NATIONAL INSTITUTE OF RURAL DEVELOPMENT, HYDERABAD

NATIONAL CONFERENCE ON EMERGING TRENDS IN STATE-LOCAL FISCAL RELATIONS
[DECEMBER 18 - 19, 1996]

SOME FISCAL IMPLICATIONS OF DECENTRALISATION

Dr. Alok Sheel, I.A.S
Special Secretary, Finance [Expenditure],
Government Of Kerala

The 73rd and 74th Constitutional amendments make possible greater transfer of functions and resources to Local Bodies. The actual impact of the amendments is still to be seen however. Local Bodies have been in existence for a long time, but their presence has been by and large invisible, and one may add, ineffectual. The reasons for this are many, but perhaps one can single out 'financial constraint' as the most important reason why these institutions have had so little impact on local governance in the country.

One can perhaps identify three major factors that were, and indeed still are, responsible for this financial constraint. These are:-

(1) The inability,or unwillingness, of Local Bodies to effectively tap the revenue resources assigned to them under the law. Property taxes constitute potentially the most lucrative source of income of Local Bodies. Another major source, viz. user charges for services rendered, can augment revenues only where public services offered are of a minimum standard. Cash strapped Local Bodies are hardly in a position to provide such services. On the other hand, a number of Local Bodies have become unduly dependent on regressive taxes such as octroi, on which

there is a national consensus that they need to be abolished. If this is done revenue mobilisation by Local Bodies is bound to be adversely affected, unless they can mobilise resources from alternative resources, such as from property and agriculture.

(2) The second major factor constraining local body finance is the inequitable revenue sharing arrangement between the Centre and State Governments on the one hand, and Local Bodies on the other. Not only was a very small proportion of the revenue receipts made available to Local Bodies, but even this modest share was not released on account of growing fiscal deficits both in the Centre and the States. Thus, insufficient budgetary provisions were made to transfer the shares due to Local Bodies. As a result, State Governments in fact owe significant amounts to Local Bodies. To cite one example there are arrears in excess of Rs. 150 crores payable to Local Bodies by the Government of Kerala, chiefly on account of stamp duty, basic [ie. Land] Tax, Vehicle Tax compensation Grant, and Grant for maintenance of Panchayat Roads.

(3) The third major constraint on Local Body finance is the existing structure of resource transfers to them. On account of the inability of Local Bodies to raise resources, and the inability of higher tiers of Government to share revenue receipts with them, ad hoc and discretionary grants have typically been the mainstay of Local Body budgets. The very adhoc and discretionary nature of these transfers made it difficult for Local Bodies to step up the scale of their operations in a planned and systematic manner.

The State Finance Commissions were set up under Article 243 I of the Constitutional [73rd] Amendment, to remove the major constraints on Local Body finances. A number of these Commissions have submitted their Reports, while most others are in the final stages of doing so. The present Conference, it is presumed, is part of this ongoing exercise to effectively operationalise the 73rd and 74th Constitutional Amendments by discussing threadbare its fiscal implications.

The whole issue of mobilising resources for Local Bodies must be viewed within the overall fiscal scenario prevalent in the country. It is widely acknowledged that there has been a rapid fiscal slide since the early eighties. The fiscal deficit was within manageable limits till then, with a small surplus on the revenue account financing atleast part of the capital expenditure required for growth and development. Around this time, however, the Centre's Revenue Account rapidly deteriorated, peaking at 3.47%of the GDP in 1990-91. The States, while showing deteriorating Revenue Accounts, nevertheless still ran small surpluses which helped in keeping the overall revenue deficit in some check. By the early nineties, however, the States too had slipped into Revenue Deficit. The combined Revenue Deficit of the States and the Central Government stood at 4.42% of the GDP in 1990-91, while the combined fiscal deficit rose from 4.59% in 1975-76 to 9.88% in 1990-91. Of this 8.34% was accounted for by GOI's fiscal deficit.

As part of its macroeconomic stabilisation and reform programme initiated in 1991, there has been some attempt at fiscal tightening by the Government of India. The Center's fiscal deficit has been brought down to under 6% through cutbacks in both the Revenue Deficit as well as on Capital Expenditure. It has been argued that these cutbacks are at least partly illusory, since the burden of some expenditures, especially in the social sector, have simply been passed on to State Governments. The fact nevertheless is that State Governments continue to record increasing revenue as well as increasing fiscal deficits in relation to their domestic products.

