

THE FIFTH STATE FINANCE COMMISSION AND ISSUES IN FISCAL DEVOLUTION

Draft Outlines of Approach paper

Fifth State Finance Commission
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LIST OF ABBREVIATIONS

BP	Block Panchayat
CSFC	Center State Finance Commission
DP	District Panchayat
GP	Grama Panchayat
GPF	General Purpose Fund
GST	Goods and Services Tax
LSGI's	Local Self Government Institutions
MC	Municipal Corporation
NTR	Non Tax Revenue
OTR	Own Tax Revenue
RLB	Rural Local Body
SFC	State Finance Commission
SOTR	State's Own Tax Revenue
ToR	Terms of Reference
ULB	Urban Local Body

1.CONSTITUTION OF FIFTH STATE FINANCE COMMISSION

The Fifth State Finance Commission (SFC-V) was constituted by the Government as envisaged in Article 243-I and 243-Y of the Constitution of India and as provided in Section 186 of the Kerala Panchayat Raj Act, 1994 and Section 205 of the Kerala Municipality Act, 1994, vide notification No.785/2014 dated 17.12.2014, for a period of one year from the date of notification. As in the case of the previous three Commissions, SFC-V is also a three member Commission with the following members

Professor B A Prakash, Former Head of Economics Department, University of Kerala and former Chairman, Kerala Public Expenditure Review Committee.	Chairman
Shri.James Varghese, Principal Secretary Local Self Govt. Department, Government of Kerala.	Member
Shri R K Agarwal, Secretary to Government, Finance (Resources) Department, Government of Kerala.	Member

Shri E K Prakash, Special Secretary is posted as Secretary of the Commission

2.TERMS OF REFERENCE

The Terms of Reference of the Commission as given in the notification are extracted below:-

The Finance Commission shall review the financial position of the

Panchayats and Municipalities and make recommendations as to

(a) The principles which should govern,

- (i) the distribution between the State, Panchayats and Municipalities of the net proceeds of the taxes, duties, tolls and fees leviable by the State, which may be divided between them under part IX and part IX- A of the Constitution and the allocation between the Panchayats at all levels and the Municipalities of their respective share of such proceeds.
- (ii) the determination of the taxes, duties, tolls and fees which may be assigned to or appropriated by the Panchayats and the Municipalities.
- (iii) the grants-in-aid to the Panchayats and the Municipalities from the Consolidated Fund of the State.

(b) The measures needed to strengthen the financial position of Panchayats and Municipalities with special reference to

- (i) the potential for Local Governments to raise funds from financial institutions and the market and to suggest a framework for realizing the potential.
- (ii) improving the quality of upkeep of assets owned by Local Governments as well as those transferred to Local Governments.
- (iii) rationalizing of taxes and revenues now collected by Local Governments
- (iv) achieving economy and efficiency in expenditure by Local

Governments

- (v) providing incentives for higher own resource mobilization by the Local Governments.
 - (vi) maintaining a proper fiscal data base relating to Local Governments
 - (vii) putting in place measures required for improving the capacity of financial management by Local Governments
 - (viii) improving monitoring of the fiscal performance of the Local Governments.
- (c) The measures needed for the proper institutionalization of the decentralization initiatives in the State”.

The Commission is also entrusted to revisit the recommendations of first four Commissions and suggestions are invited on the recommendations of earlier commissions, which had been accepted by Government but have not been operationalized

3.MAJOR RECOMMENDATIONS OF 4TH SFC

Sl No	Recommendation	Status												
1	LSGIs be given 3.5% of SOTR using the t-2 method as General Purpose Fund (GPF)	The Recommendation has been accepted and implemented												
2	Maintenance Fund may be allocated in the following manner <table border="1" data-bbox="386 1606 857 1978"> <thead> <tr> <th>Year</th> <th>Percent of SOTR (t-2) method</th> </tr> </thead> <tbody> <tr> <td>2011-12</td> <td>4.5%</td> </tr> <tr> <td>2012-13</td> <td>5.0%</td> </tr> <tr> <td>2013-14</td> <td>5.5%</td> </tr> <tr> <td>2014-15</td> <td>5.5%</td> </tr> <tr> <td>2015-16</td> <td>5.5%</td> </tr> </tbody> </table>	Year	Percent of SOTR (t-2) method	2011-12	4.5%	2012-13	5.0%	2013-14	5.5%	2014-15	5.5%	2015-16	5.5%	The Recommendation has been accepted and implemented
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2011-12	4.5%													
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2013-14	5.5%													
2014-15	5.5%													
2015-16	5.5%													

