



# **WORKING PAPER**

# **98**

## **FISCAL DECENTRALIZATION IN INDIAN FEDERALISM**

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# **FISCAL DECENTRALIZATION IN INDIAN FEDERALISM**

**M. Govinda Rao\***

## ***Abstract***

*The paper analyses fiscal decentralization in a three-tier federal framework in India. After describing the prevailing system, the paper identifies anomalies in assignments of intergovernmental transfers. Analysis shows that fiscal deficits in the country are due to mismanagement at both the central and the state levels. Despite the semblance of a hard budget constraint at the State level, the states have found ways to soften them. The transfer system has equalizing impact, but has disincentives for fiscal management as well. It is also seen that despite Constitutional recognition, the role of local governments in providing public services is abysmal.*

## **Introduction**

In recent years, the subject of fiscal decentralization has received enthusiastic attention from academic analysts and policy makers alike. Most analysts find inherent merit in decentralization; often it is considered as a component of human well-being and therefore, an end in itself. In decentralization, the policy makers see a panacea for many ills afflicting society. It is expected to achieve many things, such as enable efficient allocation of resources, improve governance, accelerate economic growth and reduce poverty, achieve a gender balance and empower weaker sections of society. This enthusiasm towards decentralization is seen in countries with federal constitutions and unitary systems; it has spanned across countries with different ideological spectrum and varying levels of development. Of course, there have been a variety of reasons and motivations for decentralization in different countries. These include democratization of polity, advent of a multi-party system, transition from planned to market economy and accommodating diverse ethnic, linguistic and religious identities (Litvack, Ahmad and Bird, 1998).

Much of the analyses, however, are based on the preconceived notion that decentralization will necessarily result in more efficient delivery of public services, irrespective of the institutional setting, capacity of the institutions and economic environment in which they are rooted. Empirical evidence points towards important preconditions for decentralization to achieve efficient and equitable delivery of public services. The experiences

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in developing countries, in particular, underline the fact that there is much to be done to create appropriate conditions for fiscal decentralization to be successful in achieving its objectives. Tanzi's (1996) contribution in this area is in cautioning us that even in achieving allocative efficiency, a number of preconditions must be met for decentralization to be successful. The co-ordination requirements between different governmental levels are even more stringent with regard to achieving effective macroeconomic stabilization and the desired state of redistribution. The problems are particularly severe in developing and transitional countries.

Among developing countries, India with a federal constitution is a case with relatively greater degree of fiscal decentralization. However, in terms of delivering public services, mobilizing physical and human resources, harnessing the synergies and unleashing incentives to exploit the developmental potential, regional and local fiscal autonomies have worked with varying degrees of success even within the country. In some regions, fiscal decentralization has been more successful. The experience of decentralization in India should help us to gain a better understanding of the preconditions and institutional requirements and capacity development essential for fiscal decentralization to achieve efficient and equitable delivery of public services.

There are a number of additional reasons for the analysis of fiscal decentralization in India. The adoption of market-oriented reforms since 1991 has redefined the role of the state and this has necessitated a re-examination of fiscal arrangements between different levels of government. In fact, there have been opposing forces at work. On the one hand, the transition from centralized planning and market-based resource allocation have enhanced the role of subnational governments in delivering social and physical infrastructure, increasing trend in regional inequalities has necessitated a greater central role. Inter-regional distribution of incomes has shown increasing inequality during the 1990s (Rao, Shand and Kalirajan, 1998). There is also considerable debate on the trends in poverty with official statistics showing increasing trend in recent years. Efficient anti-poverty interventions warrant a solution within the co-operative federalism framework (Inman and Rubinfeld, 1992). It must be noted that despite a decade of fiscal adjustment, fiscal imbalances at both the central and the State levels continue to pose a serious threat to macroeconomic stability in the country.

Another important reason for the examination of fiscal decentralization in the Indian context is the statutory recognition of the third tier of fiscal structure and evolution of a formal three-tier federalism subsequent to the 73rd and 74th Constitutional amendment in 1993. The introduction of the third tier of fiscal authority has met with varying degrees of success in delivering public services in different States and it is important to examine the extent of sub-State decentralization in different

States. The analysis assumes importance also due to the fact that the institutional environment for the delivery of services has significantly changed with the advent of a coalition of parties in power at the Central level and emergence of regional parties in the States and as partners in the Central coalition.

While there is a large body of literature on Indian fiscal federalism, much of this is confined to the discussion of the fiscal relationship between the Union<sup>1</sup> and State governments. Despite constitutional recognition of the third tier in 1992, analysis of fiscal decentralization incorporating the role and functions of the third tier in conjunction with the first two tiers does not exist. This paper attempts to provide a more complete picture of fiscal federalism in India incorporating the relative roles of all the three tiers of government.

## **Evolution of Indian Federalism**

### **Evolution of two-tier federalism**

India is a federation with constitutional demarcation of functions and sources of finance between the Union, State and local governments. However, statutory introduction of the third tier is a recent phenomenon, i.e., after the 73rd and 74th amendments of the Constitution in 1992 gave the rural and urban local governments constitutional status. Until this development, India evolved as a two-tiered federal structure with the powers and functions demarcated between the Union and the States. Though informally, also some degree of decentralization below the state level existed for a long time.

Historical factors have played an important role in the adoption of a federal constitution with strong unitary features in India. During British rule, centralization was a colonial necessity. At the same time, the difficulty of administering a large country with a number of principalities, different languages, cultures and traditions did force the Central government to devolve some powers to regional units. Indeed, for a period of about two decades in British India, prior to the enactment of the Government of India Act 1935, the system required the provinces to make a contribution to the Union.

There were strong arguments for decentralization before independence. The Cabinet Mission sent by the imperial government envisaged limited powers for the Union in a three-tiered federal structure. Nevertheless, the Constitution that was eventually adopted by the Indian Republic closely followed the Government of India Act, 1935, with pronounced 'quasi-federal' features. The shift probably occurred for two reasons: First, once the Muslim majority areas opted out of India for a separate country (Pakistan), the principal reason for a loose federal structure vanished. Second, a strong centre was found desirable to

safeguard against fissiparous tendencies among constituent units. (Chelliah, 1991). The decentralization framework provided by the founding fathers of the Indian Constitution was an experiment to adopt the federal idea to a large and extremely diverse economic, cultural, social and linguistic society. The heavy reliance on the 1935 Act was justified on the grounds of 'continuity and harmony' (Chanda, 1965). Naturally, many important features of the Act, including a heavy centripetal bias and administrative and judicial arrangements enacted for the limited purpose of colonial administration, were formally incorporated into the Constitution.

The centripetal bias in fiscal matters was seen mainly in the assignment and vesting of residuary powers with the centre. The most important factor that concentrated economic powers with the union government, however, was entry 22 in the concurrent list - 'Economic and Social Planning' and the consequent experiment on social engineering attempted through centralized planning in a mixed economy framework. What is however significant is the fact that the development over the years concentrated the financial powers with the Union government. The most important event that concentrated the financial powers of the Union government, however, was the nationalization of major financial, including banking and insurance institutions.

The Constitution of the Indian Republic, like the Government of India 1935 Act, provided the three-fold division of powers. The matters of national importance were placed in the Union list, while those of regional importance were placed in the State list and those that would require a co-operative solution were placed in the Concurrent list. The residuary powers were assigned to the Union government.

## **Sub-State decentralization**

Formally, Indian federalism evolved as a two-tier structure until 1992. Nevertheless, local government units existed both in urban and rural areas, basically acting as agencies of the State government. Historically, in rural areas Panchayat Raj (PR) institutions in villages provided basic community services and dispensed justice. In 1957 a committee was appointed by the Government of India to review the functioning of these local government agencies. The committee recommended that:

- (i) these local governments should be constituted through a democratic electoral process,
- (ii) the elected members should represent the local interest and should ensure proper selection and supervision of various projects to conform to the preferences of the residents,
- (iii) the local governmental units should be vested with adequate financial powers.

Subsequent to the recommendations of the committee, most State governments introduced the third level of government in rural areas. In many of the States, a three-tier structure of the local government unit evolved with panchayats established at village, taluk (block) and district levels. Similarly, in urban areas, the State governments instituted municipal corporations, municipalities and notified area committees and devolved some revenue and expenditure powers to provide urban services.

However, the framework was not adequate and the system was not congenial for the development of local self-government in most of the States. The oligopolistic power structure in local jurisdictions did not provide the elected representatives a representative character. The socially disadvantaged groups who also belonged to the poorer sections of society did not effectively participate in the decentralization process. There was no mechanism to prevent the State governments from superceding the duly elected local governments nor was there any mechanism forcing them to hold regular elections to the local bodies. The fiscal powers of the local governments did not generate adequate revenues and they had to perennially depend upon the State government grants to provide services. In the event, the third level did not really function as a unit of self-government and it could hardly provide the services corresponding to the varying needs and preferences of different localities. Of course, the effectiveness of these institutions varied from State to State, depending upon the initiative taken by them.

