Chapter III

Fiscal Decentralization in Kerala

Preface

Contemporary development literature has acknowledged Kerala's unique social attainments, such as high literacy rate, high life expectancy, low infant mortality rate and egalitarian social security measures - all achieved despite a low growth rate and a low rate of industrialization. Kerala has now added a new dimension to its achievements with the state's remarkable progress towards decentralized planning and participatory governance following the 73rd and 74th Constitutional Amendments. The necessary conditions for decentralized governance have been substantially laid down with the great strides made in literacy, especially that of women, and with the progress in surmounting caste and class barriers through social reform movements, land reforms, the wide public distribution of essential commodities through fair price shops, and a host of public action measures. Thus the fact of Kerala's relatively good progress towards greater functional, financial and administrative autonomy is recognized. However, the reality is that even in Kerala, much ground remains to be covered. This study examines the Kerala experience of fiscal decentralization to consider the way ahead - not only for the state, but for India as a whole.

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Introduction: the study framework

Kerala's achievements in decentralized planning and fiscal decentralization merit study not only to improve the decentralization process in the state, but also to provide lessons for other states in India.

Decentralization: the background

In India the 73rd and 74th Constitutional Amendments (1992) sought to build a third stratum of government in an otherwise two-tier federal system. In the wake of attempts to build "institutions of local self-government" with the mandate to plan for economic development and social justice, fiscal decentralization has become a subject of considerable academic debate and policy interest in India. Fiscal decentralization is particularly significant in the rural setting where it was, at best, an appendage of rural development departments with some bureaucratic decentralization in a few states in the pre-Amendment period. Karnataka and West Bengal made some progress towards decentralization, but this was more political than fiscal. Karnataka, however, was a pioneer in setting up the institution of the State Finance Commission (SFC). For Kerala, democratic decentralization has largely been a post-Amendment phenomenon. What distinguishes Kerala from the other states in India is the "big-bang" approach the state has taken. The strategy was to implement a significant fiscal decentralization program and then "learn by doing." Indeed, it was a question of transferring powers, then setting up procedures and precedence for their exercise. As far as fiscal decentralization was concerned, funds were transferred and accountability mechanisms and procedures set up. Much of the impact of Kerala's decentralization can be linked with this approach.

The study focus

Kerala has 991 villages or gram panchayats (GPs),[128] 152 intermediate level panchayats (block panchayats or BPs) and 14 district panchayats (DPs). This study concentrates on the village panchayat level, which alone has revenue raising powers, and interacts by statute with the citizen's assembly called the gram sabha. The GP could well be considered the only real level of local self-government in rural areas. The DPs and BPs, which came into existence in 1996 in Kerala, have a relatively short history. They do not have any revenue raising powers and depend almost entirely on grants from the central and state governments.

Study objectives

It is in such a context that this empirical study of fiscal decentralization takes stock of the resources flowing to, or being generated in, the sample districts of rural areas vis-à-vis the functions assigned to Panchayat Raj Institutions (PRIs). The study identifies and assesses the channels of accountability that link PRIs upward to state and central governments, and downward to local constituents. It proposes a fiscal devolution package to resolve the mismatch between functions and resources, while promoting economic efficiency, horizontal equity and accountability. More specifically, the analysis examines the level and composition of expenditures; the pattern of own tax and non-tax revenue (NTR); the adequacy, design and impact of the transfer system; and the accountability mechanism of rural local governments in Kerala.

> The various study objectives have one unifying aim: determining an acceptable fiscal devolution package using Kerala as a case study.

Datasets

This study analyzes four unique datasets that have not to date been used to study rural government finance in India.

- The first set consists of time series data for six years (1993-94 to 1998-99) for all GPs collected by the Second State Finance Commission (SSFC) (1999-01) of Kerala. The SSFC data contain receipts and expenditures of own funds, including funds received for centrally sponsored schemes (CSS), but do not include people's plan campaign funds and funds from other departments for transferred institutions and schemes.

[128] The term gram is used in consistency with usage in other states.

- The SSFC data do not have information on state plan grants[129] to local bodies and have been supplemented with data on plan grants from the state budget for 1997-98 and 1998-99. For plan expenditure, the data used were collected by ten district planning offices as part of the monitoring of plan implementation by the State Planning Board.[130]
- The third dataset comprise primary data collected from 26 GPs selected on a multi-stage random sampling basis, covering 1998-99 to 2001-02 (see Box 3.1). Finally, secondary data were collected from official and non-official sources wherever necessary.

Box 3.1 : Supplementary data: sample survey and special studies

Supplementing existing data with a sample survey became necessary because

- The SSFC study had collected data only up to 1998-99.
- A preliminary examination of SSFC data showed a high accumulation of closing cash balances in a large number of GPs. This called for a study of fiscal balances calculated from various accounts. The survey attempts to project a consolidated picture of the total finance of GPs - involving own funds, plan funds, funds of transferred institutions, state and centrally sponsored schemes (CSS), and receipts and expenditures relating to agency functions (such as pension schemes) taken up by GPs. Care was taken to select a truly representative sample of GPs.

The percentage of GPs covered by SSFC study ranges from 58 percent in Wayanad district to 94 percent in Kollam with a state average of 81 percent. In this sense, it is more a census than a sample. The number of GPs for which plan expenditure data are covered in each of the ten districts form about 65 percent of the total GPs in the state. It also needs to be said that the study's findings have been limited by the inadequacy of data collection and recording at the GP level, the frequent transfer of senior officers handling data, and the time lag in updating accounts. But despite these limitations, and the fact that data from four different sources have been pulled together, this study draws useful inferences from its initial exercise in data building at the level of rural local bodies.