	It is also recommended to allocate 2/3 rd of the Maintenance Fund for road maintenance and the remaining 1/3 rd for non-road maintenance													
3	<p>Allocation of 25% of the proposed plan size in 2011-12 as Development Fund to LGs and thereafter increase it in relation to the Plan size assumed by SFC as detailed below:</p> <table border="1"> <thead> <tr> <th>Year</th> <th>Share of the assumed Plan Size</th> </tr> </thead> <tbody> <tr> <td>2011-12</td> <td>25.0%</td> </tr> <tr> <td>2012-13</td> <td>27.5%</td> </tr> <tr> <td>2013-14</td> <td>28.5%</td> </tr> <tr> <td>2014-15</td> <td>29.5%</td> </tr> <tr> <td>2015-16</td> <td>30.0%</td> </tr> </tbody> </table>	Year	Share of the assumed Plan Size	2011-12	25.0%	2012-13	27.5%	2013-14	28.5%	2014-15	29.5%	2015-16	30.0%	Recommendation relating to financial year 2011-12 has been accepted.
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2013-14	28.5%													
2014-15	29.5%													
2015-16	30.0%													
4	The Commission has recommended to divide the GPF among GPs, Municipalities and Corporations in the ratio 75.93:10.02:14.05, after setting apart Rs.125 lakh per District Panchayat (DP) and Rs.15 lakh per Block Panchayat (BP)	Accepted and implemented. However Government has been sanctioned proportionate percent hike in SOTR to District panchayats and Block Panchayats also												
5	The Commission has recommended that while the State non-Plan and World Bank Project streams of the Development Fund may continue to be devolved in ten equal instalments as of now	Accepted												

6	<p>The formula for distribution of non-SCP/TSP portion of Development Fund should be as below</p> <table border="1" data-bbox="350 348 878 827"> <thead> <tr> <th>Criteria</th> <th>GP</th> <th>BP</th> <th>DP</th> <th>ULGs</th> </tr> </thead> <tbody> <tr> <td>Population (Excluding SC/ST)</td> <td>50</td> <td>50</td> <td>50</td> <td>50</td> </tr> <tr> <td>Deprivation Index</td> <td>30</td> <td>30</td> <td>30</td> <td>30</td> </tr> <tr> <td>Tax effort</td> <td>10</td> <td>-</td> <td>-</td> <td>10</td> </tr> <tr> <td>Area</td> <td>10</td> <td>20</td> <td>20</td> <td>10</td> </tr> </tbody> </table>	Criteria	GP	BP	DP	ULGs	Population (Excluding SC/ST)	50	50	50	50	Deprivation Index	30	30	30	30	Tax effort	10	-	-	10	Area	10	20	20	10	Accepted
Criteria	GP	BP	DP	ULGs																							
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Area	10	20	20	10																							
7	<p>The Commission has recommended to distribute a maximum of 10% of the total devolution under Development Fund to LGs on the basis of the tax effort criterion. This amount has to be distributed among the GPs and ULGs that increase their own revenue mobilization over the previous year at least by 10%.</p>	Accepted																									
Augmenting Own Revenue Of Local Governments																											
8	<p>Property Tax - A biennial inflation neutralization based Property Tax regime is recommended</p>	Accepted																									
9	<p>Surcharge - Not exceeding 50% of the Property Tax to meet any extra-ordinary expenses incurred by them towards any scheme or project or plan.</p>	Accepted																									