The initiative taken by the Union government to rejuvenate these institutions resulted in the appointment of another committee which submitted its report in 1978 (India, 1978). The committee recommended a three-tier structure of rural governance. The only difference from the previous experiment was that a cluster of villages with 8-12 thousand population (Mandal Panchayat) rather than for each village formed the lowest level of local government. The report recommended the devolution of fiscal, including borrowing, powers to local bodies. Of course, not much was done to implement the recommendations.<sup>2</sup>

The statutory recognition to local governments was accorded with the 73rd Constitutional Amendment in 1992. With this, each of the State governments was required to pass legislation appointing Panchayat Raj institutions. The election to these panchayats was to be held within the stipulated period. If the elected governments at local levels are superceded, elections should be held within the six months. An illustrative list of functions and sources of finance for both rural and urban local bodies was also set out in the amendments. Each State government was required to appoint a State Finance Commission to assign taxes and fees to local governments, and recommend tax devolution and grants.

The evolution of urban local governments was on similar lines. By necessity, the States had to create local bodies, though the

Constitutional recognition came only after the 74th amendment in 1992. Each State legislated separate Municipal Acts, assigning the civic functions and sources of revenue. In general, the assignment of revenues was inadequate. Though all municipal bodies could levy property taxes, revenue productivity from the tax was low. Most of the States were allowed to levy 'Octroi', a tax on the entry of goods into a local area for consumption, use or sale. In general, the standards of services provided by the municipal bodies were poor and the State governments had to create a number of independent agencies such as housing boards, water supply authorities, and various improvement trusts to ensure minimum services.

The amendment of the Constitution also assigned 37 activities to urban local governments. The new arrangement, in addition to those functions that were already assigned, also gave the functions of secondary and adult education, housing and land use, promotion and development of industrial and commercial estates, and electricity distribution to the urban local bodies concurrently with the State governments.

Indian experience shows that attempts to decentralize below the State level has come about more from the Centre than the States. Many states did not find it necessary to decentralize below their level until the Constitution was amended. However, some States such as Karnataka took a proactive approach to decentralization. Such an initiative was the exception rather than the rule. Thus, sub-state decentralization in India is mostly a 'top-down' process.

## **The System**

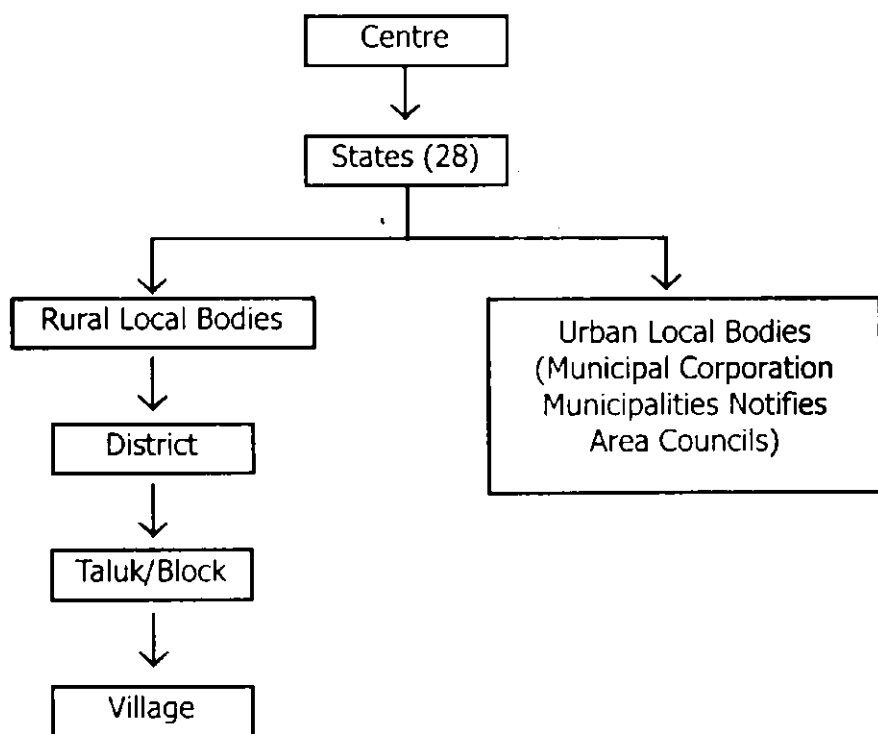
Federalism in India is characterized by constitutional demarcation of revenue and expenditure powers among the three levels of government. The institutional structure of multilevel provision of public services is shown in Chart 1. One billion people in the country are spread over twenty-five<sup>3</sup> States and seven centrally administered territories. The Seventh schedule to the Constitution specifies the legislative, executive, judicial and fiscal domains of Union and State governments in terms of Union, State and concurrent lists. The Constitution also requires the President to appoint a Finance Commission every five years or earlier to review the finances of the Union and the States and recommend devolution of taxes and grants-in-aid of revenues to them for the ensuing five years. In addition to these transfers, the Planning Commission also gives assistance to the States based on a formula determined by the National Development Council<sup>4</sup> and specific purpose transfers for various central schemes implemented by different ministries of the Union government.

Coming below the States are over a quarter million local governments. Of this, about 3000 are in urban areas and the remaining in rural areas. Rural local governments again are at three levels: district



panchayats, taluk panchayats and village panchayats. The urban local governments consist of municipal corporations in large cities, municipalities in smaller cities and towns and in notified area committees in smaller towns. Each of the State governments has devolved powers to levy certain taxes and fees to village panchayats and urban local bodies. Each State has also instituted a system of sharing its revenues and giving grants to both urban and rural local bodies. Each State government is required to appoint a State Finance Commission to review the finances of the local bodies and assign tax shares and make grants. In addition, a number of Central sector and centrally sponsored schemes undertaken by the States are actually implemented by the local governments and the funds earmarked for the purpose are passed on to them from the State governments for implementation.

**Chart I: Structure of Multilevel Government in India**



## **Fiscal Assignment and Transfer System in India**

### **Principles of Efficient Assignment System**

An important precondition for the efficient functioning of a multi-level fiscal system is to have a proper assignment system. The most important feature of a proper assignment system is that:

- (i) the functions and sources of finance should be based on comparative advantage;

- (ii) revenue powers should be, as far as possible, aligned to the assignment of expenditure functions;
- (iii) subnational governments should not have powers to undo the national initiative on stabilization and redistribution;
- (iv) a proper mechanism should be instituted to deal with vertical and horizontal overlapping of tax and expenditure systems and
- (v) there should a mechanism to offset the fiscal disabilities through a system of well-designed intergovernmental transfers.

## **Assignment between Centre and States**

The functions related to money supply, external borrowing, international relations, defence, atomic energy, space, national highways, airways, international waterways, and those having significant scale economies are assigned exclusively to the centre. The functions involving benefits spanning across States and matters with significant developmental potential are undertaken concurrently with the States. These include economic planning, energy, education, health and family welfare. The functions with State-wide implications are assigned to the States. Most progressive tax handles have been assigned to the Centre. A number of tax handles have been assigned to the States, which include land revenue, tax on agricultural incomes and wealth, stamp duties and registration fees, tax on sales and purchase of goods, excise duties on the sale of alcoholic products, tax on motor vehicles and tax on goods and passengers transported through roads and inland waterways. However, from the viewpoint of revenue productivity, the tax on the sale and purchase of goods is the most important. The residual functions and residuary tax powers are also assigned to the Centre.

Notably, the tax powers are assigned exclusively either to the Centre or to the States on the basis of the principle of separation. However, the separation is only in the legal and not in the economic sense. Thus, the centre can levy taxes on production (excise duty), whereas the tax on sale and purchase of goods has to be levied by the States. Similarly, only the States can levy the taxes on agricultural incomes and wealth and only the Central government can levy taxes on non-agricultural incomes and wealth. The States have found taxing agricultural incomes politically infeasible besides being administratively difficult. At the same time, the separation of the tax base has opened up the floodgates for both avoidance and evasion of personal income tax.

The most anomalous part of the assignment between the Union government and the States, however, is the distinction drawn between

goods and services for tax purposes. Entry 54 in the State list empowers the States to levy 'taxes on the sale and purchase of goods other than newspapers'. Taxation of services does not find specific mention in any of the schedules. As all residuary powers are vested with the Union government, it has been imposing taxes on services selectively. The compartmentalized treatment of goods and services for tax purposes has violated neutrality in taxation, rendered the levy of co-ordinated system of consumption tax difficult, and has led to significant evasion and avoidance of the sales tax (NIPFP, 1994).

The Constitution assigns the borrowing powers to both the Union and State governments. The States can borrow from the market as well as from the Union government. However, if a State is indebted to the Union government, it has to obtain the latter's permission. As all the States are heavily indebted to the Centre, borrowing by the States is determined essentially by the Union Ministry of Finance, the Reserve Bank of India and the Planning Commission. The States can also resort to some borrowing from Public Accounts and the most important item under this is the share of small savings loans<sup>5</sup> and borrowing from the Public Provident Fund. By and large, in principle, the attempt in the Constitution has been to enable the Union government to exercise overall control over subnational borrowing. However, in practice, the States have found several ways to soften their budget constraint.

