

**LOCAL GOVERNMENTS IN THE FISCAL SPACE OF INDIAN  
FEDERALISM: TOWARDS MORE RATIONAL ARRANGEMENTS**

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## ABSTRACT

The Seventy-third and Seventy-fourth Constitutional Amendments(CAs) gave constitutional status to local governments (LGs) and mandated the Union and States to make them ‘institutions of self-governments’ endowed with the vital task of delivering ‘economic development and social justice’ at the local level. The task of making LGs, in particular the Panchayat Raj Institutions (PRIs), active agents of socio-economic transformation at the local level depends a great deal on the quality of fiscal decentralization. There is a strong case for assigning local governments a viable fiscal space in Indian federal system as an integral strategy towards building sustainable local democracy. However, the Indian federation has a built-in bias in favour of the Union with great vertical imbalances in the resources and responsibilities at the state level and a local government with an amorphous functional domain and weak fiscal space. In fact LGs do not occupy a respectable space in the public finance of India. This was not corrected by the above-said CAs. Though there has been some increase in the share of local governments’ expenditure in the total public sector expenditure recently India is way below most countries and continents except Middle East and West Asia. A comparison of local expenditure share reckoned in terms of GDP for Asia Pacific region also corroborates the poor position of India. A macro fiscal policy to rationalize the multiple channels of transfers keeping a well-defined space for LGs is called for. An unambiguous Constitutional clause to give a specific share to LGs may be added. Even after 67 years of Independence there are acute disparities in the availability of primary services (including toilet coverage) in the country. A necessary condition of all transfers (grants, tax-sharing etc.,) should be to ensure equalization of fiscal capacity of all LGs. All LGs should have the fiscal capacity to provide comparable levels of public services so that no citizen should suffer deprivation due to their choice of residential location.

**Key words:** Local government, panchayat raj institutions, local democracy, public finance, fiscal decentralization, fiscal space.

## **Introduction**

The 73rd/74<sup>th</sup> Constitutional Amendments (CAs) that gave local governments, notably the Panchayati Raj Institutions (PRIs) a respectable place in Indian federal polity is a watershed in Indian democracy. Although many make romantic references to the panchayats of the past, it was the British administration that brought local governments first into the governance apparatus of the country. Despite Gandhiji's strong preference for local governance and village swaraj, the Indian constitution went for a dual federation comprising only the Union and the States. The 73<sup>rd</sup>/74<sup>th</sup> Amendments that ushered in a multi-tiered federal system in India and gave constitutional status to local governments (LGs) and mandated the Union and States to make them 'institutions of self-governments' endowed with the vital task of delivering 'economic development and social justice' at the local level (Article 243G and 243W). The creation of the District Planning Committee (DPC) (Article 243ZD) for facilitating bottom-up district planning and the State Finance Commission (SFC) (243I and 243Y) to rationalize state sub-state level fiscal relations is but complementary institutional arrangements to promote these mandates bestowed on them. The task of making LGs in particular the rural local governments (PRIs) active agents of socio-economic transformation at the local level depends a great deal on the direction and quality of the process of fiscal decentralization. The purpose of this paper is to make out a case for assigning local governments a viable fiscal space in Indian federal system as an integral strategy towards building sustainable local democracy.

### **1.0. Local governments in India's fiscal federalism**

It is important to place local governments in India's fiscal federal map from a wider theoretical backdrop and comparative perspective. Before the two CAs, India was a dual federation where LG was a subject under the state list and enjoyed no constitutional status. The Indian federation, sometimes characterized as a case of 'co-operative federalism' is different from similar patterns elsewhere in the world. For example, it is different from that of Germany or South Africa where the federal governments decide major policies and where the different levels of government are at best implementing agencies. It is also different from the Brazilian model where all the three tiers of government enjoy autonomous and equal status and coordinate their policies horizontally and vertically. India cannot also be called the 'marble cake model' of co-operative federalism where the various levels of government have shared and overlapping responsibilities and treated as equal partners. This is because Indian federation has a built-in bias in favour of the Union with great vertical imbalances in the resources and responsibilities at the state level and a local government with an amorphous functional domain and

weak fiscal space. The problem is considerably confounded by the multi-layered character of the federation (comprising the three-tier Panchayati Raj Institutions, the municipalities and corporations besides the Union and States) with its multi-tiered public finance and multiple channels of transfer arrangements. The recent dismantling of the Planning Commission which provided investible grants to states can only compound the confusion.

In a federation the responsibilities for economic activities, policy, resource mobilization, transfers and so on are divided among multiple levels of government ostensibly to enhance efficiency and improve the quality of delivery of public services. Functional mapping which tells who should do what in a federal set up ideally is done on the basis of the principle of subsidiarity according to which what can be done best at a particular level should be done at that level and not at a higher level. Local governments will have to provide local public goods like street lighting, drinking water, sanitation, primary health care, primary education, waste management, link road connectivity and the like. Revenue assignments especially the marking of taxation responsibilities viz., who should tax what and where quite often follow convenience for collection besides the demands of equity and efficiency. The Indian federation under the British evolved more in an adhoc manner rather than on any scientific basis, and the Indian constitution spells out a union list, state list and concurrent list (Schedule VII) and after the 73<sup>rd</sup>/74<sup>th</sup> CAs two lists were added, one for PRIs (Schedule XI) and the other for urban local governments (Schedule XII)<sup>1</sup>. The subjects given under schedules XI and XII culled mostly from state list or concurrent list where the state and union have joint jurisdiction. Indeed, there is a *prima facie* case for a separate local list which of course calls for an amendment of the Constitution. This is particularly important because the constitution nowhere spells out the tax domain or fiscal space of local governments.

There is a rich body of literature on the structure and working of multi-level governments, referred to as ‘fiscal federalism’<sup>2</sup>. Broadly speaking, the theoretical framework underlying the fiscal federalism literature is in a neo-liberal mode whose efficiency and equity norms have a Pareto optimality basis<sup>3</sup>. But the basic rationale of decentralization in a federal polity is equity. Otherwise

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1. Item No. 5 in the State list (given below) which gives a subordinate status to local government is a relic of the past and needs to be abolished.

Local government, that is to say, the constitution and powers of municipal corporations, improvement trusts, districts boards, mining settlement authorities and other local authorities for the purpose of local self-government or village administration.[The constitution of India, Schedule 7, List II-State List] Keeping this clause in the Constitution is certainly an anachronism.

