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# HORIZONTAL FISCAL IMBALANCES: ISSUES AND MEASUREMENT WITH SPECIAL REFERENCE TO URBAN LOCAL BODIES

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## ABSTRACT

*The federal structure in India is a three-tiered constitutionally demarcated system that allocates funds according to specific functions as listed in three separate mandates. The Constitution of the country stipulates the role and responsibilities of the three tiers, differentiating according to the macro or micro nature of the issue. For example, the Centre is responsible for matters of national importance such as defence, transportation infrastructure, international trade and macroeconomic management. The State, governed by the State list is responsible for matters of regional and State importance such as law and order, public health, sanitation, housing, irrigation, agriculture and local governments. The final tier is the Concurrent list, which includes sectors such as education, contracts, bankruptcy and insolvency, economic and social planning, employment and labour welfare, electricity, stamp duties and any other sectors that require Centre-State consensus.*

**KEYWORDS:** *Fiscal Transfers, Natural Endowment, Climate, Property Taxes, Fiscal Imbalance*

## INTRODUCTION

The term fiscal balance refers to the balance between the expenditure responsibilities of the different orders of the government and the ability to fund various services resulting from those responsibilities. The current system of federal fiscal transfers includes both a horizontal and a vertical component designed to address the two aspects of the fiscal imbalance.

The **Vertical Fiscal Imbalance** refers to a gap between revenue sources and spending responsibilities *between* orders of government, that is, between the federal and provincial governments. A vertical fiscal imbalance describes a situation where revenues do not match with expenditures for different level of government.

The **Horizontal Fiscal Imbalance** refers to the differences in the ability of individual provinces and territories to raise revenues. In general it refers to the situation where the States have differing abilities to provide comparable levels of services through the imposition of comparable tax burdens, because of demographic and economic disparities between them. It is measured by the variation in own revenue as a percentage of total expenditure. The problem of horizontal fiscal imbalance is common in all systems of multi-tiered government since sub national governments at the same level will almost never possess the same fiscal capacity. Horizontal fiscal imbalance arises because governmental entities at the same level often provide essentially the same services but enjoy different revenue capacities and face different cost differentials in the provision of these standard services for inevitable and 'unavoidable' exogenous reason (Brain, 2008). In addition to this, Richer and Tarasov (2002) also defines horizontal fiscal imbalance as a disparity of resources of among different provinces at which some are rich and others are poor.

Horizontal imbalances can arise due to revenue or expenditure differences between the states. As a result, it could be attributed to the variation in capacities arising by revenue generating power of different districts. A research which was conducted by Ravindra (2005) in India associates horizontal fiscal imbalance with geographic variations among different districts within a federal forms of government. Accordingly geographically vast countries like India face the problem of horizontal fiscal imbalance because natural endowment, climate, and physical and social conditions have significantly differed across different Indian districts. As a result, economic opportunities are not uniformly available to population residing in different districts of India. This can be manifested through significant difference among regions in the level of per capita income, levels of unemployment rate, physical quality of life etc.

## URBAN LOCAL BODIES IN INDIA

The urban local bodies in India were firmly conferred the status of democratic institution of self government in 1992, with the passing of the 74$^{th}$ constitutional amendment act. In our constitution, matters of local public sphere are enumerated in the state list because the unit states were expected to constitute local bodies and assign them the tasks, functions and responsibilities and empower them with adequate resources so that the local bodies could look after the tax assigned to them. Since the unit states fail to perform these jobs adequately, the state of India stepped in. The amendment involved a uniform pattern of local bodies across the country and suggested some of the function or responsibilities. The fiscal powers of ULBs have typically comprised property taxes, a tax on the entry of goods in to the local area for consumption, use and sell as octroi, advertisement tax, tax on non-motorised vehicles, entertainment taxes, taxes on animals and boats and taxes on profession, trades, calling and employment. The general postulates underline the assignment of fiscal powers is that the revenue from these taxes should be adequate to meet the operational expenditure of ULBs. However, given the relative inflexibility and low buoyancy of many of these taxes and the defaulting in adjusting in local tax rate, state governments have traditionally used a system of grants-in-aid and tax sharing arrangements for bridging the revenue gap faced by the ULBs. In addition to grant and tax sharing, the state government utilises the instrument of specific purpose grant for advancing state level goals and mandates. It is important to note that unlike in centre state fiscal relations, the state municipal acts do not provide for transfers to ULBs. Thus, transfers are determined in an ad-hoc manner (Mathur and Peterson,2006).