The Constitution recognizes that the assigned revenue powers are inadequate to meet expenditure responsibilities of the State governments and provides for the mechanism to transfer funds from the Union to State governments by way of tax devolution and grants-in-aid. To effect the transfers on an objective basis, the Constitution provides for the appointment of the Finance Commission every five years. The functions of the Commission include

- (i) distribution of the proceeds from sharable taxes;
- (ii) provision of grants-in-aid to the States in need of assistance;
- (iii) measures to augment resources of the State government to supplement the resources of the Panchayats and Municipalities in the States; and
- (iv) address any other matter referred to the Commission in the interest of sound finance. Since adoption of the Indian Constitution, eleven Finance Commissions have submitted their reports.

Over the years, the Planning Commission too has been giving substantial assistance to the States to finance developmental plans. The assistance is given both as grant and loan in the ratio of 30:70 for the

larger States and 90:10 for the special category States. In addition to Finance and Planning Commissions, Central Ministries give assistance to the States to implement Central schemes. The Central sector schemes are entirely funded by the Central government and the States are merely implementing agencies. The centrally sponsored schemes are shared cost programmes requiring the states to make matching contributions with the matching ratio differing depending on the projects.

## **Assignment between State and Local Governments**

With the constitutional amendments in 1992, roles and responsibilities of rural and urban local governments have been specified. Accordingly, in separate schedules, a list of 29 subjects to rural local bodies and another list of 18 subjects to urban local bodies have been specified. However, the revenue and expenditure assignments in the lists are concurrent with the States' responsibilities. The actual assignment of specific revenue sources and expenditure depends on the extent to which the State is willing to devolve. The extent of devolution of powers and functions to local governments shows wide variation depending on the willingness of the State government to devolve functions and powers to the local governments. Despite wide variations, some of the common functions performed by the Panchayats at the three levels as well as urban local bodies are listed in Annexure Table 1.

The schedules referred to above only detail the responsibilities of the local governments and not their revenue sources. The revenues of local governments are to be determined by the State Finance Commission, appointed by each of the respective States every five years. The responsibilities of these Commissions include (i) distribution of the revenues between the State and its respective local governments and determining the allocation among individual local governments; (ii) assignment of tax and non tax powers to village panchayats and urban local bodies; and (iii) determination of the grants-in-aid to the local governments from the consolidated fund of the State.

In addition to the transfers recommended by the State Finance Commissions, the State government passes on the funds to the local governments for implementation of various central sector and centrally sponsored schemes. The most important of these schemes is for poverty alleviation, but there are also others on social and community services in which the local governments have a comparative advantage in implementation. Analysis shows that local governments have very little flexibility in the use of funds. After deductions of charges for electricity and other facilities by the state government in the general purpose transfers, very little is left. The bulk of what is available is needed for administration, leaving the local governments in a position unable to execute any developmental schemes.

# **Fiscal Decentralization in India**

## **Revenue and Expenditure Shares of Three Levels**

Although it is difficult to bring out qualitative aspects of decentralization from any quantitative measure, the shares of different levels of government in raising revenue and incurring expenditures provide insights into the working of fiscal federalism in India. Unfortunately, in the past, a comprehensive picture of local government finances was not available and, therefore, much of the discussion on their role was based on qualitative judgements. For the first time, the report of the Finance Commission (India, 2000) has put together data on revenues and expenditures of local bodies and these estimates are combined with the revenues and expenditures of Union and State governments to get a comprehensive picture of fiscal decentralization in Indian federalism.

The relative roles of the Centre, State and local governments in urban and rural areas in raising revenues and incurring expenditures in Table 1 bring out interesting features of the Indian fiscal federalism. (1) the volume of aggregate fiscal deficit in 1997-98 works out to almost 15 per cent of GDP, which is about seven percentage points more than the deficit estimate only when the Centre and the States are considered. (2) It is seen that the maximum deficits are incurred at the local government level. While the fiscal deficit at the Central level was 4.4 per cent of GDP, the volume of deficit at the State and the local levels was estimated at 11.7 per cent of GDP. This has serious implications for macroeconomic stability. (3) Among local governments, the deficit is in urban local bodies and that too mainly in two States, Andhra Pradesh and Maharashtra.

## **Asymmetry between Expenditure and Revenue Decentralization**

Another salient feature of fiscal federalism in India is that decentralization is mainly in incurring expenditures and not in raising revenues. Thus, the Central government could exercise control over one-third of the revenues, but its share in raising revenues is two-thirds. In contrast, State and local governments raised only about one-third of revenues but the revenue accrual to them was about two-thirds. Each of the three levels incurred about one-third of the expenditures. At local level, urban local bodies incurred 28 per cent of total expenditures and the share of rural local bodies was less than 4 per cent. Even within the urban local governments, the spending was mainly in Andhra Pradesh and Maharashtra.

Like in all federal systems, the States have significant revenue raising powers. The States raise 35 per cent of total revenues, which finances 51 per cent of their expenditures. The expenditure share of the State governments after giving grants to local governments is 35 per cent. In social services, particularly in education and health sectors, the

**Table 1: Revenue and Expenditure Decentralization in India - 1997-98**

|                                    | Revenue Collection | Revenue Accrual | Expenditure on Core Services | Other Expenditure | Total Expenditure | Own Revenue/ Expenditure |
|------------------------------------|--------------------|-----------------|------------------------------|-------------------|-------------------|--------------------------|
| I. Per cent of GSDP                |                    |                 |                              |                   |                   |                          |
| Centre                             | 11.4               | 6.8             |                              |                   | 11.2              |                          |
| States                             | 6.3                | 10.9            |                              |                   | 12.3              |                          |
| Local Bodies                       | 0.6                | 2.1             | 6.8                          | 4.58              | 11.4              |                          |
| Urban Local Bodies                 | 0.5                | 0.8             | 6.7                          | 3.30              | 10.0              |                          |
| Rural Local Bodies                 | 0.04               | 1.3             | 0.1                          | 1.28              | 1.38              |                          |
| District Panchayats                | n                  | 0.6             | 0.06                         | 0.57              | 0.62              |                          |
| Taluk Panchayats                   | n                  | 0.3             | 0.01                         | 0.40              | 0.41              |                          |
| Village Panchayats                 | 0.04               | 0.4             | 0.04                         | 0.32              | 0.35              |                          |
| Total                              | 18.3               | 19.8            |                              |                   | 34.8              |                          |
| II. Per Cent of Total Expenditures |                    |                 |                              |                   |                   |                          |
| Centre                             | 62.45              | 34.43           |                              |                   | 32.12             | 102.05                   |
| States                             | 34.56              | 55.03           |                              |                   | 35.26             | 51.44                    |

*Contd.*

|                     | Revenue Collection | Revenue Accrual | Expenditure on Core Services | Other Expenditure | Total Expenditure | Own Revenue/ Expenditure |
|---------------------|--------------------|-----------------|------------------------------|-------------------|-------------------|--------------------------|
| Local Bodies        | 2.99               | 10.53           | 100.00                       | 100.00            | 32.62             | 4.81                     |
| Urban Local Bodies  | 2.74               | 4.07            | 98.49                        | 72.10             | 28.65             | 5.02                     |
| Rural Local Bodies  | 0.24               | 6.46            | 1.51                         | 27.90             | 3.96              | 3.23                     |
| District Panchayats | 0.03               | 3.21            | 0.81                         | 12.33             | 1.78              | 0.79                     |
| Taluk Panchayats    | 0.01               | 1.44            | 0.14                         | 8.67              | 1.17              | 0.55                     |
| Village panchayats  | 0.21               | 1.82            | 0.56                         | 6.90              | 1.02              | 10.60                    |
| Total               | 100.00             | 100.00          | 100.00                       | 100.00            | 100.00            | 52.49                    |

*Note:* n - negligible.

1. States' total expenditure has netted out transfers to local bodies
2. Centre's expenditure is net of Grants and Loans to States and Union Territories.
3. Core services are water supply, street lighting, sanitation and roads.

*Source:* 1. Public Finance Statistics 1999-2000, Ministry of Finance, Government of India, 2000.

2. Report of the Eleventh Finance Commission, Ministry of Finance, Government of India. 2000.

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| I. Per cent of GSDP                |                    |                 |                              |                   |                   |                          |
| Centre                             | 11.4               | 6.8             |                              |                   | 11.2              |                          |
| States                             | 6.3                | 10.9            |                              |                   | 12.3              |                          |
| Local Bodies                       | 0.6                | 2.1             | 6.8                          | 4.58              | 11.4              |                          |
| Urban Local Bodies                 | 0.5                | 0.8             | 6.7                          | 3.30              | 10.0              |                          |
| Rural Local Bodies                 | 0.04               | 1.3             | 0.1                          | 1.28              | 1.38              |                          |
| District Panchayats                | n                  | 0.6             | 0.06                         | 0.57              | 0.62              |                          |
| Taluk Panchayats                   | n                  | 0.3             | 0.01                         | 0.40              | 0.41              |                          |
| Village Panchayats                 | 0.04               | 0.4             | 0.04                         | 0.32              | 0.35              |                          |
| Total                              | 18.3               | 19.8            |                              |                   | 34.8              |                          |
| II. Per Cent of Total Expenditures |                    |                 |                              |                   |                   |                          |
| Centre                             | 62.45              | 34.43           |                              |                   | 32.12             | 102.05                   |
| States                             | 34.56              | 55.03           |                              |                   | 35.26             | 51.44                    |

*Contd.*



|                     | Revenue Collection | Revenue Accrual | Expenditure on Core Services | Other Expenditure | Total Expenditure | Own Revenue/ Expenditure |
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| Rural Local Bodies  | 0.24               | 6.46            | 1.51                         | 27.90             | 3.96              | 3.23                     |
| District Panchayats | 0.03               | 3.21            | 0.81                         | 12.33             | 1.78              | 0.79                     |
| Taluk Panchayats    | 0.01               | 1.44            | 0.14                         | 8.67              | 1.17              | 0.55                     |
| Village panchayats  | 0.21               | 1.82            | 0.56                         | 6.90              | 1.02              | 10.60                    |
| Total               | 100.00             | 100.00          | 100.00                       | 100.00            | 100.00            | 52.49                    |

*Note:* n - negligible.