2 For a brief review of literature see Oates (2005) and Oommen (2005).

3 An economic activity or fiscal intervention with reference to its outcome in a society is considered Pareto-optimal when no one can be made better off, without making someone else worse off. Under such a regime when Rome is burning, the fiddling Nero cannot be disturbed because that will make him worse off. This offends all canons of ethics and social justice.

what is the basis for coming together and working together of very diverse entities as equal partners to achieve common goals. The Tiebout (1956) model which is one of the very early contributions to the theory of fiscal federalism literature assumes the existence of mobile households that select a residential location/jurisdiction based on their preferences for local public services which in turn is governed by a rational cost-benefit calculus. Admittedly this is irrelevant for India on many grounds. A sizeable proportion of families in India are landless, houseless or those who cannot afford to move around and buy a house in an environment where you have all the basic goods and services to live in reasonable comfort. While the macro-economic stabilization and redistribution functions are outside the ken of a local government, given the institutional framework comprising gram sabha, ward sabha, Union Finance Commission (UFC), which is organically related to the State Finance Commission (SFC), District Planning Committee (DPC) and so on, the goal of providing every citizen a minimum level of basic local public goods irrespective of his or her choice of residence is certainly a desirable development goal. The decentralization framework envisaged in the fiscal federalism literature emanating from western scholars does not easily fit into this approach. To be sure, it cannot provide the theoretical underpinning or philosophical rationale for the democratic decentralization currently underway in India.

### ***1.1. Measuring the fiscal space***

The economic significance of LGs in a federal system is generally measured by two parameters: (1) the share of local government expenditure to total public sector expenditure (the centre, states and local governments), and (2) the share of local governments' own source revenue (OSR) to total public sector OSR. One can also gauge these variables with reference to gross domestic product (GDP). The willingness to transfer resources to LGs and the readiness to take enabling measures by the higher level governments to finance the expenditure responsibilities assigned to them or to enhance investible resources to them especially in a system of considerable vertical and horizontal imbalances assigned to them (indeed an expression of political will) are also important in investigating LG fiscal space. Table 1 shows the share of LG expenditure and OSR in India's public sector expenditure and OSR disaggregated into PRIs and Urban Local Governments (ULGs). Fig.1. shows the graphical presentation of the share of local expenditure in the public sector expenditure of PRIs, ULGs and LGs from 2002-03 to 2007-08.

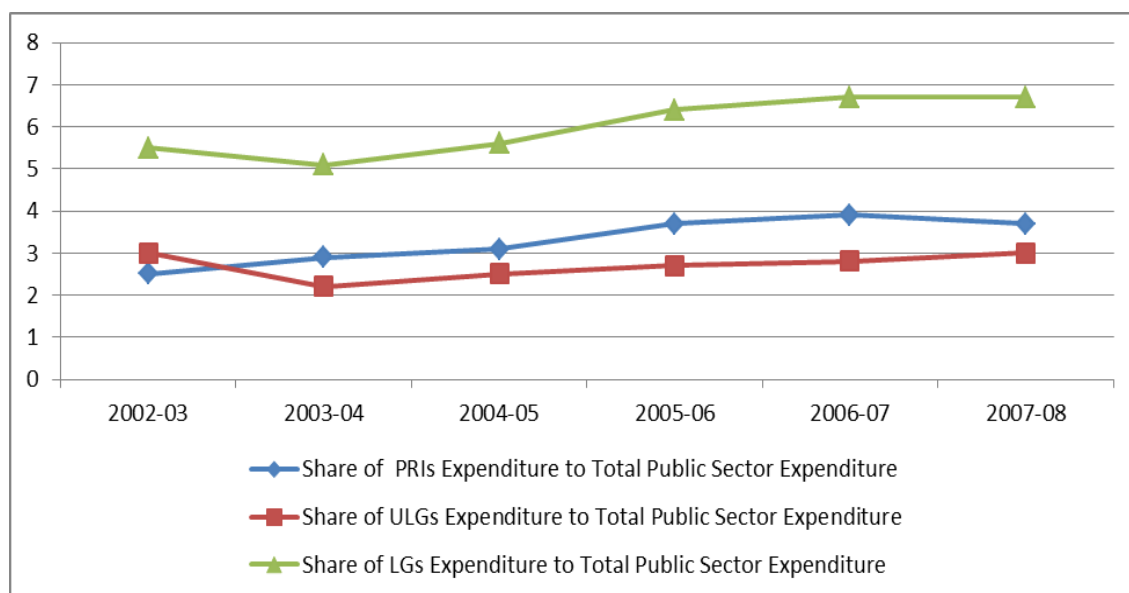
It is significant that the share of local governments' expenditure in the total public sector expenditure has increased almost steadily from 5.5% in 2002-03 to 6.7% in 2007-08. This is obviously because of the stepping up of PRIs' share which increased from 2.5% to 3.7% during this period. Actually, the share of ULGs stagnated around 3% and even declined in some years. The increasing trend of LGs has to be understood subject to the qualification that this increase is due to the step up in agency functions such as the centrally-sponsored schemes and several state sponsored programmes routed through PRIs and ULGs in recent years. This does not go well with the avowed goal of the Constitution to create 'institutions of self-government' at the third stratum of Indian federal governance.

**Table 1. Trend in the percentage Share of LGs in the total public sector expenditure, and public sector OSR (2002-03 – 2007-08)**

Items	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
<b>PRIs</b>						
Share of Public Sector Expenditure	2.5	2.9	3.1	3.7	3.9	3.7
<b>Share of Public Sector OSR</b>	0.4	0.4	0.4	0.4	0.3	0.3
<b>ULGs</b>						
Share of Public Sector Expenditure	3.0	2.2	2.5	2.7	2.8	3.0
<b>Share of Public Sector OSR</b>	3.2	3.1	2.9	2.9	2.7	2.5
<b>LGs</b>						
Share of Public Sector Expenditure	5.5	5.1	5.6	6.4	6.7	6.7
<b>Share of Public Sector OSR</b>	3.6	3.5	3.3	3.3	3.0	2.8

*Source:* Oommen [(2010):93]. *Note:* Calculations based on FC-XIII website data; Government of India, *Economic Survey* for relevant years and Reserve Bank of India, *State Finances: A study of Budgets* for relevant years.

**Figure 1. Trend in the share of expenditure of PRIs, ULGs and LGs in total public sector expenditure**



At this point it is instructive to compare the LGs in India with other countries to see where India stands. Tables 2 and 3 help to facilitate this comparison.