## FINANCES OF URBAN LOCAL BODIES IN INDIA

The finances of urban local bodies (ULBs) have been assuming much importance due to the fact that the urban areas are growing not only in terms of population share but also in economic growth. Since Municipal Corporations act as centre of government of urban areas, thus urban local government is also referred to as municipal finance in India. It is about the revenue and expenditure decision of local governments. It covers the sources of revenue of governments such as taxes (property tax, sales tax, excise duty), user fees and intergovernmental transfers, borrowings as well as charges on developers and public private partnership. Municipal Finance also addresses issues around expenditure at the local level and the accountability for expenditure and revenue decisions including the municipal budgetary process and financial management (UN Habitat, 2009). The constitution of India ordains that India is a federation of states and union territories, with residual legislative powers vesting in the central government. The constitution in its 7$^{th}$ schedule, assigns the powers and functions of the centre and states. The schedule specifies the exclusive powers of the centre in the union list, exclusive powers of the states in the state list, and those falling under the joint jurisdiction in the concurrent list. The constitutional assignment of the tax powers in India follows the principle of separation i.e. the tax handles are exclusively assigned either to the centre or to the states. Most of the productive tax handles have been assigned to the centre, including income tax, wealth tax (excluding agricultural sources), corporation tax, taxes on production (excluding those on alcoholic liquor, opium, hemp and other narcotics) and custom duties. State taxes include taxes on agricultural income and wealth, taxes on the transfer of properties (stamp duty and registration fees), taxes on motor vehicles, taxes on the transportation, sales tax on goods, taxes on alcoholic beverages, entertainment tax, etc. The centre has also been assigned all residual powers of taxation.

The constitution of India specifies the taxes to be divided between the centre and the states but it does not specify the revenue base for ULBs. Further it is not specific about the types of taxes that the ULBs should have. Simultaneously the power for determining the revenue base of ULBs consists of their own resources (tax and non tax revenues), shared revenues, state grants and loans from state governments and market borrowing. Thus it is quite evident that the revenue base of the municipal or the local governments has limited buoyancy.

## TRENDS IN EXPENDITURE GROWTH

As the economy grows, it is quite obvious that the expenditure responsibilities of the different levels of the government increases. If we analyse the growth pattern of the expenditure incurred by the ULBs, we will realize that it has increased to manifolds from 1998-99 to 2007-08. Table 1 shows that the expenditure of ULBs has two components, viz, revenue and capital expenditure. The table consists of the percentage growth rate of revenue, capital as well as total expenditure. As we can see, the growth rate of revenue expenditure kept on fluctuating during the decade. In the initial years of the study, it has declined steeply from 18% in 1999-00 to -12.56% in 2002-03. But in the very next year (2003-04), it has shown drastic appreciation from -12.56% to 55.81% after which it has declined to ground level of 3% and further increased to 21% in 2007-08. Similar pattern has been followed by the Capital expenditure which has declined from 26% to -10% in the initial years. But again there has been a drastic rise to 101% which implies a double fold increase in the growth rate of capital expenditure. Out of the two components of expenditure of ULBs, revenue expenditure experienced major decline and fluctuations may be due to over emphasis of the government on capital expenditure.

**Table1: Expenditure of Urban Local Bodies in India**

| Year | Revenue expenditure (Rs.in Crore | Capital expenditure (Rs.in Crores) | Total Expenditure (Rs.in Crores) | % Growth Rate of Revenue exp. | % Growth rate of Capital Exp. | % Growth Rate of Total exp. |
|---|---|---|---|---|---|---|
| **1998-99** | 9059 | 2975 | 12034 | - | - | - |
| **1999-00** | 10690 | 3761 | 14451 | 18 | 26.41 | 20.08 |
| **2000-01** | 11665 | 4077 | 15743 | 9.12 | 8.39 | 8.93 |
| **2001-02** | 12204 | 3709 | 15914 | 4.61 | -9.01 | 1.08 |
| **2002-03** | 10671 | 3325 | 13997 | -12.56 | -10.35 | -12.04 |
| **2003-04** | 16627 | 6689 | 23317 | 55.81 | 101.15 | 66.58 |
| **2004-05** | 19074 | 8515 | 27590 | 14.71 | 27.30 | 18.32 |
| **2005-06** | 19776 | 10631 | 30407 | 3.67 | 24.84 | 10.20 |
| **2006-07** | 23513 | 13276 | 36789 | 18.89 | 24.87 | 20.99 |
| **2007-08** | 28431 | 18594 | 47025 | 20.91 | 40.05 | 27.82 |