10	The Commission has recommended to introduce computerised ticketing and a seat-based tax system to streamline collection of Entertainment Tax from cinema theatres	Accepted
11	It has suggested to periodically revise the minimum rates of advertisement tax in Corporations, Municipalities, Special Grade Panchayats and other Panchayats	Accepted

4. FISCAL DEVOLUTION TO LSGI'S IN THE 4TH SFC PERIOD

The 4th SFC has recommended for a devolution of 3.5% of the State's own Tax Revenue (SOTR) as General Purpose Fund for meeting the establishment cost and obligatory functions. The percentage of SOTR recommended as maintenance fund for road as well as non road maintenance was 4.5% for 2011-12. An amount of 25% of the proposed plan size was allocated as development fund to LSGI's in 2011-12 with marginal increase in subsequent years. The amount allocated in the three heads is given in Table 1. The total amount allocated was 13.1 % of the total SOTR of the State for 2011-12. The percentage distribution of the total allocated funds to Grama, Block and District Panchayats, Municipalities and Municipal Corporations are given in Table 3. The 4th SFC had recommended for the allocation of 2/3rd of the maintenance fund for road and 1/3rd for non-road maintenance. Of the total maintenance fund of Rs 1387 crore, 67% was spent

for road and 33% for non-road maintenance during 2013-14 (Table 4)

Table 1
The vertical devolution to LSGI's (Rs in crore)

Details of devolution	2011-12	2012-13	2013-14
General Purpose Fund	622.2	757.9	900.2
Maintenance Fund (Road)	506.7	713.1	928.4
Maintenance Fund (Non Road)	206.3	326.4	458.5
Development Fund	2021.6	2195.0	3003.8
Devolution by State Government	3356.8	3992.4	5290.9
World Bank Assistance	140.0	284.3	270.0
13th CSFC Grant	387.8	591.2	673.9
Total Devolution	3884.6	4867.8	6234.8
Sates own tax Revenue (SOTR)	25718.6	30076.6	31809.4
Devolution by State Government as a percent of SOTR	13.1%	13.3%	16.6%

Table 2
Percent Distribution of Total Amount allocated

Name of Fund	2011-12	2012-13	2013-14
General Purpose Fund	16.0%	15.6%	14.4%
Maintenance Fund (Road)	13.0%	14.6%	14.9%
Maintenance Fund (Non Road)	5.3%	6.7%	7.4%
Development Fund	52.0%	45.1%	48.2%
Devolution by State Government	86.4%	82.0%	84.9%
World Bank Assistance	3.6%	5.8%	4.3%
13th CSFC Grant	10.0%	12.1%	10.8%
Total Devolution	100.0%	100.0%	100.0%

Table 3
Horizontal devolution (Rs in Crore)

Year	GP	BP	DP	Municipality	MC	TOTAL
2011-12	1814.9	401.9	503.1	344.3	292.5	3356.8
2012-13	2252.0	441.3	572.7	382.5	343.9	3992.4
2013-14	2879.3	617.5	839.6	496.7	457.8	5290.9
Percent to Total devolution by State Government						
2011-12	54.1%	12.0%	15.0%	10.3%	8.7%	100.0%
2012-13	56.4%	11.1%	14.3%	9.6%	8.6%	100.0%
2013-14	54.4%	11.7%	15.9%	9.4%	8.7%	100.0%

Table 4
Maintenance Fund (Rs in Crore)

Name of Fund	2011-12	2012-13	2013-14
Road Maintenance Fund	506.7	713.1	928.4
Non Road Maintenance Fund	206.3	326.4	458.5
Total Maintenance Fund	712.9	1039.4	1386.9
Percent to Total			
Road Maintenance Fund	71.1%	68.6%	66.9%
Non Road Maintenance Fund	28.9%	31.4%	33.1%
Total Maintenance Fund	100.0%	100.0%	100.0%

5. FISCAL STRUCTURE OF LSGI'S

The Panchayati Raj Institutions as well as Municipalities heavily rely the State Government for meeting their expenses connected with establishment, undertaking mandatory and civic functions, maintenance of assets, annual plan activities etc. The major sources of own revenue consist of own tax and non tax .The transfer from State Government is the

source accounting for major share of the revenue. The transfer from central government is another important source of revenue. Table 5 gives the fiscal structure of LSGL's. In the case of Grama Panchayats transfer from State Government account for 69 % of the total revenue receipts.