**Table 2: The Comparative Role of Local Government**

Countries	Local expenditure as percentage of total expenditures
Africa	7.9
Asia	
South Asia	16.0
East Asia	40.0
South –East Asia	15.5
Eurasia	26.5
Europe (2008)	23.9
Latin America	11.1
Middle East & Western Asia	4.6
North America	26.8

*Source:* Second Global Report on Decentralization and Local Democracy. 2010, p.337.

It is clear from Table 2 that India is way below most countries and continents except Middle East and West Asia which are not known for their democratic decentralisation. While the European average is 23.9%, the actual expenditure share is 35% in Norway, Sweden and Finland and goes to 55% in Denmark (See World Bank (2008):296). Enjoying considerable autonomy even under monarchic rule, as far back as 15<sup>th</sup> century LGs in Nordic countries “served their residents from cradle to grave”, a really inclusive system [Boadway and Shah (2009):267]. Many countries notably India does not have such a decentralized past. But the two CAs of India are indeed great steps towards democratic decentralization.

A comparison of local expenditure share reckoned in terms of GDP for Asia Pacific region given in Table 3 also corroborates the relatively poor position of India. Only Australia and Thailand stand below India. For China the percentage of local expenditure share goes as high as 22% and demonstrates a high degree of decentralization. But decentralization of India which statutorily gives a substantial role to the citizens forum of gram sabha and promotes several institutional arrangements for people’s participation is qualitatively different from most other countries.

The yawning gap between the exponential expansion of LG expenditure, notably that of PRIs on the one hand and the near stagnation in the share of OSR on the other noted in Table 1 is a matter of concern. This is brought out in bold relief in Figure 2 based on Appendix A. Appendix A presents the

**Table 3: Relative Size of Local Government Expenditure with reference to GDP in the Asia Pacific Region**

Countries	Local Public Expenditure (local and meso level only) % GDP
Australia	2%
China	22%
India	2.42%
Indonesia	6%
Japan	12.3%
Malayasia	4%
New Zealand	3.9%
Pakistan	2.6%
Korea , Rep. of	16%
Thailand	2%
Vietnam	11%

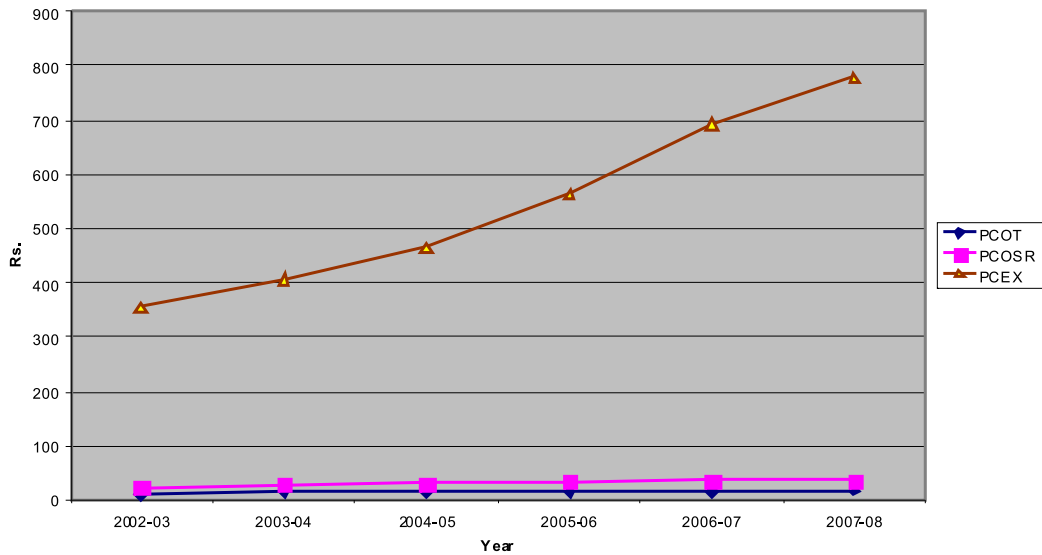
*Source:* First Global Report on Decentralization and Local Democracy in the World. 2008 p.68. For India M A Oommen (2010).

state-wise distribution of per capita tax, per capita OSR and per capita expenditure of PRIs. ULGs are left out because in their case the emerging scenario although disturbing has a solid revenue base. It is important to record some concerns that rise most prominently from Appendix A. One, the per capita expenditure trend is certainly encouraging with all-states PRI expenditure increasing at a compound annual growth of 16.9% per annum. In 2002-03, it ranges from Rs.18 in Bihar to Rs.1364 in Maharashtra with an all-states average of Rs.356; the minimum- maximum (mini-max) ratio works out to 75.7. There is a steady increase in expenditure in all the states. In 2007-08, the per capita expenditure ranges from Rs.48 in Bihar to Rs.2967 in Karnataka with an all-states average of Rs.779 and a mini-max ratio of 61.8. The min-max ratio registers a pronounced decline. Ideally the ratio should go further down. Two, all the three variables present an extremely uneven and disturbing scenario. In 2002-03, four states report no PRI tax revenue (See Appendix A). For the others per capita tax ranges from Re.1, in Uttar Pradesh to Rs.64 in Maharashtra with an all-states' average of Rs.11. Assam, Bihar, Orissa and Rajasthan continue to report zero taxing and in 2007-08, the per capita tax for the other states ranges from Re.1 in Uttar Pradesh to Rs.88 in Karnataka. While property tax constitutes the major source of revenue of LGs the world over, it is a matter of concern that some states like Punjab, Haryana and Rajasthan abolished the tax. Three, the per capita OSR which includes non-tax revenue shows a slightly altered picture again with the exception of Bihar. In 2002-03 the per capita OSR of PRIs ranges from Rs.3 in Orissa and Rajasthan to Rs.86 in Kerala with



an all-states average of Rs.24. In 2007-08 it ranges from Re.1 in Bihar to Rs.180 in Haryana with an all-states average of Rs.37. It appears 73<sup>rd</sup> Amendment has had no visible impact in Bihar and the situation in Rajasthan, Punjab and Uttar Pradesh no better compared to several other states. This means over 39 crore people or 33% (based on 2011 census) of the population of the country report no notable impact as a result of democratic decentralization that has been underway for nearly two decades..

