STATE TRANSFERS TO THE URBAN LOCAL BODIES

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PREFACE

Transfers from the higher levels of governments have universally been an important component of revenues for the municipal bodies. In India, it is estimated that transfers account for 30-35 per cent of the total revenues of the municipal bodies. Notwithstanding the important position of State transfers, the fact that these to a significant extent continue to be made on an ad-hoc basis has given rise to a number of questions such as - are such transfers essential?; can these not be substituted by devolving on the municipal bodies additional sources of revenues?; and if these can not be substituted, can there be some kind of general approach to substitute for the ad-hocism?

In this study entitled ***State Transfers to the Urban Local Bodies*** we have examined such questions, and argued that transfers form an integral part of the state-local fiscal relationship, and *prima facie* there is nothing to suggest that transfers necessarily infringe the autonomy of the municipal bodies, i.e., the extent to which the autonomy is enjoyed by them under the existing statutes. We have proposed a more systematic approach to State transfers in order to maximize their use for raising the levels of municipal services. We have further suggested that the taxes which are inherently local in character should gradually be transferred to municipal bodies in order to enhance their financial viability.

A number of staff members, including Prof. D.B. Gupta, Dr. Shekhar Mehta, Ms. Om Talajia, Dr. C. Ramachandriah, and Ms. Sreejata Sengupta have contributed to the study. I would like to particularly mention the valuable contributions made by Dr. A. Bagchi, Director, NIPFP, in giving directions to the study, Dr. Tapan Banerjee, Director, ILGUS, Calcutta who worked as a short-term consultant and produced the first draft of the report, Ms. Om Talajia who prepared the case studies, Prof. M.G. Rao for his perceptive comments on the draft report, and Ms. Rita Wadhwa for the editorial assistance. The report in its present form has been formulated and put together by Professor Om Prakash Mathur. Excellent secretarial assistance was provided by Shri R. Parmeswaran and Shri Praveen Kumar.

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The Governing Body of the Institute does not take any responsibility for the views expressed by the authors in the report, that responsibility belongs primarily to the authors.

Raja J. Chelliah
Chairman

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EXECUTIVE SUMMARY

1. Among the various components of revenues of the urban local bodies (ULBs), "transfers" from the higher levels of governments occupy a pivotal position in almost all countries, both developed and developing. In India, it is estimated that on an average "transfers" (general and special purpose grants, shared and assigned taxes, and other forms of devolution) form anywhere between 30-35 per cent of the total municipal revenues.

2. State transfers to ULBs are vitally influenced by two factors - namely, (i) the functions that the ULBs are entrusted with, and (ii) the revenues that they are empowered to raise or are able to raise within the revenue-raising powers assigned to them. Any change, addition or deletion, in the functions of ULBs or in their revenue-raising powers affects the volume of state transfers to ULBs.

3. While the state municipal legislations prescribe the nature of functions and the financial powers of ULBs, they do not normally lay down the <u>nature</u> of fiscal relationship between the State and ULBs. They do not indicate as to when and under which conditions the States would make transfers to ULBs, and what would be the nature of their transfers.

4. By and large, state transfers to ULBs fall into two categories, namely, (i) taxes which are assigned to or shared with the ULBs, and (ii) grants including general-purpose i.e., non-matching, non-specific grant; special purpose, and statutory and compensatory grants made in lieu of taxes such as octroi or for meeting the cost of dearness allowances.

5. There is a high element of diversity in the system of State transfers to ULBs. The diversity is noted not only in the number of transfers, but more particularly in --

i. the share of transfers in the revenues of ULBs (variations are very large);

ii. the constituents of transfers and their relative importance;

iii. the criteria used by States for making transfers under various heads and accounts; and

iv. the institutional arrangements that have been created in the different States for this purpose.

6. Despite the fact that states have tried out different forms and methods of devolving funds on the ULBs, the fact that these continue to be marked by ad-hocism can not be obscured. For instance, in States which have preferred to increasingly use the specific purpose grants (as opposed to general-purpose) there have been heavy distortions in the ULBs own pattern of allocations. In others, the tax assignment system has placed the economically better off ULBs at an advantage over the financial weak ULBs. Although not conclusive, transfers have caused in some ULBs some degree of substitution of their own resource mobilisation efforts.

7. Issues relating to municipal finances including those relating to state transfers have been examined in the past by various Commissions and Committees. One outstanding recommendation that runs through the reports of all Commissions and Committees is that the States should support the ULBs in the performance of their functions by way of grants, tax sharing, and assignment of taxes.

8. Taking note of the functioning of the various systems of transfers, this study has taken a view that --

i. given the existing statutory position which gives absolute powers to States in determining their functional and financial domain of ULBs, it is evident that the role of transfers will vary between states, and that the role may change from time to time, depending on the proclivity of States to alter the extent and nature of functional and financial domain of ULBs. As such, it is neither necessary nor feasible to have a single, uniform transfer policy;

ii. intergovernmental transfers do not themselves violate the autonomy of ULBs, i.e., the extent to which autonomy is enjoyed by them under the existing statutes. In view of the fact that the existing provisions allow for a flexible fiscal relationship between the States and ULBs, transfers should form an integral part of such relationship, and should be seen in a positive light than has hitherto been the case.

iii. the approach to State transfers should be aimed at overcoming the main deficiencies in the existing system, relating especially to the following --

(a) the excessively large number of transfers making it difficult for ULBs to plan and assess their impacts;

(b) the undefined, ad-hoc, and irregular nature of transfers, rendering it difficult for the ULBs to take up fiscal planning exercises;

(c) the tendency on the part of some ULBs to rely on State transfers as a substitute for utilising their own revenue base; and

(d) the overloading of the municipal system with tasks and responsibilities in which they have little direct interest or stake.

9. This study has accordingly proposed that all state transfers should be divided into two categories, namely: general-purpose and special purpose. For the general purpose, it is suggested that an appropriate share of the aggregate annual revenues of the State should be assigned to ULBs. Initially, the share can be worked out on the basis of all transfers that are currently being made by the States. As a follow-up step, a set of criteria should be laid down for the distribution of this proportion of revenues to the ULBs. Since transfers serve multiple objectives, a set of multiple criteria be used. These may include --

(a) Population size.
(b) Per cent of revenue collection to revenue demand.
(c) Per cent of expenditure on administration.
(d) Rate of increase in the revenues versus the rate of increase in the expenditure.

10. The specific-purpose transfers should be made for only the centrally or state sponsored priority projects which have the potentiality of being better implemented by the ULBs.

11. Capital transfers fall into a different category as these are extended for works of a capital nature, meant essentially to "augment" (as opposed to manage or maintain) the supply of services. However, capital transfers can have a direct bearing on the maintenance and operating budget of ULBs.

12. This study proposes that capital transfers be made on the basis of carefully-drawn up projects, although it may not particularly suit those ULBs which do not have the capacity to prepare sound projects.

13. The approach as enunciated above has a number of pre-requisites - the most important of which is the creation of a proper institutional framework at the state level to --

(a) regularly collect and analyse the municipal finance and services level data;

(b) allocate the financial resources to ULBs on the basis of predetermined criteria or guidelines, or on the basis of specific projects; and

(c) strengthen the capacity of ULBs in respect of budgeting, planning, monitoring, management and control, and project preparation and appraisal.

14. Transfers are not a panacea for the numerous problems with which the ULBs are currently faced today. All transfer policies will have some positive and some negative aspects. What is important is to begin to incrementally improve the role of transfers in meeting the objectives for which the ULBs stand.

STATE TRANSFERS TO THE URBAN LOCAL BODIES

INTRODUCTION

Among the various components of revenues of the Urban Local Bodies (ULBs), "transfers" from the higher levels of governments occupy a pivotal position in almost all countries, both developed and developing. In the United States of America, for instance, transferred revenues constituted in 1985, 38.5 per cent of the total municipal revenue budgets; in Great Britain, this proportion was estimated to be 36.3 per cent and in France, 36.3 per cent.[1] In nine European countries for which information is available for 1988, transfers from the higher levels of governments accounted for 39 per cent of the local revenues, ranging from 16 per cent in Austria and Switzerland to 81 per cent in the case of the Netherlands.[2] Likewise, transfers account for a significant proportion of local revenues in countries like Malaysia (36.40 per cent, 1986), Pakistan (43.72 per cent, 1986) and Thailand (55.61 per cent, 1986).[3]

Transfers are important not only in terms of their share in the total local revenues, but also in terms of the variety of purposes and roles that they have come to play in recent years in different countries, although almost invariably, countries use transfers to essentially close the fiscal gap and ensure that the revenues and expenditures of local governments are, by and large, balanced. Several countries use transfers to achieve "horizontal fiscal balance" among different local bodies. In many countries, these are being used to stimulate local fiscal effort, i.e., encouraging local bodies to improve and strengthen their revenue base. In addition, transfers are now

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1. Tapan Banerjee, "State-Local Fiscal Relations", unpublished, 1991.

2. The World Bank, Financing Local Government in Hungary, Working Paper, Country Economics Department, Washington D.C., March 1992.

3. See, Om Prakash Mathur, "The Financing of Urban Development", in Urban Policy Issues, Regional Seminar on Major National Urban Policy Issues, Asian Development Bank, Manila, 1987.

increasingly being used to influence the pattern of spending according to the priorities of the higher levels of governments.

In India, it is estimated that on an average with due allowance for the fluctuations in the flow of transferred resources, "transfers" - this term being used to include all forms of transfers (general and special purpose grants, shared and assigned taxes, and other forms of devolution), form anywhere between 30-35 per cent of the total municipal revenues. These proportions, however, vary considerably. In States like Bihar and West Bengal, transferred resources as a proportion of the revenues of ULBs are very large; in others, notably Kerala, Gujarat and Maharashtra these account for a relatively smaller proportion. Transfers also vary considerably between cities depending on their size, functions, capacity and ability to mobilise resources on their own, etc.

One notable feature of transfers in India is that these are being used - like in other developed and developing countries, for a wide variety of purposes, although the main purpose, i.e., of enabling the ULBs to strike a balance between their revenues and expenditures so that they can maintain and operate certain basic services continues to be dominant. In addition, as we shall see later, a number of States are using transfers in areas where the States and ULBs have mutuality of interests such as health and education. Transfers are now being used even for such tasks as poverty alleviation, employment generation, development of physical infrastructure where the ULBs have either or little direct stake.

Notwithstanding the pivotal position of State transfers in ULBs finances in India, the fact that these to a significant extent continue to be ad-hoc, and are often made without a proper and systematic assessment of the ULBs financial needs, priorities, service levels and of course, their own resources can not be obscured. There has also grown a belief that owing to the ad-hoc character of transfers and simply their increasing numbers, the ULBs are not able to effectively use them for the purposes for which these are made. The entire area of "transfers" - the volume, the purpose, the modes and systems is thus suspect, requiring a systematic review and reappraisal. As a consequence, a number of questions and issues have arisen with most of them falling into two categories —

i. Are such transfers from the higher levels of governments essential and "indispensable"? Can these not be substituted by devolving on the urban local bodies additional revenue raising powers?

ii. If these are essential and can not be substituted, can there be at least some kind of a general approach to substitute for the "ad-hocism" that exists at present, or a set of guidelines laying out the principles for State transfers to ULBs?

Within the ambit of these two umbrella questions, other issues have also arisen - do such transfers infringe or violate the autonomy of the ULBs? Do the transfers enable the ULBs to provide services at satisfactory levels? Do the transfers introduce inefficiencies in the working of ULBs by thwarting their initiatives and enterprise? Or, do they make them more efficient and provide them with opportunities that they would otherwise not be able to obtain?

This study entitled "State Transfers to the Urban Local Bodies : An Approach" is concerned with such questions. It has analysed the existing practices of transfers and suggested alternative approaches and principles to deal with them. The study is aimed at better use of the instrument of transfers in the functioning of the municipal system.

The issue of transfers, it should be pointed out at the very outset, is neither new nor is it being raised for the first time. Indeed, it has been deliberated in the country for a long time. The Local Finance Enquiry Committee, for instance, examined the issue of transfers as early as 1950 and recommended that the States should assist the local bodies by way of adequate grants, wherever they were unable to achieve the minimum national standard of efficiency from their own resources. This Committee suggested that assignment of certain sources of revenues should be preferred over grants and where grants have to be given, these should be given on some "definite and understandable principles". The Taxation Enquiry Committee which followed soon after (1953-54), also considered this issue but recommended that grants and not the assignment of taxes should be preferred as a method of financing the local bodies. The Rural-Urban Relationship Committee (1966) took a somewhat different approach in recommending that in making any kind of transfers, it should first be ensured that local bodies have exploited their own resources to the maximum, and, secondly, transfers should be linked to the standards of minimum services which must be maintained by each class of municipal bodies. Other Committees have also made from time to time a variety of suggestions in regard to transfers, grants, shared taxes, etc.[4]

What has lent this issue a sense of urgency at this juncture is a combination of several factors of which perhaps the most important is the growth rate of urban population in the country. During the past two-three decades, urban population has increased at annual average growth rate of over 3 per cent (exponential), with a very large number of cities and towns having registered growth rates of over 5 per cent per annum. These growth rates have overwhelmed the capacity of most ULBs to be able to raise additional revenues and provide adequate levels of services and facilities to the fast increasing urban population. In view of the fact that the growth of urban population has occurred on account of factors that are exogeneous in nature, questions have arisen as to whether it does not make the States obliged, both directly and indirectly to face up the challenge of urbanisation and consequently to supplement the ULBs revenue resources so that they can adequately perform their stated functions and responsibilities. Advocates of this view quite evidently suggest that the States (if not the other higher levels of governments) should own up the responsibility of meeting at least a part of the additional costs that arise as a result of urbanisation and urban growth.

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4. These have been discussed at some length in section III of this report. Also, a summary of the main recommendations of the various Committees and Commissions concerning transfers is contained in Annexure 1.

TABLE 1

Urbanisation Trends in India

Year	Urban population (in million)	Growth rate % Decennial	Growth rate % Annual exponential
1961	78.94	-	-
1971	109.11	38.23	3.21
1981	159.46	46.14	3.83
1991	217.18	36.19	3.09

Source: Census of India, 1991, Paper 2 of 1991.

Secondly, the levels of services in most urban areas are not only inadequate but are fast deteriorating. In 1985, 27.1 per cent of the total urban population had no access to safe water supply ; 71.6 per cent, no access to basic sanitation. In several States like Bihar, Andhra Pradesh, Orissa and Rajasthan, the deprivation levels in respect of these two very basic services were far higher (Table 2).

In respect of other services too, the position is very disconcerting. According to a recent survey of 157 Class I municipalities (municipalities with a population of 100,000 and over), the drainage system cover no more than two-thirds of their population. On an average, 27.5 per cent of the urban refuse is left uncollected on the roads and streets, greatly contributing to the deterioration in the environmental conditions in the urban areas.[5] Serious doubts have thus arisen about the capacity of the ULBs to raise the existing services to minimum acceptable levels without massive financial flows from the higher levels of governments.

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5. See, Amaresh Bagchi, "State of Municipal Finances in India and the Issue of Devolution : A Note", NIPFP, Current Policy Issues, No. 4, January, 1991.

TABLE 2

Levels of Basic Municipal Services, 1985

State	Per cent of urban population without	
	Safe water supply	Basic sanitation
Andhra Pradesh	47.9	89.1
Bihar	40.5	77.1
Gujarat	16.8	62.0
Haryana	30.9	71.6
Karnataka	18.8	61.6
Kerala	35.5	71.8
Madhya Pradesh	20.3	92.2
Maharashtra	12.9	60.2
Orissa	61.9	90.5
Punjab	28.8	51.5
Rajasthan	44.0	90.4
Tamil Nadu	16.2	52.5
Uttar Pradesh	29.9	85.9
West Bengal	36.3	80.5
Average	27.1	71.6

Source: Urban Data Sheet, 1986, NIUA.

Thirdly, it is now well established that the revenues of ULBs are either not increasing or increasing at nominal rates, partly if not largely on account of the inelastic nature of the sources of revenues of ULBs. On the other hand, the revenue expenditures are rising rapidly. A study of municipal finances conducted by the National Institute of Urban Affairs (NIUA) (1988) showed that during 1979-80 to 1983-84, municipal revenue incomes increased by only 9.7 per cent, whereas the revenue expenditure rose during the same period by over 56 per cent.[6] While the revenues (in absolute figures) were still in excess of expenditure on account of the statutory provisions, the surplus on revenue account which was 31.7 per cent in 1979-80 had declined to just 2.7 per cent in 1983-84, not sufficient to meet even one month's salary and related expenditures of ULBs. In the context of this situation where there is a high degree of inelasticity in the revenue structure and where expenditure has an inherent pressure to rise, questions have arisen whether there are any alternatives to "transfers" to meet such fiscal gaps.

TABLE 3

Existing Levels of Services in the Urban Areas

Urban areas categories	% population served by drainage	% of refuse collected
I. (1-2 lakh)	67.77	71.9
II. (2-3 lakh)	[illegible]5.33	66.5
III. (3-4 lakh)	79.14	76.9
IV. (4-5 lakh)	63.30	73.3
V. (5-6 lakh)	67.99	82.5
VI. (6-7 lakh)	58.47	69.1
Average	66.32	72.5

Note: Lakh = 100,000.

Source: National Institute of Urban Affairs, Upgrading Municipal Services : Norms and Financial Implications Research Study Series No.38 New Delhi, 1989.

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6. National Institute of Urban Affairs, "The Nature and Dimension of the Urban Fiscal Crisis", Research Study Series, No. 18, New Delhi, 1988.

