Part V

RESOURCE ALLOCATION MECHANISM

CHAPTER 1 : INTRODUCTION

1. With regard to the Resource Allocation Mechanism (RAM), the Commission has highlighted certain important aspects of the present financial position of the Local Bodies and the State Government as well. Micro level organisations like Village Panchayats and other Local Bodies should be strengthened in terms of finance and administration to achieve satisfactory delivery of services.

The Commission has proceeded from the **needs angle** -- needs currently being attended to and the emerging needs in the coming years on account of the growing aspirations of the people. A detailed study has been made of the norms and standards for the six core services as detailed below:

i) Drinking Water,
ii) Roads,
iii) Street Lighting,
iv) Sanitation/Sewerage,
v) Solid Waste Management,
vi) Storm Water Drains.

The financial implications of the operation and maintenance expenditure relating to these six core civic services have also been worked out and the financial gap has been arrived at.This resource gap will have to be filled up from three sources.

i) Own resources of the Local Bodies;
ii) Allocation of funds by the State Government in the form of assignments and grants.
iii) Financial assistance from the Central Government.

2. It is inescapable that the State and the Central Governments will have to come forward to bridge the need gap with necessary financial assistance in the form of grants and share of revenues to help the Local Bodies carry out their functions. The Local Bodies, hereafter, will constitute a new Government below the State. In other words, Local Bodies are now endowed with Constitutional status and statutory responsibilities to fulfil the needs of the people. Hence, there should **be a well worked out and comprehensive scheme of transfer of resources to Local Bodies** from the higher tiers.

In this regard, the State Finance Commission considered the following aspects:

(i) Full exploitation of revenue potential, proper assessment of property, easy procedure for appeal, revision of rates on both residential and commercial properties and the components of property tax, enforcement of good collection, thorough review of exempted cases from property tax net, revision of rates of other Local Body taxes and optimum adoption of user charges will strengthen the mobilisation of internal resources.

(ii) Assignment of additional taxes, subject to the efficiency of Local Body to collect those taxes, and piggy-backing on certain elastic resources such as excise duty, sales tax and motor vehicles tax etc., will improve revenues of the Local Bodies.

(iii) The sharing might be through a formula based on factors such as Revenue collection efficiency, population and expenditure needs. Grant distribution policy should satisfy the principle of equalisation of expenditure, i.e., the transfer should be made in such a way as to reduce the imbalances and equalise the financial status and service levels of the Local Bodies.

(iv) The feasibility of privatising those services where NGOs can provide efficient services at competitive cost depending on the nature and type of service should be explored.

The problem of fiscal gap can be addressed, in principle, in four different ways:

a) increased local revenue effort;
b) increased local revenue authority;
c) increased transfers from higher levels of Government; and,
d) reduced local expenditure authority;

CHAPTER 2 deals with the status of State's finances. It contains a forecast of Revenue Generation for 5 years commencing from 1997-98 to 2001-2002, as furnished by the State Government.

CHAPTER 3 describes the existing scenario of the local body finance with reference to different types of local bodies, both rural as well as urban.

CHAPTER 4 furnishes a detailed picture about fiscal projections and resources gap, in relation to local body finance. The resource gap has been worked out on the basis of normative levels of services and the consequent financial implications relating to operation and maintenance expenditure.

CHAPTER 5 : FISCAL DEVOLUTION FROM GOVERNMENT

3. A sound design for Resource Allocation Mechanism has to meet the following objectives: (Para 5.5.4)

* Efficiency;
* Equity;
* Growth; and
* Autonomy.

