***along with respective weights.***

3.10.7 There seem to be some minor differences between the criteria as well as weights assigned by the two ***FCs***. The ***XIIthFC*** has retained the criteria of ***Population, Geographical Area and Distance from The Highest Per Capita Income***, along with their respective weights assigned by the ***XIthFC,*** but has replaced the criterion of ***Index of Decentralization*** of the ***XIthFC*** by the ***Index of Deprivation***, and bifurcating the criterion of Revenue Effort into two, (a) with reference to Own Revenue of the State and (b) with reference to GSDP. The criterion of Revenue Effort is given a weightage of 20%, compared to 10% of the ***XIthFC.***

3.10.8 Based on the above criteria and weights, the ***XIIth FC*** has worked out the shares of different States ***for the period 2005-10. The share of Chhattisgarh State for PRIs comes to 3.075% of the total***, as against 8.315% of ***MP***, ***allocating Rs 615 crores for PRIs in Chhattisgarh*** and Rs 1663 crores for MP. ***Regarding Municipalities, the share of Chhattisgarh has been worked out at***

1.76% of the total and for ***MP*** 7.220% of the total, allocating Rs 88 crores for ***Chhattisgarh*** and Rs 361 crores for ***M.P***.

3.10.9 The ***XII[th]FC*** has not recommended any conditionality with the release of these grants to the states, nor expects any conditionality to be imposed by the State Government for transferring these grants to Local Bodies. The ***FC*** has made an important recommendation in this context that the central Government should take a serious view of any delay beyond 15 days in passing on these grants by the State Government to Local Bodies from the date of release by the Centre.

3.10.10 The ***CFCs*** should have recommended larger amount of devolution from the centre to the States for supplementing the resources of Local Bodies, had the ***SFCs*** facilitated them by providing some basis, in terms of quantum of Revenue Deficits of Local Bodies , separately for ***PRIs*** and ***ULBs***. In the absence of such data, the FC had to work out its devolution on adhoc basis, using its own discretion, taking into account some other ingredients, germane to the issue. So a great responsibility devolves on the ***SFCs*** in terms of estimating the Revenue Gap/Deficit of Local Bodies on some Normative Basis. Equal responsibility devolves on the State Governments for taking up the recommendations of the ***SFC*** in time for implementation more seriously and not cavalierly, as some states have treated the reports of their ***SFCs.***

3.11.0 The Extent Of Fiscal Decentralization In The Post-Constitution Amendment Period :

3.11.1 In this section, we make a rapid review of the process of Fiscal Decentralization that has taken place since the enactment of Constitutional Amendment (1992), relating to Local Bodies. Absence of reliable data at the macro level on a regular basis, is a major constraint on making such an evaluation. At the macro level, one major source of data can be the financial data collected and published in their reports by the ***XI[th]*** and the ***XII[th] FCs,*** relating to the periods 1991-92 to 1997-98 and 1998-99 to 2002-03 respectively, covering the Post-Constitutional Amendment period.

3.11.2 Recently, the sub-group on the Finances of ***Panchayats*** and ***ULBs*** of the Working Group on State Finances, appointed by the Planning Commission, has made projections of Financial Resources of Local Bodies for the period of the **X** Plan, 2002-03 to 2006-07. The **Table No. 3.8** presents such data, ***projected for Local Bodies , both at the beginning and the end of the Xth Plan period, based on some assumptions regarding the behaviour of TGR***.

3.11.3 Taking Local Bodies, both Rural and Urban together, we find that ***Own Tax - GDP Ratio,*** has been projected to increase from 0.440% in 1997-98 to 0.937 in 2006-07. ***Non-Tax-GDP Ratio*** to increase from 0.170 to 0.328 during the same period. These are extremely low figures, indicating the fact that Local Bodies are not mobilizing an increasing percentage share of GDP. There seems to be a little possibility of any buoyancy in the Tax Revenue of Local Bodies, since Taxes assigned to them have very low yield and have poor resource base, and also because efforts made in the direction of mobilization of own resources are very poor. The performance of ***ULBs*** though better than ***PRIs***, is also not encouraging, considering the fact that more than 50% of GDP originates from urban areas, revealing lack of effective linkages with activities carried on within the jurisdiction of ***ULBs***.