TABLE 4

Ordinary Incomes and Expenditure at Constant Prices

(Million Rs.)

Component	1979-80	1983-84	Per cent variation
Incomes	5,222.9	5,731.8	+ 9.7
Expenditure	3,568.5	5,574.6	+ 56.2
Income - Expenditure differential	+ 1,654.4	+ 157.2	-
Per cent to incomes	31.7	2.7	

Source: National Insitute of Urban Affairs, Research Study Series No. 18.

Fourthly, the issue of transfers has become urgent in view of the ULBs being entrusted with newer responsibilities such as poverty alleviation, development of physical infrastructure under the IDSMT Programme, environmental improvement of urban slums, Nehru Rozgar Yojna, etc. These are new responsibilities which mean greater devolution of resources from the higher levels of governments to ULBs. Persistence of such responsibilities over a long period of time will mean growing State transfers in the finances of ULBs.

This study has taken note of the above imperatives, and analysed the subject of transfers in the light of the responsibilities of ULBs and their revenue-raising powers, and, of course, in the light of the specific concerns and goals underlying State transfers.

This study is based on an analysis of the available data on the finances of ULBs which, it must be pointed out, are sparse, irregular, and often inconsistent. There exist no institutional arrangements for regular collection, sifting and analysis of municipal finance data. For instance, barring the two major studies conducted by the National Institute of Urban Affairs (NIUA) for the Eighth and Ninth Finance Commissions, there are no other major sources where municipal finance data on any scale are available.

This study, therefore, is limited in its data coverage. In order to supplement the overall data which have been taken from NIUA's studies and other studies referred to in the footnotes such as M.G. Rao's study on State Transfers to Municipalities and to better understand the performance of the existing mechanisms of transfers, studies have been done in four States, namely - Gujarat, Andhra Pradesh, Madhya Pradesh and Tamil Nadu. Some insights on the functioning of transfers have also been obtained from Maharashtra. These have been widely used in this study for purposes of drawing lessons on the existing practices of transfers in the country. A special study has been conducted on the issue of substitutability of ULBs resources by State transfers whose results have been used in the report; the study is also appended as Annexure 2.

The report is broadly divided into three parts, including this Introduction. The second part is devoted to a discussion of (i) transfers in the general context of the functional and fiscal domain of ULBs, (ii) the importance of transfers in the revenue structure of ULBs, and (iii) the role of transfers in the specific context of four States, as mentioned above. The third part deals with the approach to State transfers. This part also reviews briefly the recommendations made by the earlier commissions and committees on issues relating to transfers.

PART II

TRANSFERS AS A COMPONENT OF ULB'S REVENUES

1. Functional and Financial Domain of ULBs

State transfers to ULBs are vitally influenced by two factors, namely, (i) the functions that the ULBs are entrusted with or are responsible for, be the functions of a statutory nature or assigned; and (ii) the revenues that they are empowered to raise or able to raise within the revenue-raising powers assigned to them. Any change, addition or deletion, in the functions of ULBs or in their revenue-raising powers will impact the volume of State transfers to ULBs. In view of this critical link and in order to position the subject of transfers in a broader framework, it is useful to begin this section by pointing out that the functional and financial domain or jurisdiction of ULBs is governed and defined by the States; the Constitution of India has no provision relating to urban local bodies. All matters concerning them fall within the ambit of Entry 5 of List II (State list) of the VII Schedule. Accordingly, the States through the Acts define their functional domain and responsibilities. They decide on the taxes, tariffs, levies and duties which the ULBs can impose, and often even decide the basis and the rates of various taxes and tariffs. They determine the volume and nature of transfers to ULBs. In other words, they enjoy absolute powers in respect of ULBs, including the powers of supercession, elections, etc.[7]

Being a creature of the State, the ULBs functional domain at any given point of time reflects the extent to which the State desires to assign

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7. The proposed 72nd amendment to the Constitution, if passed, is expected to streamline the procedures with respect to supercession, elections, representation of backward classes on the councils and also in respect of State-Local fiscal relationship.

functional responsibilities to them. The extent of devolving of functions is generally guided by the capacity of ULBs to manage particular functions as are adjudged by the State. In the very nature of things, only such functions are assigned to them which can be better performed at the local level.[8]

The municipal legislations in most States make a distinction between obligatory and discretionary functions. As shown in Table 5, the Municipal Act of Gujarat (1963) contains the largest number of obligatory functions, closely followed by Maharashtra, Tamil Nadu and Punjab. In contrast, the Bengal Municipal Act, 1932 provides for only a few obligatory functions, viz., conservancy and drainage, and maintenance and management of parks and slaughter houses. In States like Gujarat, Kerala, Karnataka and Maharashtra, the maintenance of hospitals is also one of the ULBs functions along with the State Governments. An important difference in the purview of functions relates to primary education which is an obligatory function in Gujarat, Haryana, Maharashtra and Punjab. In several States, it is a combined responsibility, while in several States, primary education is entirely a State government function.

Generally, as may be seen in the table, the municipalities in Kerala, Karnataka, Uttar Pradesh, Andhra Pradesh, Madhya Pradesh and Rajasthan are delegated with relatively larger functional jurisdictions covering most of the essential services. In States where old municipal Acts are still in vogue, the size of functional domain is quite restricted.[9] In States where municipal Acts have been re-enacted or where major amendments have been

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8. What is performed better at different spatial (State and local) levels has been extensively discussed in literature. Generally, the principle used in determining the jurisdiction of States and local bodies is that the services whose quantity and quality vary with area-specific beneficiaries choices and preferences are better provided by the local governments, whereas services whose quality and quantity are neutral to the specifications of different areas should be provided by the higher levels of governments.

9. Excluding Uttar Pradesh and Tamil Nadu.

TABLE 5

Major Obligatory Municipal Functions of ULBs Including Those Shared with the State Governments

States	Water supply drainage	Sanitation	Conservancy	Hospitals	Dispensaries	Maternity and child	Preventive measures	Fire brigade	Street lighting	Primary edn.	Secondary edn.	Maintenance of cremation ground	Disposal of dead	Public parks	Municipal markets	Slaughter houses
Andhra Pradesh	M+S	M	M	S	S	S+M	M	M	M	M+S	S+M	M	M	M	M	M
Bihar	S+M	M	M	S	S	S	S+M	M	M	S	S	S+M	M	S+M	M	M
Gujarat	M+S	M	M	S+M	M+S	M	M	M	M	M	S+M	M	M	M	M	M
Haryana	M	M	M	S	S+M	S+M	M	M	M	M	S	M	M	M	M	M
Kerala	S	M	M	S+M	M+S	M+S	M	M	M	S	S	M	M	M	M	M
Karnataka	M+S	M	M	S+M	S+M	S+M	M	M	M	S	S	M	-	M	M	M
Madhya Pradesh	M+S	M	M	S	S	S	M	M	M	M+S	S	M	M	M	M	M
Maharashtra	M+S	M	M	S+M	M+S	M+S	M	M	M	M	S+M	M	M	M	M	M
Orissa	S+M	M	M	S	S	S	S	M	M	S	S	S	M	M+S	M	M
Rajasthan	S	M	M	S	S	S	M+S	M	M	S	S		M	M+S	M	M
Punjab	M	M	M	S	S+M	S+M	M	M	M	M	S	M	M	M	M	M
Tamil Nadu	M+S	M	M	S	S	S+M	M+S	M	M+S	S+M	S	M	M	M	M	M
Uttar Pradesh	S+M	M	M	S	S	S	M+S	M+S	M	S	S	M	M	M	M	M
West Bengal	S+M	M	M	S	S	S+M	S+M	M+S	M+S	S+M	S	M+S	-	M	M	M

S : Only State Government department.
M : Only municipal government.
S+M : State government is major performer.
M+S : Jointly performed but municipal govt. is the major performer.

Sources:
i. State Municipal Acts.
ii. Kerala - Report of Municipal Finance Commission, 1976.
iii. Report of Bengal Municipal Finance Commission, 1982.
iv. Report of Karnataka Taxation Review Committee, 1983.
v. Report of Urban Local Bodies in Karnataka State, 1986.
vi. Report of Gujarat High Level Grant-in-Aid Committee, 1988.
vii. Tamil Nadu Report of Municipal Finance Enquiry Committee, 1980.
viii. Report of Municipal Finance in Madhya Pradesh, Institute of Public Administration, Lucknow.
ix. Various State Information Centres.

TABLE 5A

Sharing of Major Discretionary Municipal Functions with the State Government

States	Sewage treatment	Veterinary dispensary	Leper's home and lunatics	Milk scheme	Swimming pools/grns.	Technical edn. adult/edn.	Housing for conservancy staff	Town planning	Slum improvement	Rest house and dharamsalas	Stadia/theaters	City transport	Gas/elec. supply	Taking census	Museums/libraries	Fairs/exhibitions public receptions	Promoting small scale industries	Housing
Andhra Pradesh	M	M	S	S+M	M	M	-	M	M	M	M	S	S	S	M	M	S	S
Bihar	S	S	S	S	S+M	S	S	S	S	S	M	S	S	S	S	S	S	S
Gujarat	M	S+M	M	M	M	S+M	M	M	M	M	M	S+M	S+M	M	M	M	S+M	S+M
Haryana	M	S+M	S	S	S+M	S	S+M	S	S	M	S+M	S	S	M	M	M	S	S
Kerala	M	S+M	S+M	S	S+M	S	S	S+M	S+M	M	M	S	S	M	M	M	S	S
Karnataka	M	S	M	S	M	M	M	S	S	M	M	S+M	S	M	M	M	M	M
Madhya Pradesh	M	M+S	M+S	S+M	M	S+M	M	M	S+M	M	M	S	S	M	M	M	M+S	S
Maharashtra	M	M+S	M	S	M	M+S	M	M	M	M	M	S+M	M+S	M	M	M	M+S	S
Orissa	M+S	S	S	S	S+M	S	S	S	S	M+S	S	S	S	S	S	S	S	S
Rajasthan	S+M	M+S	S	S	M	S	S	M+S	-	M	M+S	S	S	M	M	M	S	S
Punjab	M	S+M	M	-	M	S+M	-	M	-	M	M+S	S	S	M	M	M	S	S
Tamil Nadu	M	M+S	M+S	M+S	M+S	S+M	S	M	M	M	M	S	S	S	M	M	S	S
Uttar Pradesh	M	S+M	S+M	S	M+S	M+S	M	S	S	M	M+S	S	S	M	M	M	S	S
West Bengal	-	S	S	S	M	S	S	S	S	M	M+S	S	S	S	S+M	S+M	S	S

S = Major performer of the function is the state govt. dept.
M = Major performer of the function is the municipal govt.
S+M = Major performer of the function is the State govt.
M+S = Major performer of the function is the municipal govt.

Sources:
- i. State Municipal Acts.
- ii. Kerala - Report of Municipal Finance Commission, 1976.
- iii. Report of Bengal Municipal Finance Commission, 1982.
- iv. Report of Karnataka Taxation Review Committee, 1983.
- v. Report of Urban Local Bodies in Karnataka State, 1986.
- vi. Report of Gujarat High Level Grant-in-Aid Committee, 1988.
- vii. Tamil Nadu Report of Municipal Finance Enquiry Committee, 1980.
- viii. Report of Municipal Finance in Madhya Pradesh Institute of Public Administration, Lucknow.
- ix. Various State Information Centres.

brought about, the number of obligatory as well as the discretionary functions have been added to the municipal domain. It may, however, be pointed out that all functions listed as obligatory are not always undertaken by the ULBs. For example, the ULBs of Madhya Pradesh, Andhra Pradesh, Uttar Pradesh and Rajasthan are assigned a fairly large functional jurisdiction, yet they perform only a few essential services. The common explanation for this is budgetary incapacity.

It is ironical that whereas the ULBs are hard put to perform even the obligatory functions, they have in recent years been assigned such new functional responsibilities as would prima facie seem alien to municipal ethos. Although not statutory, these new functions are made obligatory by executive orders - Nehru Rozgar Yojna and Urban Basic Services for the Poor being the two examples in point. Also not provided in the Acts are functions like construction and maintenance of auditorium, stadium, dormitories which are being performed by the ULBs on increasing scales. Conversely, some traditional functions have been and are being taken over by the States through the modalities of special-purpose authorities. These have led to considerable uncertainty in the functional domain of ULBs.

Almost along the lines of defining the functional jurisdictions of ULBs, the municipal legislations of States provide for powers of taxation that the ULBs can use to raise resources within their jurisdictions. Barring Rajasthan (Section 104 of the Act) which distinguishes between obligatory and discretionary taxes, other States provide for the imposition of a number of taxes all of which are discretionary in nature. For example, the taxes which are generally devolved on the ULBs and fall within their domain include —

i. a tax on buildings, lands or holdings based on the annual letting value or the capital value, or a percentage of capital value;

ii. a water tax, lighting tax, latrine tax and a drainage tax assessed on the annual rental value of holdings or buildings;

iii. an octroi;

iv. a tax on professions;

v. a tax on trade or callings;

vi. a tax on entertainment, theatre or show;

vii. a tax on advertisement;

viii. a tax on vehicles, boats and animals used for riding, drought and burden;

ix. a tax on dogs;

x. a tax on sale of cattle;

xi. duty on transfer of property at specified rates;

xii. a betterment fee on holdings;

xiii. a toll on bridges;

xiv. a fee on pilgrims; and

xv. any other tax which the State may endow upon the ULBs.

Only a few of these, however, are significant in terms of their share or contribution to the revenues of ULBs. Studies have shown that property taxes, and octroi wherever it is levied, account for over 85 per cent of "own resources" of ULBs. Other taxes and levies account for the balance.

It is significant to emphasise that while most State Acts divide up the functional responsibilities into obligatory and discretionary, the revenue raising powers that are assigned to ULBs under the statutes are discretionary in nature. This fact itself, i.e., where the responsibilities are obligatory but the financial powers to perform them are of a discretionary nature, establishes the basis and raison d'etre of "transfers" from the States to the ULBs. Added to this stance in the statutory provisions is the fact that there is virtually no relationship between the responsibilities that the ULBs are expected to perform and their financial powers with the result that wherever there is a gap in resources, both the States and ULBs have felt obliged to resort to the mechanism of transfers to enable the ULBs fulfill their obligatory and other responsibilities.

One additional feature of ULBs which is worth noting is that while the State Acts prescribe the nature of functions and the financial powers of ULBs, there are very scant references to the nature of financial relationships between the States and ULBs. Thus, the Municipal Acts do not indicate as to when and under what conditions the States would make transfers to ULBs, and what would be the nature of those transfers. Statutory provisions for transfers exist in only few States, Maharashtra and Kerala being among those. The Maharashtra Municipalities Act, 1965, for instance, provides that —

> "The State Government may under an appropriation duly made in this behalf make such grants to every Council every year and subject to such terms and conditions and in such manner as it may deem fit for all or any of the following purposes, namely - water supply; drainage; primary and secondary education; development plans and town planning schemes under Bombay Town Planning Act, 1954; dearness allowance to the officers and servants of the Council; public health; fire brigade; construction and maintenance of roads; and such other amenities as the State Government may from time to time determine." Such grants shall be credited to the municipal council fund and applied for the purpose for which they are sanctioned.

The Kerala Municipalities Act, 1960 (Section 136) lays down that —

"The Government may contribute to the funds of any municipality by way of a grant such sums as may be fixed by the government with due regard to the needs of development and the costs of municipal administration and services."

Likewise, the process of institutionalisation of fiscal relationship between the States and ULBs has been slow and has so far taken place only in Gujarat, Kerala, Tamil Nadu and West Bengal. In Gujarat, the Gujarat Municipalities Act, 1963, provides that —

"The State Government may, after considering the recommendations of a Committee which it may appoint in this behalf, determine whether for augmenting the finances of a municipality for any of the purposes of this Act, it is necessary to make any grant to the municipality and if so, the amount thereof."

The State governments of Kerala and Tamil Nadu have set up for meeting the capital needs of ULBs, Kerala Urban Development Finance Corporation (KUDFC) and Tamil Nadu Finance and Infrastructure Development Corporation (TNFIDCO). KUDFC, apart from providing technical assistance to the ULBs in project formulation, advances loans for various approved remunerative and non-remunerative projects undertaken by the ULBs. TNFIDCO operates on the basis of a share capital contribution from the ULBs as well as the State government. The main objective of TNFIDCO is to assist financially weaker municipalities in implementing schemes and the Centrally-sponsored projects. There also exists in Tamil Nadu a Municipal Urban Development Fund (MUDF) for implementing the World Bank assisted development schemes. In West Bengal, the noteworthy feature is the appointment of the West Bengal Municipal Finance Commission for reviewing the requirements and performance of ULBs. Other States depend on their own assessment and perception of the problems for deciding on the volume and mode of transfers to ULBs.

2. Mode of State Transfers

Before we analyse the role of transfers in the revenue structure of ULBs, it would seem useful to very briefly describe the various forms of transfers and how these are generally treated in the different States. Essentially, State transfers to ULBs fall into two categories, namely —

i. Taxes which are assigned to or shared with ULBs; and

ii. Grants including general purpose, i.e., non-matching, non-specific grant; special purpose; and statutory and compensatory grants made in lieu of taxes such as "octroi" or under specific Acts (e.g., The Shops and Establishment Act, Motor Vehicles Act) or compensatory grants to enable ULBs to meet the cost of dearness allowance, etc.

i. Shared and assigned taxes

The main taxes which are either assigned to or shared with the ULB include —

(a) Entertainment tax
(b) Motor vehicles tax
(c) Tax on professions, trade and callings
(d) Entry tax
(e) Pilgrim tax
(f) Surcharge on sales tax
(g) Surcharge on stamp duty.