Fiscal decentralization in Kerala: an overview

Kerala has, over a period of time, been concerned with democratic decentralization with a focus on the village panchayat. Subsequent to the Constitutional Amendments, several measures were taken to institutionalize the process of decentralized planning and governance. But much remains to be done to promote functional, financial and administrative autonomy.

The evolution of local bodies: panchayats in Kerala

A tradition of village collectives

Kerala has an antiquity of village collectivities in which people, irrespective of caste or wealth differences, participated in decision making. These traditions were gradually undermined, and a more stratified society emerged. Subject to the caste stratifications within each group there was some democratic governance, though here too the voice of the elders generally prevailed.[131] These age-old traditions changed significantly with the advent of the British rule in India.[132]

The evolution of local bodies: pre-Amendment period

The princely states of Travancore and Cochin, and the Malabar district of the erstwhile British Indian province of Madras Presidency, were considerably influenced by Viceroy Lord Ripon's resolution of 1882, establishing local bodies called "little republics" in urban centers. They were later extended to rural

[129] Before 1996-97, the distinction between plan and non-plan did not make much difference as far as local bodies in Kerala were concerned.

[130] While the study uses non-plan expenditure data for all six years from 1993-94 through 1998-99, complete data of receipts and expenditure, including plan data, are available only for 1998-99, and only for ten districts. So in all, data from 645 GPs spread over these ten districts have been used. Plan expenditure data for four out of 14 districts were not available.

[131] For a detailed account of the evolution of panchayats in Kerala before the British time, see Pushparajan, 2002.

[132] Santha, 1993.

areas. Following the report of the Royal Commission on Decentralization (1909), a two-tier system was introduced in Malabar - the Malabar District Board at the district level and the panchayat board at the village level. Besides the Royal Commission, the Government of India Act (1919) also influenced the formation of the Panchayat Acts in Cochin and Travancore, and modified the traditional village system of these regions. In 1925, a Village Panchayat Act was enacted in Travancore and seven panchayats were formed. The assigned functions[133] and taxes[134] were way ahead of the times.[135] The financial needs of panchayats were mostly met by a system of grants. In the Malabar district, village panchayats functioned under the Madras Village Panchayat Act (1950). Their main sources of revenue were a share of land cess and duty on the transfer of property. House tax, profession tax and vehicle tax were also levied. Panchayats were not eligible for any statutory grants, but the government paid them ex gratia grants. Areas not covered by panchayats were under the administrative jurisdiction of the Malabar District Board, which carried out all the statutory functions of panchayats. These boards derived their income from profession tax, entertainment tax, education cess, land cess, surcharge on stamp duty, license fees and government grants in aid.

A checkered history

From the first Kerala Ministry (1957) to date, the history of Kerala's Panchayat Raj system has been influenced by the ups and downs of coalition politics in the state. The first ministry appointed an administrative reform committee to suggest measures for the democratization of government at various levels. The committee recommended the strengthening of panchayats in the state as viable and basic units of administration and development. Subsequently, the Kerala Panchayat Bill (1958) and the District Council Bill (1959) were placed in the state assembly, but could not be enacted as the ministry was dismissed and the assembly dissolved. The new government passed the Kerala Panchayat Act (1960), which incorporated various recommendations of the Balwantray Mehta Committee (1957), and sought to enlarge the functional domain and financial resources base of the panchayats. Based on the Act, the first panchayat election in the state was held in 1963 and a total of 922 village panchayats came into existence in 1964. In 1964, the Kerala Panchayat Union Councils and Zilla Parishad Bill was formulated, but this too was not passed as the ministry fell. After a long spell of central administration, yet another ill-fated bill, the Kerala Panchayat Bill (1967), was introduced in the state legislature.[136] Various other bills were also formulated, but it was not till 1986 when a committee was appointed to study existing legislations that some major recommendations were made for democratic decentralization at the local level. The state government, however, responded to the resulting Report on the Measures to be taken for Democratic Decentralization at the District and Lower Level (1988) with minimum amendments. Elections were held for district councils, which then came into existence in 1991. The subsequent government reduced the annual plan outlay for the district councils, and later dissolved them altogether. It was at this point, when decentralization initiatives were being reversed, that the historic Constitutional Amendment was introduced.

Fiscal features of the pre-Amendment panchayat regime

- Except for the brief period of district councils in the early 1990s, Kerala had a gram panchayat system. The several bills introduced by the various governments during the period from the first ministry (1957-59) recommended only a two-tier panchayat system.

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[133] Construction, maintenance and improvement of wells and tanks; maintenance and improvement of communications and drains; primary education; lighting of public ways and places; improvement of minor irrigation works and public health and sanitation.

[134] Land cess, profession tax, vehicle tax etc.

[135] Pillai, 1940.

[136] This bill envisaged a two-tier system at the village and district levels. The zilla parishad (district panchayat) was to have executive functions and some sources of revenue with powers of supervision and control over the gram panchayat.