3.11.4 We have calculated ratios of certain fiscal variables relating to Local Bodies in the Country, taking data from the report of the ***XIIth FC,*** juxtaposing the ratios of such parameters relating to the Central and State Government, ***with a view to indicating the place of Local Finances in the Public Finances of the Country. The data are presented*** in the **Table No.3.9.**

3.11.5 The table presents a very gloomy picture of the place of Local Finances, ***as Percent of GDP*** and also in comparison to ***the Central and State Finances***. Whereas the percentages of fiscal variables relating to the centre and State Governments to the GDP, have shown a gradual increase during the period, the percentages of such variables to GDP in respect of Local Bodies, have shown a decline, except in respect of Revenue Expenditure of Local Bodies. The percentages of GDP accruing to Local Bodies in the form of Own Tax Revenue, Own Revenue Receipts, Total Revenue Receipts and Total Receipts (both Revenue and Capital), have declined over time. As against this trend the Central and the State Governments have been increasing their shares in the GDP of the country. This is not a healthy trend in the Public Finances of the Country. The table also reveals the fact that fiscal decentralization is lagging behind functional decentralization so far as Local Bodies are concerned, indicating a big mismatch between Expenditure responsibilities and Revenue Resources, a mismatch which is on the increase. This seems to be a big flaw in the fiscal federalism in India which will delay the achievement of the goal of Fiscal Decentralization and Fiscal Autonomy, as envisaged in the Constitution.

3.11.6 We may try to look at the place of ***Local Finances in the Federal Public Finances*** from another angle, the Share of Local Revenue and Local Expenditure in the combined Revenue and Expenditure of the Central, the State and Local Governments in the Country. Decentralization is generally measured as the share of Local Tax Revenue in the combined Tax Revenue of all the three Governments. ***Fiscal Autonomy represents the share of Local Bodies Own Tax Revenue in Total Revenue Receipts and the share of Own Revenue of Local Bodies in their Revenue Expenditure.*** We have calculated data relating to these relationships from the data published in the report of the ***XIIthFC***. This presentation is intended to give an idea of the extent of decentralization and fiscal autonomy, achieved in the Post-Constitutional amendment period.

3.11.7 The **Table No. 3.10** presents data ***to know about the extent of Fiscal Decentralization that we could achieve in the Country in the Post-Amendment Period.***

3.11.8 All indicators of Fiscal Decentralization and Fiscal Autonomy Show a declining trend, in the Post Constitutional Amendment period, as revealed by the above table. The ***Share of Local Bodies in the combined Revenue*** of the Central, State and Local Government, has declined from 2.4% to 1.72% between 1998-99 and 2002-03. Similarly, ***Own Tax Revenue*** of Local Bodies as percentage of ***Combined Own Tax Revenue,*** has declined from 2.25% to 1.90% during the same period. ***Total Expenditure*** of Local Bodies ***as percent of Combined Expenditure*** of the three level governments, shows a decline from 5.26% to 4.38%, mostly due to decline in the share of Capital Expenditure of Local Bodies in total Expenditure**.** Revenue Expenditure ***of Local Bodies as percent of Combined Revenue Expenditure*** of three levels of Government, has shown an increase from 4.39% to 4.49% during the same period. The table demonstrates the fact that fiscal decentralization process has deteriorated over time. Not only the percentages of shares of Local Bodies in combined Revenues are extremely low but these low percentages are also on the decline. But ***Revenue Expenditure of Local Bodies*** as ***Percentage of Combined Revenue Expenditure has shown an increase***, indicative of higher level of ***Functional Decentralization*** compared to ***Fiscal Decentralization.***

3.11.9 The level of fiscal autonomy of Local Bodies in the country has also shown deterioration, as indicated by the percentage of ***Own Revenue*** of Local Bodies to their ***Revenue Expenditure***. ***Own Resources of*** Local Bodies could finance ***their Own Revenue Expenditure*** to the extent of 39.9% in 1998-99, but this declined to 28.36%, in 2002-03 - a steep fall. This implies that Local Bodies have to increasingly depend upon outside sources for financing their Revenue Expenditure.

3.11.10 The **Table No. 3.10** presents a ***gloomy picture of the process of Fiscal Decentralization and Fiscal Autonomy***, despite the tall claim of Political Decentralization in India, in terms of regular elections, reservation of seats for women, scheduled castes and scheduled tribes in Local Bodies . A great responsibility devolves on both the Central and the State Finance Commissions, to carry forward the process of Fiscal Decentralization and Fiscal Autonomy, by putting local finance prominently on the Federal Finance map of India. They have to ensure that the share of Local Finances in the Combined Revenue as well as Expenditure of the Country, and also in terms of percentage of GDP, registers an increase.