The combined fiscal deficit of the Centre and the State currently stands at around 7.5%, and is is clearly unsustainable. This figure, as well as the targetted reduction to 4.5% [for the Centre alone] compares adversely with the Maastricht norm of 3% set for entry into the European Monetary Union. While it is a moot point whether fiscal deficit targets for developed and developing country should be the same, there is nevertheless a National consensus that this deficit needs to be substantially pruned. Unsustainable fiscal deficits over a long period have led to a ballooning of Public Debt, both external and domestic, in the Centre as well as in the States. Difficulties in servicing this debt overhang is compounded by ongoing financial sector reforms, which are increasingly reducing the spread between the Government's borrowing costs at the margin to market rates, thereby increasing the cost of debt servicing and further worsening the Revenue Account. The country seems to be in the grip of a vicious circle taking it perilously close to a debt trap. India's public debt burden indicators, it may be observed, exceed those of virtually all developing countries, particularly those of the successful East Asian Countries. Only a few of India's South Asian neighbours come lose to India in this regard. The case for significant fiscal tightening is therefore unassailable. This tightening can be done either by raising resources - such as by enhancing the tax/GDP ratio which has been stagnating at 10 to 11% - or by limiting and reducing expenditure, in particular revenue expenditure. The tightening would has to be accomplished through an appropriate blend of both tax buoyancy and expenditure control.

The deteriorating fiscal scenario in both the Centre and the State is well known, but it has been underscored as it must form a constant backdrop to any proposals transferring functions and resources to Local Bodies. Such transfers must have at least matching cutbacks elsewhere, which are never easy, and additional revenues would have to be mobilised. This is easily achieved on paper, but is likely to prove difficult to practice. In the immortal words of T.S. Eliot, "Between the idea and the reality falls the shadow".

Take the case of expenditure cutbacks. Already the administrative costs of running the Government, both at the Centre and the State, is unacceptably high. The transfer of schemes from Government Departments to Local Bodies may itself present little difficulty. But a substantial portion of government expenditure is tied up in staff payments. If the process of decentralisation is to be fiscally neutral, part of this staff, along with the office infrastructure, would have to be transferred to Local Bodies. The last thing we need is a parallel, newly recruited Panchayat bureaucracy superimposed as a third tier of administration. How this transfer is to be effected is still not clear, and any forum discussing and formulating proposals for decentralisation would have to face up to this issue head on. The threat is very real, for there is wide spread resistance among the State Government staff to be transferred under the control of Local Bodies. On the other hand, there is a growing clamour to establish offices and to recruit large numbers of staff in the newly elected Local Bodies.

As large amounts of funds are to be handled by a large number of Local Bodies, with little or no experience in handling public expenditures on this scale, accountability will become a major issue. The problems are not merely procedural - the auditing implications are boggling. It is doubtful whether the existing CAG structure can cope with this vast expansion in the number of bodies to be audited. The Local Body auditing institutions in the States, on the other hand, do not have the ability to take on this awesome responsibility in their present form. Revamping, retraining and strengthening Local Fund Audit organisations in the States is likely to result in fresh liabilities on a substantial scale, unless the issue is handled with caution and imagination. The auditing organisation would also have to be made independent and free from political pressures from the State government.

The level of resource mobilisation by Local Bodies ultimately depends on the functions assigned to them. The textbook solution to the question as to what functions should be transferred hinges on what is termed as the principle of ‘subsidiarity’ - ie. the responsibility for each function should be assigned to the lowest level of Government capable of delivering the benefit efficiently. Going by this theory, a large number of functions are likely to fall within the ambit of Local Bodies. Indeed, the scale of these functions are, and are likely to remain, quite out of proportions to their revenue raising abilities.

This imbalance arises from another textbook problem: only those taxes should ideally be assigned to Local Bodies whose bases are 'immobile', and whose burden cannot be exported outside the jurisdiction of the Local Bodies. Thus the most lucrative and buoyant taxes, such as income, sales, excise and customs, fall outside their scope. By this yardstick, Local Bodies need to be very circumspect in levying professional and other service taxes, as over taxing might drive away the geese that lay the golden eggs. This does not, however, prevent the higher tiers of Government from sharing the revenue receipts derived from these buoyant mobile bases with Local Bodies in proportion to the functions assigned to Local Bodies. These transfers must, however be fixed according to well laid down formulae and should be non discretionary, or the all maladies will persist.