Table 5
Fiscal Structure of LSGL's (Rs in Crore)

	Gram Panchayats		Municipalities		Municipal Corporations	
	2007-08	2008-09	2007-08	2008-09	2007-08	2008-09
Own Tax Revenue	160.37	160.13	61.9	67.9	73.17	77.95
Non Tax Revenue	135.31	155.24	35.73	41.72	28.94	36.88
State Transfers	1617.21	1738.06	165.98	179.75	160.94	165.79
Central Transfers	287.49	414.06	34.29	32.08	6.15	32.68
Borrowing	4.28	12.65	5.56	6.4	0	0
Others	33.32	29.32	7.6	9.18	3.53	5.84
Total	2237.98	2509.46	311.06	337.03	272.73	319.14
Percent to Total						
Own Tax Revenue	7.2%	6.4%	19.9%	20.1%	26.8%	24.4%
Non Tax Revenue	6.0%	6.2%	11.5%	12.4%	10.6%	11.6%
State Transfers	72.3%	69.3%	53.4%	53.3%	59.0%	51.9%
Central Transfers	12.8%	16.5%	11.0%	9.5%	2.3%	10.2%
Borrowing	0.2%	0.5%	1.8%	1.9%	0.0%	0.0%
Others	1.5%	1.2%	2.4%	2.7%	1.3%	1.8%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

The Share of Own Tax and Non Tax revenue was only 12.6%.The transfer from State Government account for 53% for Municipalities and 52% for

Municipal Corporations. The share of Own Tax and Non Tax Revenue for municipalities was 32.5% and Municipal Corporations 36%. Mobilisation of more tax and nontax revenue is one of the major issues in the devolution of resources.

The tax on property, profession entertainment and advertisement are the important items of tax revenue of Grama Panchayats and Urban Local Bodies (ULB's). Table 6 gives the item of Own Tax Revenue of the LSGI's.

Table 6
Items of Own Tax Revenue of Local Bodies (Rs in Crore)

	Gram Panchayats		Municipalities		Municipal Corporations	
	2007-08	2008-09	2007-08	2008-09	2007-08	2008-09
Property Tax	85.71	75.9	34.23	36.9	38.52	40.59
Profession Tax	64.67	75.56	18.14	20.93	24.88	28.42
Entertainment Tax	4.45	3.8	8.01	7.82	8.54	8
Advertisement Tax	0.36	0.26	0.43	0.49	0.58	0.87
Other Taxes	5.16	4.6	1.07	1.72	0.63	0.07
Total	160.35	160.12	61.88	67.86	73.15	77.95
Percent to Total						
Property Tax	53.5%	47.4%	55.3%	54.4%	52.7%	52.1%
Profession Tax	40.3%	47.2%	29.3%	30.8%	34.0%	36.5%
Entertainment Tax	2.8%	2.4%	12.9%	11.5%	11.7%	10.3%
Advertisement Tax	0.2%	0.2%	0.7%	0.7%	0.8%	1.1%
Other Taxes	3.2%	2.9%	1.7%	2.5%	0.9%	0.1%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Property and profession tax account for 94 % of the total own tax revenue

of Grama Panchayats. In Municipalities property tax account for 54 % profession tax 31% and entertainment tax 12%.In Municipal Corporations property, profession and entertainment taxes account for 99% of the total tax revenue. Increasing the Own Tax Revenue through periodical revision of rates better collection and introduction of new taxes are the issues to be addressed.