**Figure 2: Per capita Own Tax, Per capita OSR and Per capita expenditure of PRIs (All States)**



*Source:* Oommen (2010), *Note:* PCOT: Per capita Own Tax, PCOSR: Per capita Own source Revenue  
PCEX: Per capita Expenditure.

Fig. 2 which shows the widening trend in the per capita expenditure of all-states on the one-hand and per capita OSR and per capita tax on the other portrays a depressing scenario. The constitutional mandate to usher in ‘institutions of self-government’ at the local level seems to recede like the horizon. The magnitude of PRIs expenditure in absolute terms has increased and as a percentage of GDP from 1.17% to 1.36% in 2006-07 although slightly declined to 1.33% in 2007-08. It is only reasonable to infer that the growing expenditure might have generated a multiplier income effect in those states which have a critical level of per capita expenditure. In all probability with the state-wise allocation for MGNREGA and other flagship programmes steadily increasing the multiplier income effect could be higher. So long as local public goods and services are almost fully financed by grants from higher governments, it may create a fiscal illusion among the local people about the cost of such services and the distribution of its burden. This has to be addressed as a major fiscal problem.

## 2.0. Fiscal decentralization: The Kerala story

Given the language of the 73<sup>rd</sup>/74<sup>th</sup> CAs the success of democratic decentralization in India depends a great deal on the readiness of state governments to devolve relevant functions, required finance and the needed functionaries to the various LGs at the sub-state level. In other words, real devolution can happen only when the state parts with power and authority and virtually empowers the sub-state level governments. At best the two Amendments are only necessary conditions and much sufficient conditions remain to be realised. Kerala admittedly is one state that has taken measures to devolve more functions, finance and functionaries to the LGs. Almost the first step taken by the LDF (Left Democratic Front) government was to devolve 35-40% of the State Plan outlay to the LGs. This was no fictitious number as it was a rough estimate based on potential expenditure responsibilities that could be devolved to panchayats and municipalities. The decision was followed up by appointing a Committee (widely called the Sen Committee after the name of its first Chairman Subrato Sen) whose primary task was to map out functions (dividing into activities and sub-activities for the sake of functional clarity)<sup>4</sup> and fiscal decentralization to facilitate financing of the assigned functions, deployment of required functionaries and creating appropriate legal framework to carry forward the process of democratic decentralisation. Table 4 gives the trend in devolution of resources to LGs by the Kerala state government from 1997-98 through 2012-13.

As already noted, the readiness to transfer resources by the higher level governments to implement the expenditure responsibilities assigned to LGs and the creation of relevant statutory and administrative framework for autonomous decision-making by them is a necessary condition and indeed the first step towards democratic deepening at the local level. That Kerala has achieved this in a big way is well exemplified in Table 4. It is clear from Table 4, that the state has devolved nearly 24% of its investible resources (Development fund/plan outlay) to the local governments and the annual devolution ranges from 20.65% in 2009-10 to 33.33% in 2002-03. Figure 3 shows per capita transfers from 1997-98 through 2012-13. Although the nominal percapita transfers shows a CAGR of 7.55% per annum, the real percapita transfers using SDP deflators at 1993-94 prices increased only at the rate of 2.76%. The 16 years average of total resource transfers including non-plan transfers vis-a-vis the total state tax revenue (SOTR) works out to 17.61%. Although this is no small achievement in terms of the magnitude of devolution, the steady decline in the fund flow to LGs as a percentage of SOTR has to be noted. While in 1998-99 it was as high as 28.7% of SOTR it declined to 12.83% in 2012-13. The development funds (previously called plan grants) devolved were untied grants. The major conditionality for the entitlement of plan grants was the preparation and implementation of annual LG plan based on a participatory decentralized planning methodology. The creation of a multi-stage process of planning with institutional mechanisms starting from calling the ward sabha to voice the

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4. The idea of activity mapping was later followed by several other states and the MOPR (Ministry of Panchayati Raj) in 2004 pushed it even by entering into MOUs with individual states by the then MoPR Minister Mani Shankar Aiyar.

**Table 4: Trends in Devolution of Resources to Local Governments by the Kerala State Government(1997-98 – 2012-13)**  
(Rs. in crore except per capita figures)

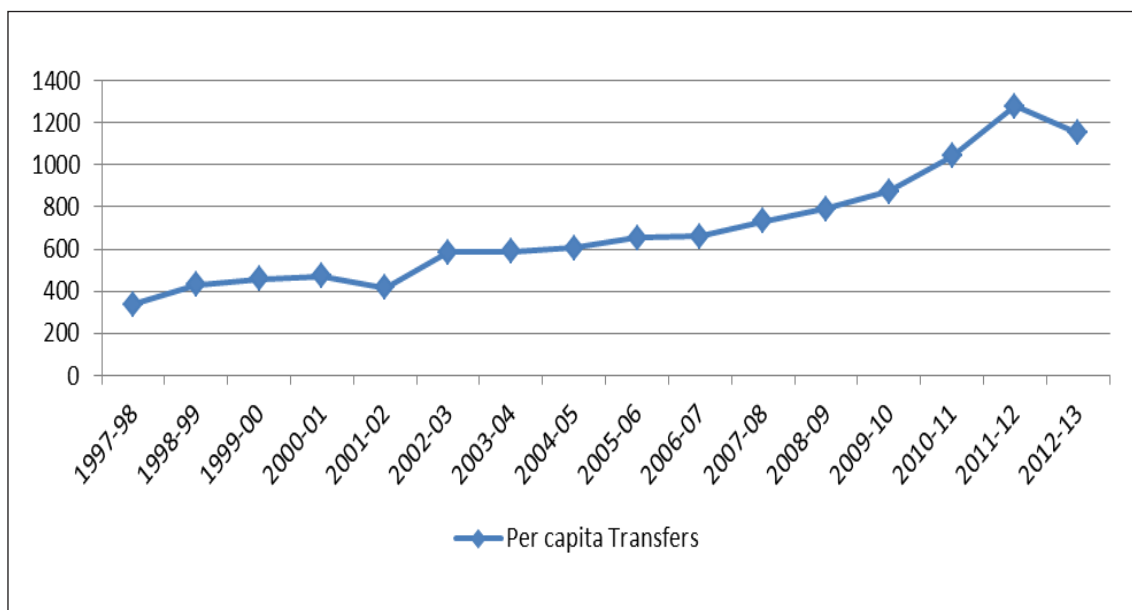
Year	State Plan outlay	SOTR	Devolution as per SFC Recommendation			Ratio of LG Plan Transfers to Plan outlay	Total Transfers as percentage of SOTR of State	Per capita Transfers
			Development Fund	Non Plan	Total			
1	2	3	4	5	6	7	8	9
1997-98	2855.00	4501.10	749.00	297.20	1046.20	26.23	23.24	337.07
1998-99	3100.00	4649.60	950.00	384.30	1334.30	30.65	28.70	429.89
1999-00	3250.00	5193.50	1020.00	405.40	1425.40	31.38	27.45	459.24
2000-01	3535.00	5870.30	1045.00	419.90	1464.90	29.56	24.95	471.97
2001-02	3015.00	5923.40	850.00	440.90	1290.90	28.19	21.79	415.91
2002-03	4026.00	7302.50	1342.00	472.20	1814.20	33.33	24.84	584.51
2003-04	4430.25	8088.80	1317.00	505.60	1822.60	29.73	22.53	587.22
2004-05	4800.00	8963.70	1350.00	531.10	1881.10	28.13	20.99	606.06
2005-06	5369.81	9778.60	1375.00	657.20	2032.20	25.61	20.78	654.75
2006-07	6210.00	11941.80	1400.00	650.00	2050.00	22.54	17.17	660.48
2007-08	6950.00	13669.00	1538.44	734.99	2273.43	22.14	16.63	732.47
2008-09	7700.47	15990.20	1670.23	786.43	2456.66	21.69	15.36	791.50
2009-10	8920.00	17403.50	1842.29	865.15	2707.44	20.65	15.56	872.30
2010-11	10025.00	21722.00	2277.72	951.67	3229.39	22.72	14.87	1040.46
2011-12	11030.00	25719.00	2563.76	1409.93	3973.69	23.24	15.45	1280.27
2012-13	14010.00	30077.00	2062.61	1797.34	3859.95	14.72	12.83	1150.88
<b>16 Year Ratio</b>	<b>99226.53</b>	<b>196794.00</b>	<b>23353.05</b>	<b>11309.31</b>	<b>34662.36</b>	<b>23.54</b>	<b>17.61</b>	<b>658.33</b>

