

## METHODOLOGY OF THE REPORT

1B.1 The Finance Commission's approach in preparing its report has been guided by the mandate given to it in the terms of reference by the Ministry of Home Affairs. The Commission was slightly handicapped by the paucity of staff and also the fact that the report had to be submitted by the 31st of October 2009.

1B.2 The Commission went about its task with alacrity and followed a methodical and logical course of action. In the initial stage, a questionnaire was sent to all the concerned Union Territories covering a gamut of fiscal and budgetary issues including fiscal decentralizations. Information from the UTs regarding their budgets, plan documents, devolution under the Panchayati Raj institutions, tax and non-tax revenue receipts were also obtained. This data was then analysed by the Commission.

1B.3 In the next stage, the Commission visited all the Union Territories and had a series of meeting with all the stakeholders. Meetings were scheduled with the senior officers in the UT administration, including heads of departments, as well as with the elected members of Municipality and Panchayati Raj institutions. Meeting were held with members of commercial bodies and important public representatives. In these meetings the officers and the leaders of local bodies gave presentations regarding the work undertaken by them. Discussions were also held with the Administrators of the UTs and also the Members of Parliament representing these UTs. Field visits were also organised by the UT administration showing the development work undertaken by the UT administrations, Panchayati Raj Institutions and Municipal bodies. This gave the Commission a feel of the ground level functioning of the local self government bodies, the bureaucratic machinery as well as a chance to interact with the people of the area.

1B.4 There are numerous approaches to decide on the distribution of resources between the UTs and their Panchayats and Municipalities. One of them is the normative approach. In this case an estimate is made of the level and services to be provided and the resources required for that. Though fixing various norms and standards is a complex task, attempts have been made in the past to fix base level standards. It is normally considered that urban and perhaps the rural local-self-government bodies should cater to providing water supply, sanitation and sewerage and solid waste collection and disposal, primary education and primary health. However, fixing norms and standards for these basic services is fraught with

complexities and is beyond the scope of expertise of this Finance Commission. They depend on a host of variables like the fiscal status of the institution, the location where the facilities are to be provided and the stage of development of the locality etc. Needless to say this requires the services of an expert body. The Planning Board of UTs with experts drawn in from specific fields can look into the matter and with the help of expert bodies prepare some kind of road map for providing these services and can build into the estimates of expenditures of the UT budget and subsequent devolution to local bodies. Then the services of funds will have to be located and subsequently the funds for maintaining these assets. Transfer of funds to the local bodies will need to be based on achieving horizontal and vertical equity for giving the desired satisfaction level for these services. Moreover, the local resources being very scanty, it would be impossible for the local bodies to find huge amounts of funds to provide for these core services. The concept of user charges has little meaning in most of these far flung territories. The Government has to bear the bulk of the cost. Since it will degenerate into a theoretical exercise this approach has not been selected by the Finance Commission.

1B.5 It was also deliberated upon whether a "tax wise" approach should be the basis of division of revenue between the UT and local bodies. This will help in identifying which tax proceeds fall under the purview of the local government and which should be retained by the UT administration. This will eventually help in evolving strong Panchayats and Municipalities and pave the way for democratic decentralisation. However, this approach given the ground realities of these small and far flung UTs will not be practical given the rather skeletal set up of most of the PRIs. It will only create confusion regarding which tax proceeds are to be shared with the local bodies.

1B.6 Another method would be to recommend a flat share of the UT's total tax collection. This approach had been suggested by the Second Finance Commission. It recommended a flat share of 10% of the tax proceeds to the local self government bodies. This is a very practical approach and it has the merit of simplicity. Given the level of devolution already having taken place, the share can be incrementally stepped up. The Third Finance Commission, based on the analysis of the past data on the finances of the local bodies and the respective UT administrations, tried to arrive at a quantum of resources as a share in total UT Budget to be devolved to local bodies.

1B.7 In preparing its report the Commission was also guided by the reports of the two earlier Finance Commissions. Stock was taken of the recommendation of these Commissions and the progress made on the ground by the Union Territory administration. The Finance Commission thus approached the subject of fiscal and administrative devolution to the local self-government on the basis of work being done at the UT level and seeks to take it to its logical conclusion. The Panchayati Raj institutions are supposed to have impact on the daily life of the villagers by strengthening democratic functioning at the grass roots level. The citizens must have a say in the processes of local governance and also get services for the taxes they pay.