6. POOR PERFORMANCE OF PLAN EXPENDITURE

The development activities of LSGI's are implemented through the annual plan. Due to the inability to prepare viable projects and schemes, failure to get early administrative sanctions, poor monitoring and implementation, lack of achievements of physical and financial targets, the plan performance of LSGI's is generally unsatisfactory. In spite of measures taken by the State Government, State Planning Board and LSGI's since the inception of decentralised planning we have not achieved much progress in this matter. Achievement of physical targets as well as quality of plan expenditure is largely determined by the spread of plan expenditure during a financial year. A review of the quarter wise annual plan expenditure show that the village Panchayats spent 82% Block Panchayats 83% and District Panchayats 71 % during the last quarter of the financial year 2012-13.A disturbing thing is the spreading of major share of plan outlay during the last month of financial year .Table 7 shows the quarter wise annual plan expenditure or rural and urban local bodies. Poor plan formulation, failure to get administrative sanction, poor monitoring and implementation of plan projects are basic issues which need urgent attention.

Table 7

Quarter wise plan expenditure of Local Bodies for 2012-13 (Rs in Lakhs)

	Village Panchayat	Block Panchayat	District Panchayat	Municipalities	Corporation
1 st quarter	696.81	190.48	457.52	144.99	9
2 nd quarter	5749.48	1297.69	2681.82	746.97	1204.03
3 rd quarter	11479.24	2156.45	2324.4	3562.35	2255.36
During March	98325.1	21230.74	18380.75	15902.57	12626.4
4th quarter	160229.63	35222.53	26581.12	20989.33	14179.37
Total	196080.69	42511.77	37508.6	29897.95	21116.15
Percent to Total					
1 st quarter	0.4%	0.4%	1.2%	0.5%	0.0%
2 nd quarter	2.9%	3.1%	7.1%	2.5%	5.7%
3 rd quarter	5.9%	5.1%	6.2%	11.9%	10.7%
During March	50.1%	49.9%	49.0%	53.2%	59.8%
4th quarter	81.7%	82.9%	70.9%	70.2%	67.1%
Total	100.0%	100.0%	100.0%	100.0%	100.0%

A review of the plan expenditure during the financial year 2014-15 shows that only 32.9% of the outlay was spent up to December 2014. In the case of Municipal Corporations the expenditure was only 23% of the outlay. This can be identified as a most serious problem in the working of LSGI's.

Table 8

Plan Expenditure in 2014-15 (up to December 2014) (Rs in Crore)

SI No.	Scheme Name	Outlay*	Expenditure*	Expenditure %
1	Corporations	376.1	85.9	22.8
2	Municipalities	482.4	145.9	30.3
3	District Panchayats	623.0	189.0	30.3
4	Block Panchayats	623.0	242.6	38.9
5	Village Panchayats	2595.6	883.0	34.0
	Total	4700.0	1546.4	32.9

7. NEGLECT OF CIVIC FUNCTIONS

A recent study based on the primary data collected from 50 sample Grama Panchayats belonging to all districts in Kerala revealed the total neglect of civic functions. The Grama Panchayats are using nearly 34 certificates, licenses, permits etc as mandatory functions. Except four items the certificate are issued by the Grama Panchayats within a reasonable time and the provision of services can be considered as satisfactory. On the other hand the study revealed that there is total neglect on the part of Grama Panchayats in executing important civic functions which affect the general health and wellbeing of the citizens. Table 8 gives the percentage of Grama Panchayats (out of 50) not implementing vital civic functions. It is disturbing to note that 56% of GP's are not taking steps to dispose solid waste and another 68.5 cleaning public markets. 90 % of the GP's are not taking any steps to prevent the sale of contaminated food products. GP's totally neglect the maintenance of burial

Table 9
GP's not implementing Civic Functions

	Civic Functions	GP's not implementing the functions (Nos)	Total Sample of GP's	GP's not implementing the functions (%)
1	Disposal of solid waste	28	50	56
2	Cleaning of Public Markets	34	50	68
3	Preventing the sale of contaminated food product	45	50	90
4	Health Inspections in Hotels	39	50	78
5	Preventing Adulteration of food products	46	50	92
6	Implementation of vaccination to prevent the spread of diseases	31	50	62
7	Maintenance of burial grounds/cemetery	43	50	86
8	Providing parking space for vehicles	48	50	96
9	Construction of waiting sheds	44	50	88
10	Constructing public comfort stations	43	50	86
11	Killing stray dogs	42	50	84
12	Maintenance of slaughter houses	48	50	96
13	Measures to control Mosquito breeding	32	50	64