Entertainment tax is both a shared and an assigned tax. In Andhra Pradesh, it is an assigned tax; after deduction of the collection costs, the proceeds of this tax are devolved to the corporations and municipalities on the basis of the source of collection. In Tamil Nadu, Maharashtra and West Bengal, it is treated as a shared tax though its devolution mechanism is different in these States.

Tax on professions, trade and callings which is typically a "local tax" has been withdrawn from the local fiscal domain in a few States, and is now being treated as a shared tax. For instance, in Andhra Pradesh this tax was provincialised in 1987; to compensate the loss of revenue owing to the withdrawal of this tax, the Government of Andhra Pradesh shares the proceeds of this tax with the ULBs at rates equivalent to the highest annual collection of this tax by the respective ULBs over the three years preceding 1987. In West Bengal too, this local tax has been metamorphosed into a shared tax but the rates of compensation are still to be firmed up.[10]

Entry tax (a tax which has substituted the "octroi") is a shared tax between the States and local bodies. Levied in a very few States, it is a tax on the entry of goods for consumption, sale or use which is collected by the State, and the ULBs are compensated for the loss that they have incurred as a result of the abolition of octroi (appropriately adjusted for inflation, etc.). Currently, only three States, namely, Madhya Pradesh, Karnataka and Andhra Pradesh levy this tax.[11]

Pilgrim tax is an assigned tax, levied in municipalities that are of religious significance and have pilgrim traffic. It is collected from the pilgrims along with the rail fares and the proceeds are passed on to the concerned municipal bodies.

Surcharge on sales tax is a shared tax. In Tamil Nadu where it is levied, of the total proceeds of the surcharge, 20 per cent is set aside for devolution to the corporations and municipalities on the basis of a composite index.

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10. Provincialisation of this tax took place immediately after the ceiling rate was raised from Rs 250 per assessee per year to Rs 2,500 in response to the demand of the ULBs.

11. In Maharashtra and Rajasthan, entry tax is levied on motor vehicles purchased outside the State and brought into the State for use and sale. Its proceeds too are shared with the local bodies.

Surcharge on stamp duty is an assigned tax. In Andhra Pradesh and Tamil Nadu the entire proceeds of the surcharge (net of collection costs) are assigned to the corporations and municipalities by origin. In Maharashtra too, it is an assigned tax but is devolved to ULBs with a population of less than 50,000.

ii. Grants

Grants are used as a mechanism of transferring financial resources to ULBs in all States. However, as already indicated, there are a very large number of grants that are given by States to ULBs, and there is a wide variation among them on this account. There are at least three grants which account for a substantial proportion of grants given by States, these being —

(a) Grants for compensating the ULBs for inflation and consequent increase in their wage bills - dearness allowance, in other words, in lieu of taxes;

(b) Education grant; and

(c) Public health grant.

Grants in the form of DA subventions are one of the important transfers made by the States to ULBs. In West Bengal, for example, a bulk of the grant is, in fact, on account of DA subventions. Andhra Pradesh has a similar policy although the quantum of transfers is pegged to 50 per cent of additional expenditure on DA and pay revision. In Maharashtra, DA subventions are used not only for supporting the municipal wage bills but also for —

i. removing inter-municipal fiscal disparities to the extent possible; and

ii. inducing the ULBs to improve their performance on the collection of property taxes.

Education grant is yet another of the grants which is common to many States. For instance, the education grant in Maharashtra is very substantial in that it constitutes about 45 per cent of the total volume of State transfers to ULBs. It is devolved to the ULBs for both primary and secondary education. On an average, 90 per cent of the expenditure incurred by ULBs on primary education and the entire expenditure on secondary education are met out of grants by the State.

In Gujarat, there is a provision for the collection of an education cess by the ULBs. Entitlement of the ULBs towards the proceeds of education cess is linked to its collection performance.

Public health grant is common among the southern States such as Andhra Pradesh and Tamil Nadu. The ULBs in both these States receive a public health grant equivalent to one-fourth of the audited expenditure incurred for implementing anti-mosquito, anti-filariasis and anti-malaria schemes and for maintaining maternity and child welfare centres.

Besides, there are several other grants which are made by different States to ULBs. While these are all minor, the one grant that may be referred to here is the general purpose per head grant given in Gujarat to municipalities.

The above represents a small sample of the different forms of transfers that are made by the States to the ULBs. A review of the position in all major States of the country will show that there are several other taxes being shared between the States and municipalities and also reveal other forms of grants being in vogue. The conditions on which the various grants are given also vary as between States. What, however, is obvious is that transfers are used universally as an instrument to make funds available to the ULBs so that they can perform their functions in an efficient manner. If transfers are excluded or withheld, not only will the financial base of municipal bodies shrink, but the entire functioning of ULBs will be seriously jeopardised.

3. Transfers as a Component of ULBs Revenues

In the following section we present a brief analysis of the share of transfers in the total municipal revenues in selected States and cities.

On an average, transfers comprising of the shared and assigned taxes as well as grants account for 30-35 per cent of the total municipal revenues in the country. In 1986-87 for which a break-up of municipal revenues is available , transfers accounted for 32.2 per cent of the total revenues of ULBs.[12] The shares of the other two components, i.e., the tax revenues and non-tax revenues were 54.3 per cent and 13.5 per cent respectively. Within the transfers, the shares of the grant-in-aid and assigned and shared taxes seem to be more or less the same, these being 16.7 per cent and 15.5 per cent respectively. It is important that within the grants-in-aid system (excluding the shared and assigned taxes), the share of specific-purpose grants is significantly larger in relation to either the general-purpose or the grants that are given in lieu of taxes. Table 7 gives the relevant figures in this behalf.

TABLE 6

Composition of Municipal Revenues, 1986-87

Components	Per cent share
Tax revenues	54.3
Non-tax revenues	13.5
Transfers	
(a) Shared and assigned taxes	15.5
(b) Grants-in-aid	16.7
Total	100.0

Source: National Institute of Urban Affairs, Research Study Series 18 and 38.

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12. These figures should be used as approximations rather than as final and firm figures.

TABLE 7

Share of Different Forms of Grants-in-Aid

Forms of Grants-in-aid		Per cent share
General-purpose		28.5
Special-purpose		45.7
Grants made in lieu of taxes		25.8
	Total	100.0

Source: NIUA, Ibid.

While the aggregate data for ULBs is useful in understanding the role of transfers in State-local relationship, it would be misleading to infer that the position is identical between and among States. There are significant differences between States in regard to the overall share of transfers as well as the composition of transfers. Table 8 exhibits this data for a selected group of States.

The table shows significant variations in the overall shares of transfers as well as in the composition of transfers between States. Transfers play a significant role in the finances of ULBs in States like Andhra Pradesh, Madhya Pradesh and West Bengal. The dependence of ULBs in these States is very high, exceeding in all cases 40 per cent of the total municipal revenues. Then there is a second category of ULBs which are dependent on States to the extent of 30-40 per cent of the total municipal revenues. This category includes the ULBs of States of Haryana, Maharashtra, Orissa, Tamil Nadu and Uttar Pradesh. In Tamil Nadu, ULBs represent a somewhat different case in that the direct transfers constitute a comparatively smaller proportion of the total revenues but a significant proportion of transfers accrue to ULBs on account of shared and assigned taxes. Then there are States where the ULBs' dependence on transfers is low, being 25 per cent or less. These States include Gujarat, Karnataka, Kerala and Rajasthan.

TABLE 8

Composition of Municipal Revenues, 1986-87

State	Composition (per cent)			
	Internal revenues		External revenues	
	Tax	Non-tax	Shared and assigned	Grants
<u>High Transfer States</u>				
Andhra Pradesh	26.3	23.6	23.6	26.5
Bihar	30.5	16.6	14.1	38.9
Madhya Pradesh	42.1	14.4	20.7	22.9
West Bengal	33.1	3.7	29.1	34.1
<u>Medium Transfer States</u>				
Uttar Pradesh	52.6	9.4	9.8	28.3
Tamil Nadu	25.3	34.7	30.8	9.2
Haryana	49.9	20.7	7.4	22.0
Maharashtra	59.5	7.4	17.2	15.8
Orissa	56.6	8.1	11.2	24.1
<u>Low Transfer States</u>				
Gujarat	64.4	10.5	11.0	14.0
Karnataka	54.8	19.8	22.5	2.8
Kerala	63.4	20.2	10.6	5.8
Rajasthan	74.6	11.3	7.0	7.0

Source: NIUA, Ibid.

Why explains such large variations in the volume of transfers between States? Are the characteristics of States where the ULBs depend on transfers to a lesser degree different from those where the dependence is high. For instance, it is often contended that the volume of State transfers is high among the non-octroi ULBs as compared to the octroi ULBs. Similarly, it is also asserted that the low-performing ULBs as measured by the efficiency in tax collection leads to higher level of dependency on State transfers. We have in the following two tables rearranged the data of Table 9 in order to test these two assertions.

TABLE 9

Matrix Showing the Levels of Transfers and the Octroi-Non-octroi Status of States

Level of transfer	Non-octroi	Octroi
High transfer	Andhra Pradesh Madhya Pradesh	West Bengal (check-post based entry tax)
Medium transfer	Tamil Nadu	Maharashtra Haryana Uttar Pradesh Orissa
Low transfer	Karnataka Kerala	Gujarat Rajasthan

Source: Table 8.

It is interesting to note that of the five non-octroi States, the ULBs of two States depend on State transfers to the extent of over 50 per cent for the performance of their functions. At the same time, there are at least two States where the ULBs are able to do with minimal transfers, thus refuting the assertion that the ULBs in the non-octroi States are uniformly more dependent on State transfers. It is also a fact that the ULBs in the octroi-raising State, such as Bihar, Maharashtra, West Bengal have still to depend for over 30 per cent of their requirements on the State governments.

Similarly, there does not appear any clear relationship between the efficiency level of ULBs in terms of tax collection and the volume or the proportion of State transfers. It is only in Gujarat, Karnataka and Kerala that the ULBs are efficient in terms of having a higher tax collection to tax demand ratio, and are able to perform their functions with lower levels of transfers. Similarly, the ULBs of West Bengal and Bihar which have low levels of efficiency have no option but to seek higher levels of transfers from the States. In the other States, there is no clear pattern.

TABLE 10

Matrix Giving Share of Transfer and Levels of Efficiency in Property Tax Collection, 1986-87

	Level of efficiency in property tax collection		
Share of transfers	**Low efficiency**	**Medium efficiency**	**High efficiency**
High transfer	West Bengal Bihar	Andhra Pradesh	Madhya Pradesh
Medium transfer	Orissa	Uttar Pradesh	Tamil Nadu
Low transfer	Rajasthan	Haryana	Gujarat Karnataka Kerala

Source: Table 8.

4. A Four-States Study of Transfers

Andhra Pradesh

The municipal bodies in Andhra Pradesh are constituted and governed under the provisions of the Andhra Pradesh Municipalities Act, 1965. According to the Act of 1965, the government may constitute any local area with a population of not less than 25,000 as a municipality. There are nearly 110 municipal bodies in the State out of 230 cities.

The functional domain of ULBs in Andhra Pradesh is no different from that in the other States. In the revenue-raising powers, however, the main difference is that Andhra Pradesh is a non-octroi State with the result that the main source of revenue with the ULBs is the tax on property. For this reason, transfers from the State including the taxes that are shared between the State and ULBs play a crucial role in their finances and of course, in meeting a significant proportion of the ULBs recurrent expenditure.

During the period 1981-82 to 1987-88, the aggregate revenues of ULBs in Andhra Pradesh increased by 89.14 per cent (13.15 per cent at 1980-81 prices); the aggregate expenditure, on the other hand, increased at a higher rate, 111.68 per cent at current prices and 26.63 per cent at constant prices. The share of taxes declined marginally during this period and that of grants and assigned taxes (combined) increased from 58.2 per cent to 60.7 per cent. Direct taxes as a source of revenues constitute the single most important component of municipal revenues, followed by assigned taxes. Own revenue component in the ULBs of Andhra Pradesh is far less important as compared to transfers. What is more, the share of internal revenues in the smaller ULBs (class II and class III) has declined at a higher rate as compared to this share in class I ULBs. Indeed, the drop in the share in class III ULBs is 8.18 percentage points. Evidently, they are dependent on the State government to a much larger extent.

TABLE 11

Composition of Municipal Revenues, Andhra Pradesh

(per cent)

Year	Internal revenues		External revenues	
	Tax revenues	Non-tax revenues	Shared taxes	Grants-in-aid
1981-82	26.29	15.47	27.80	30.43
1987-88	25.30	14.03	27.40	33.25
Per cent point Variation				
Total	(-) 0.99	(-) 1.44	(-) 0.40	(+) 2.78
For class I	(+) 0.26	(-) 1.01	(-) 1.31	(+) 2.04
For class II	(-) 2.40	(-) 1.36	(-) 0.68	(+) 4.46
For class III	(-) 4.36	(-) 3.82	(+) 4.91	(+) 3.26

Note: Tax revenues figures include "profession tax" also although it has been taken over.

Source: Field Survey and Budgets

In Andhra Pradesh, there are three types of grants that are given by the State to ULBs, namely -

(a) General purpose grants with the main objective of bridging the gap between the needs and resources of local bodies;

(b) Specific purpose grants which are tied to the provision of certain services which ordinarily fall within the ambit of the State government or are of country-wide importance but rendered by the municipal bodies; and

(c) Statutory and compensatory grants, which are given under various enactments as compensation on account of loss of revenue on taking over a tax by the State from local bodies

General purpose grant is of a lesser significance in the State in that the State government gives this at the rate of only 0.91 paise per head to all municipalities on the basis of the 1981 population. The other two categories of grants, namely, specific-purpose grants and statutory and compensatory grants are more important in Andhra Pradesh. In addition, the State government disburses to all municipal bodies annually a sum of Rs 27 lakhs, based on 1976-77 road length.

i. The Department of Education provides a grant to ULBs to meet the salaries of the staff in the municipal schools in Rayalaseema and Coastal Andhra Regions. Education grant accounts for a very large proportion, 71.3 per cent (1981-82) and 82.85 per cent in 1987-88, in the total grants on the revenue account of these regions. In the Telengana region, the State government directly manages the schools and therefore, there is no grant on this account.

ii. The Department of Health gives approximately one-fourth of the audited expenditure as grants for implementing anti-mosquito, anti-filariasis, anti-malaria schemes, etc. and for maintaining maternity and child welfare centres and a grant to meet the salaries of the staff employed in the family planning cells.

Then there are the regular compensatory grants, these being —

i. Profession tax: The State government took over this tax in 1987 and in lieu of this tax pays to all ULBs, compensation on the basis of highest collections in one of the three years preceding its take-over. The amount to which the ULBs are compensated has increased substantially in recent years.

ii. Motor Vehicle Tax: The State government compensates the ULBs to the tune of Rs 45 lakh in lieu of the loss of income from tolls and licence fees of motor vehicles.

iii. Property tax: The State government gave some concessions to property tax payers in 1976-77, and since then has continued to compensate the ULBs for the loss incurred by them on this account.

iv. The State government also gives a grant to ULBs to enable them to meet out a part of the additional expenditure incurred by them on account of the revision of pay scales and dearness allowances. The grant is based on the revision of pay scales and dearness allowance that took place in 1976-77; for subsequent revisions, no additional assistance has been given by the State to the ULBs.

Besides these grants, the State government has assigned at least two taxes to ULBs, namely, the entertainment tax and a surcharge on stamp duty. Entertainment tax is levied by the State government under Section 4 of the Andhra Pradesh Entertainment Tax Act, 1939 on the "gross collection capacity" on each show in a cinema theatre. The gross collection capacity has been defined as the notional aggregate of all payments for admission, the proprietor would realise per show, if all seats were occupied and calculated at the maximum rates of payments. The tax is payable on the notional amount per show with a fixed number of shows per week. The rates of tax and the number of shows vary according to the different grades of municipal bodies. The mode of devolution of proceeds according to Section 13 of the Act (amended upto 1.9.1987) is as follows -

(a) 90 per cent to the local authority;
(b) 3 per cent to the State government; and
(c) 7 per cent for promoting cinematography, films and arts.

The High-Powered Committee in Andhra Pradesh recommended for retention of only one per cent by the State government and payment of 99 per cent of the proceeds to the respective local bodies.[13]

A second tax that is assigned to local bodies is the surcharge on stamp duty, imposed under the Stamp Act, 1899 on the sale, exchange, gift, mortgage and lease of immovable property. The State government levies this tax at a rate not exceeding 5 per cent and assigns them to the ULBs after deducting 10 per cent towards collection charges.