- The village panchayats had a fairly good revenue base. Their receipts consisted of own tax revenue from taxes assigned by state government but collected and appropriated by panchayats; taxes assigned to panchayats but collected by the state government and passed to them; shared taxes; non-tax revenue; grants in aid from the state government; loans from the state government or financial institutions; and funds received for CSS.
- Expenditures were confined largely to traditional civic functions.
- Every panchayat was required to formulate an annual budget of receipts and expenditure and maintain a five percent budgetary balance. In fact, it was as high as 10 percent from 1991-92 to 1993-94. The average per capita revenue and expenditure of panchayats for 1972-73 and 1975-76 were Rs.4.75 and Rs.4.24 respectively.[137]
- Kerala has generally raised large amounts of own revenue compared to other states. As far back as 1960-61, the average own revenue of Kerala panchayats (Rs.10902) was the highest among the states against an all-India average of Rs.1798.[138] Own tax revenue as a percentage of total receipts was 33 percent in 1990-91 and 38 percent in 1991-92; including non-tax revenue and assigned revenue, own revenue was over two-thirds of the total income of GPs.[139]

The Constitutional Amendments and the unique decentralization efforts of Kerala

The 73rd and 74th Constitutional Amendments resulted in numerous possibilities for decentralization. The Left Democratic Front, which came to power in 1996, responded to this climate with several measures to institutionalize the process of decentralized planning and governance.

a) **Devolution of plan outlay:** Thirty-five to forty percent of the state's Ninth Plan (1997-2000) outlay was devolved to local self-governments for projects and programs drawn up by them.[140] This decision was followed by two measures to facilitate the decentralization process.

   - A decentralization planning methodology, beginning with the collection of detailed data on the history and resources of village panchayats, was put in place. The felt needs of the gram sabha were articulated; sectoral programs and projects were formulated with the help of a voluntary corps of experts and officials; panchayat development reports were drawn up and seminars held on these reports; and a shelf of projects from which the GPs chose were prepared. These initiatives comprised the People's Plan Campaign (PPC). They helped to broaden the avenues of people's participation.
   - In 1996, the state government appointed a Committee for Decentralization of Power (the Sen Committee) to review the Kerala Panchayat Raj Act (1994) and the Kerala Municipality Act (1994) and suggest "necessary amendments… so that power can be delegated effectively to the lowest level of administration and… local self government institutions (can) enjoy full autonomy in the exercise of such power…"[141]

b) **Institutional and structural changes:** The Sen Committee's reports resulted in considerable institutional and structural changes. Forty-four state legislations affecting various line department functions (such as education, health, cooperation, drinking water and irrigation) and parastatals were amended to broaden the entitlements and powers of local bodies. In addition, institutions such as the

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[137] Pillai, 1986.

[138] GOI, 1964.

[139] Government of Kerala, 1996.

[140] This was against an untied fund of 2.35 percent devolved during the Eighth Plan (1991-96). The practice of giving untied funds, which began in the early 1990s, was stopped in 1997-98.

[141] Sen Committee, 1996.

ombudsman, the Appellate Tribunals, and the State Development Council were created to make the decentralization process more effective and sustainable.

c) **Comprehensive area plan:** An important feature of financial devolution in Kerala is the comprehensive area plan prepared by each local body to claim grants in aid. The plan outlay was not confined to the grant in aid amount. The grant in aid was integrated with different state and centrally sponsored schemes, and own revenue surplus of the local bodies, loans from financial institutions, beneficiary contributions, voluntary labor and donations and other sources. The funds earmarked for local self-governments were raised from Rs.1025 crores in 1997-98 to Rs.1178 crores in 1998-99, and the share of the grant in aid component was raised from 75 to 81 percent. The own revenue of local bodies (rural plus urban) as a percentage of total state and local own revenues was only a little over 4 percent in 1998-99. When own revenue is disaggregated into its tax and non-tax components, it is clear that poor performance is due to local tax vis-à-vis the state's own revenue. But when non-tax revenue (NTR) is considered separately, the proportion of NTR of local bodies to that of the state's NTR goes up from 10.3 percent to 17.2 percent. This means 17 percent of the NTR of state and sub-state governments in Kerala come from local bodies - clearly an achievement.[142]

d) **Automatic sanction for plan and non-plan allocations:** Another important measure was the automatic sanction given to all plan and non-plan allocations to local bodies through the state budget from 1997-98 onwards.[143] The relevant document included the general sector, the Special Component Plan (SCP) and Tribal Sub-plan (TSP) meant for Scheduled Castes (SCs) and Scheduled Tribes (STs), grants in aid provided to each GP, BP, DP, municipality and corporation. The local self-governments also received a number of non-plan grants distributed on the basis of the SFC recommendations accepted by the government. This constituted the traditional source of fiscal transfer to local bodies. Its traditional route of allotment, which continued to be followed, included the distribution of assigned and shared taxes, the rural pool created in lieu of the various grants, and special-purpose grants. New procedures of fund allotment were prescribed for transferred schemes and grants in aid. In the case of transferred schemes, the concerned administrative department decided the norms of devolution and communicated the entitlements to each local body. The heads of departments issued appropriate allotments to the local bodies through authorized officers. For grants in aid, designated officers authorized allotments and funds were released in quarterly installments.[144]

The decentralization process in Kerala has broadened the entitlements and powers of local bodies. The positive changes include

- Articulation of the needs of the gram sabha
- Formulating sectoral programs and a comprehensive area plan at the local level
- The devolution of plan outlay to local body programs
- Automatic sanction given to all plan and non-plan allocations to local bodies
- New procedures for allotment of funds for transferred schemes and grants in aid
- System of midterm auditing and institutions such as the ombudsman to promote accountability and sustain decentralization.

[142] But the corresponding contribution of tax revenue of local bodies is still only 2.6 percent in 1998-99 as against 3.1 percent in 1993-94 and shows the need for greater tax effort by local governments in Kerala.

[143] Appendix IV of the Budget, the "Details of Provisions Earmarked to Panchayat Raj/Nagarapalika Institutions in the Budget."