1. States' total expenditure has netted out transfers to local bodies
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3. Core services are water supply, street lighting, sanitation and roads.

*Source:* 1. Public Finance Statistics 1999-2000, Ministry of Finance, Government of India, 2000.

2. Report of the Eleventh Finance Commission, Ministry of Finance, Government of India. 2000.

expenditure share of the States is more than 80 per cent and in economic services, it is about 50 per cent. Of course, the States still have to depend on central transfers to finance a significant portion of their expenditures. Almost 37 per cent of States' revenues accrue from transfers.

The asymmetry in revenue and expenditure decentralization is particularly significant at the local government level (Annexure Table IV). As mentioned above, total revenue raised by local bodies was just about 0.6 per cent of GDP or 2 per cent of total revenues. In fact, panchayats raised a negligible amount of 0.05 per cent of GDP. They received 1.3 per cent of GDP as transfers. Their share in total expenditures was less than 4 per cent. Thus, over quarter million local governments in rural India incur less than 4 per cent of total expenditures and this includes expenditures on core as well as discretionary services. The expenditures incurred by them also include those on centrally sponsored schemes such as poverty alleviation and social development programmes implemented through the local governments.

Thus, despite constitutional recognition, local governments in India do not raise significant revenues and have to depend on higher level governments. As State Governments themselves are faced with several resource constraints, the revenue accruals to the local bodies are not adequate to enable them effectively deliver the required standards of public services. A predominant part of the transfers is for specific purposes, mainly to implement Centrally sponsored schemes. Thus the type of decentralization at local levels seen in India may be characterized as de-concentration rather than decentralization despite the Constitutional recognition of the local governments.

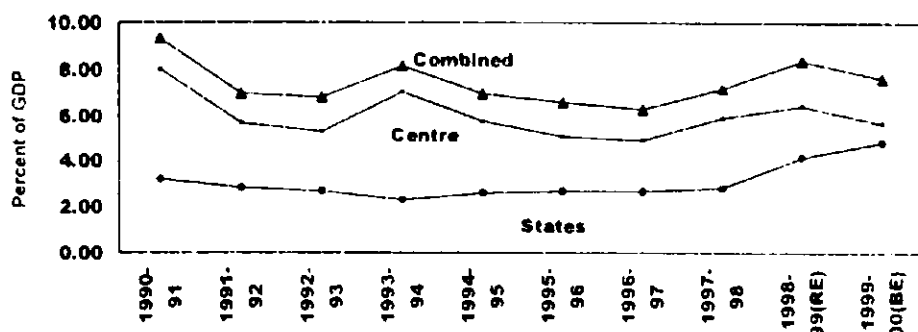
## **Fiscal Decentralization and Macroeconomic Stability**

One of the important adverse implications of fiscal decentralization highlighted in the literature is on macroeconomic stability. In the literature, macroeconomic stability is considered to be mainly the function of the central government (Oates, 1972). Nevertheless, the method of raising resources and spending at subnational levels could have macroeconomic implications. Therefore, the issue to examine is to what extent existing fiscal arrangements contribute to structural macroeconomic problems in India.

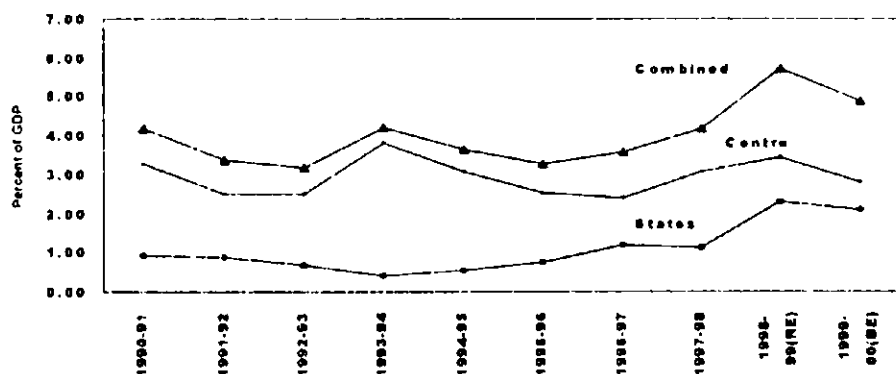
In a multilevel fiscal system where subnational functions and sources of finance are clearly defined and the local governments are required to strictly manage their expenditures from within their means, decentralization does not pose serious problems for macroeconomic management (Tanzi, 1996). This will also lead to efficient allocation of resources so long as subnational governments cannot export the tax burden to non-residents.

## Chart 2: Revenue and Fiscal Deficits in India

### Fiscal Deficits of Centre and States.



### Revenue Deficits of Center and States



## **1. Subnational Borrowing and Macroeconomic Implications**

The critical question to be addressed is, to what extent structural fiscal imbalances in India can be attributed to the State governments' fiscal operations. Despite a decade of fiscal reforms to reduce both current budget and fiscal deficits, the situation has shown a deteriorating trend at both Central and State levels since 1995-96 (Chart 2). The sharp increase in current budgetary deficits has been mainly responsible for increasing fiscal deficits. Thus, not only has the volume of deficit shown an increase, but the quality of deficit has also shown a steady deterioration.

The important question however is to what extent increasing fiscal imbalances can be attributed to the States. There are two ways in which States' fiscal operations can adversely affect structural deficits. (i) if the States have high bargaining power to secure higher transfers in the wake of their increasing expenditures, it could increase the overall deficit position. Alternatively, if the Central government has higher bargaining power, it could pass on the burden of its fiscal adjustment to the States, thus reducing the overall deficits. (ii) the States may find ways and means to soften their budgetary constraints to indulge in uncontrolled borrowing and thus contribute to structural imbalances.

As mentioned earlier, fiscal deterioration since the mid-1990s is seen both at the Centre and the State levels. It is also seen that the increasing deficit at the central level cannot be attributed to higher transfers to States. In fact, while the percentage of current budgetary deficits at the central level has shown a steady increase, particularly after 1996-97, current transfers from the Centre to the States have shown a decline. Longer term trend also shows a similar picture (Chart 3). In fact, the central government has not shown keenness to achieve fiscal consolidation. The inability of the central government to show the way in fiscal discipline has been a major shortcoming in macroeconomic management in India.

## **2. Softening the Hard Budget Constraint by States**

There has also been a steady increase in the deficits of the State and this has added to the structural imbalances. Although the system has provisions for the central government to exercise strict control over States' borrowings, the latter have found ways and means of softening the hard budget constraint. The prevailing situation calls for introduction of more stringent measures to contain States' borrowings.

Thus, the Centre's inability to control its own deficits and impose hard budget constraint on the States is an important factor responsible for fiscal deterioration. The emphasis on large sized plans year after year even when the resources did not permit such spending has led both the Central and the State governments to indulge in unsustainable borrowings.

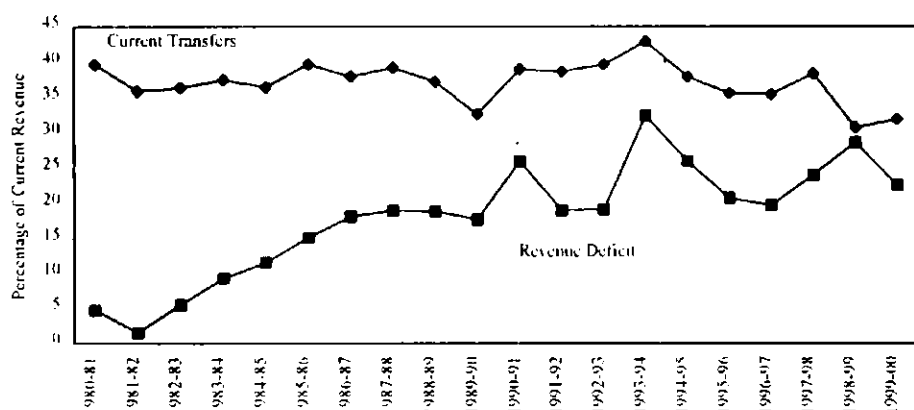
The States, on their part, have found ways to soften their budget constraint through three important ways:

- (i) creating contingent liabilities by floating corporations on major projects implemented by States and borrowing from the market instead of providing funds from the States' own resources;
- (ii) borrowing from public enterprises in times of need;
- (iii) borrowing from public account;
- (iv) overdrafts from Reserve Bank of India (RBI) (Lahiri, 2000).