*port of Central Finance Commission, Government of India*

## TRENDS IN REVENUE GROWTH

Growth in expenditure due to augmentation of public services is inevitably responsible on the growth in revenue income of the local body. An elastic and buoyant source of revenue provides the much needed funds at an increasing rate for financing the provision of services. Having analysed the trends in expenditure, we are now required to take a look at the revenue generation capacity in order to compare the relationship between expenditure and revenue and the nature of revenue base and financial mobilisation of the ULBs in India. In the initial years of our study, the revenue base of the local bodies has shown a slow but a decent growth except the year 2002-03 in which it has declined from Rs.15000 crores to Rs. 12500 crores. After that, it has increased and infact have shown an appreciating growth. The uneven growth in revenue is chiefly because of the fact that in certain years share of the ULBs in assigned taxes and the grants to it were not released in time. Hence when these were released in the next years, the revenue receipts of the ULBs grown rapidly.

**Table 2: Total Revenue Receipts of Urban Local Bodies in India**

(Rs. in crores)

| Year | Own tax | Own non tax | Own revenue | Other revenue | Total revenue | %Growth Rate |
|---|---|---|---|---|---|---|
| **1998-99** | 4755 | 2118 | 6873 | 4641 | 11514 | - |
| **1999-00** | 5151 | 2229 | 7379 | 5793 | 13172 | 14.39 |
| **2000-01** | 5617 | 2643 | 8260 | 6320 | 14581 | 10.69 |
| **2001-02** | 5885 | 2874 | 8760 | 6389 | 15149 | 03 |
| **2002-03** | 4941 | 2419 | 7360 | 5236 | 12596 | -16 |
| **2003-04** | 9704 | 4735 | 14440 | 8670 | 23111 | 83 |
| **2004-05** | 10861 | 5425 | 16285 | 10469 | 26755 | 15 |
| **2005-06** | 12152 | 6083 | 18235 | 13427 | 31662 | 18 |
| **2006-07** | 14198 | 6632 | 20830 | 16592 | 37422 | 21 |
| **2007-08** | 15277 | 8244 | 23521 | 20907 | 44429 | 18 |

*es-Report of Central Finance Commission, Government of India*

## FISCAL MISMATCH

The analysis of fiscal mismatch between own revenue and expenditure responsibilities of ULBs present very interesting picture and shows that the ULBs are facing a huge deficit and their own resources are actually inadequate to meet their fiscal needs. Table 3 shows that in most of the years the fiscal gap between the revenue generating capacity and the expenditure responsibilities has been wide and the ULBs have suffered huge deficit. The above analysis shows that there is a huge fiscal mismatch between own revenue and total expenditure at all tiers of the ULBs. It means that the own financial resources of the ULBs are highly inadequate to meet out the fiscal needs. Even though the financial devolution has been ensured to the local bodies, they still face fiscal deficit. The main reason behind this gap is that the revenue of ULBs is not increasing in the same proportion as that of expenditure. Another reason is that the functions which are performed by the ULBs require huge amount of revenue which the local bodies are inadequate in financing by their own sources. Thus there is a need to reconsider the devolution criteria and transfer of resources to the ULBs for their fiscal needs.

**Table3: Fiscal Mismatch in the Total Expenditure and Revenue of ULBs**

| Year | Total Expenditure (Rs. in crores) | Total Revenue (Rs. in crores) | Fiscal Gap (Rev – Exp) |
|---|---|---|---|
| 1998-99 | 12034 | 11514 | -520 |
| 1999-00 | 14451 | 13172 | -1279 |
| 2000-01 | 15743 | 14581 | -1162 |
| 2001-02 | 15914 | 15149 | -765 |
| 2002-03 | 13997 | 12596 | -1401 |
| 2003-04 | 23317 | 23111 | -206 |
| 2004-05 | 27590 | 26755 | -835 |
| 2005-06 | 30407 | 31662 | 1255 |
| 2006-07 | 36789 | 37422 | 633 |
| 2007-08 | 47025 | 44429 | -2596 |