[144] The first installment was made once the District Planning Committee (DPC) approved the local plan. The second release was automatic on request by the local body and on submission of a utilization certificate. The third installment was released on a certificate of utilization demonstrating that 30 percent or more of the allotments of the first two installments had been utilized. The condition for claiming the fourth installment was that at least 60 percent of the allotments received till then were actually utilized. If a local body did not utilize 90 percent of the grant in aid by the end of the financial year, the unutilized amount was deducted from the first quarterly installment of the next year. Subsequently, this floor amount was reduced to 75 percent.

e) **Midterm auditing:** To facilitate accountability and promote monitoring and midterm correction, a quarterly system of midterm auditing was introduced. Besides the usual local fund departmental audit, a performance audit was also envisaged,[145] and the social audit undertaken by the gram sabha. Although it was not formally defined, or legally enforced the social audit appeared to mean a view of the administrative system from the perspective of the vast majority of people.

f) **Modification of criteria for fund distribution:** A new formula was adopted in 1998-99 for the distribution of plan grants in aid. Instead of a mere population criterion, a composite index of entitlement was evolved, taking into consideration population, the geographical area of the local body, area under paddy, and a composite index of backwardness based on houses without latrines and electricity.

The fund flow system of panchayats

The functional and financial devolution following the implementation of the 73rd Constitutional Amendment and the Conformity Act in the state have perhaps been too quick and radical. The financial flow and accounting system is still in the process of evolving.

The GPs in Kerala prepare a budget as well as an annual financial statement based on the rules of the Kerala Panchayat Act (1960).[146] The 1962 rules left the task of preparing the budget and presenting it to the panchayat committee to the panchayat executive officer (EO). But the Kerala Panchayat Act (1994) made the budget a more democratic process: the chairperson of the GP's finance committee, with support from the secretary, was given the responsibility. Traditionally there was only one account called the Village Panchayat Fund (VPF) or own fund, consisting of own source revenue (OSR) and state government grants.[147] While the GP budget consists of the actual (audited) statement of the receipts and expenditures of the previous year, budget and revised budget estimates of the current year, and the estimates for the coming financial year, the annual financial statement is a separate account of the actual or updated receipts and expenditures of the current year as reported to the audit department. Although the structure and content of the two are more or less the same, the budget format is more elaborate. The increased devolution of more functions and funds, particularly plan funds, called for changes in budgeting practices.

> Budgets are prepared in a routine fashion, quite often to satisfy statutory requirements, not serve as an instrument of financial control and financial management.

According to the Kerala Panchayat (Amendment) Act (2000), all funds, and plan funds in particular, were to be brought into the budget. But despite this set of rules and regulations, comprehensive budget preparation is still seldom practiced. The logic of preparing two documents, the budget and the annual financial statement, and seeking approval by the panchayat committee, is not clear. The secretary generally prepares the annual financial statement with very little participation from the panchayat committee. All the details asked for in the budget format are generally not filled up.[148] The elaborate process of plan preparation seldom gets reflected in the budget document. Neither the budget nor the annual financial statement presents an integrated picture of finance of a village panchayat. Nor do they

145 Government Order (P) No.185/97 LAD 26.7.1997

146 Articles 112 and 202 of the Indian Constitution require the union government and every state government to prepare an "annual financial statement" called "budget," showing the detailed estimates of the receipts and expenditure of the government (for the approval of the parliament and state legislatures respectively) for the coming fiscal year. There is no such constitutional mandate for the local self-government.

147 It had three accounts: general accounts, mostly dealing with current receipts and expenditure; capital account; and "debt head" account, or payable funds such as deposits received, state or central taxes collected on their behalf, and library cess.

148 This study examined the budgets and statements of a large number of GPs.

provide a full picture of the flow of funds to a village panchayat. There is also a tendency to inflate the estimates[149] and prepare a high surplus budget because of the statutory requirement that the closing balance (CB) should be at least five percent of the total revenue, excluding loans and debt heads. Lack of clarity in budgeting can also lead to the misappropriation of funds. Though the budget is required to be presented to the gram sabha, citizens are not adequately informed of all the budget details.

The fund-function devolution package that has evolved under the decentralization regime has transformed a simple fund flow arrangement and accounting system into a somewhat complex one. It is too early to say when it will be stabilized. As of now, there are five broad divisions of accounts, with several satellite accounts being added from time to time. The major accounts are the Village Panchayat Fund (VPF), the People's Plan Account currently called the Kerala Development Plan Account, transferred institutions/ schemes, the welfare (pension) scheme account and the CSS accounts. In addition, there are several accounts created or continuing on an ad hoc basis, or on a project/scheme basis.[150] In the absence of a consolidated statement of accounts and detailed statement of receipts and expenditure, there is no management information system, rendering efficient planning, financial control and financial management difficult.

Despite the statutory requirement to prepare a comprehensive budget, an integrated picture of all the accounts is not yet a reality.

The major sources of receipts of GPs are OSR, comprising tax and non-tax revenue (NTR), and grants from state and central governments. Debt heads,[151] borrowed funds, donations and contributions occupy a position of less importance (see Figure 3.1). Untied grants/state plan grants, maintenance grants for transferred institutions, grants for schemes transferred, and social security pensions are relatively new. Some taxes assigned to GPs, such as the duty on transfer of property, are collected by the state government and transferred to the GPs. In addition, 20 percent of the Motor Vehicles Tax is shared with the village panchayats on the basis of the type and length of road mileage in a GP. The assigned and shared taxes ("statutory grants") are not, however, automatically passed on to the panchayats. Finally, the NTR items are numerous, with as many as 25 fees.