Source: State Plan Outlay, Development Expenditure, Non plan expenditure etc., CAG Reports for various years and Government of Kerala (2011)

SOTR:-State's Own Tax Revenue – Budget in Brief (various Years), Government of Kerala.

felt needs of the citizens, to projectisation by the working groups and vetting by Technical Advisory Group and final clearance by the District Planning Committee has widened the avenues for consultation and participation by the people. While the decentralized planning initiative was a great participatory democratic project, over the years it got routinized and bureaucratic reassertion has become a reality, [see GoK (2009) for a documented evaluation upto 2009]. Even so, no one can gainsay the achievements made through greater fiscal space, which of course now needs reform and corrective action.

**Fig. 3. Per capita Transfers (1997-98 – 2012-13)**



Receipts do not include MPLAD and MLALAD funds that pass through the LGs. Table 5 presents the structure and composition of LG finance of Kerala for the period from 2006-07 through 2012-13 based on data for seven years provided by the Annual Reports of the Comptroller and Audit General of India since 2006-07. Such a macro trend is not available for earlier years. The pie-diagrams for 2006-07 and 2012-13 [figure 4 (a), and 4 (b)] help to compare two periods and the changes that occurred in the structure and composition of the funds at the LG level in the State in recent years. Unfortunately, CAG does not provide separate figures for panchayats and municipalities. The total receipts of LGs in 2006-07 was over Rs.3707 crore and rose to Rs.9579 crore with a compound annual growth rate (CAGR) of 17% per annum. The per LG number works out to Rs.3.07 crore in 2006-07 and Rs.7.92 crore in 2012-13. That several gram panchayats in Kerala today spend over Rs.10 crore per annum is certainly an enviable record compared to their counterparts in the rest of the country.

**Table 5. Structure and Composition of LG Receipts by major sources from 2006-07 to 2012-13** **Rs. In crore**

Sl. No.	Sources of Resources	Year										CAGR
		2006-07	2007-08	2008-09	2009-10	2010-11*	2011-12	2012-13				
	Total Tax Revenue	357.41	334.42	385.36	450.76	—	561.79	661.01				
	Total Tax Revenue as %age to total Receipts	9.64	7.64	8.04	8.56	0.00	7.37	6.90				
	Non Tax revenue	230.25	315.08	349.37	377.43	—	376.69	599.60				
	Non Tax revenue as %age to total Receipts	6.21	7.20	7.29	7.17	0.00	4.94	6.26				
1	Total OSR (i+ii)	587.66	649.5	734.73	828.19	952.97	938.48	1260.61	12.45			
	<b>Total OSR as %age to total Receipts</b>	<b>15.85</b>	<b>14.84</b>	<b>15.33</b>	<b>15.73</b>	<b>12.80</b>	<b>12.32</b>	<b>13.16</b>				
	State Grant: General Purpose Grant	299.96	329.98	363.98	399.31	440.47	644.98	757.89	16.65			
	State Grant: General Purpose Grant as% to total receipts	8.09	7.54	7.59	7.59	5.92	8.46	7.91				
	Development Fund	1400.36	1538.44	1670.23	1842.29	2277.12	2021.52	2062.61	7.47			
	Development Funds % to Total receipts	37.77	35.14	34.85	35.00	30.58	26.53	21.53				
	Maintenance Expenditure (Road + Non Road) Assets	350	404.98	397.52	448.04	440.58	713.94	1039.45	17.44			
	Maintenance Expenditure (Road + Non Road assets) as % to Total Receipts	9.44	9.25	8.29	8.51	5.92	9.37	10.85				
	State sponsored Schemes & State Share of Centrally Sponsored Schemes	585.84	976.91	807.44	840.8	1358.24	1358.45	1865.73	18.09			
	State sponsored Schemes & State Share of Centrally Sponsored Schemes as % to total Receipts	15.80	22.32	16.85	15.97	18.24	17.83	19.48				
2	<b>Total state Grant</b>	<b>2636.16</b>	<b>3250.31</b>	<b>3239.17</b>	<b>3530.44</b>	<b>4516.41</b>	<b>4738.89</b>	<b>5725.68</b>	12.97			
	Total State Grant as % to total Receipts	71.11	74.25	67.58	67.07	60.66	62.19	59.77				
3	<b>Centrally sponsored schemes</b>	<b>323.09</b>	<b>454.68</b>	<b>811.12</b>	<b>832.49</b>	<b>1163.79</b>	<b>1903.56**</b>	<b>2582.77</b>	40.20			
	Total GoI Grants as %age to total Receipts	8.71	10.39	16.92	15.82	15.63	24.98	26.96				
	Receipts from loans and other sources	160.42	23.14	7.81	72.35	812.36	39.16	10.27	18.19			
	Receipts from loans and other sources as % to total Receipts	4.33	0.53	0.16	1.37	10.91	0.51	0.11				
	<b>Total Receipts</b>	<b>3707.33</b>	<b>4377.63</b>	<b>4792.83</b>	<b>5263.47</b>	<b>7445.53</b>	<b>7620.09</b>	<b>9579.33</b>	<b>17.00</b>			