Creating separate corporations to implement many infrastructure projects and borrowing from the market to finance them is the most widespread practice of overcoming the hard budget constraint at the State level. The contingent liabilities thus created do not form a part of fiscal deficit. Such liabilities in 18 States have increased at 12 per cent per year during 1992-97 and constituted 9.1 per cent of their Net State Domestic Product (NSDP) in 1997. Borrowing from public enterprises to overcome the liquidity problem is another method employed. In fact, the States having control over temple funds are known to have borrowed even from these trusts.

Certain liabilities, which do not form a part of the main account of the government and in respect of which the government acts only as a banker, are kept in public account. These liabilities include transactions relating to provident funds, small savings collections and other public deposits with the government. A major item in these is small savings loans. States received 75 per cent of the net collections from post office national saving certificates collected in their respective jurisdictions. This,

**Chart 3: Revenue Deficit and Current Transfers to States**



in fact, is a high cost borrowing for, besides attractive interest rates, these instruments attract income tax concessions. Many States require that the employees should deposit a certain proportion of arrears on pay increases and dearness allowance in order to offset higher living costs.

Each State has been given overdraft limits for normal and special purposes by the RBI and all the States resort to them. In the past, there were instances when these overdrafts had to be converted into medium term loans since the situation became irretrievable. However since 1985, the overdraft regulation scheme is in operation and at present, if a State runs an overdraft for 10 continuous working days, the RBI can dishonour the checks issued by the State governments.

A major source of contingent liability to the States is the guarantee given to local government borrowing. In general, the local bodies in rural areas face hard budget constraints. However in urban areas local bodies resort to borrowing from the state government with a guarantee to augment urban infrastructure facilities such as water supply and sanitation, roads and housing from public sector financial institutions. Life Insurance Corporation and Housing and Urban Development Corporation have been making significant loans to urban local bodies. In recent years, multilateral institutions, including the World Bank and Asian Development Bank, have given substantial assistance to augment infrastructure of urban local governments. Lending to local governments adds to the contingent liability of the State governments.

Thus, in spite of the fact that formal fiscal arrangement vests enough powers to the Central government to control the structural deficits from the States' fiscal operations, the States have found a variety of ways to overcome their hard budget constraint. In other words, the fiscal system and arrangements have not been able to prevent the States from indulging in fiscal profligacy. Disincentives to fiscal prudence in the transfer system, the irrelevant distinction between plan and non-plan expenditures, growing populism associated with coalition politics and the culture of free-riding are some of the major factors responsible.

## **Intergovernmental Transfers and Regional Equity**

### **The Transfer System**

In all multilevel fiscal systems, efficient assignment of expenditure powers does not correspond to efficient revenue powers. Further, variations in revenue capacity among subnational units can cause horizontal inequity. The resulting vertical and horizontal fiscal imbalances have to be offset through a system of unconditional intergovernmental transfers. In addition, efficient provision of public services with significant spillovers at subnational levels or for merit good reasons, specific purpose transfers will have to be made.<sup>6</sup> It is generally recognized that (i) the transfer

system should be formula based rather than negotiated; (ii) the design of transfers should not have adverse incentives in fiscal management and in particular, general purpose transfers should be designed to offset shortfall in revenue capacity and excess expenditure needs of subnational units and specific purpose transfers should be designed to ensure minimum standards of targeted services.

## **Central Transfers to States**

The Constitution of India makes an implicit assumption that the assignment system results in surpluses for the Central government and, therefore, provides for transfers to States by way of tax devolution and grants-in-aid of revenues. To determine the transfers the Constitution provides for the institution of the Finance Commission every five years by a presidential order. The Commission is required to recommend devolution of taxes from the centre to the States and provide grants to the States in need of additional assistance.

After the recent amendment to the Constitution, sharing of total revenues from all centrally levied taxes rather than selected taxes is being done. The Eleventh Finance Commission, which submitted the report recently, has recommended the distribution of 28 per cent of net proceeds from central taxes to the States (India, 2000).<sup>7</sup>

In addition to the Finance Commission, with central planning gaining emphasis, the Planning Commission has also become a major dispenser of funds. It provides grants and loans to the States for plan purposes. The funds are distributed according to the formula evolved and modified by the National Development Council (NDC) from time to time.<sup>8</sup> Besides these two agencies, various central ministries also make transfers for specific purposes. Some of the specific purpose transfer schemes are entirely funded by the Centre, and others are shared cost programmes. Major programmes on poverty alleviation, family planning and adult literacy fall in this category. In 1998-99 the transfers given on the recommendation of the Finance Commissions constituted 60 per cent, those given by the Planning Commission 22 per cent, and the remaining were for central sector and centrally sponsored schemes.

Besides these explicit transfers, there are implicit transfers as well. These occur due to control of prices and regulations implemented in the context of a planned regime. The important sources of implicit transfers are subsidized loans to the State governments by the Central government. Moreover, resource transfers (not necessarily through governments) occur also due to subsidized lending to the priority sector by the financial and banking system and, more importantly, inter-state tax exportation. The implications of such implicit transfers are not examined here.<sup>9</sup>

The efficiency and equity implications of the Indian fiscal transfer system have been a subject of considerable critical scrutiny, and yet, the problems have continued (Rao and Sen, 1996). The multiplicity of agencies making transfers often work at cross-purposes and this makes achievement of objectives difficult. Although the transfers are formula based, they are not targeted to offset fiscal disabilities of the States. The Finance Commission formula for tax devolution is based predominantly on general economic indicators (Annexure II). The Plan assistance to the States is also based on general economic indicators rather than fiscal disabilities. Often, planning and finance commissions work at cross-purposes.

The worrisome issue pertaining to the transfer system in India is its disincentives for fiscal management of States. The grants recommended by the Finance Commissions are based on the estimated post-tax devolution gaps in the non-plan current budgets of the States. It has been pointed out that this 'fiscal dentistry' has only contributed to widening 'budgetary cavities' year after year at the State level. Thus, on the one hand, the transfer system is not targeted to offset fiscal disabilities and on the other, it rewards the States with poor fiscal management.

The design and implementation of specific purpose transfers too has attracted criticisms. There has been a proliferation of populist reasons and at present there are more than 200 schemes in operation. The thin spread of resources in these schemes has not helped to achieve the objectives of specific purpose transfers. Often, the schemes are chosen for political reasons and this has obscured objectivity.

## **Equalizing Impact of Central Transfers**

Despite the shortcomings in the design of the transfer system noted above, the overall impact of central transfers to States is equalizing for major States, although the effect is not significant when all the States are considered (Table 2). Special category States have higher per capita income levels than many of the poorer States and yet, receive more favourable treatment in the transfer system. On the whole, therefore, it would be correct to state that the transfer system is equalizing.

The equalizing impact is primarily due to the Finance Commission transfers, particularly to tax devolution. Neither the grant given by the Planning Commission nor the specific purpose transfers given for the central sector and centrally sponsored schemes have significant equalizing impact.

The equalizing impact of the transfer system comes out clearly when we consider various parameters of state finances presented in Table 3 (Annexure Table III). Analysis shows that, in general, while the revenue-Net State Domestic Product (NSDP) ratios are higher in more prosperous States, expenditure-NSDP ratios are higher in low income States. Thus, the shares of States' own revenue within the total revenue are lower for



states with higher per capita income levels. In other words, Central transfers constitute 16.3 per cent of the total revenues in high income States, 32.9 per cent in middle income states and 51.4 per cent in low income States. In special category states, 73 per cent of the revenues accrue from transfers and their own revenues constitute just about 33 per cent.

**Table 2: Equalizing Effect of Central Transfers to States, 1997-98**

| Transfers  | Income Elasticity@  |                    |
|--|---------------------|--------------------|
|  | Major States        | All States         |
| Tax Devolution   | -0.414*<br>(3.361)  | -0.471<br>(-1.196) |
| Non-plan grants  | -1.027<br>(-1.780)  | -1.001<br>(-1.285) |
| Total Finance Commission Transfers                         | -0.508*<br>(-4.027) | -0.558<br>(-1.351) |
| Plan Grants-State Plan Schemes                             | -0.040<br>(-0.212)  | -0.817<br>(-0.943) |
| Plan Grants-Central sector and centrally sponsored schemes | 0.197<br>(0.737)    | 0.114<br>(0.221)   |
| Total Plan Grants  | 0.041<br>(0.240)    | -0.585<br>(-0.798) |
| Gross Current Transfers                                    | -0.375*<br>(-3.518) | -0.594<br>(-1.118) |

Figures in parentheses are T values. \* Significant at 1 per cent level.

@ Income elasticity has been estimated by regressing the transfer items on NSDP in a log-linear model.

In terms of financing total expenditures, the dependence of high-income states is 36 per cent, whereas almost 62 per cent of the expenditures of the low income states are financed through central transfers. Of course, the fiscal dependence of the special category States is over 77 per cent.