Multiple agencies and instruments deal with the fund flow, and this naturally affects the budgeting and accounting process.

As the decentralization process expanded and size of devolution increased, the number of accounts also increased. As part of the implementation of the Kerala Panchayat Act (1994),[152] the state government transferred to the panchayats certain offices and staff attached to the development departments, as well as certain programs and functions handled by them. From 1995-96, panchayats began to get more plan and non-plan funds related to schemes and for the maintenance of the transferred institutions. But the decentralization efforts were accelerated only when the state

149 The own revenue estimate of Sreekariyam panchayat (Thiruvananthapuram district) and actuals is a case in point:

+Items	Budget 1998-99 (Rs. in lakhs)	Annual Financial Statement 1998-99 (Rs. in lakhs)	Actual (authentic) Data as per records reported to SSFC (Rs. in lakhs)
Tax Revenue	33	27.7	15.58
Non-Tax Revenue	15.26	8.0	10.00
Total	**48.26**	**35.7**	**25.58**

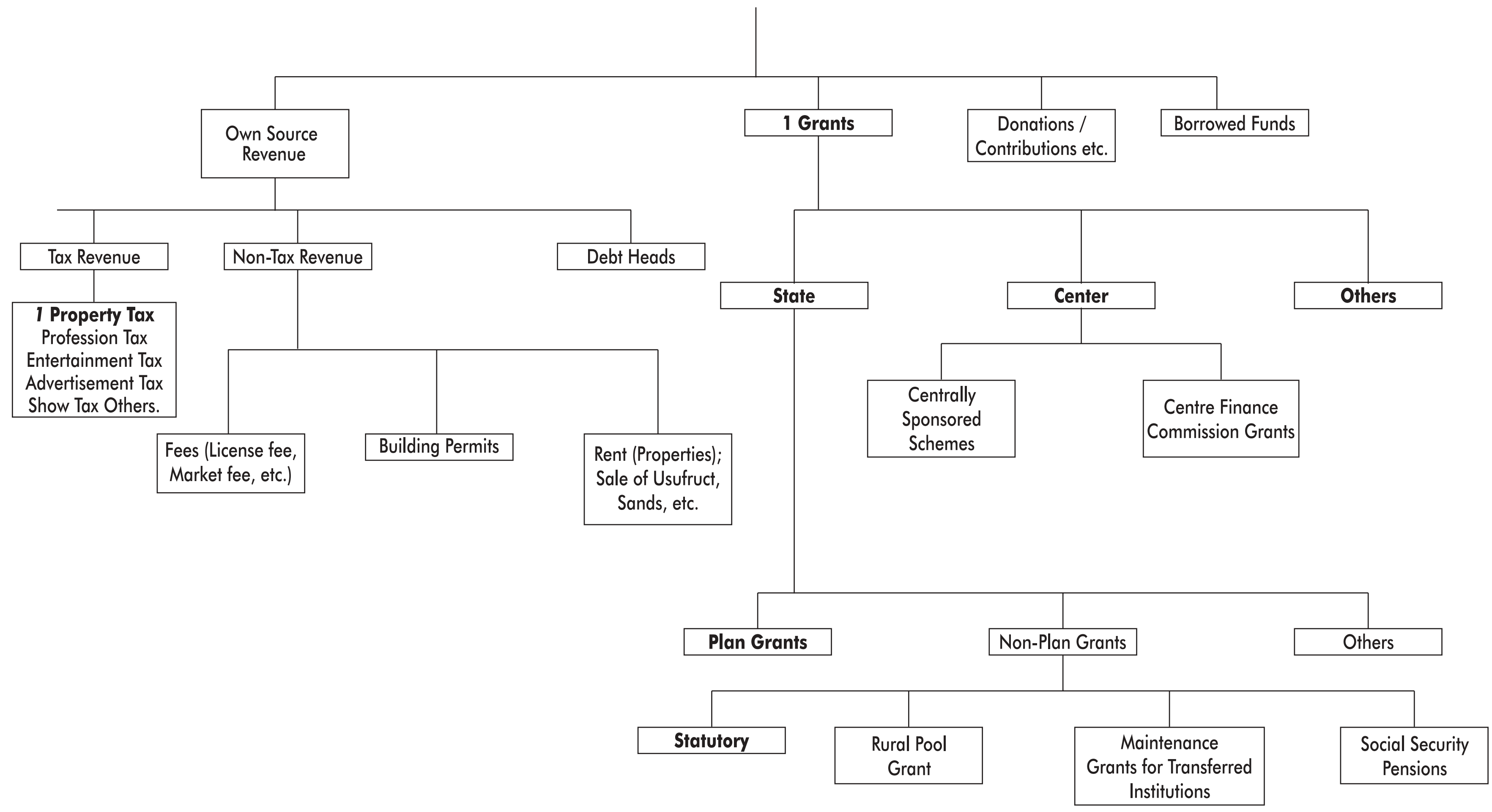
The actual is nearly half of the budgeted figure.

150 Such as the total sanitation program, Literacy Mission, Kudumbasree project, funds received as awards, or special donations.

151 Strictly speaking, debt heads do not constitute a revenue source as items such as earnest money received, funds deposited as securities, sales tax and income tax collected, provident fund of employees, library cess are to be paid back. But they remain a sizeable flow of resources that add to the GP's liquidity, though this may be a problem when there is a rush for withdrawal of funds.

152 This Act was passed to enable the existing panchayat legislations to be in conformity with the 73rd Constitutional Amendment. All the states have passed such conformity legislations.

