

CHAPTER - 2

APPROACH AND METHODOLOGY

2.1.0 Introduction :

2.1.1 *In terms of Article 243 (I) and 243 (Y) of the Constitution, the SFC is required to perform a number of tasks which include devolution of resources from the State Government to Local Bodies through Tax Sharing and Grants-in-Aid, suggesting measures for augmenting resources of Local Bodies for improving their capacity to perform their functions more efficiently and effectively, designing criteria for inter-se distribution of shares of PRIs and ULBs, making explicit the principles underlying its recommendations, making review of State Finances and their projections on Normative Basis. These tasks are of considerable importance in view of their likely impact on Functional and Financial Decentralization of Local Bodies. The successful implementation of its recommendations can go a long way in taking Local Bodies a step further in the direction of making them units of Self-Governance. The magnitude of funds needed by Local Bodies is very large, compared to their *Own Resources* and those provided by the *State Government* on its own and also on the recommendations of the *SFC*, and by the *Central Government* on the recommendations of the *CFC*.*

2.1.2 *The importance of the SFC in the process of Fiscal Decentralization is considerable.* Besides arbitrating on the claims to the resources by the State Government and the Local Bodies, their recommendations are expected to impart growth and strength, stability and predictability to the transfer mechanism. The tasks before the SFC are important and the issues involved are numerous. The approach of the Commission would determine its course of action. Its approach has to be realistic and pragmatic. It may adopt such a methodology, which is justified by the availability of reliable data. The correctness of approach would help the Commission in tackling the issues, in a realistic manner.

2.2.0 Approach Of The State Finance Commission :

2.2.1 What should be the approach of the SFC while undertaking its task? No cut-and-dried answer can be given to this question. The approach would be influenced and shaped by a number of factors which are given below :

- 1) The *Constitutional Provisions*,
- 2) The *Terms Of Reference* designed by the State Government ,
- 3) The requirements of the *CFC* in respect of formulation of its recommendations for Devolution of Funds from the Centre to the States, for supplementing the resources of Local Bodies,
- 4) The *Financial Resources* of State Government ,
- 5) The *Financial Requirements* of Local Bodies and,
- 6) The *Approach adopted by earlier SFCs*.

2.2.2 The *SFC is a Quasi-Judicial Body which can determine its own procedures, methodology and principles governing its recommendations*. The Commission has to strike a balance between the needs of Local Bodies and the financial commitments of the State Government. The approach has to be objective, taking into account the different interests, it has to safeguard, and the different factors influencing its approach. The approach has to be comprehensive and systematic, suggesting right type of procedures and methodology for the collection and interpretation of data. Sometimes the methodology suggested by the Commission may not be adopted due to non-availability of reliable data, a common feature of Local Finances. Sometimes the approach of the SFC may not yield the desired results because of the non-availability of data, rendering its difficult to adopt the right type of technique and methodology.

2.3.0 Review Of State Finances :

2.3.1 *The exercise of devolution of resources from the State Government to Local Bodies on the recommendations of the SFC has to be attempted against the background of the Financial Position of the State Government, and the ways and means of improving and strengthening its Financial Position for balancing Revenue and Expenditure, and reducing Revenue and Fiscal Deficits*. The exercise would reveal

the capacity of the State Government to transfer funds to Local Bodies. It would also include projections of *Revenue and Expenditure* on some *Normative Basis* over the *Next Five Years*. *The capacity of the funding agency and its economic health has to be one of the major considerations which the Commission has to bear in mind, while designing the Fiscal Package for Local Bodies.*

2.4.0 Review Of Local Finances :

2.4.1 The report of the *SFC* would contain *an analysis of the Finances of Local Bodies*, at the pre and post transfer stage. *This constitutes an important step in the estimation of Revenue Gap which is essential for designing fiscal package for Local Bodies by the SFC and the CFC.* Since Revenue considerations are guided by Expenditure requirements, and Expenditure needs, flow from functions which Local Bodies have to perform, the *SFC*, in the *First instance*, would be required to *make an assessment of Functional Decentralization of Local Bodies* in the light of *Constitutional requirements*. The *Next* step may be to *make an assessment of Revenue Resources of Local Bodies* against the background of their taxation powers, assigned by the State Government and the extent of their exploitation by Local Bodies. *A Macro Review of Finances of Local Bodies would be made on the basis of data published by the XIIth FC in its report and memorandum submitted to the XII FC by Finance Department of Chhattisgarh Government*, despite the fact that such data are not disaggregated and are for a short period of 5 years. Besides the Macro survey, a Micro level study of Finances of Local Bodies would be made on the basis of sample survey. This would give us a more detailed and disaggregated picture of Revenue and Expenditure of *ULBs* and *Panchayats*. The data so collected may be blown up for the whole state and projections made for the *next five years on a normative basis*.