Despite being progressive in its impact, it would not be correct to infer that the transfer system in India satisfactorily resolves horizontal fiscal imbalances. Although the expenditure -NSDP shares are higher, per capita expenditures in poorer States are lower. Since a higher proportion of expenditures in these States is preempted for administrative purposes (due to near uniform pay scales in the states), per capita expenditures available for physical and social infrastructure are much lower. To add to these problems, the implicit transfers are found to be disequalizing. It is therefore not surprising that after market-based reforms were introduced in 1991, the regional inequalities have shown a sharp increase (Rao, Kalirajan and Shand, 1998).

**Table 3: Selected Indicators of State Government Finances, 1997-98.**

| State                | Per cent of State' Own Revenue to NSDP | Per cent of States' Own Revenue to Total Revenue | Per cent of Current Expenditure to NSDP | Per cent of States' Own Revenue to Total Expenditure |
|----------------------|--|--|---|--|
| High Income States   | 11.50                                  | 83.71  | 15.56                                   | 64.26  |
| Middle Income States | 10.94                                  | 67.18  | 18.02                                   | 54.52  |
| Low Income States    | 8.46                                   | 48.64  | 19.74                                   | 37.66  |
| Smaller States       | 11.46                                  | 27.14  | 40.13                                   | 23.40  |
| 25 STATES            | 7.16                                   | 61.48  | 12.86                                   | 48.77  |

*Source:* Annexure Table III.

### **Fiscal Transfers from the State to Local Governments**

As mentioned earlier, the States are required to appoint a Finance Commission every five years to make recommendations on the transfers to be made to urban and rural local bodies. They are required to make recommendations on the assignment of tax revenues to local bodies, sharing of tax revenues between the States and the local governments and their distribution among individual local bodies and grants to be made to them.

The experience of implementation of this by various States does not bring much cheer, however. Of the 25 States, five are yet to constitute the Commissions and in six States the Commissions are yet to submit the reports. In States where they have submitted the reports, very little has been done in terms of giving revenue raising powers to the local bodies. The volume of transfers made is inadequate mainly because the States themselves have been facing a severe financial crunch. Due to paucity of information at local levels, sharing of taxes and grants are not based on any scientific criteria. Often, particularly to village panchayats, the distribution is done on a lump sum basis irrespective of their capacity or need. In fact, after deducting the cost of electricity at source by the State government, very little is available for actual spending by local bodies. In many States, it is seen that the activity of village Panchayats are mainly to implement the Centrally sponsored schemes (Aziz, 2000). Of course, these generalizations are simplistic and there are States where local bodies play more active roles than has been portrayed here, but that is the exception rather than the rule.

The fiscal indicators of local bodies in different States presented in (Annexure Table IV), bring out the role of the third tier of government and the importance of State transfers in local revenues and expenditures. A summary of these indicators presented in Table 5 shows that the local governments play only a marginal role in the provision of public services

and much less in raising revenues. On an average, in 1997-98 they raised just about 0.5 per cent of NSDP and this constituted less than 5 per cent of subnational revenues (total revenues of state and local governments). Even in high income States, local revenues contributed less than 10 per cent of the subnational revenue. In fact, as may be seen from Table IV the share of rural local bodies was negligible - less than 0.05 per cent and among the urban local bodies the revenue contribution was just about 0.5 per cent of NSDP (Annexure Table IV).

Disaggregated analysis of data (Annexure Table IV) show that expenditure levels were relatively high, almost 10.6 per cent of NSDP in urban local bodies. However, this is entirely due to the high expenditures incurred in Maharashtra and Andhra Pradesh by issuing bonds and borrowing from multilateral institutions. In all other States, expenditure levels of both urban and rural local bodies were extremely low.

Analysis shows that local bodies raised relatively more revenues in more affluent States (Table 5). The State transfers to local bodies do not show any clear pattern. Nevertheless, the revenue accruals are marginally higher in richer States. Even so, even after transfers are included, the revenues are extremely low and the impact on the service levels is not very significant. Thus, even in high income States, the impact of local bodies both in urban and rural areas to provide public services is not significant. Exceptions are the cases of Maharashtra and Andhra Pradesh, where the urban local bodies have taken substantial loans to improve urban infrastructure. However, within the limited role that the urban local bodies play, in some of the States they are more successful in raising revenues and delivering public services. It is interesting to examine the factors determining their success which should be a subject matter of a detailed inquiry.

**Table 4: Fiscal Indicators of Local Governments in India**

| State Category          | Per cent of Own Revenues to NSDP | Per cent of Total Revenues to NSDP | Per cent of Total Expenditure to NSDP | Per cent of Own Revenues to Total Expenditure | Per cent of Local Revenue to Subnational Revenue |
|-------------------------|----------------------------------|------------------------------------|---------------------------------------|---|--|
| High Income States      | 1.60                             | 3.64                               | 35.37                                 | 43.91   | 10.42  |
| Middle Income States    | 0.67                             | 3.5                                | 15.61                                 | 19.08   | 3.94   |
| Low Income States       | 0.31                             | 2.38                               | 2.51                                  | 13.03   | 1.75   |
| Special Category States | 0.16                             | 0.88                               | 1.12                                  | 18.52   | 0.38   |
| All States              | 0.58                             | 2.13                               | 12.02                                 | 27.11   | 4.73   |

*Note:* Includes both urban and rural local governments.

*Source:* Annexure Table IV.

**Table 5: State Transfers to Local Governments**

(Per Cent of NSDP)

| Category of State       | Rural Local Bodies | Urban Local Bodies | All Local Bodies |
|-------------------------|--------------------|--------------------|------------------|
| High Income States      | 1.73               | 0.3                | 2.04             |
| Middle Income States    | 2.16               | 0.47               | 2.58             |
| Low Income States       | 1.74               | 0.33               | 2.07             |
| Special Category States | 0.21               | 0.20               | 0.21             |
| All States              | 1.3                | 0.25               | 1.55             |

## Concluding Remarks

The paper analyses fiscal decentralization in a three-tier federal framework in India. The analysis helps to understand the relative roles of the three levels of government to get a comprehensive picture of deficits as it includes this part of contingent liabilities in the deficit calculation. Inclusion of local finances shows that aggregate fiscal deficits are much higher than that usually measured. A large part of the deficit arises from the borrowings undertaken in recent years by the local bodies in the two States of Andhra Pradesh and Maharashtra.

The paper brings out the anomalies in assignments both between the Centre and the States and States and local bodies. There is considerable need to rationalize the assignment system to enable the decentralized governments to raise revenues and incur expenditures according to the preferences of their citizens.

Empirical analysis shows that there has been an increasing trend in structural deficits and both the Centre and the States are guilty of fiscal profligacy. The deficits are not the result of higher transfers. The States, on their part, have not bothered to observe fiscal discipline and have found several ways to soften their budget constraints at the cost of macroeconomic stability.

The transfer system from the Centre to the states has inherent moral hazard problems. Despite this, the problem has continued. Multiple agencies making transfers makes it difficult to target the transfer system to meet the objectives of transfers. The gap-filling role adopted by the Finance Commissions has only contributed to fiscal indiscipline.

Despite weaknesses, the central transfers are generally equalizing. The major contributor to equalization is the Finance Commission transfer. The Planning Commission transfer and assistance given to centrally sponsored Schemes are not equalizing. Despite the overall equalizing impact, per capita expenditure of States is positively related to taxable capacity.

In spite of constitutional recognition to the third tier, the local governments seem to play a very limited role both in raising revenues and in spending. It would be correct to characterize decentralization at the third level as mostly top-down. It is also seen that the initiative for decentralization at the third level has come from the Centre and not from the States. In raising revenues, their role is negligible. Nor have the States given enough transfers to enable them to play a meaningful role even in implementation. The only way they could play a meaningful role is to resort to heavy borrowings as seems to have happened in urban local bodies in Andhra Pradesh and Maharashtra. But this has significantly added to their deficits.

The transfers at the local level do not follow any clear pattern. Of course, the level of development of the States does seem to be a factor contributing to the success of decentralization in terms of raising revenues. However, in absolute terms the local role is not substantial. From this, it will not be an exaggeration to say that the institutional environment does not seem conducive to the success of decentralization at the local level in India. It is necessary to understand the policies and institutions necessary to make local fiscal governance successful.

## Notes

1. The terms 'Union' and 'Centre' are used interchangeably in this paper.
2. Some of the State governments implemented the recommendations of the committee in modified forms subsequently. Karnataka was one of the States which pioneered the implementation of the recommendations with certain modifications in 1985.
3. The government has taken the decision to create three more new States. The State of Uttaranchal will be carved out of Uttar Pradesh, Chattisgarh will be carved out of Madhya Pradesh and Jharkhand will be carved out of Bihar. This has already been approved in Parliament and the three additional States would come into existence before the end of the year.
4. This is called the 'Gadgil' formula after the name of the Deputy Chairman of the Planning Commission (Prof. D.R. Gadgil) who introduced the formula for the first time in 1969.
5. Investments in national saving certificates issued by the post offices get income tax concession. The Union government is required to lend 75% of the net collections under this account to the States according to the agreement in vogue.
6. For a normative model of intergovernmental transfer system see, Ahmad (1996). See also, Boadway and Flatters (1982).
7. In addition, 1.5 per cent of net proceeds of central taxes is assigned to States as a part of tax rental arrangement with them for not levying sales tax on sugar, textiles and tobacco products.