Gujarat

Municipal corporations in Gujarat are created and governed under the provisions of the Bombay Provincial Municipal Corporations Act of 1948, while the municipalities are governed by the Gujarat Municipal Act of 1963. Both these Acts have entrusted the corporations and municipal bodies with vast functional responsibilities. In terms of revenue raising powers too, Section 99 of the Gujarat Municipalities Act of 1963 empowers the municipalities to levy the following taxes - property tax, octroi, taxes on vehicles, toll tax on animals and vehicles, dog tax, special sanitary tax, drainage tax, special and general water tax and lighting tax. Out of these, octroi and property tax are the two most important components of municipal taxation in Gujarat. The significance of octroi in the municipal revenue system has grown steadily over the last decade, as its share in the total revenues of ULBs has increased from 41 per cent to 47 per cent during 1979-80 to 1988-89. In per capita terms, its growth has been substantial, over 12 per cent per year at current prices and 2 per cent per annum in real terms. Although property tax yields account for 14 per cent of the total revenue receipts, these have remained largely stagnant and not shown any particular buoyancy. In real per capita terms, the growth of property taxes has been negligible. Non-tax revenue receipts in Gujarat comprise of fees, fines, rents, income from markets and revenues from

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13. Government of Andhra Pradesh, Report of the High Powered Committee on Municipal Finance and Financial Administration, p. 69, 1971.

commercial enterprises. Until 1982-83, non-tax revenues were the second largest component of revenues; however, its share has declined to 13.46 per cent in 1988-89 both on account of the fall in incomes from commercial enterprises as well as the inability to effectively mobilise the users charges.

TABLE 12

Composition of Municipal Revenues, Gujarat

Year	Composition of revenues (per cent)		
	Internal resources		External revenues
	Tax revenues	Non-tax revenues	Grant-in-aid
Total			
1979-80	66.62	18.26	15.12
1988-89	68.01	13.46	18.54
Per cent point variation			
Total	(+) 1.39	(-) 4.80	(+) 3.42
Corporations	(-) 1.08	(-) 8.24	(+) 6.15
Class A	(-) 9.17	(+) 3.61	(+) 5.56
Class B	(-) 2.56	(+) 4.76	
Class C	(+) 4.43	(-) 1.41	(+) 0.43

Source: Field Surveys and Budgets.

State transfers in Gujarat account for 18.54 per cent of the total municipal revenues. Essentially, these transfers are made on three counts, namely, (i) education grant, (ii) a share of the entertainment tax, and (iii) grants to enable the ULBs meet out the additional expenditure on account of wages and salaries. Together, these three components account for over 80 per cent of the transfers that accrue to ULBs. At the same time, it is important to point out that Gujarat is one of those States where there are as many as four general-purpose grants, 16 specific-purpose grants, four statutory grants and shared taxes. The table below gives a list of such transfers together with their share in the total transfers.

It is interesting to note the differences in the corporations and municipal bodies, in that the municipal corporations draw on the State-level transfers on very few counts, in fact, mainly on education which accounts for nearly 90 per cent of the total transfers. The only other significant transfer in the case of municipal corporation is a share in the entertainment tax. Also, as shown in Table 13, the overall dependence of municipal corporations on State transfers is lower as compared to municipalities of different classes. Of course, the per capita transfers in the case of municipal corporations are significantly higher than those made to other classes of municipalities.

TABLE 13

State Grants and Shared Taxes to Municipal Bodies in Gujarat (1983-86)

(Rs in '000)

Sl.No.	Grant	For Municipalities		For Municipal Corporations	
		Annual average	% to total	Annual average	% to total
A.	GENERAL PURPOSE GRANT				
1.	Per head grant	1209	0.8	-	-
2.	Grants from non-agricultural assessments	1843	1.23	1759	1.11
3.	Grants from land revenue and irrigation cess	1807	1.20	1392	0.88
4.	Incentive grant	3450	2.30		
B.	SPECIFIC PURPOSE GRANTS				
1.	Grants-in-aid for primary education	60511	40.37	117022	73.70
2.	Grants-in-aid for secondary education	1433	0.95	-	-
3.	Grants-in-aid from education cess	6665	4.45	24353	15.33
4.	Grants-in-aid for salaries and wages	24067	16.06	-	-
5.	Grants-in-aid for water supply and drainage	5030	3.35		

Contd....

TABLE 13 (Contd.)

(Rs. in 000)

Sl.No.	Grant	For Municipalities		For Municipal Corporations	
		Annual average	% to total	Annual average	% to total
6.	Grants-in-aid for conversion of dry latrines into water borne ones	218	0.14		
7.	Grants-in-aid for purchase of wheel barrows and hand carts	22	0.01		
8.	Grants-in-aid for construction of conservancy staff quarters	44	0.03		
9.	Grants-in-aid for maintenance and repairs of hospitals and dispensaries	1647	1.09	-	-
10.	Grants-in-aid for maintenance and repair of maternity homes and hospitals	72	0.05	-	-
11.	Grants-in-aid for maintenance of maternity homes and child welfare centres	95	0.06	-	-
12.	Grants-in-aid for buildings and equipment for dispensaries, hospitals, maternity homes and child welfare centres (non-recurring)	1246	0.83	0.20	Negligible

Contd...

TABLE 13 (Contd.)

(Rs. in '000)

Sl.No.	Grant	For Municipalities		For Municipal Corporations	
		Annual average	% to total	Annual average	% to total
13.	Grants-in-aid for salary of health officer and sanitary inspector	72	0.05		
14.	Grants-in-aid for anti-epidemic measures	-	-	-	-
15.	Grants-in-aid for	2623	1.75	1428	0.90
16.	Grants-in-aid for repair and maintenance o. roads	353	0.23	675	0.44
C.	STATUTORY GRANTS				
1.	Grants-in-aid under Bombay Vehicles Act, 1958	22	0.03	-	-
2.	Grants-in-aid under Bombay Public Conveyance Act, 1920	-	-	-	-
3.	Grant under Bombay Shop Establishment Act, 1948	-	-	-	-
4.	Grants-in-aid from fines realised under Municipal Acts tried by the Magistrates	194	0.13	-	-
D.	GRANTS-IN-AID FROM ENTERTAINMENT TAX	37264	24.86	12123	7.64
	TOTAL	1498.87	100.00	1587.72	100.00

Source: Field Surveys and Budgets.

TABLE 14

Per Capita Transfers in the Different Classes of ULBs in Gujarat

Class of ULBs	Per capita total transfers (Rs)	
	1979-80	1988-89
Municipal corporations	16.84	72.44
A class municipalities	49.63	52.42
B class municipalities	28.46	55.71
C class municipalities	17.09	43.75
Aggregate	21.94	63.77
Total per capita revenues	145.12	344.02

Source: Field Surveys and Budgets.

General purpose grants in Gujarat do not play a significant role in the total scheme of transfers to ULBs. The share of per-head grant which is designed in a way as to give higher level of grants to smaller municipal bodies is only 0.8 per cent. Thus, while the design favours the relatively small ULBs, the amount is so small that it is neutralised in its effects by other transfers. Within this category is what the Gujarat government calls an "Incentive Grant" which is given to ULBs to enable them to step up their resource mobilisation efforts and effect economies on the establishment expenditure. The incentive grant is based on the per head income earned percentage collection of arrears and the expenditure on establishment as a proportion of total expenditure.

TABLE 15

Per Head Grant System in Gujarat

Class of ULBs	Per head grant (Rs.)
A	1.00
B	1.50
C	2.50

Specific purpose grants form a large proportion of the total transfers to ULBs. Between 1983-86, the average transfers on special purpose account constituted 69 per cent in the case of municipalities and nearly 90 per cent for corporations. Here too, the most important grant is for primary education whose share in the total transfers is 40.4 per cent in municipalities and over 70 per cent in the case of municipal corporations. The grant is disbursed on the following basis —

TABLE 16

Disbursement of Grant-in-Aid for Primary Education

Percentage recovery of education cess against a demand	Percentage of primary education grant admissible	
	Municipalities	Municipal Corporations
70 per cent and above	100	85
60 - 70 per cent	95	80
60 per cent and below	90	75

Thus, as is evident, it is linked with the efficiency in the recovery of education cess. In order to impart some measure of equity between municipalities and municipal corporations, the percentage of grant admissible to municipalities is higher than the corporations.

Grants-in-aid from education cess accounts for about 4.5 per cent of the total revenue transfers to municipalities and about 15 per cent to the municipal corporations. Municipal bodies collect education cess on behalf of the State government and are allowed to retain an amount equal to 50 per cent of education cess as grant for the maintenance and repair of primary school buildings. Municipal bodies who do not perform primary education functions get only 5 per cent of net collections from education cess.

A third component of special-purpose transfers relates to the grant made to municipal bodies for meeting the salaries and dearness allowance of municipal employees. This transfer which was earlier known as dearness allowance grant accounts for 16 per cent of the total revenue grants to municipalities. Under the provisions of this grant, the State government gives 33.3 per cent of the total salaries of municipal employees as grants, subject to the following conditions regarding the rates and collections of property taxes -

TABLE 17

Disbursement of Grants for Dearness Allowance and Salaries of Municipal Employees, Gujarat

Rate of Primary Tax as a per cent of Annual Rateable Value	Actual per cent collection	Grant per cent of admissible grant of 33%
16 per cent and above	18 per cent and above	100
Less than 16 but more than 12 per cent	Less than 18 but more than 14 per cent	75
Less than 12 but more than 8 per cent	Less than 14 but more than 10 per cent	50
Less than 8 per cent	Less than 10 per cent	Nil

Besides the grants for education, payment of dearness allowance and salaries and grants from the education cess, all other specific purpose grants are meagre and in financial terms, of no consequence. Similarly, although there are four statutory grants, they too form a negligible proportion of the total transfers.

An important transfer which is worth pointing out relates to entertainment tax which is shared between the State and ULBs. This grant which is about 25 per cent of the total State transfers to ULBs and about 8 per cent to the corporations is channelled to ULBs through the Gujarat Municipal Finance Board which uses a composite index for disbursement of this shared tax. It includes the following indices —

TABLE 18

Criteria for Disbursement of Grant Under Entertainment Tax

Criteria	Percentage of total grant amount
Population	40.0
Area	15.0
Per capita revenue receipts (excluding all grants)	20.0
Special project grant	15.0
Revolving Fund	10.0
Total	100.0

The index also gives larger weightage on population count to smaller municipalities so that they do not remain disadvantaged on this account.[14]

The most important feature to note here is the institutional changes that have been brought about in Gujarat in respect of State transfers to the ULBs. One change relates to Section 144 of the Gujarat Municipalities Act, 1963 which provides for a revision in the system of grants every five years and the constitution of a Grant-in-Aid Code Committee. The Committee has become an established practice in the State of Gujarat.

The establishment of the Gujarat Municipal Finance Board is yet another institutional innovation that has been brought about in Gujarat. Although its jurisdiction is limited, the very fact that a Board has been set up with the task of making grants-in-aid to municipal bodies is a step away from ad-hoc transfers to transfers on accepted principles and basis.

Madhya Pradesh

Municipal bodies are constituted in Madhya Pradesh under the provisions of the Madhya Pradesh Municipalities Act, 1961. There are over 198 municipal bodies in the State out of 321 urban settlements.

The State transfers to ULBs in Madhya Pradesh constitute almost 50 per cent of their total revenues. The share of the revenues and non-tax revenues has been estimated at about 32 per cent and 18 per cent respectively. More recent information (1989-90) for Bhopal Corporation shows that the dependence of Bhopal on State transfer is nearly 53 per cent while the shares of tax and non-tax revenues are 21.8 per cent and 25 per cent respectively.

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14. Details in respect of how the Gujarat Municipal Finance Board disburses the share of the entertainment tax to ULBs are annexed.

TABLE 19

Per Cent Composition of Municipal Revenues, Madhya Pradesh, 1980-81

Class of municipal body	Per cent Composition of		
	Tax	Non-tax	State transfers
Total	31.9	18.3	49.8
Corporations	34.1	19.4	46.5
Class I	34.4	15.2	53.4
Class II	25.5	13.5	61.0
Class III	31.0	20.0	49.0
Class IV	29.0	23.0	48.0

An important feature of State transfers that distinguishes Madhya Pradesh, e.g., from Andhra Pradesh, another non-octroi State, is that these consist largely of general purpose grant and all other forms of transfers are of either no or lesser consequence. General purpose grants accrue to the municipalities via (i) a per head grant which is designed in a way that it gives a higher weightage to smaller municipal bodies, (ii) and compensatory grants in lieu of octroi which was abolished in 1976, and (iii) profession tax which is shared between the State and ULBs.

According to the provisions of the Madhya Pradesh Municipalities Act, the per capita grant is paid as per the following basis —

TABLE 20

Criteria for the Disbursement of Per Head Grant

Class of Municipal Body	Per head grant permissible (Rs.)
Municipal Corporations	0.50
Class I	0.75
Class II	1.00
Class III	1.25
Class IV	1.50

The per head general purpose grant has remained unchanged since it was instituted at the time of the enactment of the Act. While it is the most important transfer of resources from the State, its importance and financial significance have declined after the State began to compensate the ULBs for the loss of octroi. In Bhopal, for instance, its share in the total transfers is now only 1 per cent.

Compensatory grants in lieu of octroi and a proportion of profession tax and entertainment tax are the most important transfers to ULBs from the State government. In the case of Bhopal, for instance, these account for 77 per cent of the total State transfers; the share of such grants is expected to rise further according to the projections of the Bhopal Corporation.

There are a number of specific purpose grants whose combined share in the case of Bhopal is approximately 21 per cent. These include grants for primary education, which are given out of collections from education cess; road maintenance, given out of the Motor Vehicles Tax; public health, etc.

However, there grants are ad-hoc in nature and the quantum of grants differ from year to year.

Tamil Nadu

Municipal bodies in the State of Tamil Nadu are created under the provisions of Section 4(1) of the Tamil Nadu Municipalities Act, 1920. In 1990, there were approximately 106 municipalities including 8 township committees out of about 450 urban centres.

The municipal bodies in Tamil Nadu are in a state of financial crisis in that their revenues and expenditures in real terms are barely rising. During 1982-83 to 1985-86 period, their revenues and expenditures declined and the rate of decline was sharper in revenues as compared to expenditures, making the ULBs particularly vulnerable in terms of their capacity to perform their statutory functions.

Revenues of ULBs in Tamil Nadu consist of taxes (property tax and profession tax), shared taxes such as the entertainment tax, surcharge on stamp duty and other minor taxes on carriages, animals and carts, pilgrim tax and fines; non-tax sources of revenues and the transfers made by the State for various purposes. Taxes are the most important source of income for the ULBs in Tamil Nadu, which account for approximately 29-40 per cent of the total revenues. Non-tax sources account for 22-23 per cent and the balance of 38 per cent accrues to ULBs by way of State transfers. Within the State transfers, the component of shared taxes is 24.9 per cent and that of other transfers and grants, 12.0 per cent.

TABLE 21

Composition of Municipal Revenues, Tamil Nadu

Class of municipality	Composition Per cent			
	Internal revenues		External revenues	
	Taxes	Non-tax	Shared taxes	Grant-in aid
Total				
1982-83	20.9	16.9	46.8	15.4
1988-89	39.1	22.0	26.9	12.0
Per cent point variation				
Class I	(+) 22.8	(+) 2.3	(-) 20.7	(+) 5.6
Class II	(+) 14.8	(+) 7.6	(-) 19.9	(-) 2.5
Class III	(+) 14.3	(+) 6.0	(-) 16.2	(-) 4.2

Source: Field Surveys and Budgets

It is important to note that in the case of Tamil Nadu, the role of State transfers in financing the expenditure of ULBs has declined sharply over the period 1982-83 to 1988-89. The share of shared taxes which was 46.8 per cent in 1982-83 has declined to 26.9 per cent and that of other grants from 15.4 per cent to 12.0 per cent during the same period. Moreover, such a diminishing role of transfers is not limited to one class of municipal bodies but runs to all classes of municipalities. This study shows that it has occurred on account of the revision in the property tax structure in 1987-88 which has changed the relative shares of the various constituents of revenues of ULBs.

Entertainment tax is an important tax which is shared between the State and ULBs. Sixtyfive per cent of the proceeds of the entertainment tax are devolved to municipalities in the selection, first, second and third grades and 70 per cent in other grades of municipal bodies.[15] In addition to the entertainment tax, the surcharge on stamp duty, after deduction of collection charges, is also devolved to the municipal bodies.

The grants that are given to the ULBs in Tamil Nadu, like in the other States, are of three types, namely: (i) general purpose grants, (ii) specific-purpose grants, and (iii) compensatory grants.

Traditionally, no general purpose grants were given to ULBs in Tamil Nadu. However, a portion of the surcharge on sales tax (20 per cent) is now devolved to the municipal bodies on the basis of the following criteria -

TABLE 22

Criteria for the disbursement of surcharge on sales ta

Criteria	Proportion (%)
Population	50.0
Revenue collection	25.0
Deficit in the revenue account	25.0
Total	100.0

15. The Tamil Nadu Municipal Finance Enquiry Committee (1980) having noted that no new tax measures have become available to the municipal bodies, had recommended that the State government may apportion the entire proceeds of the entertainment tax to municipal bodies after deducting 5 per cent of the proceeds as collection charges.

Thus, a system appears to be evolving in Tamil Nadu for the disbursement of collections on the sales tax account. Other specific purpose transfers include grants for public health to meet a part of the expenditure on maternity and child welfare centres, anti-mosquito scheme and family planning; education (two-thirds of expenditure incurred on the maintenance of secondary schools); and road maintenance (ad-hoc basis, although length of roads is supposed to be taken as the basis).

5. State Transfers to ULBs : An Assessment

That there is a high element of diversity in the system of State transfers to the ULBs is evident from the analysis contained in the previous section. The diversity is noted not only in the number of transfers that are made by the different States — the number being amazingly large, but are more prominently manifest in —

i. the share of transfers in the revenues of ULBs in the different States;

ii. the constituents of transfers and their relative importance;

iii. the criteria used by States for making transfers under various heads and accounts; and

iv. the institutional arrangements that have been created in the different States for this purpose.