Source RGIDS (2013): Effectiveness of Service Delivery in Panchayati Raj Institutions in Kerala

grounds/ cemetery, providing parking spaces for vehicles construction of waiting sheds, public comfort stations, killing stray dogs and maintain slaughter houses. In this context a rethinking is needed in the priority and importance given to the implementation of vital civic functions. There is also the need to provide more

allocation of funds for the execution of civic functions.

8. FISCAL CRISIS AND RESTRICTION IN RELEASE OF FUNDS TO LSGI'S

The State Government has been following a practice of releasing the funds awarded by the State Finance Commission to local Governments in installments. This has helped the LSGI's to function smoothly and retain the fiscal autonomy. But in time of a fiscal crisis, the State Government may be forced to impose restrictions on the release of funds and incur expenditure on many items. This will create serious problems to Local Governments. How to address this problems is another issue.

9. INCLUSION OF ENTERTAINMENT TAX IN THE PROPOSED GOOD AND SERVICES TAX (GST)

As seen in Table 6 above Entertainment Tax is one of the major sources of revenue to the LSGI's. In the proposed GST regime ,if the Entertainment tax is subsumed, it will seriously affect the own revenue of local bodies.

10. ISSUES IN FISCAL DEVOLUTION

1. The total devolution by the State Government as percent of SOTR was 16.6% in 2013-14. Currently the State Government is facing fiscal problems. So the question is whether we can retain the same level of allocation of funds to LSGI's
2. Rapid Urbanisation is taking place in Kerala and the ULB's will have to undertake more civic functions. In this context it is desirable to give more priority in the allocation of resources to Municipalities and Municipal Corporations. The share of funds allocated to them was 18.1% of total funds

in 2013-14

3. Of the total maintenance fund allocations to LSG's, 2/3rd are earmarked for road and 1/3rd for non-road maintenance. The issue is whether we have to give more priority and allocation for maintenance of non-road assets of LSGI's and the institutions transferred by the State Government

4. The GP's are heavily rely on the state funds for their survival (69%). Their OTR and NTR is only 12.6% of the total receipts. How to increase the revenue sources of GP's?

5. The OTR and NTR of Municipalities was 32.5% of the total receipts. There is considerable scope for increasing the tax and non tax revenue sources of Municipalities and Municipal Corporations. How to achieve it?

6. Currently the LSGI's both rural and Urban heavily rely on State Government for resources. The objective should be to reduce the dependence through the mobilization of their own resources viz. tax and non tax sources. Periodical revision of tax and non tax revenue sources, prompt collection of arrears of tax increasing efficiency in tax collection introduction of new tax and non tax sources etc are the options to be explored

7. Poor plan formulation implementation and monitoring are the basic problems of LSGI's in Kerala. In spite of the decentralized planning experience for two decades, we have not able to improve the situations. How to improve plan performance?

8. Studies suggested that the LSGI's are neglecting the vital civic functions

like disposal of waste, cleaning of markets, preventing food adulterations, maintaining burial grounds, parking places, waiting sheds, public comfort stations, slaughter houses etc. There is a need to give high priority and more allocation of funds to civic functions.

9. Due to fiscal problems, State Government may be forced to impose restrictions in the release of funds and incurring expenditure on many items of LSGI's. How to address the issues?

10. There is a proposal to include entertainment tax in the proposed GST regime. In this context what are the steps to be taken to prevent the revenue loss of LSGI's.

[Comments and suggestions if any, may be intimated to the Chairman, 5th SFC at Office of Chairman, Finance (DPC) Building, University of Kerala Campus, Palayam, Thiruvananthapuram 695034, email chairmanfsfc@gmail.com Contact No 0471 2305654]

The Commission acknowledge the research assistance provided by Shri Abhilash S, Assistant Section Officer for preparing the paper