8. NDC is a body constituted by the Prime Minister and central cabinet, Deputy Chairman and members of Planning Commission and all the Chief Ministers of States.
9. For a more detailed analysis of such transfers see, Rao (2000)

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**Annexure Table I: Illustrative List of Important Functions of Local Governments**

| Village Panchayat  | Taluk Panchayat   | District Panchayat  | Urban Local Governments  |
|--|---|---|--|
| <ol style="list-style-type: none"> <li>1. Preparing annual plans</li> <li>2. Preparing and implementing annual budget</li> <li>3. Promotion of :<br/>Agriculture, horticulture, animal husbandry, poultry, dairying, fisheries, afforestation, cottage industries</li> <li>4. Provision of drinking water</li> <li>5. Distribution of house sites</li> <li>6. Implementing various centrally sponsored schemes on poverty alleviation, social development and family welfare</li> <li>7. Promotion of adult literacy, ensuring school enrollment and attendance at primary level</li> <li>8. Rural water supply and sanitation</li> <li>9. Monitoring the functioning of public health centres</li> <li>10. Monitoring the public distribution system</li> </ol> | <ol style="list-style-type: none"> <li>1. Preparing annual plans and consolidating the plans of village panchayats</li> <li>2. Preparing annual budget</li> <li>3. Promotion of agriculture, animal husbandry, agricultural extension</li> <li>4. Maintenance of irrigation works</li> <li>5. Rural water supply and sanitation</li> <li>6. Social forestry</li> <li>7. Construction and maintenance of public roads and communication</li> <li>8. Monitoring the implementation of various programmes and policies at village levels</li> <li>9. Promotion of health, family welfare, development of women and children</li> </ol> | <ol style="list-style-type: none"> <li>1. Preparation of annual plan for the district; consolidation of village and Taluk Panchayat plans</li> <li>2. Construction and maintenance of roads, buildings and bridges</li> <li>3. Construction of rural water supply works</li> <li>4. Co-ordinating the implementation of various activities and programmes on poverty alleviation and social development at village and Taluk Panchayat levels</li> <li>5. Watershed development and wasteland development</li> <li>6. Management of hospitals and dispensaries</li> <li>7. Monitoring the public distribution system</li> </ol> | <ol style="list-style-type: none"> <li>1. Urban planning including town planning</li> <li>2. Regulation of land use and construction of buildings</li> <li>3. Construction and maintenance of roads and bridges</li> <li>4. Water supply, sanitation public health, conservancy and solid waste management</li> <li>5. Urban forestry and protection of environment</li> <li>6. Slum improvement and upgradation</li> <li>7. Formulation and implementation of urban poverty alleviation programmes</li> <li>8. Provision of urban amenities, parks, gardens and playgrounds</li> <li>9. Management of burial grounds, crematoriums</li> <li>10. Vital statistics on births and deaths</li> <li>11. Public amenities like street lighting, parking lots, bus stops, and public conveniences</li> <li>12. Regulation of slaughter houses and tanneries</li> </ol> |

**Annexure Table II a: Criteria for Tax Devolution:  
Eleventh Finance Commission (2000-2005)**

(Percent)

| Criteria                    | Share   |
|-----------------------------|---|
| States Share                | 29.5 per cent of the net proceeds of all Union taxes and duties |
| Criteria for Distribution   |   |
| 1. Population               | 10.0  |
| 2. Income (Distance Method) | 62.5  |
| 3. Area                     | 7.5   |
| 4. Index of Infrastructure  | 7.5   |
| 5. Tax effort               | 5.0   |
| 6. Fiscal Discipline        | 7.5   |

1. Distance Formula =  $(Y_h - Y_i)P_i / \sum (Y_h - Y_i)P_i$

Where,  $Y_i$  and  $Y_h$  represent per capita GDP of the  $i^{th}$  and the richest state,  $P_i$  - the population of the  $i^{th}$  state,  $(Y_h - Y_i)$  for the ' $h$ ' state is to be equivalent to that of the second highest per capita GDP state.

**Annexure-Table II b:  
Formula For Distributing State Plan Assistance**

| Variable  | Weight |
|---|--------|
| Population (1971)   | 60.0   |
| Per capita GDP of which,  | 25.0   |
| (i) Deviation from the average to the States below average per capita GDP | 20.0   |
| (ii) Distance Formula   | 5.0    |
| Fiscal performance, of which,   | 7.5    |
| (i) Tax effort  | 2.5    |
| (ii) Fiscal Management  | 2.5    |
| (iii) National Objectives   | 2.5    |
| (iv) Special Problems   | 7.5    |
| Total   | 100.0  |

*Note:* 1. This formula is applied to general category States. They receive 70 per cent of the total plan assistance, of which 30 per cent is given as grants and the remaining as loans.



**Annexure Table III: Selected Indicators of State Government Finances**

Per cent

| State                       | Per cent of<br>State' Own<br>Revenue to<br>NSDP | Per cent of<br>States' Own<br>Revenue to<br>Total Revenue | Per cent<br>of Current<br>Expenditure<br>to NSDP | Per cent of<br>States' Own<br>Revenue<br>to Total<br>Expenditure | Per cent of<br>Revenue<br>Deficit to<br>Fiscal Deficit | Per cent of<br>Fiscal Deficit<br>to Total<br>Expenditure |
|-----------------------------|---|---|--|--|--|--|
| 1                           | 2   | 3   | 4  | 5  | 6  | 7  |
| <b>Major States</b>         |   |   |  |  |  |  |
| <b>High Income States</b>   | <b>11.50</b>                                    | <b>83.71</b>  | <b>15.56</b>                                     | <b>64.26</b>   | <b>43.87</b>   | <b>23.23</b>   |
| Punjab                      | 12.06   | 85.04   | 17.49  | 61.18  | 59.89  | 28.06  |
| Maharashtra                 | 10.55   | 85.45   | 13.91  | 64.88  | 40.05  | 24.08  |
| Haryana                     | 15.03   | 84.77   | 19.89  | 71.17  | 63.80  | 16.05  |
| Gujarat                     | 11.70   | 79.21   | 16.12  | 61.62  | 32.06  | 22.20  |
| <b>Middle Income States</b> | <b>10.94</b>                                    | <b>67.18</b>  | <b>18.02</b>                                     | <b>54.52</b>   | <b>45.79</b>   | <b>18.84</b>   |
| Tamil Nadu                  | 12.69   | 72.18   | 19.34  | 62.43  | 64.28  | 13.51  |
| Kerala                      | 13.30   | 70.99   | 21.69  | 53.01  | 46.52  | 25.32  |
| Karnataka                   | 13.25   | 72.33   | 18.79  | 62.80  | 17.19  | 13.17  |
| Andhra Pradesh              | 11.31   | 64.31   | 18.48  | 54.72  | 28.96  | 14.92  |
| West Bengal                 | 6.16  | 55.01   | 14.04  | 38.10  | 57.24  | 30.74  |
| <b>Low Income States</b>    | <b>8.46</b>                                     | <b>48.64</b>  | <b>19.74</b>                                     | <b>37.66</b>   | <b>46.45</b>   | <b>22.56</b>   |
| Rajasthan                   | 10.73   | 59.17   | 19.39  | 45.39  | 22.80  | 23.29  |

Contd.

| 1                     | 2            | 3            | 4            | 5            | 6            | 7            |
|-----------------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Madhya Pradesh        | 10.79        | 58.48        | 19.22        | 50.34        | 25.78        | 13.92        |
| Uttar Pradesh         | 7.33         | 47.18        | 19.62        | 32.96        | 61.03        | 30.13        |
| Orissa                | 8.14         | 42.37        | 22.97        | 30.50        | 50.18        | 28.01        |
| Bihar                 | 6.02         | 31.98        | 19.38        | 28.74        | 26.89        | 10.14        |
| <b>Smaller States</b> |              |              |              |              |              |              |
| Arunachal Pradesh     | 4.73         | 7.70         | 48.71        | 6.73         | ##           | 12.63        |
| Assam                 | 6.70         | 29.20        | 21.41        | 28.27        | ##           | 3.18         |
| Goa                   | 32.58        | 85.52        | 38.57        | 76.88        | 11.24        | 10.11        |
| Himachal Pradesh      | 11.09        | 32.17        | 42.87        | 20.70        | 43.97        | 35.65        |
| Jammu & Kashmir       | 9.74         | 14.93        | 52.98        | 13.53        | ##           | 9.38         |
| Manipur               | 4.30         | 8.84         | 44.94        | 7.26         | ##           | 17.85        |
| Meghalaya             | 5.87         | 14.85        | 38.84        | 12.57        | ##           | 15.36        |
| Mizoram               | 5.53         | 7.44         | 68.09        | 6.35         | ##           | 14.69        |
| Nagaland              | 4.04         | 7.94         | 51.44        | 6.58         | 5.39         | 17.04        |
| Sikkim                | 168.08       | 73.66        | 220.91       | 70.05        | ##           | 4.90         |
| Tripura               | 5.72         | 9.84         | 56.92        | 8.33         | ##           | 15.32        |
| <b>Smaller States</b> | <b>11.46</b> | <b>27.14</b> | <b>40.13</b> | <b>23.40</b> | <b>##</b>    | <b>13.78</b> |
| <b>25 STATES</b>      | <b>7.16</b>  | <b>61.48</b> | <b>12.86</b> | <b>48.77</b> | <b>40.23</b> | <b>20.67</b> |

Notes: ## These States are Revenue Surplus States  
NSDP is Net State Domestic Product.