1B.8 Revenue collection by the PRIs is very insignificant in all the UTs studied by the Finance Commission. Most of the taxes are difficult to collect, politically not very popular and yield low revenue. The most important tax at the local level is house tax. The PRIs have also not evolved any mechanisms to enhance their tax base by additional revenue mobilisation. However, despite various practical tax proposals suggested by earlier Finance Commissions they do not have a large potential scope of taxation as the geographical area and population is rather small. Few people are having taxable assets and overall taxable capacity is very low. The Panchayats also do not have adequate staff for revenue assessment and collection. The UT governments also exercise too much bureaucratic control for these village Panchayats to function effectively. The local elected leaders also do not like to exercise coercive powers to collect taxes as such moves make them unpopular. This leads to not levying of taxes or there is gross underassessment of taxes. Hence, in practice the collections are very low and the PRIs especially the village Panchayats are totally dependent on the UT administration for grants-in-aid for running their institutions. This leads to a very weak and fragile fiscal set-up at the Panchayat level with abysmally low level of fiscal autonomy.

1B.9 Grants-in-aid contribute to the bulk of the resources of the local bodies. The figures vary in each UT. This does not lead to a strong and functional local self government. Funds are also needed for maintenance of existing assets and these are also not forthcoming.

1B.10 Raising resources through other sources like from the private sector, market borrowings etc are also not possible especially in the far flung island territories where even the local UT administration is hamstrung in raising resources and the Central Government finances almost the entire administrative and developmental expenditure, though it varies across UTs. In these places both the UT administration and the local self-government Institutions are mostly dependent on injection of funds from the central Government and the UT administration respectively.

1B.11 Most of the recommendations of the 1<sup>st</sup> and 2<sup>nd</sup> Finance Commission have been accepted by the Home Ministry and the UT administration have been told to implement them. However, in many cases operationalisation of these recommendations is still tardy and leaves a lot to be desired.

1B.12 Grants play a vital role in the functioning of local govts in these UTs. Fund transfer are supposed to fill in the gap caused by lack of own resources. Hence, its aim is to provide better services. Moreover, there is no coherent system of transfer. It has made both the Panchayats and Municipalities dependent on the UT administration.

1B.13 The transfer of funds should encourage efficiency in the utilisation of resources given to the local bodies. These must be predictable in nature and based on complete understanding of the ground rules on both the side of the UT administration and the Municipalities and the Panchayats. The aim should be that of meeting the vertical and horizontal gaps in the finances of the local bodies. The objective of this exercise of transfer should be that the local bodies discharge their obligatory functions at a satisfactory level without compromising the objective of fiscal decentralization. In order for the local bodies to perform their duties, grants-in-aid by the UT government has to be combination of (a) specific grants (b) General purpose grant and (c) incentive grants.

1B.14 Specific grants could be for upgrading specific services by the local bodies. General purpose grant could be based on the size of the population, the remoteness of the area and other factors representing cost and fiscal diabilities of individual local bodies. Incentive Grants could be for streamlining the operations of the local bodies either along with the general purpose grants or tied up with a specific purpose to deliver their mandatory functions.

1B.15 As mentioned earlier, a system of devolution of specific share of the UT expenditure as grants could be introduced as one way of bolstering the revenues of the local bodies and their fiscal autonomy. This will help in providing autonomy to the local governments and also an assured and predictable source of funds to plan out their services efficiently and effectively. As mentioned earlier in this chapter, the ground level inconveniences will have to be negotiated carefully.

- a. Thus, the rationale for transfers is to offset fiscal disadvantage and cost disabilities across various constituent units to ensure certain minimum levels of public services with substantial benefit spillovers. Hence, general-purpose transfer of funds in the form of unconditional grants is recommended, as well as specific purpose matching transfers from the UT government is recommended for specific schemes.

1B.16 The fiscal capacities differ across various Union Territories because of the differences in their revenue bases and the differences in the unit costs of providing public services. The expenditure in any UT is not a one to one functional relationship of revenue base or the unit costs of providing public services. The expenditure functions are constitutionally defined responsibilities. Thus, irrespective of the revenue capacity, each unit has to perform these functions. In other words, the size of the expenditure, measured in terms of expenditure assignment, may go far beyond their capacity to generate own revenue. One of the ways to overcome these differences in fiscal capacities is to make provision of equalization grants. Hence, in assessing the grants-in-aid to each of these four UTs is not similar exercise. Different parameters will have to be used for each territory keeping in view the special features prevailing there.

1B.17: While making its recommendations, the Third Finance Commission has taken into consideration the issues discussed above and recommended a combination of general purpose, specific purpose and incentive grants to make the local bodies fiscally autonomous, capable of functioning as effective institutions of local-self governments.