The share of transfers in the revenues of ULBs varies sharply — between a low of 18.54 per cent in Gujarat (1988-89) and a high of 60.65 per cent in the case of Andhra Pradesh (1987-88). In 1985-86, for which comparable data are available for most of the States, the range is between 25.0 per cent for Gujarat and 50.10 per cent for Andhra Pradesh. What is important to recognize here is that such large variations can not be explained in terms of either the octroi/non-octroi status of the State or the efficiency with which the ULBs in specific States operate their revenues; rather these are attributable to a multiplicity of factors which are both endogeneous (e.g., efficiency) and exogeneous (e.g., the level of economic development) to the municipal systems. Thus, the level and share of transfers are highly complex entities in the functioning of ULBs, and are dependent on a number of factors including the per capita municipal revenues, efficiency, octroi/non-octroi status and also the overall economic status of the State to which the ULBs belong.

TABLE 23

The Level of Transfers and Data on Related Indices, 1986-87

State	Level of transfers %	Per capita municipal income (Rs)	Tax collection efficiency in respect of property taxes (%)
Andhra Pradesh	50.10	247.4	41.5
Gujarat	25.00	453.03	59.3
Madhya Pradesh	43.60	199.62	64.0
Maharashtra	33.00	13.27	57.0
Tamil Nadu	40.00	148.05	63.6

(Corresponding to Table 8 of this Report).

Note: Sampled municipalities in the population range of 100,000-750,000.

The constituents of transfers and their relative importance vary from State to State. Tamil Nadu is one such State where the municipal system relies more on shared/assigned taxes, while in the other States, there is a greater reliance on the grants, including those grants which accrue to the ULBs in lieu of certain taxes or in lieu of statutory provisions.

TABLE 24

Constituents of Transfers

(Per cent)

States	Constituents of	
	Shared and assigned	Grants
Andhra Pradesh	23.6	26.5
Gujarat	11.0	14.0
Madhya Pradesh	20.7	22.9
Maharashtra	17.2	15.8
Tamil Nadu	30.8	9.2

One of the major elements of diversity in respect of transfers lies in the criteria for making transfers to the ULBs. Thus, there are —

(a) simple transfers, made on a per capita basis as is the case with the general purpose grants in Andhra Pradesh, Gujarat and Madhya Pradesh. In most States, these grants are disbursed in a way as to give a greater weightage to smaller municipal bodies in comparison with larger municipalities and corporations;

(b) transfers made on the basis of multiple criteria as is the case with the disbursement of entertainment tax in Gujarat and disbursement of surcharge on sales tax in Tamil Nadu. In both these cases, it is important to note, while population is an overwhelming criterion, there are other components which are linked with the performance efficiency of the ULBs. In Gujarat, for instance, 20 per cent of the entertainment tax is disbursed on the basis of per capita revenue receipts; similarly, 25 per cent of the surcharge on sales tax are disbursed on the basis of revenue collection. It is also important to note that in the disbursement of surcharge on sales tax, the equity aspect is also an important component. All these criteria seem to reflect some combination of the desire to equalize fiscal capacity or to encourage resource mobilisation by local governments and to reduce disparity in the public services levels;

(c) transfers are linked to fiscal performance of ULB, as seems to be the practice with the disbursement of grant-in-aid for primary education and dearness allowance in Gujarat. Such transfers are clearly designed in a fashion as to give advantage to those municipal bodies which are able to demonstrate better fiscal performance. For instance, the municipal bodies in Gujarat which are able to recover 70 per cent and more of the education cess receive 100 per cent of the admissible education grant. This proportion declines with the decline in the collection of education cess.

(d) Then, there are other miscellaneous forms of transfers such as disbursement of fixed amounts on the basis of road length (Andhra Pradesh), reimbursement of expenditure for programmes such as the anti-malaria scheme (Andhra Pradesh). In Gujarat, transfers are being linked with the per cent of expenditure on administration so as to mote reduction of administrative expenditure, etc.

(e) In addition, there are ad-hoc grants whose amounts vary from year to year. There are many examples of such grants, although the volume of such grants is small.

Finally, it is significant that there have been trends towards institutionalisation of the transfer mechanisms. In Gujarat, as pointed out above, Gujarat Municipal Finance Board has been set up and the Act has been amended to provide for a Grants-in-aid Code. Several other States such as Kerala and West Bengal have taken similar steps to move away from transfers being determined on an ad-hoc basis to a more formalised system.

A more difficult question with respect to transfers relates to their impact on the objectives for which these are advanced. This study has not been able to isolate the impact of transfers from the overall impact of incomes or expenditures; the problem is the separation of the impact of the transfers from everything else, i.e., an improvement in tax administration may be as responsible for an increase in local tax effort as the State transfers. One of the points that is often made is that the State transfers have a tendency to substitute local fiscal efforts. In order to test this assertion, NIPFP conducted a separate study entitled "State Grants and Local Fiscal Effort". This study which is annexed to the report shows that the ULBs may be replacing their own revenues by grants from the States. Using the data of four States, namely, Haryana, Maharashtra, Rajasthan and Orissa, it shows that one per cent rise in the State transfers replaces approximately 0.22 per cent of the local revenues. It should be pointed out that the results should be read with the usual caveat of limitation of data.[16] This study has also stressed the need to probe this aspect further by taking a larger sample of ULBs.

Some insights on the performance of transfers are available from M.G. Rao's study of State Transfers to Municipalities.[17] According to Rao's study, different patterns have produced different types of problems. For instance:

i. in Gujarat, the overwhelming nature of the specific purpose grants has resulted in distortions in the ULBs own pattern of allocations;

ii. in Kerala, the tax assignment system has placed economically advanced ULBs at an advantage over the financially weaker

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16. Another study of NIPFP showed that there was no substitution of local revenues by State transfers. See, Shyam Nath and B.C. Purohit, "Local Fiscal Adjustment and State Grants Policy : An Empirical Analysis", 1990.

17. M.G. Rao, "State Transfers to Municipal Bodies", forthcoming as a part of the World Bank publications.

municipalities. Furthermore, the absence of a proper institutional mechanism to periodically assess the quantum of transfers needed is a serious shortcoming in the State;

iii. in Tamil Nadu, the allocation of shared taxes to the ULBs on the basis of origin has resulted in smaller assistance being given to financially weaker municipalities; and

iv. in Maharashtra, the needs of financially weaker ULBs are not adequately taken into account in the distribution of specific purpose transfers.

Similarly, there are some positive aspects in every system of transfers, of which the most important is the attempt to institutionalize the mechanisms of transfers to ULBs - Gujarat and West Bengal being the forerunner States in this regard. Another positive aspect worth pointing out is the weightage being given to the relatively smaller municipal bodies in the allocation of transfers from States to the urban local bodies.

III

STATE TRANSFERS TO THE URBAN LOCAL BODIES
AN APPROACH

1. A Resume of Recommendations made by Committees and Commissions on State Transfers

It was mentioned in the early part of the report that issues relating to municipal finance including those relating to State transfers are neither new nor are these being raised for the first time. Various commissions, committees and study groups in the light of the deteriorating financial situation of ULBs have examined these issues from time to time, and suggested reforms to strengthen the municipal finances, indeed the entire municipal system. It is useful to briefly review these recommendations in so far as these relate to the transfer of resources from the States to the urban local bodies.

One outstanding feature of the recommendations made from time to time is that the States should support the ULBs in the performance of their functions by way of grants, tax sharing and assignment of taxes. This is a common thread that runs through the recommendations of various commissions and committees. The Local Finance Enquiry Committee, set up in 1950, for instance, suggested that the States should assist the local bodies with grants-in-aid where they were unable to achieve the minimum national standard of efficiency from their own resources. This committee further suggested that while assignment of sources of revenues were a preferable mode of providing assistance, all grants whether these were statutory or non-statutory, should be given on some definitive and understandable principles, and each State should formulate such principles for its guidance. This committee implicitly accepted that the principles of grants-in-aid may vary from State to State.

The Taxation Enquiry Committee, 1953-54 in its report observed that the municipalities own taxes, even if these were fully and efficiently used, could not alone provide adequate finances to enable the ULBs to perform their assigned functions. This Oommittee accordingly suggested that municipal sources of revenues should be supplemented by a well-designed system of general-purpose grants-in-aid. Unlike the Local Finance Enquiry Committee, it preferred a grants-in-aid system as a method of financing the local bodies.

The Zakaria Committee (1963) set up by the Central Council of Local Self-Government made comprehensive recommendations on the augmentation of financial resources of urban local bodies. Firstly, it observed that "the principle that the grants-in-aid should form one of the important sources of revenues of local authorities has been accepted all over the world", thus affirming that grants in themselves did not violate the canons of local autonomy. Secondly, it endorsed the position taken by the Taxation Enquiry Committee that each State should lay down a grants-in-aid code and principles for making grants to ULBs. Thirdly, it proposed a scale of grants (general-purpose grants) which gave higher weightage to smaller municipal bodies compared to larger corporations and municipalities, taking the position that the smaller municipal bodies had a weaker financial base and needed higher support from the States. The scales as proposed by the Zakaria Committee are shown in the following table.

TABLE 25

Scale of ULBs (Population)		Per Capita Grant Norm (Rs)	
		1960-61 prices	1986-87 prices
A.	**Special** Above 20 lakh and industrial cities above 10 lakh	0.25	1.53
A.	5 - 20 lakh	0.25	1.53
B.	1 - 5 lakh	0.50	3.06
C.	50,000 - 1 lakh	0.75	4.59
D.	20,000 - 50,000	1.00	6.13
E.	Below 20,000	1.50	9.19

The Rural-Urban Relationship Committee (1966) while agreeing with the general proposition that the system of grants should be used to improve the municipal services, proposed that the general-purpose grants-in-aid should be linked with the performance of local bodies in raising their own resources and to the extent possible, grants-in-aid should be extended on the principle of matching grants. It also suggested the setting up of Municipal Finance Commissions to help the States to formulate principles and determine the quantum of grants.

In subsequent years, many of the State governments appointed commissions and committees to look into the financial health of municipal bodies and the structure of the grants-in-aid. They all seem to have accepted the view that transfers are an integral part of the municipal finance system. In varying degrees of emphasis, they have proposed that -

i. grants-in-aid should encourage the ULBs to step up their resource mobilisation efforts;

ii. grants-in-aid should follow a set of principles and codes; and

iii. grants-in-aid should take note of the special problems of ULBs and not be neutral to their size or other problems.

Mention should be made here of the West Bengal Municipal Finance Commission, 1980 which departed from the practice of lump-sum general purpose grant, and proposed instead a "gap-filling" approach. The Karnataka Municipal Finance Commission, 1986 recommended that 50 per cent of the general purpose grants should be disbursed on the basis of per capita basis, without any conditions. The balance of 50 per cent should be made available subject to their potentials to improve the resource potentials.

The various commissions and committees, in addition, made recommendations on tax sharing as a method of providing support to ULBs.

Among the taxes that figure in their recommendations include the Motor Vehicle Tax, Land Revenue, Entertainment Tax, Surcharge on Sales Tax, State Electricity Duty, Profession Tax, and Entry Tax. All committees have suggested the sharing of these taxes, although the proportions as proposed by them and the methods of sharing are different from committee to committee.

2. Approach to State Transfers

a. Basic considerations

There are certain basic considerations in formulating an approach to State transfers that must be recognized at the very outset. The first consideration is that in terms of the division of functions between the Centre and the States, urban development is a State subject, and it is within the jurisdiction of the States to assign, or share with, the urban local bodies the functional responsibilities and financial and fiscal powers as the States may deem appropriate. In other words, the States have absolute powers in determining their functional and financial domain and in defining the mode and conditions of their relationships with the ULBs.

Secondly, given this statutory position and given that this position will be maintained, it is evident that the role of transfers will depend on the functions that the States may assign to them, and the resource-raising powers that they may entrust to them. It follows, then that —

i. the role of transfers may vary between States; and

ii. the role of transfers may change from time to time, depending on the proclivity of States to alter the extent and nature of functional and financial domain of the ULBs.

As such, it is neither necessary nor feasible to have a single, uniform transfer policy; indeed, such a uniform policy, if attempted, may prove to be counter-productive.

Thirdly, the existing statutory position allows for a more flexible relationship between the States and ULBs. The provisions visualise that the ULBs should be financially viable, but these do not visualise them to be financially independent. It follows that intergovernmental transfers do not in themselves infringe the autonomy of ULBs, i.e., the extent to which the autonomy is enjoyed by them under the existing statutes. This study has taken the position that the oft-repeated view that transfers infringe the autonomy is neither sustainable nor should it be used for suggesting that transfers should be done away with. Such transfers form an integral part of the state-local fiscal relationship. These should be seen in a more positive light and be indicative of the benign relationship between the States and ULBs.

The need for flexibility in State-local fiscal relationship is also warranted by the changing pattern of demand for municipal services. It is therefore, necessary to take a more flexible rather than a one-time, static view of the flow of financial resources from the States to ULBs.

Finally, the approach to State transfers should be so designed that it is able to overcome the main deficiencies in the existing system of State transfers and respond to the changing fiscal and financial needs of ULBs. We saw in the earlier part of this report as well as in the reports of the other commissions and committees that the existing transfer systems are vulnerable on four counts —

i. the excessively large number of transfers on different accounts, making it extremely difficult to assess their impacts;

ii. the undefined, <u>ad-hoc</u> and irregular nature of transfers, rendering any attempt on the part of ULBs to make a realistic assessment of their resource position and consequently to plan out their service activities;

iii. the natural tendency on the part of ULBs to substitute their own local resources and resource-mobilisation efforts for transfers; and

iv. the overloading of the municipal system with such tasks and responsibilities for which it may either not be adequately equipped or may lead to diversion from their main statutory tasks.

It follows from the above that the approach to transfers policy should be designed in such a way that —

i. it does not contain transfers on too many counts;

ii. the transfers are regular and clearly-defined, and so structured as to encourage fiscal planning by the urban local bodies. Just as any other regular revenue source, transfer revenues should be a part of the local budgeting process. Transfers determined on an ad-hoc basis are hardly conducive for purposes of planning; and

iii. it must not lead to any substitution of local resources and local efforts.

b. Approach to State Transfers (Revenue)

It is against this background that we have suggested a transfer system under which all transfers are to be divided under two categories, namely —

i. General-purpose transfer; and
ii. Specific-purpose transfers.

For the general purpose transfers, it is suggested that an appropriate share of the aggregate annual revenues raised by the State should be assigned to the urban local bodies. As an initial, simple measure, the share can be worked out on the basis of all transfers which are currently being made by the States to the ULBs. Thus, if 5 per cent of annual revenues are being transferred to ULBs, it can serve as the first approximation of the volume of transfers to the ULBs.

A follow-up step in operationalising the general-purpose transfer system lies in laying down the criteria for the distribution of this proportion of the aggregate revenue to the ULBs. It is recommended here that since such transfers have multiple objectives, a set of multiple criteria be used for its disbursement. In the selection of criteria three aspects are important —

i. population size of the ULB;

ii. the level of efficiency with which it collects its revenues; and

iii. the level of cost consciousness a ULB has in regard to its main function, i.e., provision of essential services.

For taking into account these aspects the following criteria are proposed —

i. Population size: In view of the fact that the population range of ULBs is wide, it is proposed that smaller municipal bodies be given a higher weightage as compared to larger municipal bodies;

ii. Per cent of revenue collection to revenue demand: Higher the percentage, greater should be the volume of transfers;

iii. Per cent of expenditure on administration: Higher the expenditure on administration, lower should be the volume of transfers; and

iv. <u>Rate of increase in the revenues versus the rate of increase in the expenditure</u>.[18] Higher the gap, lower should be the volume of transfers.

These criteria, rather guidelines, can meet the basic objectives underlying the transfer of resources from the States to ULBs. Of course, it is possible to add to this set of criteria but on account of the constraints of data and the methodological problems in using them, it is necessary to keep the number of criteria small, i.e., the extent to which these are able to take into account the major concerns in State-local transfers.

It is critical to create a proper institutional framework for the management of State transfers to the urban local bodies. The need for such a framework has been emphasized for a long time but action on establishing a framework has been tardy and taken by only a few states. A proper use of transfers in conjunction with other routine matters can not be ensured by ad-hoc, lackadaisical approaches. Only a regular machinery charged with at least the following functions can help the entire process --

i. collection and analysis of finance and service level data from the urban local bodies (e.g., income and expenditure, collection ratios, defaults, expenditure on administration versus the provision of services, the levels of municipal services, gaps in services according to norms etc.);

ii. allocation of financial resources to ULBs on the basis of predetermined criteria or guidelines; and

iii. strengthening the capacity of ULBs in respect of budgeting, planning, monitoring, management and control.

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18. The backwardness of a ULB can be better measured by per capita sales tax revenues.

It is important to recognise that transfers unaccompanied by appropriate institutional set-up at the State level and capacity-building at the level of ULBs will hardly be an improvement over the existing system. It is no less important that the institutional set up - be it a Municipal Finance Commission, or bodies called by other names, is committed to gradually transferring to ULBs those sources of revenues that are inherently local in nature. Such actions will significantly contribute to the financial health of ULBs and will eventually result in a healthier State-local fiscal relationship.

The specific purpose transfers should be extended for only the Centrally or State sponsored priority projects which are able to be better implemented by the ULBs. In this category fall programmes and projects such as the poverty alleviation programme.

c. **Capital Transfers**

In addition to revenue transfers, the urban local bodies receive from time to time financial resources which fall in the category of "capital transfers". These transfers accrue to ULBs for works of a "capital nature" such as the augmentation of water supply or sewerage systems, construction of mandis, markets, stadia, and so on. Thus, unlike the revenue transfers which are designed to assist ULBs in meeting, e.g., the revenue-expenditure gap, the purpose for which capital transfers are made are of a different nature.