Figure 3.1 : Sources of finance of gram panchayats in Kerala



government decided to transfer 35-40 percent of the state plan funds to the local bodies to be spent on the projects and schemes they had prepared as part of an elaborate process of bottom-up planning. The latter includes assessing the felt needs of the gram sabha and approval by the District Planning Committee (DPC), the statutory body created following the 74th Constitutional Amendment.

To make local plan formulation quicker and more transparent, a new set of simplified financial rules were issued by a government order (GO). The various sources of funds available to local bodies were spelt out, and so were the modes of release, and accounting and review procedures. The funds available to local bodies were reclassified into three categories: state plan grants for local bodies; amounts for the implementation of schemes transferred by the line departments to the local bodies, funds for the maintenance of transferred institutions, funds for CSS and funds receivable from any agency; and own revenue of GPs (OSR and statutory grants). The state plan grant for the general sector and TSP (Tribal Sub-plan) now includes the Eleventh Finance Commission (EFC)[153] grant. This GO, and Appendix IV of the state budget, which details state plan allocations for each local body and the funds earmarked for transferred institutions and schemes, are landmarks in the evolution of local public finance in Kerala, possibly in the country as a whole.

Although the local bodies are free to prepare their plans, there are some guidelines on broad sectoral expenditures as far as plan grants are concerned. At least 40 percent of the plan funds to GPs have to be invested in productive sectors; not more than 30 percent can be invested in infrastructure such as roads; and at least 10 percent has to be earmarked for gender-sensitive schemes called the Women Component Plan (WCP). These are over and above the special component plan (SCP) for the development of SCs, and the TSP for the development of STs. The plan grant under SCP has been distributed between rural and urban local governments according to the ratio of SC population in rural and urban areas. The share of each tier of the PRI is currently divided in the ratio of 60:20:20 among village, block and district panchayats, and the general sector grant among rural and urban local governments in the ratio of their population and the distribution of the rural share in the ratio of 70:15:15 among village, block and district panchayats respectively.

At the level of block and district panchayats

> There is no systematic budget preparation at the block and district panchayat levels. Nor does it work as a coordinating instrument.

The fund flow structure is essentially the same for BPs and DPs. District and block panchayats do not follow any uniform and systematic practice of budget making. With virtually no tax assignments and very little non-tax revenue to bank upon, they depend on establishment grants for office expenses and plan grants for development. The fact that these panchayats have no control over transfers affects their budget estimates. The finance committee coordinates the preparation of the annual budget by the three standing committees (development, welfare and finance) with feedback from working groups set up to formulate proposals. A similar exercise occurs at the DP level, with larger working groups and in consultation with BPs. Plan budget proposals are, at present, streamlined at all levels. The various implementing officers at BP and DP levels use state plan grants, donations and beneficiary contributions and loans (often linked to particular projects). At the DP level, there are about 25 accounts or more, depending on the number of implementing officers. The General PD Account in the treasury has a substantial flow; and it is susceptible to bans and restrictions. The central government account is not affected because each scheme has a separate bank account. The BP is under the administrative jurisdiction of two state government departments, rural development and local-self government. This creates multiple

[153] The EFC recommendations are for a five-year period, i.e. 1999-2000 to 2003-04.

lines of control and problems in budgeting and coordination.

For all practical purposes, the GP, BP, and DP work independently, despite some coordination at the level of the District Planning Committee. The absence of adequate and timely financial reporting has its effect on accountability. The vertical reporting is in the nature of utilization reports of funds transferred by the central or state governments. The utilization certificates provided by the implementing officers tend to be accepted, giving rise to the possibility of corruption. In short, the accounting system is still evolving. Much work needs to be done to promote functional, financial and administrative autonomy. Budgeting as a tool of financial control and management has not been much of a success in the context of rural local bodies in Kerala. For instance, the practice of keeping budget and annual financial statements separate is untenable. In sum, the budget does not act as a unifying factor in organizing the finances and programs of the panchayats at the various levels as well as of the PRIs as a system.

Analyzing panchayat expenditure and revenue

The increase of fiscal assignments to GP has contributed to the advances Kerala has made in fiscal decentralization. Village panchayats have come to take up planning and development tasks besides the traditional recurring expenditures on maintenance and civic functions The issue of own revenue, assumes new significance in such a context.

Expenditure, structure, pattern and disparities[154]

Expenditure decentralization: some key ratios

Comparing GP expenditure with that of the state, Table 3.1 shows the total expenditure of GPs as a percentage of state domestic product (SDP) as well

Table 3.1 : Expenditure decentralization in Kerala, 1993-94 and 1998-99 (Rs. in crores)

Items	1993-94	1998-99
1. Total expenditure of GPs		
Including CSS		
(b) Excluding CSS	161.5	776
2. State Domestic Product* (Current prices)	129.7	740
3. Total State Expenditure	18837	53552
4. Percentage of GP expenditure to SDP		
(Including CSS)	4656	10611
Percentage of GP expenditure to SDP		
(Excluding CSS)	0.8	1.44
5. Percentage of GP expenditure to total state	0.6	1.38
Expenditure (Including CSS)	3.5	7.3
Percentage of GP expenditure to total state		
Expenditure (Excluding CSS)	2.8	6.9

*Net domestic product. Note: 1993-94 state figures for GPs are estimated from the SSFC survey and the corresponding figures for 1998-99 from the sample survey. The SSFC data are not used for 1998-99 because it covers only the VPF expenditures and does not include plan expenditure, expenditures incurred by transferred institutions and pension funds besides CSS.