Although it is unlikely that Local Bodies would ever be able to raise sufficient revenues on their own, it does not follow that they cannot substantially enhance their income from the revenue collection sources assigned to them. The State Finance Commissions have made several concrete suggestions in this regard, including identification of new tax and revenue sources, modification of tax rates and methods of evaluation. Property tax and land revenue are seem to be potentially the most important sources in this regard. Property taxes constitute the single biggest source of local body revenues globally. On average around 50% of the revenues of Local Bodies are derived from property taxes globally.

In India, however, the figure is less than 30% and there is consequently substantial scope for increasing the yield from this source. This can be done by lowering rates on the one hand, and linking the valuation of the property closer to the market value. Thus Local Bodies in Andhra Pradesh have been able to substantially enhance property tax collections in this manner. It has also been suggested that property and land tax should be divided into two components, viz., a tax on property, which would be linked to ability to pay, and a second component which would in fact be in the nature of user charges payable by all owners for the upkeep of street lighting, roads, scavenging, sewage etc. As for land revenue, Dr. Raja Chelliah, the architect of tax reform in India in recent years, is firmly of the view that "If we do not get some contribution from land, then there is going to be very great difficulty in trying to transfer more resources or making available more resources to the Local Bodies".

While considering the whole issue of mobilising additional resources for Local Bodies, restraint needs to be exercised so that there is no increase in the rates of taxation which are already too high and in fact need to be brought down. We would do well to heed the advice of Dr. Raja Chelliah in this regard:

> *"After all, our per capita income is one of the lowest in the world. Although there are rich who could be taxed, it is very difficult to tax them. You know that there are many ways of getting out of the tax net, including the hawalas. So, the major part of the taxes, according to our studies, fall on the majority of the people. Even if you tax 100% of the rich, 100% of the*

income of the top 10% of the population, that will not be sufficient for the Government. You will have to tax the majority of the people, including the poorer sections. So, in the context of mobilising resources for the Government, the citizens cannot be squeezed too much. It is neither easy not is it going to be feasible in the long run. People will resist, revolt against, avoid and evade the stern tax measures. That is what is happening today."

Dr. Chelliah cites the example of Stamp Duty as a case in point, where rates need to be reduced to increase buoyancy, to reduce evasion and corruption, and ultimately to raise tax/GDP ratios. Therefore, it is low tax rates, with few exemptions, and simple methods of levy and collection, which will widen the tax and revenue bases of Local Bodies. If certain sections are seen to be evading taxes, or not paying any, many others who may otherwise have paid their taxes will not do so. For this reason alone there are good grounds for introducing agricultural income tax or land revenue.

It is sometimes argued that Local Bodies can augment their resource base through market and institutional borrowings, as is the pattern prevalent in a number of developed countries, and as is being attempted by the Ahmedabad Municipality it is learnt. There are two problems here, however. Firstly, in the emerging financial environment, the balance sheets of Local Bodies would have to be robust, as they would have to get credit rated if their instruments are to be acceptable to the market, which is becoming increasingly risk conscious. Only a very few large and well managed Municipalities and Corporations would be able to do so in the foreseeable future for projects which are commercially viable. Secondly, with a large debt overhang at the level of the Centre and the States, the last thing that we need is a third tier of indebtedness. In any case, no State guarantees should be given to Local Bodies for their borrowing requirements from the market, as the States already have large contingent liabilities through their big exposure to Public Sector Undertakings. In the emerging scenario, where non-performing assets are regularly monitored, there is a very real danger that State government guarantees would be invoked by banks. Local Bodies would have to live within their means. A hard Budget constraint, or fiscal discipline, is essential.

As long as Local Bodies remain dependent on external transfers, neither autonomy nor fiscal discipline will be easy. This is the one lesson that we have learnt from Centre-State fiscal relations. A hard Budget constraint is impossible if transfers are adhoc and discretionary, as unsustainable fiscal expansion may occur with the conviction that political clout would increase transfers to particular constituencies. The functions and responsibilities of Local Bodies need to be clearly fixed, and the structure of transfers need to be clearly defined and made transparent. It should be made clear that fiscal expansion would be possible only through additional revenue mobilisation, or on fiscal discipline based market borrowings. In other words, there should be a hard Budget constraint. Ofcourse, an element of grant-in-aid to specified Local Bodies relatively deficient in resource raising ability [as opposed to unwillingness, on grounds of populism] would be necessary to achieve some degree of horizontal equity between Panchayats. But, again, such grants-in-aid need to be transparent and based on well laid down criteria. If this is not done, decentralisation can be fiscally destabilising.