While the capital and revenue transfers are different in scope and purpose, it is important to recognise that capital transfers can have a major impact on the ULBs resource position. There are several instances where capital transfers have led the ULBs into financial crises as they found it difficult to sustain the capital investments. There are other instances where the ULBs could not repay the debt obligations arising out of capital transfers.

It is important to point out that unlike in the case of revenue transfers where there is only one source, i.e., the State government, in the case of capital transfers, there are several sources. These include the international agencies (like the World Bank which have extended credit for water supply and sewerage projects), Central Government (physical infrastructure under the IDSMT Programme), State Governments (plan grants), financing institutions, and, of course, the market borrowings. Apart from the above sources, funds are received by ULBs through various conduits - e.g., the thirty six ULBs in the Calcutta Metropolitan area receive capital assistance, both loans and grants, through CMDA, while other ULBs in the State receive funds from the concerned Departments. In Gujarat, the Gujarat Municipal Finance Board devolves a portion of the proceeds of entertainment tax as capital assistance in addition to other sources of capital finance of ULBs.

Several States have institutionalized the process of making capital transfers to the urban local bodies.

Should the transfer of capital resources be governed by a set of predetermined guidelines on criteria, or should such transfers be entirely project-based? This is not an easy question to address as --

i. while capital transfers on the basis of a given set of criterion may be regular and may help the ULBs in capital budgeting and planning, these in reality may not bear any relationship with the financial needs of specific projects; transfers in such instances can lead to wastage of resources;

ii. while the project-linked transfers may be able to better reflect the needs of ULBs, these are irregular in nature and can be demanding in terms of ULBs own capacities;

iii. although most capital projects have a longer than one-year life cycle, the budgeting and transfers are done on an annual basis.

This study has taken the position that capital transfers should be project-linked, although the transfers may accrue to ULBs on an annual basis. This alone will ensure proper use of capital funds. This system will mean --

i. preparation of sound projects with detailed plans of debt servicing and repayment;

ii. incorporation of such projects in the State Plans, a proposal which has often been made but not acted upon;

iii. capacity building at the level of ULBs in project formulation and approval.

Like in the case of revenue transfers, proper and effective use of capital transfers is possible only when the ULBs are adequately supported and strengthened by institutions such as a Municipal Finance Commission. A proper institutional base is a pre-requisite for supplementing a wide-ranging and flexible transfer policy.

It should be mentioned that transfers are not a panacea for the numerous problems with which the ULBs in India are currently faced with. To be effective, a transfer policy will demand several concurrent actions on the part of ULBs, the first of which being that they must improve their own efficiency in terms of resource mobilisation and expenditure planning. Without these, the case for transfers will continue to be contentious. It is equally imperative for the ULBs to augment and improve their own capacities to plan, monitor and appraise projects and use more innovative ways to improve efficiency. Finally, it must be said that no matter what transfer policy is pursued by a particular State, it will have some positive and some negative effects. A search for an optimal transfer policy is likely to be as futile as a search for an ideal municipal governance system.

Annexure 1

RECOMMENDATIONS OF VARIOUS COMMITTEES/COMMISSIONS ON LOCAL BODIES

(A) COMMITTEES/COMMISSIONS AT NATIONAL LEVELS

I. REPORT OF THE LOCAL FINANCE ENQUIRY COMMITTEE, 1950

1. Grants

i. The State should come to the assistance of the local bodies by way of adequate grants-in-aid where they are unable to achieve the minimum national standard of efficiency from their own resources.

ii. Assignment of sources of revenue wherever possible is preferable to grant-in-aid: it was emphasised where it is not possible to meet the full requirements of a local body from assigned revenues, grant should be given as a last resort.

iii. It is desirable that all grants, whether statutory or non-statutory, should be given on some definite and understandable principles, and each State government should formulate such principles for its guidance.

2. Shared Taxes

(a) Motor vehicle tax

i. The net proceeds of the motor vehicle tax may be shared with the local bodies.

ii. The damage done to the roads of the local bodies by extraordinary heavy traffic can be made good either by the State sharing the proceeds of the motor vehicles tax with them or by the levy of a surcharge on trucks above one ton in weight for the benefit of the local bodies concerned.[19]

3. Compensations in lieu of Taxes

i. The basis of the compensation for loss of income due to the abolition of tools on motor vehicles should be reopened and fresh amounts fixed in the light of altered facts.

II. REPORT OF THE TAXATION ENQUIRY COMMISSION, 1953-54

1. Grants

i. Normally, grant-in-aid should be preferred to assignment of shares of taxes as a method of financing of local bodies.

ii. There should be a basic general purpose grant for each local body other than the bigger municipalities and the corporations.

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19. The Committee made some recommendations for sharing taxes for Improvement Trust and Development separately. These are as follows:
    i. Annual contribution of 2 per cent of the annual rateable value from municipal funds;
    ii. Share of the proceeds of the entertainment tax;
    iii. Share of the proceeds of the terminal tax on inland waterways;
    iv. Betterment tax; and
    v. Government grants.

iii. The basic grant should be such that after taking into account its own resources, the local body will have fairly adequate finances for discharging its obligatory and executive functions.

iv. There should in addition be specific grants for particular items and services. These should be conditional on the particular service being maintained at a prescribed level of efficiency and the local body exploiting its own resources to the extent indicated by the Government from time to time.

2. <u>Shared Taxes</u>

(a) Motor vehicle

i. The proceeds from motor vehicles tax. Not less than one-fourth of the proceeds from the motor vehicle tax should be distributed to the local bodies especially municipalities and district boards.

(b) Land revenue

ii. Land revenue should be shared. Not less than 15 per cent of land revenue should be distributed to the village panchayats and rural boards.

III. REPORT OF THE COMMITTEE APPOINTED BY THE CENTRAL COUNCIL OF LOCAL SELF-GOVERNMENT ON AUGMENTATION OF FINANCIAL RESOURCES OF URBAN LOCAL BODIES, 1963 (*ZAKARIA COMMITTEE*)

1. <u>Grants</u>

i. As recommended by the Taxation Enquiry Commission each State should have a grants-in-aid code embodying certain well defined principles, and that there should be a basic general purpose grant for each local body in addition to specific grants for particular items and services.

ii. A more liberal pattern of financial assistance should be adopted for large pilgrim centres, places of tourists' interest, hill towns and towns where due to technical difficulties the cost of water supply schemes is unusually high. In the cases of these local bodies, a minimum contribution by the local body need not be insisted upon and the percentage of grant assistance can be increased according to the circumstances of each case.

iii. For development activities such as public health measures, parks and gardens, sports stadia, theatres, libraries, swimming pools, grants may be given to the extent of 25 per cent.

iv. To cover the increased administrative costs over payment of increased salaries, cost of living allowance, etc., at least 50 per cent grant should be given.

2. Shared Taxes

(a) Entertainment tax

i. To begin with at least 25 per cent of the proceeds of the entertainment tax should be earmarked for the urban local bodies and this percentage should be gradually raised so that ultimately the entire proceeds of this tax are assigned to the urban local bodies. The entire proceeds of any surcharge that is being levied on the entertainment tax should be straightway handed over to the local bodies. The theatre tax and the show tax could be administered by the local bodies themselves but in cases where these taxes are levied by the States, their proceeds should be earmarked for the local bodies. The proceeds of the entertainment and other allied taxes need not necessarily be distributed on the basis of population or the source from which the tax originated. The State government should have the discretion to distribute it on the basis of needs of different categories of local bodies.

(b) **Motor vehicle tax**

ii. At least 25 per cent of the proceeds of the motor vehicles tax should be earmarked for local bodies and a formula should be evolved to distribute the proceeds to the different local bodies on the basis of population, mileage of roads maintained by them, volume of traffic, etc.

IV. REPORT OF THE RURAL URBAN RELATIONSHIP COMMITTEE, 1966 (Ministry of Health and Family Planning, Delhi)

1. Grants

i. In making grants, it must be ensured that local bodies are compelled to exploit their own resources to the maximum. The grants-in-aid should thus be linked to the standard of minimum services which must be maintained by each class of local body. To provide proper inducement to the local bodies to tap their own resources of revenue to the maximum, the principles of matching grants should be fully exploited. The system of grants should aim at improving municipal amenities and services in the field of health, education, improvement of roads and communications, purchase of equipment for sanitary public works, anti-epidemic measures, fire fighting and arrangements for removal and disposal of town refuse and night soil. The Committee recommends the widest possible use of a system of specific grants to achieve these ends. Whenever such general purposes grants are given, they should be linked with the performance of local bodies in raising their own resources.

ii. The provisions for capital grants for water supply and sewerage projects in the State budgets were often meager and the progress of water supply and sewerage schemes in the urban areas was actually hindered as the local bodies put off the works till such time as grants are made available. It would be better to convert a portion of the loan granted for these schemes into subsidies.

iii. The local bodies should know well in advance the quantum of grants-in-aid which will be made available to them, so that they can plan their expenditure accordingly. The Committee's proposal for the appointment of the Municipal Finance Commission would help the State governments to formulate principles and determine the quantum of grants for a period of five years.

2. <u>Shared Taxes</u>

(a) Motor vehicle tax

i. 25 per cent of the receipts from motor vehicles tax should be allocated to the local bodies.

(b) Entertainment tax

ii. The entertainment tax is essentially local in character, being paid by the local residents and its proceeds should be made over to the local authorities after the deduction of collection charges in cases when collections are made by the State government.

(c) Fines

i. The entire receipts from fines in the cases for the breach of municipal laws as well as in prosecutions under State and Union laws administered by local authorities (such as the Prevention of Food Adulteration Act) should be paid as grants to the municipal bodies after making a deduction of 5 per cent as administration costs.

V. THE STUDY GROUP ON RESOURCES URBANISATION OF URBAN LOCAL BODIES OF MUNICIPAL CORPORATIONS, GOVERNMENT OF INDIA, (Ministry of Works and Housing), 1980

1. <u>Grants</u>

i. The obligations of the State government should be clearly defined for providing assistance to local bodies for carrying out functions devolving from national policies. The distribution of earmarked assistance amongst local-bodies should also be on the basis of well-defined guidelines.

B. COMMITTEES/COMMISSIONS AT STATE LEVEL

I. MUNICIPAL FINANCE AND FINANCIAL ADMINISTRATION, GOVT. OF ANDHRA PRADESH (Report of the High Powered Committee), 1971

1. <u>Grants</u>

i. Basic grant of Rs 6 per head of population be given by the State government to each of the municipalities every year to fill the gaps in resources.

ii. Anti-mosquito, anti-filariasis, anti-malaria grants be paid on the certificate of the Director of Medical and Health Services.

iii. Maternity and Child Welfare Centres - Grant be fixed on the average expenditure incurred on such centres and paid promptly.

iv. Family Planning Grants - salaries to staff be paid direct by the Director of Medical and Health Services.

v. Relief for drought or flood affected municipalities be given by the State government as in the case of rural areas.

2. Shared Taxes

(a) Motor vehicle tax

i. Large share from the proceeds of motor vehicle tax be given to the corporation.

(b) State excise duty

i. Per cent share from Abkari revenue and licence fees from wine shops from the city be given to the corporation.

3. Surcharge on Sales Tax

i. Levy of a surcharge of 5 per cent on sales tax collected within corporation limits is recommended - the proceeds to be given to the corporation.

4. State Electricity Duty

i. Levy of duty of 10 per cent on sales of electricity energy made over to the corporation.

II. REPORT OF THE TAXATION ENQUIRY AND RESOURCE COMMITTEE, GOVT. OF PUNJAB, 1971

1. Grants

i. Massive grants to local bodies for their developmental programmes are not proper. The municipal committees should become more economically oriented so that they are able to recover the cost of providing various services to the residents. The municipal committees can obtain loans for this purpose from the Government or through any institution like the Finance Corporation which can be set up with the Government assistance for financing such schemes of different municipal committees in the State.

III. REPORT OF THE MUNICIPAL FINANCE COMMISSION, *GOVT. OF MAHARASHTRA*, 1974

1. Grants

i. The State government should make a statutory provision to give its present system of grant-in-aid the status of a grant-in-aid code.

2. Shared Taxes

(a) Entertainment tax

i. Entertainment tax is a local tax in character and the local bodies should be given a share in it.

(b) Motor vehicle tax

i. 25 per cent of net collections of motor vehicles tax should be distributed to municipal bodies.

IV. REPORT OF THE MUNICIPAL FINANCE COMMISSION, 1976 (*GOVT. OF KERALA*)[20]

V. REPORT OF THE GUJARAT TAXATION ENQUIRY COMMISSION, 1980

Shared Taxes

(a) **Motor vehicle tax**

i. The motor vehicles tax should be levied only by the State government. The local bodies should be given suitable grants to cover the cost of construction and maintenance of national and State highways passing through the jurisdiction of the municipal corporations and municipalities.

(b) **Entertainment tax**

i. 50 per cent of the net proceeds of entertainment tax should be shared with local governments

(c) **Profession tax**

i. The net proceeds of the profession tax should be shared by the State government with municipal corporation and municipalities.

20. No recommendations on grants and sharing taxes.

VI. REPORT OF THE MUNICIPAL FINANCE ENQUIRY COMMITTEE, *GOVT. OF TAMIL NADU*, 1980

1. <u>Grants</u>

i. 50 per cent maternity grant and 75 per cent of maintenance expenditure on high schools be paid.

2. <u>Shared Taxes</u>

(a) Entertainment tax

i. The entire collection of entertainment tax and surcharge on entertainment tax be apportioned to municipal bodies deducting 5 per cent towards collection charges.

VII. REPORT OF THE *WEST BENGAL* MUNICIPAL FINANCE COMMISSION, 1980

1. <u>Grants</u>

i. The Commission has taken the view that the variety of grants should be reduced to one single deficit grant except a few special grants mentioned below.

Education grant

i. For those municipal bodies which either already run some primary schools or want to run some in this period, the State government should give a specific revenue grant covering all expenses as per the State government's own standard.

ii. All the existing different grants for this purpose from various State departments should be henceforth discontinued.

iii. Some municipal bodies are committed to paying their teachers some extra allowances because of this earlier grants policy. These extra liabilities will not be covered by the education grants.

Other special grants

i. For estimating potential expenditure all existing dearness allowances have to be taken into account. It is, however, not feasible to foresee new dearness allowance obligation. These when they arise, will have to be financed by special grants.

ii. The same consideration applies to revisions of pay-scales.

iii. There may be special functional delegation to the municipal bodies for special services. The choice should depend on the criterion of efficiency mainly. For all such specially delegated functions, special grants will be necessary.

2. **Shared Taxes**

(a) **Entry tax**

i. It is recommended to introduce the Madhya Pradesh type of entry tax. The tax should be administered at the State level.

ii. Pending the introduction of the Madhya Pradesh type of entry tax, the Commission recommends that the net receipts from the 1972 entry taxes be distributed among the different shares in the following manner: CMDA 50 per cent - Calcutta 30 per cent and the other CMD municipal bodies 20 per cent.

iii. The Commission further recommends that the receipts from the 1955 entry taxes be distributed only among the non-CMD municipal bodies.

iv. An alternative to the above two recommendations is to pool the yields of the two sets of taxes and adjusting the shares so as to produce the same results as recommended above.[21]

(b) Motor vehicles tax

i. A part of motor vehicle tax is continued to be distributed among local bodies. The amount distributed was small, around Rs. 2 crore. The Commission recommended doubling of the shares of municipal bodies.

(c) Entertainment tax

i. A half of the net yields of the entertainment tax should be distributed among the municipal bodies. This should also be done on the basis of population.

ii. An alternative to the above will be to permit municipal bodies to impose "surcharges" on entertainment taxes and retain the amount collected. The decision about the total entertainment taxes should be left to the State Government and if surcharges are imposed they should be uniform all over the State.

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21. There are at present two sets of entry taxes in West Bengal: first, the taxes on the entry of a few selected commodities into the Calcutta area imposed under the Act of 1955 (commodities: tea, jute and fruits) and secondly, the wider entry taxes imposed on goods entering the Calcutta Metropolitan Area, under the Act of 1972. The receipts from the 1955 taxes are fully included in the State Government.

3. **Method of Transfers**

1. Estimate Revenue Budget Expenditures at rates of growth of (i) 5 per cent per annum for salary and wages, and (ii) 10 per cent per annum for other expenditures.

2. Estimate own revenue at an assumed rate of growth of 10 per cent.

3. Derive revenue gap for each municipal body.

4. Derive the share State level taxes as follows:

(a) Transfer of Calcutta

i. 30 per cent of net receipt of 1972 Entry Tax

ii. Share of a pool of 50 per cent of net receipts of Entertainment Tax on a population basis (1981).

(b) Transfer of other CMD municipal bodies

i. 20 per cent of net receipts of 1972 Entry Tax on a population basis (1981)

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revenues, while the net receipts from 1972 entry taxes are distributed as follows: CMDA 50 per cent, Calcutta Corporation 25 per cent, other CMD municipal bodies 17 per cent (on a population basis) and all other municipal bodies 8 per cent (also on a population basis).

ii. Share of a pool of 50 per cent of net receipts of Entertainment Tax on a population basis (1981).

