Dr. M. Ramachandran
Secretary
Ministry of Urban Development

D.O. No. N-11025/20/2008-UCD **Dated the 31st March, 2009**

Dear Chief Secretary,

The 73rd and 74th Constitution Amendment Act, 1992 are the most significant milestones in so far as strengthening of local governance in rural and urban areas are concerned. Further, Article 280 (3) (c) attempts to streamline fiscal devolution system between the states and municipalities. Under the new fiscal devolution system/framework every state government is required to constitute, once in five years, a finance commission and entrust it with the task of reviewing the financial position of local governments and making recommendations as to the principles that should govern (a) the distribution between the state and the local governments of the net proceeds of the taxes, duties, tolls and fees leviable by the state; (b) the determination of the taxes, duties, tolls and fees that may be assigned to or appropriated by the local governments; and (c) the grants-in-aid to local governments from the consolidated fund of the state.

The constitutional amendments have placed crucial responsibilities on the new institution of the finance commission of states. Over and above recommending the principles that should govern state local fiscal relations, SFCs are expected to (i) undertake a review of the finances of municipalities; (ii) estimate the future financial requirements of municipalities; and (iii) suggest measures for strengthening the finances of municipalities.

Experience so far shows that the spirit of 74th Amendment as well as Article 280 (3) c has not been fully realized. Therefore, reforms related to implementation of the 74th CAA including those related to State Finance Commissions were included under the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) as part of Mandatory reforms to be implemented within the Mission period. All States have committed specific timelines for implementation of these reforms.

In order to strengthen implementation of these reforms, I shall like to highlight some of the key issues relating to State Finance commissions which need to be attended to.

1. Composition of SFCs –Qualification of Members, Rotations and Transfers:

The importance of SFCs in terms of its potential to carry out the process of democratic decentralization and to evolve competencies by strengthening the ULBs needs to be fully recognized. The first step towards this is to constitute SFCs with people of eminence and competence. SFCs should not be viewed as mere a constitutional formality. Experience shows that in many cases, SFCs were constituted in phases and were subject to frequent reconstitution. Such eventualities need to be avoided.

2.Time Limit of SFCs and Synchronization of SFCs with CFCs

The timely submission of the SFCs reports is very important. The report should be available before the commencement of the award period to avoid the adhocism in financial devolution and it should be available to Central Finance Commission (CFC) to make recommendations as to measures needed to augment the consolidated fund of a state to supplement the resources to ULBs. This can be achieved if the issue is accorded priority.

3. Permanent SFC Cell in Each State

The need for supporting SFCs with a permanent secretariat cannot be over emphasized given the crucial role SFCs play in overall system of fiscal devolution. It is important to retain the institutional memory and capacity to provide optimal level of support to SFC. Therefore, it is recommended that a permanent SFC cell may be created in each state and all members and chairman should be on full time basis which can look in details of functioning of the ULBs and their problems of sustainability. It should also maintain good databases (time series) of ULBs related to finances, functions and functionaries etc. It will also help in improving the credibility of information on the finances of ULBs.

4. Consistent Methodology of SFCs

There is a need for consistency in methodology used by various SFCs and each SFC should analyse the existing resource generation capacity of the ULBs, expenditure and resource gap. It should also look into the existing SFCs grants and compensatory grants and other state transfers. Moreover, the incorporation of the functions listed in the 12th Schedule of the 74th CAA have not been taken into account by the most of SFCs. Therefore, the estimated financial needs of ULBs are not appropriate. Clarity in respect of the functional jurisdiction of ULBs is an essential, first step in deciding upon the principles for tax assignment, revenue-sharing and grant-in-aid. Only after their functions are known could any decision be taken with regard to how these could be financed. In fact, the structure of financing mechanism – the mix of taxes, user charges and transfers that is appropriate in a given context depends on the functions assigned to ULBs.

5. Defining Minimum Standards of Performance of ULBs

SFCs must lay down the minimum standards of resource generation by the ULBs. SFCs should make guidelines for the effective implementation of tax sources and user charges. SFCs should also suggest new tax devolutions to ULBs especially where the Octroi is abolished. On Expenditure side also, SFCs should come up with guidelines on how to achieve the cost cutting exercise especially on the cost cutting of establishment and salaries account.

6. Defining of Minimum Service Standards Norms

To see the resource gap of the ULBs there is a need to define minimum service standards norms. The SFCs and States should look at the National Benchmarks related to basic services pertaining to water supply, sewerage, solid waste management and storm water drainage. After giving suggestions on improving resource generation capacity, cost cutting by ULBs and arriving at the resource gap to meet out the minimum service standards; SFCs should explore the possibilities to fill this resource gap by means of public private partnerships, community participation, franchising and outsourcing of certain functions to reduce the resource gaps. The remaining resource gap may be advised to be filled by the state grants.

7. Proposed SFCs Grants to Link with Enhanced Levels of Services

SFCs should not merely follow a gap filling approach. After giving guidelines on cost cuttings and enhanced resource generation, the proposed formula of grants should be based on global sharing with state level tax and non-tax sources to capture the elasticity of these funds. SFCs must point what will be the impact on service standards after releasing these grants and should also point out linkages with grant-in-aid. Clarity in respect of the functional jurisdiction of ULBs is an essential, first step in deciding upon the principles for tax assignment, revenue-sharing and grant-in-aid. Only after their functions are known could any decision be taken in regard to how these could be financed. At the very minimum, the SFCs must cater to the core functions adequately.

8. Analysis of State Finances

The SFC reports should contain an estimation and analysis of the finances of the State government as well as the urban local bodies at the pre and post transfer stages along with a quantification of the revenues that could be generated additionally by the urban local bodies by adopting the measures recommended therein.

9. Focus of the Main Recommendations of SFCs

Poor resource generation by ULBs is a major problem to achieve self-sustainability. This problem is particularly acute in the traditional octroi levying states where property tax machinery is weak. The way to correct the situation is to link ULBs' tax and non-tax efforts with SFCs grant-in-aid entitlements for service upgradation and specific functions. Unless fiscal transfers to the ULBs have built-in compulsions to improve their tax and non-tax performance, this problem is likely to continue. For fiscal sustainability of ULBs, it is essential to introduce hard budget conditions on ULBs if a durable solution to their fiscal issues is to be found. Ensuring ULBs fiscal sustainability would need a number of actions, such as –controlling growth of expenditures, improving property tax assessment collections, enhancing user charge collections and linking revenue with improved service delivery etc.

There is a gradual shift from individual tax sharing to a 'global' sharing of state taxes with the ULBs. In absence of a minimum percentage of 'global' sharing, the rationale of such a shift seems to be States' administrative convenience. Adequacy and timely release of these grants is also not appropriate. SFCs generally find that the normative resource gap approach greatly exceed the states' capacity to compensate, given its own fiscal limitations. A 'pragmatic' adjustment then is made to bring revenue sharing costs into line with state financing constraints.

10. Response by State Government to SFCs Reports

The States should avoid delays in submission of SFC reports and tabling of the ATR in the legislature. The SFC reports should be readily available to the Central Finance Commission, when the latter is constituted so that an assessment of the state's need could be made by the Central Finance Commission on the basis of uniform principles.

With regards,

Yours sincerely,

Sd/-

(M. Ramachandran)

To

Chief Secretaries all States