Source: SDP figures from Economic Review, State Planning Board and state expenditure from RBI, 2000.

[154] The analysis in this subsection on expenditure is constrained by the availability of an integrated expenditure dataset for a reasonable period of time. This study has endeavored to piece together data from various sources to examine the structure, composition and disparities of GP expenditure.

as of total state expenditure for 1993-94 and 1998-99. The year 1993-94 indicates the situation before the decentralization process when the expenditure of the village panchayat was confined to the VPF and the CSS implemented through the GPs. The GP was the only PRI in Kerala at that time. The year 1998-99 is the second year after the launching of the people's plan campaign, and considerable functional and financial devolution to the GP level had already taken place. The percentage of total expenditure of GPs[155] to SDP rose from 0.8 percent in 1993-94 to 1.44 percent in 1998-99. As a ratio of total state expenditure, actual GP expenditure increased from over Rs.161 crores to Rs.776 crores, an increase of 4.8 times in 1998-99 compared with 1993-94; and the percentage of GP expenditure to state expenditure from 3.5 percent to 7.3 percent. These percentages signify the advances Kerala has made towards expenditure decentralization.

Structure and pattern of expenditure[156]

Apart from the composition and pattern of expenditure, a question that needs to be considered is whether the VPF generates any surplus from current revenue. This question is particularly important because a government order on decentralization mentions balance from current revenue (BCR) as an important source of plan financing.[157] Traditionally, own fund expenditures (OFE) are divided into three, , revenue expenditure, capital expenditure and debt heads. Total revenue or recurring expenditure (such as on salary and maintenance) as a percentage of total OFE remained within the 65-68 percent range except for 1998-99, when it rose to over 72 percent (see Table A1). Establishment cost, consisting of management and salary, was 22-32 percent of the total OFE, and around 47-48 percent of the revenue expenditure, for all the years except 1997-98 when it was only 39 percent. The single largest component of revenue expenditure is the expenditure on public works, which ranged between 24-27 percent.

Maintenance of assets

One of the important causes of the poor quality of life in rural India has been the poor maintenance of assets created, and it is widely acknowledged that PRIs could make a great difference to the situation.

- Per capita maintenance expenditure more than doubled from Rs.15.6 in 1993-94 to Rs.33.7 in 1997-98, and fell to Rs.29.5 the next year (see Table A2). The maintenance expenditure on core functions[158] was around 11-13 percent of total revenue expenditure. The percentage of total maintenance expenditure to revenue expenditure ranged from 40 percent in 1998-99 to 47 percent in 1994-95. As more assets are created, operation and maintenance need to be stepped up, and it is apparent that actual expenditure would have been higher if some norms of standard maintenance expenditure had been followed.
- In addition to revenue expenditure and its components, capital expenditure has also remained relatively stable. The single largest component of capital expenditure is expenditure on public works, which accounts for 71-79 percent. Public works occupy the major share of OFE - as much as 36-40 percent of total revenue and capital expenditure.
- Under the old regime, the planning and development of village areas was, for the most part, left to the state and center. The traditional pattern of expenditure was confined to

[155]Estimated from SSFC survey data.

[156]The structure and pattern of the expenditures from village panchayat fund (VPF), also called own fund (OF), or, broadly, non-plan expenditure from 1993-94 to 1998-99 based on the SSFC data, are examined. This is supplemented with a cross section survey data of 645 GPs spread over 10 districts showing the structure and pattern of planned and actual expenditure for 1998-99, and the sample survey data for 1998-99 to 2001-02. The latter includes the VPF, as well as plan expenditure by GPs, expenditure of the transferred institutions, and pension funds now disbursed through the GPs besides the CSS.

[157]Even otherwise, balance from current revenue is basic to public finance as a source of financing capital expenditure.

[158]Sanitation and drainage, water supply and street lighting.

Table 3.2 : Per gram panchayat and per capita distribution of total expenditure by major sub-categories, sample districts, Kerala, 1998-2002

Details	1998-1999		1999-2000		2000-2001		2001-2002	
	Per GP	Per capita	Per GP	Per capita	Per GP	Per capita	Per GP	Per capita
Own Fund Expenditure	2641115	110.7	2764407	114.8	3277739	134.9	2448319	99.9
Plan Expenditure*	3233783	135.5	5343682	221.9	4378869	180.2	2510373	102.4
Transferred Institutions/ Scheme	1205146	50.5	1054657	43.8	1162623	47.9	983818	40.1
Centrally Sponsored Schemes	363445	15.2	328635	13.6	308113	12.7	431152	17.6
Pension Schemes	387941	16.3	652005	27.1	766421	31.5	1031301	42.1
Total	**7831431**	**328.2**	**10143387**	**421.3**	**9893765**	**407.2**	**7404961**	**302.1**

* Refers only to expenditure out of plan grants. Source: Sample Survey, 1998-99 to 2001-02

establishment cost, maintenance expenditure, and a modicum of capital expenditure (limited to public works). Under the new dispensation, all plan expenditure is generally treated as capital expenditure.

- The dramatic change in the structure and pattern of GP expenditure following decentralisation can be gauged from per GP and per capita trend in expenditure (see Table 3.2). The expenditure pattern of GPs (including CSS) rose from around Rs.17 lakhs per GP and Rs.68 per capita in 1993-94, to over Rs.101 lakhs (over Rs.10 million) per GP and Rs.421 per capita in 1999-2000. It declined sharply in subsequent years, in 2001-2002 for example. What seems to make the major difference is plan expenditure within the whole gamut of expenditure.