2.5.0 Estimation Of Revenue Gap :

2.5.1 Estimation of Revenue Gap is crucial since *this gap would constitute the basis for the recommendation of Fiscal Package for Local Bodies by the SFC and also by the Central Government, on the recommendation of the CFC.* In this connection, the methodology suggested by the *XIIth FC* is quite relevant and may be adopted by the

SFC. The *CFC* observes “*while Estimating the Revenue Gap, the SFC would follow a Normative Approach in the assessment of Revenue 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 Revenue by the *ULBs*, assuming reasonable buoyancies and the scope for Additional Mobilization of Resources. Per capita norms could be evolved on the basis of average Expenditure incurred by some of the best performing *ULBs* and *Panchayats* in the provision of core services”. *The gap between the Aggregate Revenue Expenditure and Aggregate Own Revenue known as the Revenue Gap* would provide the basis for the approach of the *SFC* and the *CFC* for recommending *Devolution of Funds*.

2.5.2 The Divisible Pool :

One of the important tasks of the *SFC* is to determine the size of the *Divisible Pool* and the principles regarding the determination of the pool taking into account the functional domain of the State Government and Local Bodies. The approach of the *SFC* in this respect is crucial. *The Divisible Pool would consist of three components, Share in State Taxes, Assignment of Revenue from certain Taxes, and Grants-in-Aid*. In this context, a number of important questions arise, (1) whether the *Divisible Pool* should include Plan as well as Non-Plan Funds, to be allocated to different Local Bodies? In this context it would not be out of place to mention that the *CFC* constituted under Article 280, has to allocate funds only for Non-Plan Revenue Expenditure requirements of State Governments, leaving the task of *Allocation of Plan Funds* to the *Planning Commission*. The Constitutional requirements do not draw any distinction between Plan and Non-Plan needs of Local Bodies. In fact, at the local level, the distinction between Plan and Non-Plan Expenditure is blurred because majority of Local Bodies do not maintain their Plan and Non-Plan accounts separately. In some states, the *First* and the *Second SFCs*, had included both plan and Non-Plan Funds in their proposals of devolution. But the First and Second *SFCs* of Madhya Pradesh, along with many others, had confined their devolution to Non-Plan Funds only, leaving the allocation of Plan funds to their respective State Planning Boards. (2) The next question that arises is whether the *Divisible Pool* should include

Sharing of Tax Revenue only or both the Tax and the Non-Tax Revenue of the State Government ? A number of State Finance Commissions, including the first SFC of Madhya Pradesh, had recommended the concept of Global Sharing, by including both Tax and Non-Tax Revenue in the Divisible Pool.

2.5.3 We have different models of *Revenue Sharing* to choose from; (i) the model of Sharing Total Revenue of the State Government which includes both Revenue Receipts and Capital Receipts, Plan Funds and Non-Plan Funds, (ii) the model of the Tax Sharing, (iii) the model of Sharing Revenue from specific Taxes and (iv) the model of Own Tax Revenue Sharing. *The choice of model may be guided by the TOR of the SFC and in their absence in the TOR, by the judgment and discretion of the SFC and the Constitutional provisions.* We do not find any justification for the inclusion of Plan Funds and Capital Account Funds in the Divisible Pool. Similarly there seems to be no justification for the inclusion of Non-Tax Revenue in the Divisible Pool. All this runs counter to the Constitutional requirements. If we accept the model of Tax Sharing, the obvious question that arises is: should we include only the Own Tax Revenue of the State Government or the Total Tax Revenue which also includes the share of the State Government in Central Taxes devolved to the States, on the recommendation of the CFC ? In this regard, the Constitutional position is clear, which states *“the distribution between the States and Local Bodies the net proceeds of Taxes, Duties, Tolls and Fees, leviable by the State”*. Obviously, the Share of the State in Central Tax Revenue has to be excluded from the purview of the Divisible Pool. The confusion was created by some of the SFCs which had recommended the inclusion of the Share of Central Taxes also in the Divisible Pool, despite the fact that the Constitutional position is very clear in this regard. This SFC, *therefore, recommends that Local Bodies should receive a certain percentage of the net Own Tax Revenue of the State Government, to be arrived at by deducting the share of the State Government in Central Taxes and also by netting out collection charges from the gross Own Tax Revenue, to arrive at the figure of Net Own Tax Revenue, constituting the Divisible Pool.* This amount is to be estimated every year on the basis of the figures of the previous year during the award period.