(c) **Transfer to other municipalities**

i. Net receipts of the 1955 Entry Tax on a population basis (1981).

ii. Share of a pool of 50 per cent of net receipts of Entertainment Tax on a population basis (1981).

iii. Taking the difference between 3 and 4, and the revenue surplus or net deficit for each municipality.

iv. Carry the surpluses to the concerned municipalities' plan budget and give a revenue grant to the others equivalent to the final revenue deficit so derived.

VIII. *KARNATAKA* TAXATION REVIEW COMMITTEE PART II, REPORT ON LOCAL FINANCE, 1983

1. Grants

i. To enhance development grants to urban local bodies from Rs 200 lakhs to Rs 400 lakhs.

2. Shared Taxes

(a) **Professional tax**

i. 75 per cent of the collection from profession tax be transferred to local bodies on the basis of population.

(b) **Motor vehicle tax**

i. Share 2 per cent of motor vehicle tax collected with urban local bodies.

3. Compensation in lieu of Taxes

i. To continue 10 per cent growth rate for octroi compensation in view of abolition of octroi.

ii. To delink the entry tax to the octroi compensation grants.

IX. TAXATION REVIEW COMMITTEE REPORT, PART I, STATE AND LOCAL TAXES, VOL. II, GOVT. OF *UTTAR PRADESH*

1. Grants

i. It has been recommended to carry out a systematic exercise for computing the requirement of local bodies for bringing the desirable improvement in civic services provided by them, and their revenue. The gap between desirable expenditure and estimated own revenue can be adjudged whether the existing grant-in-aid to them are adequate or need to be raised.

X. REPORT ON URBAN LOCAL BODIES IN *KARNATAKA* STATE, 1986

1. Grants

i. Grant-in-aid is a method of paying subsidy by the Government to the local bodies to improve the services and amenities which are expected to these institutions. After examining the financial position of all these institutions, the Commission recommends the per capita grant of Rs 6.01 crores. The details are as follows:

(a)	Corporations	Rs 2 per capita.
(b)	City Municipalities	Rs 5 per capita.
(c)	Town Municipal Councils and Notified Area Committees	Rs 10 per capita.

It is recommended that total per capita grant should be paid as under:

(a) 50 per cent of the general purpose grant should be paid without any conditions.

(b) The remaining 50 per cent shall be made available to the local bodies subject to improving their own resources.

ii. The urbanisation in the State has placed the local bodies in a tight financial position. Several of the services and amenities are not provided satisfactorily. Therefore, to improve the position, the Commission has recommended a sum of Rs 10 crores as Grant-in-aid per year for the present for providing these amenities.

2. <u>Shared Taxes</u>

(a) Motor vehicles tax

i. 25 per cent of the motor vehicles tax realised should be shared.

(b) Entertainment tax

i. The distinction between Section 3 and 3(A) of the Karnataka Entertainment Tax Act, 1958 may be removed and 90 per cent of the entertainment tax collected under Sec. 3 and 3(A) may be paid not only to the corporations and municipalities but also to municipalities with less than a population of 25,000.

(c) Duty on transfer of immovable properties

i. At present under the Karnataka Municipal Corporations Act, 1976 and Karnataka Municipalities Act, 1956, 2 per cent and 1 per cent surcharge is levied respectively on the stamp duty. This may be uniformly raised to 10 per cent.

(d) Surcharge of sales tax

i. Surcharge of 10 per cent on sales tax may be levied for the benefit of municipalities in addition to the entry tax.

3. <u>Compensation in-lieu of Taxes</u>

i. The octroi has been abolished in the year 1978-79. To compensate for the loss, the Government is paying compensation to improve the loss with 10 per cent increase every year. There are 27 municipalities which are not getting the octroi compensation for the reason that they were not levying octroi at the time of abolition. This Commission recommends that these municipalities also be compensated at the rate of Rs 10 per head, which amounts to Rs. 81,88,920.

ii. The octroi was really a flexible source of income and if this is reintroduced, to a very great extent, the Government will be able to reduce the grants from the general revenue. If, however, the

Government is not agreeable, the Commission recommends to raise octroi compensation to 20 per cent every year.

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STATE GRANTS AND LOCAL FISCAL RESPONSE
(Case Study)

I. Introduction

In countries with strong federal system, the higher level government uses the system of grants as an instrument to monitor the fiscal behaviour of the local governments. In such countries, knowledge about the impact of grant on the fiscal choice helps planners in designing policy for local governments. A major contention about its impact is that whether a rise in grant stimulates local expenditure or replaces local money with state or federal money? In other words whether a rise in grant (under the assumption of balanced budget) encourages or discourages the willingness of local governments to better mobilise revenue from their own resources? In India studies on this issue dealing municipal bodies have not been so far attempted. The reasons may be that (i) the role of urban local bodies in federal set-up is not as important in India as in the developed countries (Bagchi), and (ii) the availability of data on local government is itself a serious problem.

The purpose of the present study is very specific: It is to test the hypothesis whether grants from the higher level government have encouraged or discouraged municipalities to mobilise revenue from local sources. The scheme of this chapter is as follows. This chapter/section consists of four sections (sub-section) including the present one. The second briefly describes the existing system of transfer/grant in various States. The third carries out empirical exercise, and the last section discusses the empirical findings.

II Existing System of Transfer/Grant from States to Local Bodies

There are four modalities of transferring revenue from States to local bodies. (i) **Compensation in Lieu of Taxes**: Many States transfer the revenue to local bodies to compensate the revenue loss from those taxes which were once administered by the local government. For instance, octroi in Madhya Pradesh and Karnataka, which was replaced by entry tax, that is administered at State level. A somewhat similar example is entertainment tax in Andhra Pradesh. **(ii) Shares in State taxes**: In some States, a small portion of revenue from a few taxes, such as motor vehicle tax and entertainment tax which are considered to be local in nature is shared with local Governments on the basis of population. **(iii) Non-Matching Specific Purpose Grant**: Almost all States grant some money to local bodies to perform some specific functions. The purposes for which grants are extended include primary health, elementary education, employees' dearness allowance, road repairs and maintenance, sewerage maintenance etc.. and **(iv) Closed-end Non-Matching Non-specific grant (General Purpose Grant)**: A few States devised a system of general purpose grant. The grant is given as follows: (a) A small portion of the total grant paid in the preceding year is given as an incentive to raise tax effort. For instance, in Gujarat, an incentive grant is worked out taking into account a number of factors, namely, per capita municipal tax and recovery of dues etc., (b) A portion of grant is given on the basis of population in such a way that the relatively rich municipalities receive relatively smaller portion of grant than the relatively poor municipalities, and (iv) **Matching Grants**: Under such kinds of grants, the grantor agrees to reimburse the receiving Government for expenditure undertaken at some predetermined rate. These kinds of grants are reported to prevail in some states such as Maharashtra. In addition, a variant of matching grants, known as specific purpose matching grants too, prevails in some States.

For all practical purposes, four kinds of transfers referred above can be classified in two categories, first, transfer of revenue from certain taxes either some or whole portion of tax collection is transferred, and second grant. The first two kinds of transfers (i and ii) in the previous para belong to the first category[22]. In most States, the first category in contrast to the second (grant) constitutes a smaller portion in the total revenue of

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22. That the line of demarcation between the first two transfers is thin is pointed out in other studies as well. (Banerjee)

municipal bodies (Table A.1). This study concentrates its efforts to examine the effects of grant only.

Before proceeding further, it will be useful to point out that the effects of different grants on fiscal efforts of local government (in terms of size and direction) may be different. The closed-end general purpose grant places no restriction as to how the grant is to be used. This kind of grant may stimulate either increased expenditure or tax reduction. The closed-end specific purpose grant restricts local governments to make expenditure at least not less than the amount of grant on the project for which the grant is meant. If the project is new, then the specific purpose grant is likely to cause a greater rise in the total Local government's expenditure than the equal amount of general purpose grant would have caused. However, in the case of this kind of grant, the substitution is feasible if grant money is more than some bench mark expenditure. The matching grant reduces effectively the price of public goods or services for which grant is given. Thus, its effects on public spending corresponds with the effects of price reduction on price goods. In general matching grants are biased in favour of aided items, and since the Local government has to match some portion of the expenditure its effect on efforts is, therefore, expected to be positive: a rise in expenditure will be more than a percentage rise in grants. However, such kinds of grant produce other kind of distortionary effects. It is argued that the receiving government may suffer due to such distortion, but society as whole might gain (Tresch).

Studying the effects of each kinds of grants separately is more fruitful for policy makers, the data on each kind of grant is, however, not available separately. Thus, we are bound to examine the effects of all kinds of grants together. Besides, it is to be noted that the theory of grant makes no *a priori* predictions about the direction of response of grants. The question whether an increment in grant encourages or discourages local expenditure depends upon the income and price elasticity of local public goods (goods and services provided by local government). Thus, it is an empirical exercise and to ascertain their impacts is what this study plans to do.

III Empirical Exercise

In order to test the hypothesis referred above, two approaches may be employed, one is based on expenditure response and the other on tax response. Both seek to address the same question. Equations for tax/expenditure on public services are derived using utility maximizing approach. The approach has some advantages over ad-hoc specification by putting forward a few testable restrictions. The approach is very simple. Local governments incur expenditure (E) to provide their citizens some public services (Q)[23]. To finance expenditure, they raise revenue from tax and non-tax sources. Besides, they receive funds from State governments such as grant and a share in a few State taxes. In order to simplify the analysis (mainly due to data problem), we consider two groups of revenue sources, grant (G) and other than grant (R). The latter consists of tax and non-tax revenue. Such grouping entails to see the impact of grants on both tax and non-tax revenue combined. Although the aim is to see the effects of grants on tax efforts only, combining of tax and non-tax may not weaken the analysis since the impacts of grants on non-tax revenue may be anticipated to correspond with those on tax revenue. Recently a study on State resources (Rao and Mundle 1991) points out that a high growth of subsidies which is some kind of grant may be the reason for low recovery rate (non-tax resource) in many expenditure heads in States.

The budget constraint for local governments (taking into account the fact that by and large they are required to balance their expenditure with their total receipt) may be specified as **Expenditure(E) = Grant(G) + other than Grant(R) or $PQ_a = G + R$**: where P_a represents average cost (price) per unit of public services, and Q_a, the amount of total public services and goods. Welfare of the citizens of local areas depends on the amount they consume of local public goods and services (Q_a), and of goods and services other than local goods and services (Q_b)[24]. The variable, (Q_b), can be

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23. In this study the analysis is made for total expenditure. This might have been more fruitful if it were made for each major service separately. This was not feasible due to data problem.

approximated by income (UI) net of local taxes and non-taxes paid by citizens (UI-R). In notations the utility function (U) for a representative citizen can be expressed as $U = U(Q_a,(UI-R))$ and the budget constraint as $E + (UI-R) = (UI-R) + R + G$. Using optimization technique (See Appendix), the following stochastic equations can be derived:

$$E = a_0 + aUI + aG + d_{1i}D_i + u \qquad 1$$

$$R = b_0 + (1-b)UI - bG + d_{2i}D_i + v \qquad 2$$

In the first model, grants[25] are considered to be stimulative or substitutive if a > or < 1. If a = 0, then substitution is complete. Under the second model grants are stimulative or substitutive if b < or > 0. The model also implies that coefficients in both models can be estimated by computing either of the equations (For detail see Appendix). Besides, the model puts forward thr e testab e hypotheses. First, the coefficients of UI in both equations should be same. Second, the coefficients of UI minus coefficient of G in Equation 2 [(1-b)-(-b)] equals to one. Last, the coefficients of UI and G in Equation 1 should be the same that is, a rise in income and grant have the same impact on expenditure. It is worthwhile to point out at the same coefficients of both variables in Equation-1 do not imply that the model does not not capture the price effect if any caused by the increment in grant. If the first hypothesis get rejected, for instance, the size of coefficient of

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24. An important assumption is involved in the approach. A rise in public services as a result of an increment in grant generates redistributional effects. The approach employed here assumes that the grant does not exert such effects.

25. In both models the grant is assumed to be exogenous variable. The grant is considered to be endogenous if it depends on some formula which depends on certain economic variables such as per capita and population of municipality. If it is so, then the estimates of the coefficients of equations will be biased. The problem get further aggravated if such economic variables are part of the equation for expenditure or tax. Thus, one must take into account this fact while interpreting the coefficients

grant is greater than that of income, then it implies that the grant variable consists of price effects[26] (For detail see Oates: He has shown that general purpose unconditional grants have price effects).

IV EMPIRICAL RESULTS

At the outset it is necessary to point out coverage of time period and data in this study. The study is carried for the period from 1976-77 to 84-85. The reason for this time period is that data on the variables used in the model are available for this period only. Besides, these data are readily available for four States only, Haryana, Maharashtra, Rajasthan and Orissa[27]. Thus, the study uses the data relating to these four states only. The study is conducted at the State level data instead of at municipal level data mainly because the data on income (or proxy for income) are not available for each municipality separately[28]. Besides, it is to be pointed out that data on urban income are not available. These are derived by subtracting from State domestic products the agricultural and mineral sector income. The urban income thus derived does not truly represent the income for municipal area as the urban income data consist of those income, generated in municipal corporations as. Besides, some part of value addition in agriculture sector may be generated in municipal areas, these urban income data, however, do not include such income. However, in the absence of any other suitable indicator, urban income derived from State domestic product is the best indicator for municipal income.

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26. The models will, of course, not reveal the price effect if the restriction (the coefficients of urban income and grant are the same) is introduced to compute the model.

27. For two States a little longer time series is available. However, for all four states, data are available only for the time period taken in this study.

28. The data are compiled from the various issues of State Statistical Abstracts of the four States. The abstracts cover almost all municipalities to prepare the data set at state level.

Descriptive Statistics

During the period from 1976-77 to 84-85, municipal expenditure as percentage of urban income in all States combined is fairly stable: It varied from 1.07 to 1.30 per cent in the period of nine years[29] (Table A.2). During the same period, municipalities in all the States combined managed 1/4 of their expenditure with the help of grant money (Table A.2). Unlike the share of expenditure in urban income, the share of grants in expenditure registered a marginal rise from 23 to 28 per cent (last column in Table A.2 and Figure 2). Does this trend imply on an average a rise in dependence of municipalities on the higher level Governments or in other words does it indicate that raised expenditure of Municipal governments is mainly met out of grants?

Among individual States, a remarkable similarity can be noted in the trend in municipal expenditure (taken as percentage of urban income). It increased marginally up to 1981-82 and thereafter started declining (Figure 1). On the other hands trends in the share of grants differs from one state to another. The trend in grant-share has shown a marginal rise in Haryana and Maharashtra, while remained almost constant in Orissa but declined substantially in Rajasthan. This indicates that dependence of municipalities on grant money in Rajasthan is likely to have come down.

Regression Results

The results are presented in Table A.3. The results fairly support the restrictions embodied in the model. The discussion on regression results and three hypotheses stated earlier are presented in Appendix to this Chapter. In this section we just report our inferences drawn from the regression results.

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29. This is corroborated by the regression results as well (Table 3): The coefficient of urban income in the first equations is around one indicating that a percent rise in expenditure as a result of a per cent increment in urban income does not exert the change in expenditure-income ratio in the period of the study.

From the regression results and discussion on these results, the following conclusions can be drawn.

First, a rise in State grants does not appear to stimulate the municipal expenditure in four States combined, or in simple words urban local bodies might be replacing local revenue with grant money and thereby rendering relief to local residents[30]. Second, the above inference is supported by the results of Equation 2. The negative and significant coefficient of grant in Equation 2 shows that a percentage rise in State grant replaces 0.22 percent local revenue. Last, a percentage rise in urban income causes an equal percentage increment in municipal own revenue and consequently an equal percentage increment in municipal expenditure.

It is necessary to point out the limitations in the exercise: (i) the inferences drawn in this exercise shows the average behaviour of local government: it is possible that the behaviour of individual municipalities do not follow the average trend; (ii) the study does not make the distinction between different kinds of grants; and (iii) the results are subject to data limitation.

V CONCLUSIONS

A major finding for which the whole exercise is carried out is that grants in four major States induce urban local bodies <u>not</u> to tap the potential of their own resources, rather such grants tend to induce the local bodies to give relief to local residents by replacing local money with state money. On an average descriptive statistics also suggest the same finding: see Figures 1

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30. The zero coefficient of grant in Equation 1 narrows down our inference that <u>the substitution of local revenue by State money can be thought of complete</u>. However, this is not fully supported by the value of the coefficient of grant in Equation 2 since if substitution is complete, then the value of grant in Equation 2 should have been -1.

and 2, grant-expenditure has marginally risen, while the expenditure-income ratio has remained constant in the period of the study[31]. It is worthwhile to point out that this conclusion is contrary to that drawn in the study by Nath and Purohit (1990). They attempted to examine the same issue with respect to municipal corporations. They found that "the fear that grants (non-matching) in the hands of local government are generally instruments of extending relief to taxpayers seems to be unfounded". The contrary conclusion

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31. This finding puts forth that the present system of transferring resources from State governments to municipalities is not satisfactory if the major objective of the State government is to persuade local government to exploit the local resources optimally. Thus, a scheme of grant-in aid should be designed in such a way that aided-money can not be utilized to provide fiscal relief to local residents. Although the possibility of extending such relief is, to some extent, possible in the case of majority of grants, the possibility is low in the case of conditional grants. Conditional grants also serve another purpose, that is, accountability of the aided-money: if the State government authorizes Rs 1 lakh of aid to a municipality for education expenditure, then the Government knows that Rs 1 lakh is being spent on education. If the State government simply gives Rs 1 lakh unconditionally, the money could be spent on anything and perhaps foolishly. The <u>accountability</u> is given to be the major reason why in the USA the vast majority of grants are conditional and closed-end plus either matching or non-matching.