*Sources-Report of Central Finance Commission, Government of India*

## HORIZONTAL FISCAL EQUALIZATION: NEED AND ISSUES

Equity is a criterion that usually applies to people, not governments. If the ultimate goal of HFE is equal treatment of otherwise-equal individuals, reflection suggests that the equity argument for fiscal equalization must depend primarily on the claim that jurisdictionally-immobile sections of populations may otherwise be unreasonably disadvantaged by the operation of the fiscal system. Moreover, it needs explaining why governments that pursue only partial equalization of budget capacities of private persons, should attempt full equalization of public budget capacities. All redistributions have efficiency consequences, some positive and some negative. In the absence of an overriding ethical principle that supports the goal of exact fiscal equality, democratic nations generally accept a trade-off between efficiency and equity, for constitutional and political reasons. Against this viewpoint, there is a large theoretical literature in public economics on fiscal equalization—see Boadway 2004 for a survey; also Boadway and Tremblay 2010: the seminal pieces were by JamesBuchanan 1950, 1952—designed to show the social planner if and how fiscal equalization can be used to achieve an efficient assignment of taxing powers and expenditure responsibilities; or to induce autonomous subordinate jurisdictions to choose the optimal tax rates and spending, so as to internalize fiscal externalities (Oates and Schwab 1988); or to share fiscal risks optimally. Fiscal equalization is not always necessary for optimality and generally not sufficient5; or the correct equalization formula is too hard to derive.6 In this literature, the consequences of inter-jurisdictional mobility have been investigated :sometimes it makes the job of the social planner easier, sometimes not (Wildasin 1991; Boadway and Tremblay 2010). However, largely the literature is not well integrated with Public Choice, the school of thought founded by Buchanan and Gordon Tullock, which views the assumption of benevolent dictators or benign social planners; or with the more recent field of mechanism design. Moreover, it is curious that it is mostly about how to avoid the inefficiencies caused by the very fact of federalism itself—as though federalism were merely an unfortunate historical accident: if the omniscient social planner existed, then federalism would indeed be a sub-optimal institution.

There are several motivating factors to form a federation. Apart from having common defence facilities, accessibility to unified common national market and getting best use of scarce resources of the country, a federation also aims at "equality of all citizens". All the federating states are not equal in terms of economic development, social development, natural resource endowment, and fiscal capacity. Because of such factors, there exists a serious regional disparity. Different sub-national government typically have different costs and capacities to raise revenue for reasons that are beyond their control. The process to address these differences is termed as Horizontal Fiscal Equalisation. Firstly, the government should try to off-set unequal impact of its own taxation as well as expenditure policies on the budget of the constituent states. Secondly, the federal government should use federal financial transfers to offset adverse impact of the inter-state spillovers of expenditure benefits and tax costs of the state governments. If such spillovers are unequal between the states, inter-state fiscal imbalances will arise which will give way to inter state conflicts and instability of the federation. Thirdly, the federal financial transfers should be used to ensure a minimum level of essential public services to all the citizens all over the federation. Such provision may not be possible in all states because of varying fiscal capacity and fiscal needs of different states. Therefore, federal financial transfers should be linked to the fiscal needs of the state governments for ensuring minimum level of essential public services. Finally, with a view to reducing inter-state economic disparities, the federal government will have to use federal financial transfers in such a way as to generate economic activities in poorer states. In other words, it means the federal government will have to interfere in the process and pattern of development of the constituent states with a view to reducing inter-state economic disparities.

## CONCLUSION

There is widespread acceptance of the fact that decentralization of the lower tier government is efficiency augmenting. Sub national governments are better informed and can more easily respond to the needs and the preferences of the citizens living in their jurisdiction. Local bodies directly influence the welfare of the people by providing various services and facilities to the people living in urban as well as rural areas. Decentralization increases efficiency of the lower levels of the government in the provision of their services due to their limited jurisdiction and better knowledge about their area.

While analyzing the finances of ULBs, it has been observed that there exist a huge gap between their expenditure responsibilities and revenue generating capacity. The ULBs are facing deficit in terms of excess expenditure over revenue despite of the fact that they are receiving a handsome amount of grants from the state government. Thus the study concludes that there is a need for certain lines of reforms to restructure the system of municipal finances in the country by revisiting expenditure assignment and revenue assignment.

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