3.11.11 In this context, ***we have to make recommendations which call for the attention of the Central Government. There is the need for creating an institutional framework at the level of the Central Government to monitor, guide, coordinate and advise the State Governments regarding the*** Constitution ***and functioning of the SFCs and also regarding the implementation of their reports.*** The creation of such a framework is intended to facilitate the task of the ***CFC***, while making its recommendations in respect of devolution of funds from the Centre to the States, for supplementing the resources of Local Bodies, on the recommendations of the ***SFCs.*** The absence of such an institution, has already created confusion and made the task of the ***CFC*** a difficult one.

3.11.12 ***To move further in the direction of Fiscal Decentralization in the Federal set up, it is recommended that there should be a separate list of Local Taxes in schedule VIIth of the Constitution, for exclusive use of Local Bodies.*** The experience of more than a decade of Post-Constitutional amendment period shows that the State Governments are reluctant to share their financial powers with Local Bodies. When the Constitution has assigned separate functions to Local Bodies vide ***schedules XIth and XIIth*** there is every justification for earmarking a separate list of local taxes for Local Bodies. The list may include such taxes which have a predominantly local base. This issue may be taken up by the State Governments at a proper forum.

3.12.0 Conclusion :

3.12.1 No system of Fiscal Federalism can be final and perfect from all points of view and for all time to come. The system has to undergo adjustments and re-adjustments, according to changed circumstances. India has evolved a system which has been serving the needs of ***Center-State Financial Relations*** and more recently the State, local relations, though much more needs to be done in the domain of these relations. The role of the ***CFC*** has been substantial, which during the last 55 years have been suggesting new initiatives and new steps in the direction of ***Centre-State-Local Relations*** in the federal framework. Despite limitations, the Finance Commissions have made significant contribution to the theory and practice of Public Finances in the Country. The ***SFC***, though a new comer in the domain of Federal Finance, is an important stakeholder in the process of Fiscal Decentralization. Its contribution is of no less importance in strengthening the Federal Financial system of the Country. ***The future of Fiscal Federalism in India depends to a large extent on how the transfer system works, and reconciles Decentralization with Centralization and equity with efficiency, while respecting the Fiscal Autonomy of the States and Local Bodies.***

Table No. 3.1

Transfers From The Center To States

(As % Of Gross Revenue Receipts Of The Center)

Finance Commission	Share In Central Taxes	Grants	Total Through Finance Commissions	Other Transfers: Through Planning Commission	Other Transfers: Non-Plan Grants (Non-Statutory)	Total Transfer
1	2	3	4	5	6	7
VIIth	22.39	1.96	24.35	12.11	1.66	38.11
VIIIth	20.25	2.52	22.77	13.56	1.54	37.86
IXth	21.37	3.42	24.79	14.48	1.06	40.33
Xth	21.40	2.43	23.75	10.57	0.63	35.79
XIth	20.93	5.20	26.13	10.39	0.82	37.20

(Source : XIIth **Finance Commission Report – page 125)**

Table No. 3.2

Relative Share Of The States In The Combined

Revenue Receipts And Expenditure

(In %)

Finance Commission	Revenue Receipts Before Transfer	Revenue Receipts After Transfers	Revenue Expenditure
1	2	3	4
VIIth	35.3	61.4	58.0
VIIIth	34.6	62.0	55.7
IXth	37.5	64.7	56.9
Xth	38.6	63.0	56.8
XIth	39.0	63.9	57.1

(**Source – Report of the** XIIth **Finance Commission page 12)**

Table No. 3.3

Percentage Shares Of Grants And Tax Sharing Recommended By Finance Commissions

Finance Commission	**% Share Of Grants-In-Aid**	**% Share In Central Tax Revenue**
1	2	3
VII th	7.72	92.28
VIII th	9.55	90.45
IXth	9.96	90.04
Xth	8.96	91.04
XIth	13.47	86.53
XIIth	18.87	81.13

(Source : XIIth **Finance Commission Report – page 175)**

Table No. 3.4

Transfers Recommended By The XIth And XIIth FCs
The Composition(% Of Total Devolution)

SNo.	**Composition Of Transfers**	**XIth FC**	XIIth **FC**	**Devolution As Recommended By XIIth FC**	
				M.P.	**Chhattisgarh**
1	2	3	4	5	6
1	Tax Sharing	86.53	81.13	88.90	89.12
2	Grants-in-Aid of Which	13.47	18.87	11.10	10.88
(i)	Non-Plan Revenue Deficit Grant	8.13	7.52	Nil	Nil
(ii)	Grants for Up-Gradation of Certain Socio-Economic Services Including Calamity Relief	3.04	8.04	6.73	7.03
(iii)	Grants for Local Bodies	2.3	3.31	4.37	3.85
	Total (1+2)	**100**	**100**	**100**	**100**