    It is, however, feared that a scheme of grant-in-aid based on fiscal effort criteria may not be suitable in the case of those municipalities where local revenue sources are draining off due to shifting of bases of revenue therefrom: A few studies have reported, for instance, urbanization and/or volume of properties (in value terms) in some municipalities relative to others have not raised, even have declined in some other municipalities over the years. In such a case how the grant to the municipalities can be attached with the performance of their fiscal efforts. Such a argument against the scheme of grant based on fiscal efforts depends on the nature of conditions :in majority of conditional grants such argument does not seem to be plausible since the measure (index) of fiscal efforts is conceptually based on the potential sources of municipalities, and the measure is calculated for given resource. Thus, if revenue sources are draining off from a particular municipality, then this should be captured in the measure of fiscal efforts. In the case of matching grants where receiving government has to share some portion of expenditure irrespective of their fiscal capacity, such argument has some weight. Such municipalities, of course, need some special attention. The attention should be paid on incorporating draining-off aspect of resources in the conditions of a grant scheme instead of giving away conditions from the formula of the grant.

suggests the need for further investigation in this issue of local fiscal response to State grant[32].

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32. It is very important to check to whether the results in both studies are robust to model specification since both studies use different model specifications. The current study employs utility maximization approach, while other study uses partial adjustment approach. It will be useful to briefly describe the procedure followed in Nath and Purohit's Study:

    They performed the regression equation for 11 states (one equation for all municipal corporations combined in each selected State). The equation has expenditure in the current period as the dependent variable and the expenditure with one period lag as an explanatory variable among other explanatory variables, such as grant and urban income. They estimated the equation in simple linear form and in log linear form. Further they estimated the equation with grant and without grant. They estimated total 44 equations and thereby obtained 44 estimates of coefficient of lagged expenditure, that is, 4 equations for each State. Their inference that grants do not appear to be used as providing tax relief to local resident depends on the value of adjustment parameter - coefficient of lagged expenditure minus one. It is to be noted that of 44 estimates of the parameter, 23 are not significant, their inference is being generalized on the basis of 47 percent of estimates favourable to this inference.

FIGURE 1

Expenditure As % of Urban Income

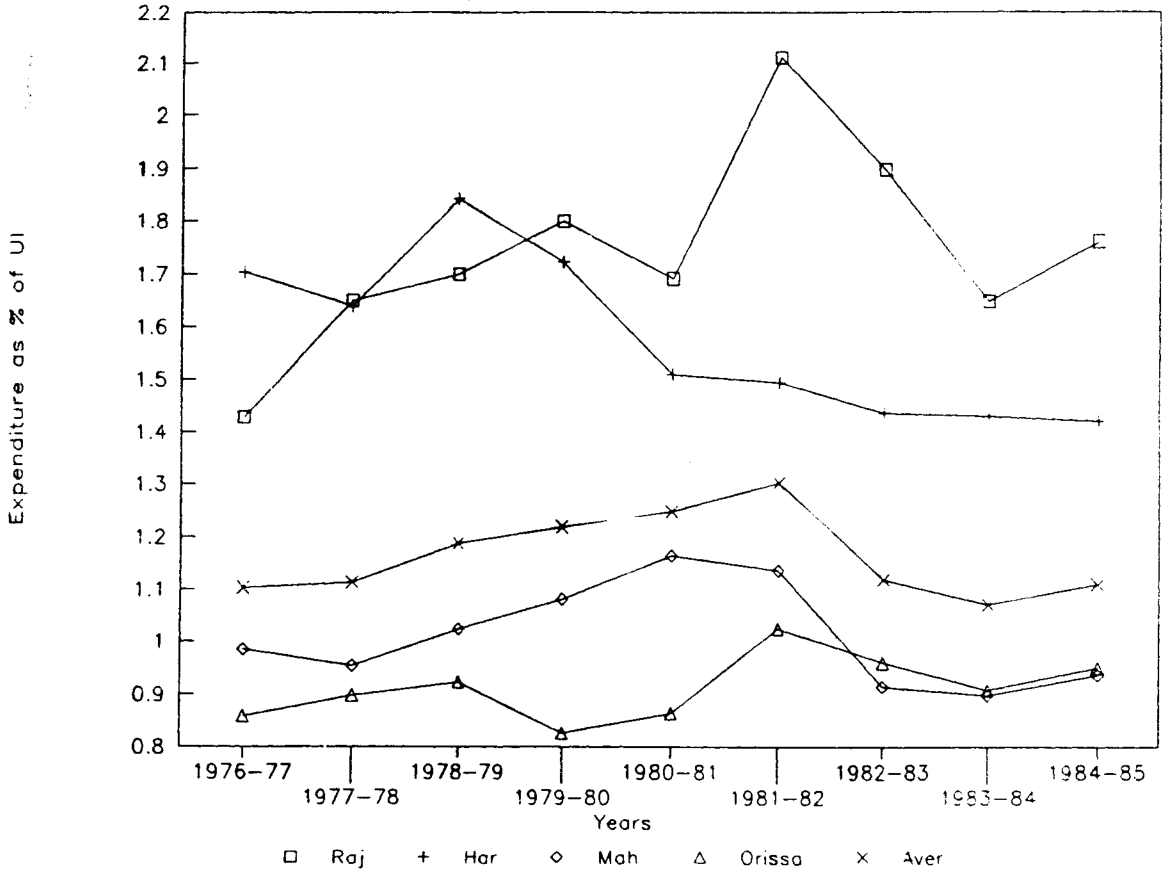
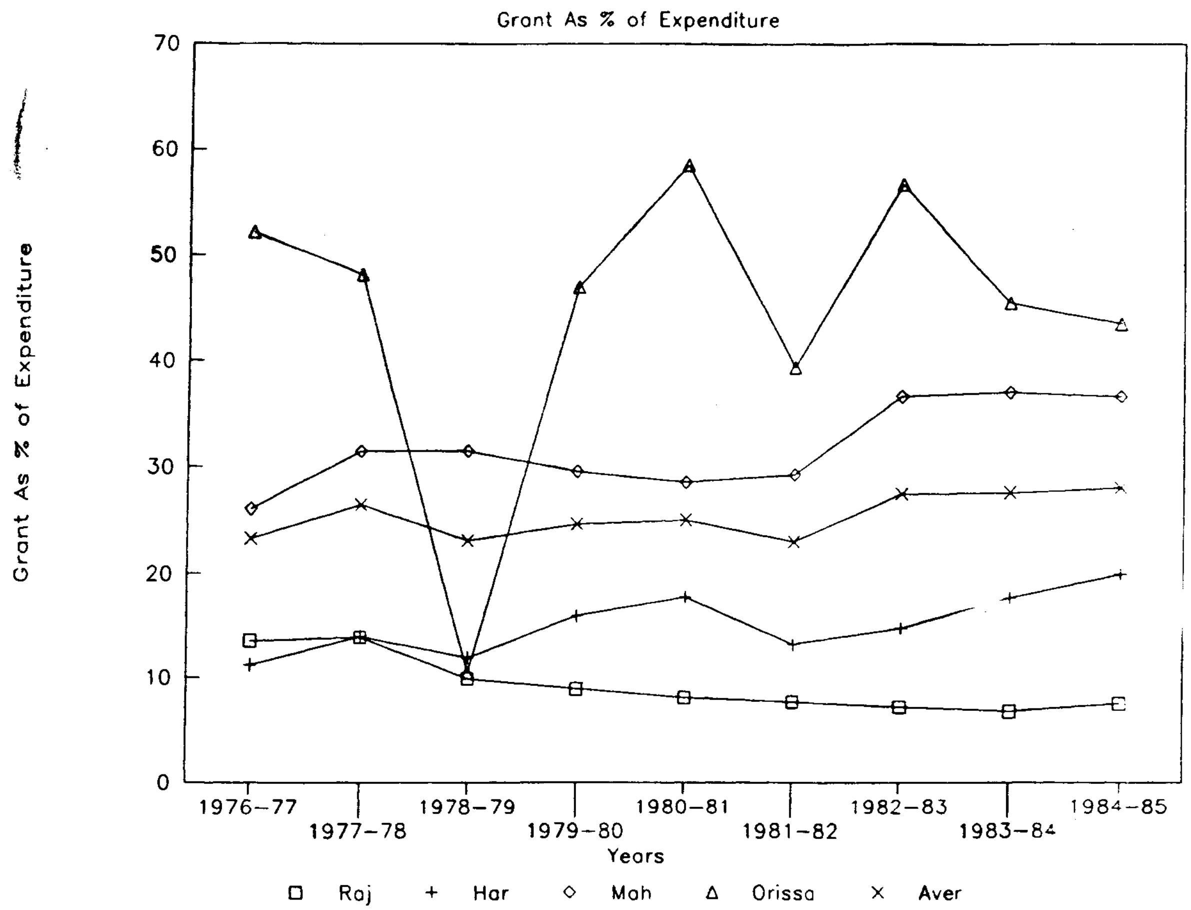


FIGURE 2



Grant As % of Expenditure
70
60
50
40
30
20
10
0
Grant As % of Expenditure
1976–77
1977–78
1978–79
1979–80
1980–81
1981–82
1982–83
1983–84
1984–85
Years
Raj
Har
Mah
Orissa
Aver

Table A.1

Transfer of Revenue From States to Municipal Bodies in Some Major States (1986-87)

(percentage)

States	Transferred Revenue				Total Revenue
	Grants	Shared Taxes	Others	Total	
Andhra Pradesh	27	11	12	50	100
Gujarat*	14	4	7	25	100
Karnataka	3	8	14	25	100
Kerala	6	11	-	17	100
Madhya Pradesh	23	2	19	44	100
Maharashtra*	16	5	12	33	100
Orissa*	24	-	12	36	100
Rajasthan*	7	-	7	14	100
Tamil Nadu	9	29	2	40	100
Uttar Pradesh*	28	1	9	38	100
West Bengal	34	29	-	63	100

Note: Octroi collecting States

Source: Banerjee (1991)

Table A.2

Expenditure as % of Urban Income and Grant as % of Expenditure

(%)

Year	Expenditure					Grants				
	Har	Maha	Oris	Raj	Average	Har	Mah	Orissa	Raj	Average
1976-77	1.70	0.98	0.86	1.43	1.10	11.21	26.01	52.16	13.56	23.26
1977-78	1.64	0.95	0.90	1.65	1.11	13.94	31.48	48.21	13.90	26.43
1978-79	1.84	1.02	0.92	1.70	1.19	11.91	31.49	10.48	9.90	23.07
1979-80	1.72	1.08	0.83	1.80	1.22	15.96	29.56	46.98	8.91	24.60
1980-81	1.51	1.16	0.86	1.69	1.25	17.76	28.55	58.64	8.10	25.05
1981-82	1.50	1.14	1.03	2.11	1.30	13.22	29.29	39.35	7.67	23.01
1982-83	1.44	0.91	0.96	1.90	1.12	14.80	36.60	56.75	7.19	27.50
1983-84	1.43	0.90	0.91	1.65	1.07	17.72	37.01	45.51	6.76	27.57
1984-85	1.42	0.94	0.95	1.76	1.11	19.93	36.58	43.47	7.46	27.98
Average	1.26	0.33	0.92	1.47	1.03	15.79	26.56	45.07	8.46	25.72

Table A.3

Regression Results

Explanatory variables	Expenditure (E)	Revenue (R)
Urban income (UI)	0.9920	1.0627
	(11.8910)	(8.1849)
Grants (G)	-0.0293	-0.2162
	(-0.5159)	(-2.4429)
D_1	0.6329	0.5148
	(8.8885)	(4.6445)
D_2	0.5680	0.4642
	(7.4444)	(3.9096)
D_3	0.1442	0.0937
	(1.6464)	(0.6870)
Constant	-2.2666	-2.2671
R^2 bar	0.9802	0.9431
F(1,33)	-	1.8671*
t	0.8479**	1.3664*

Notes: Figures in parentheses are t-statistics. * These tests are carried out to check the hypothesis **(1-b)+b** = 1. **This test is to assay the equality of coefficients of Urban income (UI) in Equations 1 and 2.

The dependent variables (E and R) and explantory variables (UI and G) are in per capita term.

APPENDIX

Derivation of Equations 1 and 2 and Discussion of Regression Results

For deriving the two equations in the text, the Stone-Greary form of utility function(U) is assumed. The function can be written as:

$$U = (Q_a - r_a)^a (UI - R - r_b)^b$$

Where $a+b = 1$, r_a and r_b represent the committed expenditure of public expenditure and other than public expenditure, respectively. The budget constraint shown in the text is: $P_aQ_a = G + R$. The langrangian expression (L) for the optimization can be written as

$$L = (Q_a - r_a)^a (UI - R - r_b)^{1-a} + \lambda(P_aQ_a - G - R)$$

Where λ is a langrangian multiplier. Differentiating the above expression with respect to Q_a, R and λ yields

$$Q_a: \quad a(Q_a - r_a)^{a-1}(UI - R - r_b)^{1-a} + \lambda P_a = 0$$
$$R: \quad (-1)(1-a)(Q_a - r_a)^a (UI - R - r_b)^{-a} - \lambda = 0$$
$$\lambda: \quad P_aQ_a - G - R = 0$$

Solving these equations for Q_a and R gives

$$E = aUI + aG + [(1-a)r_aP_a + ar_b]$$
$$E = (1-b)UI - bG + [br_aP_a + (b-1)r_b]$$

The expression within the brackets represent the sum of committed public and other than public expenditure weighted by elasticities thereof. This amount may be State-specific, varying from one State to another. This may be thought of depending on the socio-economic conditions of the regions. In this simple model, it may well be represented with the help of dummy variable in panel data-time series and cross section data (D: one dummy for each State). Thus, the above two equations can be rewritten as

$$E = aUI + aG + d_{1i}D_i + u \qquad \text{(i)}$$

$$R = (1-b)UI - bG + d_{2i}D_i + v \qquad \text{(ii)}$$

u and v, stochastic terms, are incorporated to make the equation estimable. The relationship in both equations show that coefficients in both equations can be estimated using either of the equations: In the first model, grants are considered to be stimulative if $a > 1$. This ($a > 1$) ensures the positive sign of coefficient of grants in the second model since $-b$ in the second equation is $a-1$. That is, an inference derived from the first equation can also be derived from the second equation. Similarly grants are considered to be substitutive if $a < 1$. This implies the negative sign of the coefficient of grants in the second equation.

Regression Results

Equations 1 and 2 are estimated employing the technique known as 'within estimator' in the literature on panel data[33]. The data used in estimation procedure are in log form. Thus the coefficients of explanatory variables can be directly interpreted as elasticities. The results are presented in Table a.3.

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33. It is to be pointed that grant is considered as exogenous variable in both models. This may not be implausible as the determination of grant amount does not appear in the decision making process of the local government. On some other grounds it might not be considered as exogenous since the amount of grant generally depends on some formula comprising population and income as base. While carrying out the empirical exercise, these problems have to be kept in mind.

Both regression equations fit well considering the high value of R^2-bar. The coefficients of the explanatory variables in both equations are significant except the coefficient of grant in Equation 1. The results fairly support the the restrictions embodied in the model. The first hypothesis considers the equality between the coefficients of urban income in both equations. The estimated values of t-statistics (0.7970 in Equation 2 and 1.2422 in Equation 1 - not shown in Table a.2) confirm the null hypothesis that there is no significant difference between both coefficients. Similarly the estimated value of F-statistics supports the second hypothesis also - the coefficients of urban income (UI) and grant (G) sum to one in Equation 2. However, the third hypothesis which seeks the equality between the coefficients of UI and G in Equation 1 is not supported. Surprisingly the sign of grant in that equation is negative. The sign is unexpected. The negative sign of grant in the second equation is not unexpected since the model specification anticipates that the negative sign of grant in Equation 1 should lead to a negative sign of grant in Equation 2 but expects the value thereof should be < -1[34], while it is -.2185, that is > -1. The negative sign of grant in Equation 1 may indicate that a rise in grant tends to bring a decline in municipal expenditure. It is, however, to be noticed that coefficient of grant in Equation 1 is, as stated earlier, not significantly different from 0. This suggests that grant does not have impact on expenditure or in technical terms it perfectly substitutes the local money with State money . The negative and significant sign of grant in Equation 2 unambiguously indicates that a rise in grant leads to a decline in municipal own revenue. According to a restriction in the model, [a-1 = b], the zero coefficient of grant in Equation 1 should result in -1 value of coefficient of grant in Equation 2, and this would have indicated that grant perfectly replaces the local money. However, value of coefficient of grant in

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34. The coefficient, -b, in Equation 2 can be translated as a-1 from the restriction a+b=1. Substituting the estimated value of a from Equation 1 leads to the value of -b lower than -1.

Equation 2 is -.22 implying that a percent rise in grant replaces 1/4 percent of local money. Although regression results do not perfectly support the restriction underlying the model, one can at least safely infer that grants do not appear to stimulate tax effort of urban local bodies and expenditure thereof.

Over all, three conclusions can be drawn from the above discussion. First, a rise in State grants does not appear to stimulate the municipal expenditure in four States. Or in other words urban local bodies might be replacing local revenue with grant money and thereby rendering relief to local residents. Second, the above inference is supported by the results of Equation 2. The negative and significant coefficient of grant in Equation 2 shows that 100 percentage rise in State grant replaces 22 percent local revenue. Last, a percentage rise in urban income causes an equal percentage increment in municipal own revenue and consequently an equal percentage increment in municipal expenditure.

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