Deducting Entertainment Tax included in Pool A, the net State Tax will be **Rs.7747 Crores. Percentage of Pool B works out to 8% on the net**. (Para 5.5.18)

6. The need for filling up the Gap over and above the additional tax and non-tax revenues of the local bodies have been considered with reference to the fiscal gap of individual units. As already pointed out, the overall aggregate deficit indicated in the tables 5.25 to 5.31 in the Report does not really reflect the position of individual units. However, examining samples of a few of these units with reference to real deficit, the State Finance Commission has arrived at the quantum of devolution needed from the net tax revenue of the State for the 5 years covering 1997 to 2002. (Para 5.5.19)

DISTRIBUTION: (Para 5.5.21)

7. Quantum of devolution from the net tax revenue of the State has been proposed after considering the devolution that would be feasible due to constraints on State Fiscal Conditions. It is also a point whether the Local Bodies would have built the capability to absorb any sudden jump in devolution in the very first year itself, because they will have to get properly equipped to manage the funds provided. In this context, the State Finance Commission considered whether the devolution can be in a phased manner to reach the target percentages atleast during the last year i.e. 2001-2002. Accordingly, State Finance Commission fixed the overall percentage for devolution in a phased manner. The percentage of devolution proposed for each year with gradual increase is as below:-

1997-98	-	8%
1998-99	-	9%
1999-2000	-	10%
2000-01	-	11%
2001-02	-	12%

SPECIAL RESERVE FROM GLOBAL SHARING: (Para 5.5.22)

8. The State Finance Commission recommends that the quantum of general allocation based on 8, 9, 10, 11, and 12 percentages for the respective year from the Divisible Pool B can be distributed after 15% of that is set apart as Reserve to meet the post devolution conditions:

Equalisation and incentive fund: (1) to correct deficiencies arising in the implementation of principle of distribition newly suggested and (2) **Incentive fund** to continue the incentive grants now made available for improvement of local tax collection efforts and the resources in the rural local bodies, viz., House Tax Matching Grant and Local Cess Surcharge Matching Grant. A part of it can be utilized for rewarding performance in tax collection in the Urban Local Bodies as well. A portion of the Incentive Fund can be utilised for rewarding the best Institution, Leader and Employee also, on the basis of a detailed Scheme to be worked out by the Government.

4. In order to achieve the above mentioned objectives, the design for RAM should be based on the following principles: (Para 5.5.5)

* Simplicity;
* Transparency;
* Dynamism;
* Pragmatism; and
* Predictability.

5. The suggestions incorporated in Part II of the Report aim at devolution from various sources of State revenues. They will form the basis for recommendations of State Finance Commission for financial devolution. Those recommendations aim at assistance on indivudual tax base. However, for having a percentage of general sharing from the State Taxes, they have been taken as basis, as indicated in the Pool A and B below. If a general sharing is not accepted, the sharing of individual taxes will arise. (Para 5.5.18)

I. **Pool A**: This contains taxes which rightly belong to the local bodies but collected by the Government - The items included and projection of income for 1997-98 are as below. This is not included in the Total Tax Revenue Projections furnished by Government except for Entertainment Tax. This is to be distributed among the Local Bodies concerned.

	Projection for 1997-98 Rs. in Crores
a) Surcharge on stamp duty (Figures arrived at based on actuals for 1995-96 indicated by the Registration Department during evidence)	230.00
b) Local Cess and Local Cess Surcharge (Due as per the basic L.R. computed by Damodaran Committee, 1990 - at Rs.5.30 crores)	30.00
c) Entertainment Tax	120.00
Total	**380.00**

II. **Pool B**: This forms the nucleus for General Devolution from Net Tax Revenue of the State to the Local Bodies. This quantum and percentage has been computed by adding the shares recommended by State Finance Commission on certain Levies in Part II and also from other State Taxes and projected for 1997-98.

	Rs. in Crores
a) Sales Tax } b) Motor Vehicle Tax } c) State Excise Revenue } d) All others }	620.00
Total	**620.00**
Total Tax Revenue of the State projected for 1997-98	**7867.00**

9. In this context, it may be noted that the Equalisation Fund proposed considering the fact that the distribution under the new formula is being made for the first time and that there may be genuine cases where the new system may not work in its true spirit. The quantum needed cannot be decided at this stage and hence an ad hoc provision has been suggested. With the experience gained during the first year of distribution, the reserve for the future years can be suitably modified. If any sum is left undisbursed out of the Equalisation Fund, it can be redistributed to all the Local Bodies on the principles as formulated for general distribution. The question of surrendering the reserve may not, therefore arise.

