CHAPTER 5

FISCAL DEVOLUTION FROM GOVERNMENT

5.5.1. The resource gap for each of the tiers of LBs for the five years covering 1997-2002 indicated in the Tables 5.26 to 5.30 in Chapter 4 does not, however, take into account the additional resources likely to be generated from the new taxes proposed and the over-all improvements expected from non-tax revenues based on the recommendations of the SFC. since they will depend on their acceptance by the Government.

5.5.2. The resource gap indicated could be covered only through the following:

(i) Additional resource generation in LBs from their revenue resources;

(ii) Increase in assignment by way of additional tax assignment or increase in the share of revenues of the State;

(iii) Grants from Central and State Governments.

5.5.3. It may thus be seen that there is need for a well-worked out and comprehensive scheme of transfer of resources to LBs from the higher tier, namely, Government to reduce the imbalances.

5.5.4. Such devolution should have a sound design for Resource Allocation Mechanism (RAM) to ensure the following objectives:

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

5.5.5. While achieving the above mentioned objectives, the design for RAM should also be based on the following principles, namely,

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

Existing Method of Assistance

5.5.6. Before examining a revised system of devolution, the existing method are discussed below:

The Local Bodies, both Urban and Rural are assigned revenue from the taxes of local base earmarked for them which are colleceted by the Government. In addition, assignments of revenue from some of the State taxes are also passed on to the Local Bodies like Sales Tax Surcharge. In the latter case, the entire distribution is on an adhoc basis, and no regular system of devolution has been prescribed.

5.5.7. The rural Local Bodies mainly depend on sizeable grants from State Government, mainly purpose oriented and as development grants, while the Urban Local Bodies had very little grants. The assignment of grants to the urban local bodies, by the State has been adhoc and arbitrary. This is clear from the fact that the total grants extended to the three types of local bodies under urban, both under the capital account and the revenue account, have exhibited wide fluctuations during the three years. One of the fundamental requirements of a good local body finance system is predictability. The existing system is anything but this, Effective expenditure planning at the local level suffers as a consequence. The level of assistance to Urban Bodies are as given below:

Revenue Grants

5.5.8. At present, the revenue grants extended to the urban local bodies account for 3.58% of the total revenues of Corporations, 4.24% of the total revenues of Municipalities and 2.52% of the total revenue of the Town Panchayats. The level of grants has undergone very marginal changes over a period even in absolute terms.

Capital Grants

5.5.9. In 1993-94, the Corporations received Rs.4.42 crores as grants, not including the grants given for specific State Schemes. This amounted to 11% of their total receipts. During the same year, all the Municipalities received a total of Rs.3.18 crores which made up 5.45% of their total capital receipts and the Town Panchayats received Rs.4.79 crores totally which added upto 15.87% of their total capital receipts.

Loans

5.5.10. Loans constitute an important form of capital assistance to the LBs. Loans amounted to 75.6 %, 22.5 % and 17.19% of the capital receipts of the Corporations, Municipalities and the Town Panchayats respectively.

Concept of Global Sharing

5.5.11. Keeping the principles and objectives indicated in paragraphs 5.5.4 and 5.5.5 in mind, the SFC has considered a three level model for devolution of financial resources in the ensuing paragraphs. In this context, the concept of global sharing of tax revenue by the Centre to the States has also been studied. Pooling of all the tax resources or select tax resources would lead to emergence of a divisible pool. The TFC has recommended 29% of resources to be handed over to the States from a central divisible pool. This concept of global sharing has its merits as well as demerits.

5.5.12. The claimant from the Central Government divisible pool would be one category viz. States. In the case of divisible pool of resources at the State level, there are six claimants viz. Municipal Corporations, Municipalities, Town Panchayats on the urban side, District Panchayats, Panchayat Unions and Village Panchayats in the rural sector with more number of individual units in each sector. These Local Bodies are also not on equal footing. Therefore, the task of distribution of resources at the State level to all Local Bodies is more elaborate and complicated.

5.5.13. The various recommendations in Part II "Augmentation of Resources" aim at higher assignments from the various sources of State revenues besides improving local resource generation. The assignments from State revenues are related to individual tax bases which have a local bearing. However, a devolution based on a percentage of total State tax revenues is considered in relation to the quantum of assistance anticipated under the recommendations in Part II. In this context, the recommendations based on individual tax base will be relevant only if the Government are not agreeable to a pattern of general devolution.

5.5.14. The devolution from the State on the basis that a percentage of total tax revenues should be allocated to various tiers of Urban/Rural LBs based on the principles of allocation recommended by the SFC is discussed in the ensuing chapters. Similarly, the horizontal distribution among the different units of LBs can be made on the guidelines indicated by the SFC for such devolutions. The SFC has devised RAM after considering the deficiencies of the existing system and also the resource requirements of the Local Bodiess to cover the gap indicated in the Tables given in the earlier Chapter.

5.5.15. State Finance Commission also examined the options of sharing tax-wise and general sharing out of total tax revenue. Some of the taxes levied by the State are identified and earmarked as taxes for local bodies viz. Local Cess, Local Cess Surcharge, Stamp Duty Surcharge and Entertainment Tax indicated in Pool A in the ensuing paragraphs, but collection is being done by the Government for the sake of efficiency and better management. This being dependent on the local potential, the yield will also vary. The inclusion of these taxes in general sharing is not advisable and may not also be acceptable to Local Bodies. This type of distribution will not only affect adversely the existing resources but will also lead to improper distribution by diverting the income from one local body with a good potential to another local body which does not possess this capacity. Hence, State Finance Commission has decided to retain the existing method of devolution of revenue, in respect of taxes already earmarked for the Local Bodies, either collected by them or by the Government.

5.5.16. The sharing of the State Tax Revenue has been indicated in Pool B in the ensuing Chapter which includes all taxes except Entertainment Tax on the basis of projected estimates given by the State - Finance Department.

5.5.17. Since there is a possibility that too much of assignments to local bodies may curb the incentive to raise adequate own resources, assignments should generally supplement revenues, and not replace them. In order to ensure this, a clear line of accountability has to be established.

5.5.18. However, for having a percentage of general sharing from the State Taxes, the recommendations in Part II have been taken as basis, as indicated in Pool A and B below.

I. **Pool A**. This contains taxes which rightly belong to the local bodies but collected by the Government - The items included the 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, as is being done now.

		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 Land Revenue 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 the State Finance Commission on certain Levies indicated in Part II and also from other State Taxes as projected for 1997-98.

			Rs. in Crores
a)	Sales Tax	}	
b)	Motor Vehicle Tax	}	620.00
c)	State Excise Revenue	}	
d)	All others	}	
	Total		620.00

Total Tax Revenue of the State projected for 1997-98 7867.00

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.**

5.5.19. 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.

Distribution

5.5.20. Quantum of devolution from the net tax revenue of the State has been proposed after considering what would be feasible after duly considering the 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 and utilize 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, the 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:-

1997-1998	-	8%
1998-1999	-	9%
1999-2000	-	10%
2000-2001	-	11%
2001-2002	-	12%

Special Reserve from Global Sharing

5.5.21. 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 the 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, best elected Leader and Employee also, on the basis of a detailed Scheme to be worked out by the Government.

5.5.22. 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.

5.5.23. In this context, it may be noted that the Equalisation Fund is 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 adhoc 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