**Annexure Table IV: Finances of Local Bodies 1997-98**

| State                | Rural Local Bodies |                 |                   |                                  | Urban Local Bodies |                 |                   |                                  | Total Local Bodies |                 |                   |                                  | Per cent of Local Revenue to Total Sub-national Revenue |
|----------------------|--------------------|-----------------|-------------------|----------------------------------|--------------------|-----------------|-------------------|----------------------------------|--------------------|-----------------|-------------------|----------------------------------|---|
|                      | Revenue Collection | Revenue Accrual | Total Expenditure | Per cent of Own Rev to Tot. Rev. | Revenue Collection | Revenue Accrual | Total Expenditure | Per cent of Own Rev to Tot. Rev. | Revenue Collection | Revenue Accrual | Total Expenditure | Per cent of Own Rev to Tot. Rev. |   |
|                      | Per cent of NSDP   |                 |                   |                                  | Per cent of NSDP   |                 |                   |                                  | Per cent of NSDP   |                 |                   |                                  |   |
| High Income States   | 0.08               | 1.81            | 2.25              | 4.50                             | 1.52               | 1.83            | 33.12             | 82.94                            | 1.60               | 3.64            | 35.37             | 43.91                            | 10.42   |
| Punjab               | 0.12               | 0.30            | 0.36              | 39.78                            | 0.91               | 1.05            | 0.80              | 86.62                            | 1.03               | 1.35            | 1.16              | 76.13                            | 6.75  |
| Maharashtra          | 0.07               | 2.01            | 2.79              | 3.39                             | 2.13               | 2.42            | 62.99             | 88.09                            | 2.20               | 4.43            | 65.77             | 49.64                            | 15.11   |
| Haryana              | 0.16               | 0.26            | 0.44              | 62.20                            | 0.31               | 0.54            | 1.03              | 58.39                            | 0.47               | 0.79            | 1.47              | 59.63                            | 2.59  |
| Gujarat              | 0.05               | 2.96            | 3.01              | 1.81                             | 1.08               | 1.58            | 1.26              | 67.97                            | 1.13               | 4.55            | 4.27              | 24.84                            | 7.10  |
| Middle Income States | 0.10               | 2.46            | 2.40              | 3.92                             | 0.57               | 1.04            | 13.21             | 54.72                            | 0.67               | 3.50            | 15.61             | 19.08                            | 3.94  |
| Tamil Nadu           | 0.04               | 0.55            | 0.63              | 8.07                             | 0.85               | 1.58            | 1.62              | 53.77                            | 0.90               | 2.13            | 2.25              | 42.06                            | 4.85  |
| Kerala               | 0.26               | 2.59            | 1.92              | 10.08                            | 0.30               | 0.69            | 0.72              | 43.64                            | 0.56               | 3.27            | 2.64              | 17.13                            | 2.91  |
| Karnataka            | 0.05               | 6.50            | 6.38              | 0.80                             | 0.28               | 0.72            | 0.77              | 38.96                            | 0.33               | 7.22            | 7.15              | 4.60                             | 1.78  |
| Andhra Pradesh       | 0.18               | 3.19            | 3.18              | 5.49                             | 0.44               | 0.83            | 52.84             | 52.86                            | 0.61               | 4.02            | 56.02             | 15.25                            | 3.37  |
| West Bengal          | 0.02               | 0.60            | 0.69              | 4.02                             | 0.77               | 1.14            | 0.47              | 67.57                            | 0.79               | 1.74            | 1.16              | 45.55                            | 6.63  |
| Low Income States    | 0.04               | 1.78            | 1.90              | 2.24                             | 0.27               | 0.60            | 0.64              | 45.20                            | 0.31               | 2.38            | 2.54              | 13.03                            | 1.75  |
| Rajasthan            | 0.07               | 3.28            | 3.32              | 2.02                             | 0.82               | 1.10            | 1.06              | 74.54                            | 0.89               | 4.38            | 4.37              | 20.24                            | 4.66  |
| Madhya Pradesh       | 0.05               | 2.92            | 2.93              | 1.80                             | 0.24               | 0.79            | 1.02              | 30.59                            | 0.30               | 3.71            | 3.94              | 7.96                             | 1.58  |
| Uttar Pradesh        | 0.04               | 0.78            | 0.80              | 5.28                             | 0.15               | 0.55            | 0.54              | 27.49                            | 0.19               | 1.34            | 1.34              | 14.50                            | 1.23  |

*Contd.*

| State              | Rural Local Bodies |                 |                   |                                  | Urban Local Bodies |                 |                   |                                  | Total Local Bodies |                 |                   |                                  | Per cent of Local Revenue to Total Sub-national Revenue |
|--------------------|--------------------|-----------------|-------------------|----------------------------------|--------------------|-----------------|-------------------|----------------------------------|--------------------|-----------------|-------------------|----------------------------------|---|
|                    | Revenue Collection | Revenue Accrual | Total Expenditure | Per cent of Own Rev to Tot. Rev. | Revenue Collection | Revenue Accrual | Total Expenditure | Per cent of Own Rev to Tot. Rev. | Revenue Collection | Revenue Accrual | Total Expenditure | Per cent of Own Rev to Tot. Rev. |   |
|                    | Per cent of NSDP   |                 |                   |                                  | Per cent of NSDP   |                 |                   |                                  | Per cent of NSDP   |                 |                   |                                  |   |
| Orissa             | 0.03               | 2.66            | 2.66              | 1.09                             | 0.35               | 0.49            | 0.57              | 72.60                            | 0.38               | 3.14            | 3.23              | 12.17                            | 1.95  |
| Bihar @            |                    | 0.79            | 1.43              |                                  |                    |                 |                   |                                  |                    | 0.79            | 1.43              |                                  |   |
| Smaller States     |                    |                 |                   |                                  |                    |                 |                   |                                  |                    |                 |                   |                                  |   |
| Assam              | 0.02               | 0.08            | 0.22              | 22.32                            | 0.13               | 0.21            | 0.28              | 59.65                            | 0.14               | 0.29            | 0.50              | 49.15                            | 0.62  |
| Goa                | 0.14               | 0.36            | 0.26              | 37.46                            | 0.24               | 0.55            | 0.59              | 43.98                            | 0.38               | 0.91            | 0.85              | 41.39                            | 0.98  |
| Himachal Pradesh   | 0.01               | 0.40            | 0.40              | 2.69                             | 0.34               | 0.63            | 0.55              | 54.42                            | 0.35               | 1.03            | 0.95              | 34.25                            | 1.01  |
| Jammu & Kashmir ## |                    |                 | 0.00              |                                  | 0.05               | 0.56            | 1.14              | 8.70                             | 0.05               | 0.56            | 1.14              | 8.70                             | 0.08  |
| Manipur            |                    | 0.02            | 0.12              |                                  | 0.15               | 0.22            | 0.16              | 67.35                            | 0.15               | 0.24            | 0.28              | 61.79                            | 0.30  |
| Meghalaya          | 0.18               | 0.99            | 1.34              | 18.04                            | 0.01               | 0.30            | 1.34              | 4.95                             | 0.19               | 1.29            | 2.67              | 15.02                            | 0.49  |
| Mizoram @          | 0.00               | 0.08            | 0.15              | 1.33                             |                    |                 | 0.72              |                                  | 0.00               | 0.08            | 0.88              | 1.33                             | 0.00  |
| Nagaland           |                    | 4.76            | 4.76              |                                  | 0.01               | 0.01            | 0.05              | 48.00                            | 0.01               | 4.77            | 4.80              | 0.13                             | 0.01  |
| Sikkim @           |                    | 0.26            | 0.26              |                                  |                    |                 | 0.00              |                                  |                    | 0.26            | 0.26              |                                  |   |
| Tripura            | 0.00               | 3.75            | 3.75              | 0.09                             | 0.06               | 0.39            | 0.57              | 16.78                            | 0.07               | 4.14            | 4.31              | 1.65                             | 0.12  |
| Smaller States     | 0.03               | 0.54            | 0.61              | 4.84                             | 0.14               | 0.34            | 0.52              | 40.07                            | 0.16               | 0.88            | 1.12              | 18.52                            | 0.38  |
| 25 STATES          | 0.05               | 1.35            | 1.46              | 3.66                             | 0.53               | 0.78            | 10.56             | 67.73                            | 0.58               | 2.13            | 12.02             | 27.11                            | 4.73  |

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