Source: Comptroller and Auditor General Report for various years. Note: All the Ratios are worked out. \*The break-up of OSR into tax and nontax revenue is not available for 2010-11. \*\* including Development expansion fund. CAGR-Compound Annual Growth Rate.

Receipts do not include MPLAD and MLALAD funds that pass through the LGs.

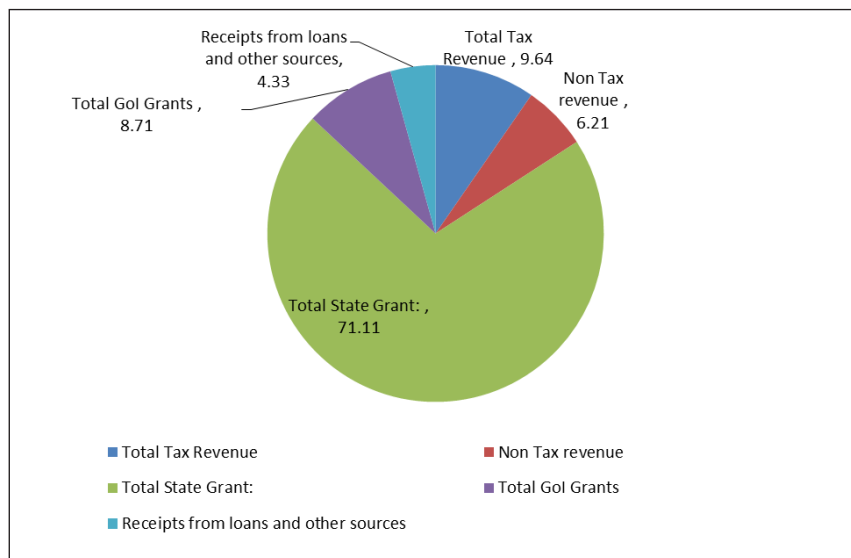
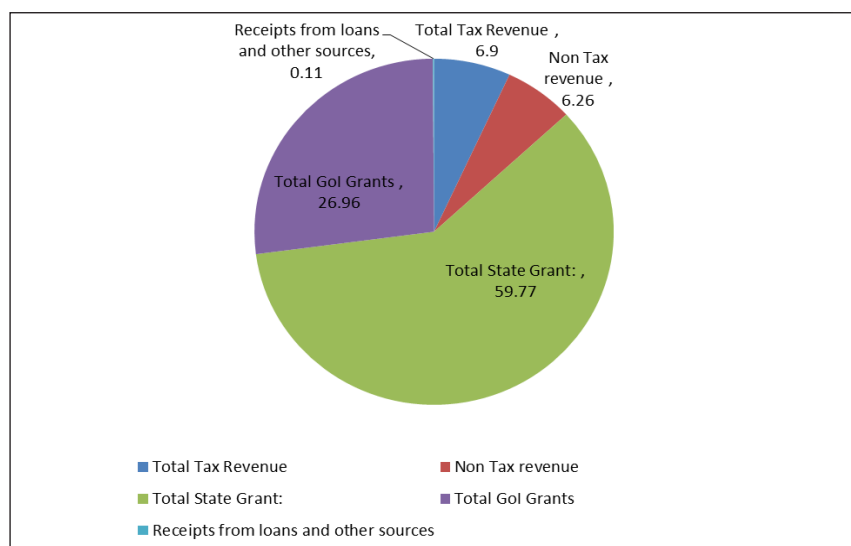
**Figure 4 (a): Percentage Share of Receipts of LGs of Kerala 2006-07****Figure 4 (b): Percentage Share of Receipts of LGs of Kerala 2012-13**

Table 5 clearly shows that state government grants constitute the major share. It ranges from around 60% in 2012-13 to over 74% in 2007-08. Of late, there is a tendency for GoI grants to increase and over the 7 year period their CAGR is over 40%. Probably, the worst part is the decline in the share of OSR over the years. In 2006-07 the share of OSR was 15.85% and if loans are included it is well over 20%. The share of OSR declined to 13.16 in 2012-13 and that of loans to a negligible sum. But this does not mean a disturbing indication because the per capita OSR in 2006-07 which was Rs.176 rose to Rs.270 in 2011-12 and Rs.363 in 2012-13, the latter more than double that in 2006-07.

A moot question that arises at this stage is to investigate whether the increase in grants has adversely affected the revenue mobilisation efforts of gram panchayats. Appendix B gives the list of 24 gram panchayats and the correlation coefficient. The clear conclusion is that increase in grants has not adversely affected the tax efforts. There is no flypaper effect.

### **3.0. Working towards a well-reasoned LG space**

To be sure, LGs notably the PRIs do not occupy a respectable space in the public finance of India. The 73<sup>rd</sup>/74<sup>th</sup> CAs offered a historical opportunity to restructure public finance and address the issue. However, the issue persists as an unfinished task. Barring the creation of several institutions like the gram sabha, SFC, DPC, State Election Commission, introduction of reservation of seats for women, and backward communities and so on, the onus of transferring power and authority through appropriate statutory changes was left to the State Legislative Assembly. While the conformity legislations were passed by all the states as scheduled by April 1994, the empowerment of LGs, particularly the fiscal decentralization exercise and fiscal empowerment of LGs have turned out to be a matter of relevant statutory support and political will. This explains the ‘big bang’ decentralization of Kerala compared to the snail-like progress in other states. The terms of reference of the XI<sup>th</sup> UFC as well as that of the XII<sup>th</sup> UFC required these Commissions to make recommendations for restructuring public finance. However, both commissions submitted their recommendations without bringing LGs into the picture. The problem continues and has to be addressed by the decision makers of the country.