10. Out of the total net allocation available for general distribution under the Divisible Pool B, as stated in earlier paras, 15% had been earmarked for Equalisation and Incentive Fund. The remaining 85% may be made available for distribution on the formula proposed by the State Finance Commission for sharing between Urban and Rural Local Bodies and for inter se distribution among the various tiers. This special reserve Fund may be kept at the State level.

11. The 85% of net allocation available for general distribution indicated in earlier paragraphs, will be allocated for vertical and horizontal distribution as per the principles discussed hereafter. These principles have emerged after detailed discussions with Line departments and the State Planning Commission.

CHAPTER 6 : RESOURCE ALLOCATION MECHANISM (Para 5.6.6)

12. According to the terms of reference, the State Finance Commission is to recommend the principles which should govern the distribution of resources between the State and the Local Bodies. While doing so, the following aspects are borne in mind: (5.6.6)

(i) the transfer of resources is on revenue account only i.e. for operation and maintenance (O & M),

(ii) the resources should be utilised for core civic services by the Local Bodies,

(iii) the financial position of the Local Bodies should be assessed upto 31.3.94 and the allocation is to be recommended for application for a period of 5 years commencing from April 1997 onwards.

VERTICAL AND HORIZONTAL DISTRIBUTION: (Para 5.6.8)

13. This allocation available for general distribution from State to Local Bodies involves the following two vertical levels and the third, horizontal level of distribution and the recommendations are as below.

LEVEL I: (Vertical) Allocation of funds earmarked by the State for transfer to Local Bodies

(i) Rural Local Bodies and

(ii) Urban Local Bodies

LEVEL II: (Vertical)	Distribution of allocations earmarked to Rural/Urban Local Bodies in Level I to the respective tiers of District Panchayats, Panchayat Unions, Village Panchayats under Rural and Town Panchayats,Municipalities and Municipal Corporations under Urban.
LEVEL III: (Horizontal)	Inter se distribution of funds allocated to the respective tiers viz. allocation among Village Panchayats/Panchayat Unions/ District Panchayats and Town Panchayats /Municipalities/ Municipal Corporations.

14. To decide these transfers to appropriate levels as explained above, the principles followed should be:

(i) Simple and clear
(ii) Based on data which are available and authentic;
(iii) Just and equitable.

The methodology recommended by the State Finance Commission for the transfer of funds from State to Rural and Urban Local Bodies are given below:(Para 5.6.9, 5.6.11)

Level-I : From State to Rural and Urban Local Bodies: (Vertical) (Para5.6.12)

The population formula is generally accepted as a good basis for allocation of funds to Local Bodies both from the point of view of volume of services to be delivered and from the point of equity. The transfer of funds from State to Rural and Urban Local Bodies will therefore be based on population as per the last census. The ratio for the distribution of funds between the Rural and the Urban Local Bodies would be 60:40.

Level-II : Rural (Vertical) (5.6.13)

Distribution from out of the funds allotted to the **Rural Pool** to different tiers viz.:

(i) District Panchayats
(ii) Panchayat Unions
(iii) Village Panchayats will be as follows:

(i) **District Panchayats**: The District Panchayat is a new phenomenon and its structure and functions are yet to be spelt out clearly. Hence, only a lumpsum grant (Block grant) is now suggested to meet its actual needs out of the total allocation for the Rural Pool. Tentatively, this is fixed at 14% of the total Rural Pool.

(ii)**Panchayat Unions/Village Panchayats**: Considering the number of Institutions involved, their respective sphere of activities, nature and level of civic services and the staff deployed to carry out such services, the ratio between the Panchayat Unions and Village Panchayats has been recommended on 50:50 basis, out of the balance remaining, after distribution to District Panchayats under (i) above.