2.6.0 The Sharing Mechanism :

2.6.1 *The Next Task* of the *SFC* is to evolve the sharing mechanism for allocation to Local Bodies. This includes: (i) to lay down the percentage of Net States' Own Tax Revenue which will *constitute the Divisible Pool* for allocation among Local Bodies. This percentage would remain valid for the entire award period of the *SFC*, (ii) to determine the share of *PRIs* and *ULBs* separately, in the earmarked fund, (iii) to lay down the *criteria for inter-se distribution among different PRIs and ULBs*.

2.6.2 The approach of the *SFC* in respect of determining the criteria for recommending vertical transfers to Local Bodies has to be simple. There can be many criteria which the *CFC* may be adopting for recommending vertical transfers. The *SFC* may be adopting a simple criterion of population which largely represents needs, for recommending vertical transfers between *PRIs* and *ULBs* in the State. For horizontal transfers relating to inter-se distribution among different Local Bodies, there can be a number of criteria, population, per Capita Tax Revenue, cost disabilities, arising out from factors beyond the control of Local Bodies, like hilly terrain, excessive rainfall, proneness to droughts, the index of infrastructure development, slum population, the occupational pattern in urban areas. Certainly, it would be desirable to base transfers on the basis of an index, with different weights to the different factors in the index, to be constructed for the purpose. But at the local level, particularly at the village level, and the level of small towns, it would be difficult to adopt this approach on account of non-availability of reliable data. Moreover, the determination of relative weights would be a complicated affair. Most of the first and second *SFCs* in different states, had included the simple criteria of population, Per Capita Tax Revenue, Per Capita Expenditure on certain services, for determining horizontal transfers. To give some incentive for Revenue Mobilization, some *SFCs* had included Per Capita Tax Revenue among the criteria.

2.6.3 The Second *FC* of Madhya Pradesh had recommended 90% share of each Municipality, to be determined by the criterion of Population and 10% on the basis of share of an *ULBs* in Total Slum Population of Urban M.P. The amount so allocated on the basis of percentage of Slum Population would be exclusively utilized for the improvement of Slum Population in respective *ULBs*.

2.6.4 This Commission would adopt the criterion of population which is objective and for which reliable data are made available by the census, along with some weightage to the percentage of Slum Population in the Urban Area, to impart an element of equity to the allocation formula, knowing fully well that some more criteria could be included. But we may not adopt that, to avoid complications arising out of non-availability of data and also element of subjectivity entering into the criteria.

2.7.0 Grants-In-Aid To Local Bodies :

2.7.1 *Apart from Sharing of Tax Revenue*, the *SFC* has to recommend transfers in the form of *Grants-in-Aid*. The general purpose grants may have some element of incentive/disincentive to spur Local Bodies to improve their Financial Performance. Such grants are untied in nature, mostly to be utilized for the improvement of basic services according to priorities. *The Commission may adopt the criterion of population as the basis for the allocation of such grants along with an element of incentive. This element of incentive is to be based on the collection of Property Tax in relation to demand in the preceding year, Per Capita Grant increasing with increase in percentage of collection of Property Tax.*

2.7.2 The specific grants are tied in nature, meant for financing certain identified activities like drinking water, primary education, primary health facilities, street lighting, maintenance of roads, etc. These grants are to be conditional on particular services being rendered and maintained at particular level of efficiency, and Local Bodies exploiting their Own Resources to the extent indicated by the grant-giving agency.

2.8.0 Transfer Of Assigned Revenue :

2.8.1 The *SFC* has also to consider the transfer of *Assigned Revenue to Local Bodies*. There are some *Taxes like Passenger Tax, Entry Tax, Entertainment Tax, Surcharg /Cess on Certain Taxes*, which though belonging to the legitimate domain of Local Bodies, are levied and collected by the State Government either because of some historical reasons or because of better collection by the State Government. The net proceeds of such Taxes are to be assigned to Local Bodies, on the *Basis of Collection of Revenue* from their respective jurisdictions.

2.8.2 It has to be examined empirically by the *SFC* as to what extent the *Own Resources* have been exploited by *Local Bodies* and also to what extent power to levy taxes and introduce changes in the rates of taxes, is restricted by the State Government . In a federal set-up some restrictions are inevitable. Since self effort to raise resources may be one of the criteria for determining devolution of resources from the State Government to Local Bodies, the *SFC* would make efforts to collect data from Local Bodies to ascertain reasons for poor performance on this front.