We have already underlined the yawning gap between the growing expenditure and shrinking OSR of LGs. Two sets of reforms seem to be in order: one, at the macro level and the other at the level of the states in order to strengthen the process of fiscal empowerment of the LGs. Some general observations that will be helpful in working towards a reasonable fiscal space for LGs are discussed below.

First we may take up the macro reforms. The most compelling macro fiscal policy reform especially with the exit of the Planning Commission relates to the redesigning of the transfer arrangements. The real macro fiscal policy that needs attention is to rationalize the multiple channels of transfers keeping a well-defined space for LGs. Fiscal space and inter-governmental resources flow take place through assignments and transfers in India. As part of assignments we reiterate the suggestion already made to revisit Schedule VII of the Constitution and add a proper local list (in which case one can even drop schedules XI and XII) spelling out the fiscal space of LGs. Another assignment that needs reform is the scheme of Union tax sharing. An unambiguous clause to give a specific share to LGs through suitable constitutional amendments may be added. Till the dismantling of the Planning Commission, Indian federal system had three major channels of transfers (i) the Union Finance Commission (ii) the Planning Commission and (iii) the Centrally Sponsored Schemes of the central ministries. These agencies have multiple objectives and strategies and require suitable reforms. Needless to say, the overarching concern of all transfers should be towards delivering improved quality

of life and social justice. It is not clear whether the Five Year Plan formulations are going to be dispensed with. Whatever be the possible outcome, there is a great need to work towards a comprehensive framework of transfers. The distinction between plan and non-plan certainly will have to be re-examined because even before the exit of the Planning Commission much confusion has crept in. For one, plan allocations are no longer investible resources meant to augment the productive capacity of the economy and the bulk of the so-called plan expenditure is now revenue expenditure [for details See GoI (2011)]. Moreover, for any evaluation of the outlay vis-à-vis outcome, an integrated and holistic picture of expenditure is needed. In other words, the transfer system needs to be redesigned. Although it is not the purpose of this paper to go into the design of transfer arrangements that should be considered, how the normal central assistance based on the modified Gadgil formula and all other central assistance to state plans (e.g. centrally sponsored schemes, additional central assistance, special central assistance, central sector schemes and so on) cannot be omitted in any scheme of rethinking. Surely no redesigning can afford to ignore the issues related to the fiscal space of LGs. CSSs assume particular significance in this respect. The state governments have all along been resisting the proliferation of CSSs, many of them being implemented through the LGs. If the various central ministries continue to execute the CSSs without quantitative and qualitative evaluation of delivery and outcome (and in substantial number of cases even transfers are treated as expenditure)<sup>5</sup> the transfer system of the country under the new regime without planning commission can only worsen the situation. Moreover, the growing presence of CSSs means the super imposition of people's preference by the central government preferences. The most compelling rationale for establishing local governments in a democracy is that they reflect the preferences of the local people.

While admittedly the LGs in several states have a poor record of resource mobilization, it is important to point out that several moves and measures taken by the Union and State governments have also harmed the process of creating autonomous LG institutions. The Member of Parliament Local Area Development Scheme (MPLADS) introduced almost simultaneously with the inauguration of the decentralised process of governance, the MLALAD copied by most states for their MLAs as constituency development fund, several Chief Minister's funds (e.g. Janmabhoomi fund in Andhra Pradesh), the centrally-sponsored and state-sponsored schemes and other parallel projects and parallel bodies have aggressively encroached into the functional and fiscal domains of local governments constraining their operational fiscal domain and jeopardizing the process of autonomous local governments and the project of local democracy itself in the country. The Sansad Adarsh Gram Yojana released by the Prime Minister on October 11, 2014 requires MPs to identify one village with a population of 3000-5000 in the plains and 1000-3000 in the hills within a month for convergence of existing schemes for socio-economic development. Being initiated and going to be coordinated and monitored by the Centre, we are on the threshold of a centralization process that seemingly neglects

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5 According to GoI(2011) (Rangarajan Committee Report), 31% of Union government expenditure treats allotment (transfers) as expenditure.



the role of PRIs in the economic transformation of the country. It is widely documented that the central ministries and the Planning Commission (till its recent exit) have been widening their areas of discretion in the use of central resources even after constitutional amendments and the passing of the conformity legislations by the states in 1994. Out of the total centrally sponsored schemes (CSSs) of Rs.6.6 lakh crore during the XIth Plan, the nine flagship CSSs alone constituted 79.4%. The share of all CSSs as percentage of GBS (Gross Budgetary Support) has continuously increased during the last four plan periods. [For more details see GoI (2011) (a) (also called Chaturvedi Committee Report)].

Given the primary focus of this paper we may have to indicate also the underlying principle that should govern all transfers at the Union government level (whatever be the channel) as well as at the state sub-state level. It is acknowledged that even after 67 years of Independence there is acute disparities in the availability of primary services (including toilet coverage) in the country. A necessary condition of all transfers (grants, tax-sharing etc.) should be to ensure equalization of fiscal capacity of all LGs. In brief, all LGs should have the fiscal capacity to provide comparable levels of public services at reasonably comparable levels of taxation so that no citizen should suffer deprivation due to their choice of residential location. Making tax effort is very important. Of course, this is easily said than done [See Table 1 and Fig 2). Even so, considerable progress can be achieved if the UFC and SFCs which are organically linked, work towards a common goal.

So far we have discussed some macro reforms to be considered in providing a viable fiscal space to LGs. In those panchayats where the size is very small the question of building a viable size needs to be examined. This is an issue which the country has skirted around. Along with that it is very important to take steps to have a working financial reporting system based on proper annual budgets, accounting practices and audit reports. For this, building a reliable consistent and historical data set is a prime requisite. To build such a data base the practice of budget making and accounting has to be streamlined. This is the major drawback of local governance in India. Even in Kerala known for its advance in democratic decentralisation the situation leaves many things to be desired. A senior IAS officer of Kerala with a firm commitment to the cause of decentralisation famously remarked: "At the local government level, the data given on Monday will be different from that provided on Tuesday." While this is a fact, it is equally important to note that the revenue and expenditure of the LGs after the 73<sup>rd</sup>/74<sup>th</sup> CAs expanded on an unprecedented scale. The union, state and parallel agencies started pumping in money via LGs to be utilized for multifarious purposes. The old accounting system and certainly the administrative system were inadequate to tackle the growing challenges. As this situation suited a corrupt regime demand for reforms was slow and actions remain slower. Of course, the needed reforms cannot be handled at the LG level.