Leve III : (A) Interse Distribution - Panchayat Unions:

(i)	Weightage on total population (last census) of the Panchayat Union	50%
(ii)	Weightage on SC & ST Population	25%
(iii)	Weightage for financial viability of Panchayat Unions (Average Per Capita Land Revenue)	25%
	Total :	**100%**

15. Since the categorisation of the Panchayat Unions has been done on the basis of their average per capita land revenue earnings, this parameter acts as a proxy for the financial strength of the local bodies. The lower category can be assigned a higher weightage, so that the local bodies under this category can be compensated for their lower earnings, while the higher category of Panchayat Unions can get relatively lower weightage, with the highest category getting the least weight. (Para 5.6.14)

16. In view of the fact, that the population in the Panchayat Unions is the dominant factor that derives benefits from the expenditure of the Unions, a larger weightage in the allocation process is given to the above factor. The weightage suggested is 50%. The balance of 50% is assigned to the other bases viz. 25% Weightage on SC & ST population and - 25% allocated for financial viability. This financial indicator means an inverse proportion for weightage viz. the higher the per capita land revenue the lesser the weightage to be given and lower the per capita, higher the weightage. The formula for the Panchayat Unions has been demonstrated in the sample furnished in Appendix (Para 5.6.15)

17. The horizontal distribution of funds allotted to Village Panchayats will be as below:- (Para 5.6.16)

Level III (B): Inter se Distribution - Village Panchayats

(i)	Weightage on Total population (Last Census i.e. 1991)	-	50%
(ii)	Weightage on SC/ST population (Last Census i.e. 1991)	-	15%
	Sub Total		**65%**
(iii)	Per capita House Tax Collection Performance	-	15%
(iv)	Core Civic Services infrastructure maintenance deficiency (with reference to physical assets available in the Village Panchayat area)	-	20%
	Total		**100**

NB: For sample Village Panchayats, the formula has been demonstrated in Appendix.

18. The Principles of distribution recommended by the State Finance Commission of **urban** allocations are as below:- (Para 5.6.17)

Urban Local Bodies (Vertical)

Level I (Vertical)	Distribution of funds from the state to the Rural and Urban Local Bodies based on the ratio of population of Rural and Urban Local Bodies i.e. 60:40 basis. (As already indicated under Rural)
Level II (Vertical)	Distribution of funds from the **Urban pool** to different tiers (i) Town Panchayats (ii) Municipalities. and (iii) Corporations

19. The above distribution is based on the ratio of the total population of respective tiers viz. Town Panchayats, Municipalities and Corporations based on - 1991 census figures. (Para 5.6.18)

The current ratio will be:

		Percentage
(i)	Town Panchayats	38
(ii)	Municipalities.	31
(iii)	Municipal Corporations	31

Level III (Horizontal)	Distribution of funds inter se the institutions viz. Town Panchayats, Municipalities and Municipal Corporations

20. The following principle of weightage will be adopted for inter se distribution from out of the divisible pool of the respective tier of Local Body. (Para 5.6.19)

	Town Panchayats	Municipalities	Corporations
(i)Total Population (1991)	45%	45%	40%
(ii)Total SC/ST Population (1991)	20%	10%	10%
Sub Total	**65%**	**55%**	**50%**
(iii) **Financial indicator** Per Capita receipt under own resources (Average of both Tax and Non-Taxresources for the last 3 years ending with 31.3.94)	15%	15%	15%
(iv) **Service indicator** (Existing Per Capita Expenditure on core civic services for the last 3 years ending with 31.3.94.)	20	30	35
Total	**100**	**100**	**100**

21. OPERATIVE PORTION OF THE REPORT: (Para 5.6.21)

Pool A: This contains taxes which belong to Local bodies but collected by the Government. However, this does not form part of State taxes except for Entertainment Tax. This is to be distributed among the Local bodies concerned.