2.9.0 Beyond The Fiscal Package :

2.9.1 Apart from recommending devolution of resources from the State Government to Local Bodies, the *SFC* would also go beyond the Fiscal Package and make recommendations in the areas of *Capacity Building and Administrative Reforms, the relationship between the Elected and Executive Wings of Local Government, Public-Private Participation in certain local services, Privatization of Certain Services, Fiscal Reforms including Budgetary Procedures and Accounting Methods, Building Up Data Base – all these are clubbed together under the head “Beyond The Fiscal Package”*. The successful performance of Local Bodies, to a large extent, depends on tackling problems arising in this field. So, the approach of the SFC would not only be to make efforts to improve the Financial Resources of Local Bodies but also improve their performance through certain Non-Fiscal measures.

2.10.0 Restructuring Of State Finances :

2.10.1 While recommending restructuring of State Finances, the SFC will take note of some *Key Fiscal Trends* that cause serious concern, Tax/Gross State Domestic Product Ratio (GSDP Ratio), large pre-emptive claims of Interest Payment on Revenue Receipts, high Revenue Deficits, large unsustainable Fiscal Deficits, declining level of Capital Expenditure, etc. but our approach would not be to consider every type of Fiscal Deficit as undesirable. *Fiscal Deficit which is mainly caused by increasing Revenue Deficit is not sustainable. But Fiscal Deficits caused by increasing capital investment, can be sustainable and may be desirable in the interest of development of the state.*

2.11.0 Implementation Of The Recommendations Of The SFC :

2.11.1 Measures recommended by *SFC*, relating to the augmentation of the consolidated fund of the State Government and also for augmenting the resources of Local Bodies and relating to Fiscal Reforms, call for appropriate action at different levels – the Local Government, the State Government and the Central Government. Though most of the recommendations are to be considered by the State Government which is required to decide about the “*Action Taken Report*”, there are certain issues and areas which are the concern of the Central Government and, therefore, call for action at that level. The *CFC* may be required to give its considered option on such matters for the guidance of the *Central Government*. At present, the *SFCs* of most of the states are not identifying such issues and problems which call for the action of the Central Government. This fact has been highlighted by the *XIIth CFC* in its report. *This SFC would make an attempt to identify such problems and recommendations which call for Central Action.*

2.12.0 Conclusion :

2.12.1 In this Chapter, the Commission has delineated its approach to deal with issues arising from its *Terms of Reference and its Constitutional obligations*. *It has evolved a systematic approach relating to evaluation of the process of Functional Decentralization in the light of Constitutional obligations, estimation of Financial Requirements on a reasonable Normative Basis, estimation of Revenue Gap to enable the Commission to design its Fiscal Package for Local Bodies, to examine the extent of Mobilization of Own Resources by Local Bodies and the flow of Grants-in-Aid from the State Government. It has also indicated its approach in respect of allocation of Divisible Pool among PRIs and ULBs, inter-se distribution of earmarked funds among different Local Bodies, and measures for the augmentation of Financial Resources of Local Bodies, Non-Fiscal measures to strengthen Local Government. We have also indicated our approach relating to the issue of restructuring the State Finances, with a view to improving the Fiscal Health of the State Government, so essential for devolving a larger amount from its kitty to the Local Bodies.* We would adopt a comprehensive and objective approach to the issues referred to the Commission under its Terms Of Reference and also to the issues relating to the role of the *SFCs*, raised by the *CFC*.

2.12.2 The recommendations of the *SFC cannot fill up the Entire Revenue Gap* of Local Bodies in the State. Neither this can be done by the devolution recommended by the *CFC*. In a Dynamic Society, Revenue Gap is bound to increase, with the widening and deepening of local functions. The task of filling up the Revenue Gap, is a difficult one, requiring efforts by all the concerned bodies – the Local Bodies, the State Government, the Central Government and agencies providing Institutional Finance in the Country, both domestic and foreign.

2.12.3 In every *Federal Set-Up*, devolution of funds takes place from the higher levels of government to the lower ones, but nowhere the devolution could meet the gap to the full extent. *In India*, the system of fiscal transfers from the Central to the States, operating for more than 50 years, could not meet all the financial needs of the State Governments. The task of meeting the Revenue Gap of *ULBs* and *Panchayats*, is more difficult because demands are much larger in magnitude and the kitty of the State Government is more limited compared to that of the Central Government. The capacity of Local Bodies to raise their Own Financial Resources is also limited. *The approach of the SFC would be to recommend Devolution of Funds to Local Bodies from the State Government, to the extent possible, as wanted by the Fiscal Health of the State on the one hand and the requirements of Local Bodies on the other.* Our approach would be to strengthen the basic fabric of the fiscal domain of Local Bodies. Our approach may provide such a magnitude of resource transfers from the State Government which would ensure correction for the decline in the volume of transfers relative to the GSDP of the State and the State Government Revenue Receipts.