(Source : Calculated from the data provided by the XIIth FC in its report)

Table No. 3.5

Devolution Criteria For Determining
Share Of Each State In Tax Devolution

SNo.	Criterion	Relative Weights Given To Each Criterion	
		XIth FC (%)	**XIIth FC (%)**
1	2	3	4
1.	Population	10	25
2.	Income Distance	62.5	50
3.	Area	7.5	10
4.	Tax Effort	5.0	7.5
5.	Index of Infrastructure	7.5	-
6.	Fiscal Discipline	7.5	7.5
	Total	**100**	**100**

Table No. 3.6

First Five Ranks Of States Along With Their Percent Shares In The Total

XIth Finance Commission			**XIIth Finance Commission**		
Rank	**State**	**% Share**	**Rank**	**State**	**% Share**
1	2	3	4	5	6
1	UP	19.798	1	UP	19.26
2	Bihar	14.597	2	Bihar	11.03
3	MP(Composite)	8.838	3	AP	7.36
4	West Bengal	8.116	4.	West Bengal	7.06
5.	AP	7.701	5.	MP	6.71

(Source : Report of the XIIth Finance Commission)

Table No. 3.7

Inter-Se Allocation Of Grants To
The State For Local Bodies Along With Weights

SNo.	Criterion	Weights (%)	
		XIth FC	XIIth FC
1	2	3	4
1.	Population	40	40
2.	Geographical Area	10	10
3.	Distance from the Highest Per Capita Income	20	20
4.	Index of Decentralization	20	-
5.	Index of Deprivation	-	10
6.	Revenue Effort	10	20
A.	With Reference to Own Revenue of State	-	10
B.	With Reference to GSDP	-	10

(Source : Report of the XIIth Finance Commission)

Table No. 3.8
Own Tax And Non-Tax Revenue Of Local Bodies As % Of GDP

Year	PRIs		ULBs		All Local Bodies	
	Tax	Non-tax	Tax	Non-tax	Tax	Non-tax
1	2	3	4	5	6	7
1997-98	0.026	0.021	0.413	0.149	0.440	0.170
2002-03	0.033	0.027	0.662	0.228	0.695	0.255
2006-07	0.037	0.030	0.900	0.298	0.937	0.328

(Source : Planning Commission – Working Sub-group on Local Finances)

Table No. 3.9
Fiscal Variables As Percent Of GDP
Central, State And Local Government
(1998-99 & 2002-03)

SNo.	Fiscal Variables	1998-99			2002-03		
		Central Govt.	State Govt.	Local Govt.	Central Govt.	State Govt.	Local Govt.
1	2	3	4	5	6	7	8
1.	Total Revenue Receipts	8.5	10.13	1.65	9.4	12.43	1.62
2.	Own Tax Revenue	6.01	5.11	0.30	7.07	6.30	0.26
3.	Own Revenue Receipts	8.5	6.50	0.46	9.4	8.44	0.39
4.	Total Receipts (Rev.+Capital)	16.41	15.09	1.65	20.90	18.85	1.62
5.	Revenue Expenditure	12.48	12.64	1.15	15.06	14.87	1.40
6.	Total Expenditure	16.0	15.29	1.74	18.36	18.64	1.69

(Calculated from the data provided by the XIIth FC and Reserve Bank – studies of central and state finances)

Table No. 3.10
The Extent Of Fiscal Autonomy And Fiscal Decentralization Achieved By Local Bodies In The Federal Structure Of India
(1998-99 & 2002-03)

S.N.	Indicators	1998-99	2002-03
1	2	3	4
1.	Share of Local Bodies in The Combined Revenue of The Central, State and Local Government (%).	2.40	1.72
2.	Own Tax Revenue of Local Bodies As % of Combined Tax Revenue.	2.25	1.90
3.	Revenue Expenditure of Local Bodies As % of Combined Expenditure	4.39	4.49
4.	Total Expenditure of Local Bodies as A% of Combined Total Expenditure	5.26	4.38
5.	Local Bodies Own Revenue as % of Their Revenue Expenditure	39.99	28.36
6.	Own Revenue of Local Bodies as % of Their Total Expenditure	26.47	23.51
7.	Own Tax Revenue of Local Bodies As % of Total Own Revenue	67.02	65.19

(Calculated from data provided in the report of the XIIth FC and the RBI study of Central and State finances).