		Projection for 1997-98 (Rupees in Crores)
a)	Surcharge on Stamp Duty	230.00
b)	Local Cess and Local Cess Surcharge	30.00
c)	Entertainment Tax	120.00
	Total:	**380.00**

Pool B: This is the divisable pool containing all State taxes excluding Entertainment Tax in Pool A.

			Projection for 1997-98 (Rupees in Crores)
a)	Sales Tax	}	620
b)	Motor Vehicle Tax	}	(This constitutes nearly
c)	State Excise Revenue	}	8 percent of the Divisible
d)	All Others	}	Pool*)

*** DIVISIBLE POOL:** Total tax revenue of the State projected for 1997-98 = Rs.7867 crores - Entertainment Tax of Rs.120 crores = Rs.7747 crores.

Progressive Devolution: Pool B

1997-98	8%	of the total tax revenue of the State
1998-99	9%	-do-
1999-2000	10%	-do-
2000-01	11%	-do-
2001-02	12%	-do-

Principles of Distribution: Only out of Pool B

Total	100%
State Reserve (15% towards Equalization Fund and Incentive Fund)	15%
Divisible Pool	85%

		Out of 85	Out of 100
Rural Local bodies	-	**51**	**60**
District Panchayat	-	7	8
Panchayat Union	-	22	26
Village Panchayat	-	22	26
Urban Local bodies	-	**34**	**40**
Corporation	-	10.5	12.5
Municipalities	-	10.5	12.5
Town Panchayats	-	13	15

Mode of Release:

Funds will be released by the State Government to the local bodies in three instalments as follows:

1st Instalment - April - May	-	25% of provision
2nd Instalment - August - September	-	50% of provision
3rd Instalment - January-February	-	25% of balance

The difference with actuals will be adjusted during the release of Ist Instalment of the following years.

22. ADDITIONAL DEVOLUTION BY THE STATE: (Para 5.6.21)

1993-94	(Actuals)	-	Rs.341.5 Crores
1996-97	(R.E.)	-	Rs.556.90 Crores
1997-98	(SFC's Recommendation)	-	Rs.1000 Crores
Percentage of increase over the previous year		-	80%

The impact of devolution proposed for the period from 1997-98 to 2001-02 is attached.

Once the principles of devolution on the above basis are given effect to, the assistance to be based on individual taxes and tied and un-tied grants for maintenance purposes will not arise. However, it needs to be explained, that these recommendations are related to the existing levels of service. Any further devolutions of functions and additional infrastructure creation in future years will have to be taken care of separately outside the scope of the devolution now proposed, since the yearwise devolutions are designed to take into account the inflationary trends of existing assets only.

CHAPTER 7 : PRINCIPLES FOR DISTRIBUTION OF ALLOCATION MADE BY THE TENTH FINANCE COMMISSION

23. CAPITAL FUND: (Para 5.7.11 to 5.7.16)

The TFC award along with investment by surplus local bodies will constitute a Corpus fund, in which Local Body will hold shares and State Government will give matching contribution. Over this market borrowing could be done for the Capital Fund. It could be accessed through matching contribution by the local bodies.

Statement Showing the Devolution to Local Bodies

(Rs. in Crores)

	O.R.	Local Base Tax Pool A	Divisible Pool B (85% for Local Bodies)	Equalization & incentive Fund (15% of the Pool B) State Reserve	Total	Total Expenditure Proposed	Net Position
1997-1998	518.05	380.00	527.00	93.00	1518.05	1472.50	45.55
1998-1999	556.19	410.40	655.68	115.71	1737.98	1619.74	118.24
1999-2000	655.97	448.23	805.56	142.34	2053.10	1781.34	271.76
2000-2001	723.87	478.69	931.17	164.32	2298.05	1959.92	338.13
2001-2002	800.48	516.99	1066.21	188.15	2571.77	2156.10	415.67