The XI<sup>th</sup> UFC realised the seriousness of the problem. They recommended that (a) the Comptroller and Auditor General (CAG) should help the Department of Local Fund Audit (DLFA) to improve the situation. In addition to the Technical Guidance and Supervision (TGS-later renamed as Technical

Guidance and Support) and (b) CAG should prescribe the formats for budgeting and accounting. The CAG has taken steps at the local level including capacity building of the Department of Local Fund Audit. After long deliberations the CAG has prescribed the accrual-based double entry system for municipalities and the cash based single entry system of accounting for the panchayats<sup>6</sup>. Kerala not only adopted this accounting format first for municipalities, but later on adopted it for panchayats. At the instance of the Principal Accountant General (Audit) Kerala, reform measures were instituted from 2003 onwards. Kerala can now boast that it has fully implemented the accrual-based accounting for both panchayats and municipalities. Unless and until this is done in all the states, the case for building more fiscal space will remain weak.

To conclude, the panchayats and municipalities are now constitutionally endowed with the vital task of providing primary services and delivering ‘economic development and social justice’ at the local level. This is also envisaged as a way for deepening participatory democracy in the context of a representative democracy that failed the people in ushering in an inclusive society. Without assigning a respectable fiscal space for LGs in India’s federal polity, all the grandiose objectives regarding local democracy would be empty rhetoric. The rich body of fiscal federalism literature handed down from the West does not offer the policy-theoretic required for developing local democracy in India. The task of fiscal empowerment depends on assignments and transfers. This paper argues the case for reforms in assignments and transfers from the perspective of LGs that are required for a restructuring of public finance in realising these objectives. There is a strong case for a comprehensive, holistic and integrated transfer system based on territorial equity. The overarching goal should be to equalize the fiscal capacity of local governments given their genuine tax effort so that all citizens should have basic needs irrespective of their choice of residential location. Even so, building OSR is the best and sure way to create institutions of local self-government in the country.

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6 It is to be recalled here that in the Regulation on Audit and Accounts, 2007, issued by the Comptroller and Auditor General of India, on the authority of the powers vested in him/her under Article 150 of the Constitution and Section 23 of the CAG’s (DPC)Act,1971, CAG has mandated that, within a short period, the accounts of the Union and States shall be switched over from the cash based single entry system to the accrual based double entry system of accounting. This is a running score on the democratic polity of the country.

## Appendix A

## Per capita Own Tax, Per capita OSR and Per capita Expenditure of PRIs

(in Rs.)

States	2002-03			2003-04			2004-05			2005-06			2006-07			2007-08		
	PCOT	PCOSR	PCEX	PCOT	PCOSR	PCEX	PCOT	PCOSR	PCEX	PCOT	PCOSR	PCEX	PCOT	PCOSR	PCEX	PCOT	PCOSR	PCEX
Andhra Pradesh	20	51	187	22	52	192	25	60	216	28	66	263	31	70	281	33	89	371
Assam	0	4	272	0	4	489	0	4	555	0	4	863	0	6	1257	0	7	866
Bihar	0	0	18	0	0	18	0	0	1	0	0	44	0	1	45	0	1	48
Gujarat	7	22	1342	7	22	1387	14	39	1507	7	27	1718	12	34	2013	26	45	2080
Haryana	3	74	177	1	73	201	5	134	234	4	173	451	4	187	469	4	180	637
Karnataka	19	19	1199	33	33	1335	24	24	1409	36	36	2057	46	46	2391	88	88	2967
Kerala	49	86	351	48	94	600	52	107	674	66	127	760	66	133	820	63	112	874
Madhya Pradesh	5	11	77	6	12	69	7	13	341	7	15	468	3	11	868	3	13	1153
Maharashtra	64	85	1364	106	127	1531	85	109	1687	70	96	1872	73	103	2067	80	114	2268
Orissa	0	3	268	0	3	295	0	3	291	0	3	326	0	3	568	0	3	576
Punjab	2	77	175	2	70	193	11	95	235	11	95	267	12	111	520	8	29	136
Rajasthan	0	3	50	0	3	51	0	4	81	1	3	90	1	4	84	0	3	75
Tamil Nadu	14	65	686	22	55	715	24	65	828	27	70	838	29	78	979	34	74	1229
Uttar Pradesh	1	5	93	1	5	129	1	6	146	1	7	169	1	6	196	1	7	186
West Bengal	2	7	181	3	9	209	2	12	254	3	13	267	4	17	433	0	0	581
<b>All States</b>	<b>11</b>	<b>24</b>	<b>356</b>	<b>15</b>	<b>28</b>	<b>406</b>	<b>14</b>	<b>31</b>	<b>466</b>	<b>15</b>	<b>33</b>	<b>564</b>	<b>15</b>	<b>36</b>	<b>692</b>	<b>18</b>	<b>37</b>	<b>779</b>

**PCOT:** Per capita Own Tax, **PCOSR:** Per capita Own source Revenue, **PCEX:** Per capita Expenditure

Source: 13<sup>th</sup> Finance Commission website Note: State wise rural populations as per 2001 census is used for per capita computation. No Projection is made.

## Appendix B

### Correlation between Tax and Grants

	2012-13		2013-14
Correlation	0.252		0.435

LG Code	2012-13		2013-14	
	Percapita Grants	Percapita Tax	Percapita Grants	Percapita Tax
GP103	2,456	138	2,620	153
GP12	2,014	80	1,956	90
GP26	1,942	120	2,230	121
GP29	1,272	87	1,431	93
GP35	2,980	293	2,922	348
GP42	3,583	472	3,729	466
GP44	4,529	346	3,904	179
GP45	3,673	290	3,542	208
GP46	2,757	233	3,015	214
GP47	1,585	123	3,245	98
GP54	2,019	126	2,343	149
GP58	3,435	105	3,579	107
GP60	3,320	520	4,826	565
GP64	2,635	209	2,864	212
GP65	2,518	179	2,719	179
GP75	3,251	553	3,290	608
GP83	2,437	199	2,348	237
GP87	2,788	277	2,835	417
GP90	3,153	157	2,349	186
GP91	4,109	162	3,600	156
GP93	5,140	134	3,962	180
GP94	5,174	191	4,822	232
GP95	4,494	149	3,790	211
GP96	3,277	81	2,425	98

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