Balance from current revenue of GPs

Given the substantial mismatch between own resources and expenditure responsibilities at the GP level, three questions need to be considered:

a) How many GPs in Kerala can generate a surplus from their own revenue (reckoning own revenue with and without assigned taxes@) after meeting recurrent expenditure such as salaries, office expenses maintenance expenditure?

b) What is the proportion of own revenue to total OFE?

c) How does that proportion change when the entire expenditure spectrum of the panchayats is taken into account?

More than half the GPs failed to meet their revenue expenditure even after accounting for shared and assigned taxes.

A district-wise distribution of the number of GPs and per GP balance from current revenue (BCR) is given in Table A3. It shows that in 1993-94, 88 percent of GPs in the state did not have enough revenue from OSR to meet salary, office expenses and routine maintenance expenditures. By and large the situation continued in 1997-98. A corresponding BCR after adding assigned taxes along with OSR and deducting total revenue expenditure shows the percentage of panchayats falls to 48 percent from 88 percent in 1993-94 [Table not reported]. The highest proportion of GPs with a revenue deficit at the state level (69 percent) was recorded in 1997-98 when the people's plan implementation was well under way. In 1997-98, the percentage of panchayats with a revenue deficit ranged from 41 percent in Kannur district to 84 percent in Thiruvananthapuram district. In 1998-99, the state average of GPs with a revenue deficit works out to 56 percent. Thus more than half the GPs failed to meet their revenue expenditure even

@Shared taxes, which are really specific-purpose grants for road maintenance, are not included after accounting for assigned taxes. All the same, only 3.4 percent of GPs cannot meet the running expenditure related to core services even in the worst of times.

What is the situation when the small amount of capital expenditures traditionally handled by the GPs with state grants is also taken into account?[159] A district-wise distribution of panchayats with deficits or surplus (see Table A4) shows that not more than 10-15 percent of the GPs could generate a surplus after meeting their minimum revenue needs and capital expenditures.[160] Taking the state as a whole in 1998-99, 78 percent of panchayats (or an estimated 773 panchayats) required transfers of resources from higher-level governments.

As functional and financial devolution expands, the volume of expenditures panchayats incur or manage continues to expand. Hence the need to rationalize and standardize the accounting system, and understand the own resource situation vis-à-vis the growing structure of expenditures. Sample data on all major expenditures in the 26 sample GPs indicate that no panchayat generates a surplus from own revenue (including assigned tax grants) consistently between 1999 and 2002 in the 26 samples (see Table A5). In 2001-02, five GPs have surpluses. The average total deficit of all GPs (estimate for the state) was Rs.8.3 lakhs in 1998-99 and Rs.9.4 lakhs in 2000-01. In other words, the situation fluctuates from year to year. If the own revenue position is examined with reference to all categories of expenditures (see Table A6) it is apparent that even the improvement assigned taxes make to the own revenue situation is not very substantial. The average for the sample GPs with OSR including assigned taxes ranges from 21.4 percent in 1998-99 to 27.1 percent in 2000-01.

Decentralized planning and expenditure[161]

In the unfolding regime of decentralized governance, the single largest component of the total expenditure of a GP consists of plan expenditure - including expenditure through transferred institutions and schemes. This is about 57-63 percent of total expenditure. The mainstay of the development of a local area has to come largely from this decentralized planning. The effective organic linkage of local planning, services and resources can take place only when the transferred institutions and CSS become an integral part of the GP's functions.

> To build the capacity of PRIs and make them "institutions of self-government" engaged in "planning for economic development and social justice," there has to be effective linkage of local planning, services and resources.

The process of bottom-up planning at the GP level commenced in 1998-99 with clear guidelines for the preparation of local plans. A district-wise distribution of total expenditures planned and achieved by GPs in 1998-99 (see Table A7) illustrates plan grants in aid from the state government as well as the various other sources expected to finance the GP's plan; and the fund flow from state-sponsored and centrally sponsored schemes.

a) **A significant gap between planned and actual expenditures:** GPs often tend to exaggerate plan size because of political pressures. In 1998-99, for instance, out of a planned expenditure of over Rs.700 crores, only Rs.337 crores (barely 48 percent) was achieved on average for the ten sample districts. Barring the negligible item of cooperatives, this gap was most evident for own funds.[162] While more than 90 percent of GPs reported that own funds would be earmarked for financing the plan, in practice,

[159] This is done by relating the total revenue and capital expenditure with reference to the own income (including assigned tax grants) of panchayats.

[160] In 1993-94 the proportion of deficit panchayats ranged from 75 percent in Kollam district to 96 percent in Alappuzha district. In 1997-98 no GP in Idukki and Kasargode districts could generate any surplus.

[161] In the absence of any independent evaluation this study uses some of the data collected by the State Planning Board using a structured format for 1998-99 for 10 districts. This is supplemented with information collected through the sample survey for four years from 1998-99 to 2001-02.

[162] Own fund actual expenditure was as low as 24.5 percent for the state (all district average), ranging from 19.7 percent in Thiruvananthapuram to over 35 percent in Alappuzha.

only 192 GPs out of 645 GPs (30 percent) made any contribution from their own funds.

b) **Plan grants in aid as the largest item of actual plan expenditure:** Reckoned in terms of per capita or as percentage to the total, the single largest item of actual plan expenditure is plan grants in aid from the state.[163] The critical factor that can trigger local development comprises the plan grant. Per GP expenditure from grants in aid is Rs.35.5 lakhs and over Rs.135 per capita. This is followed by beneficiary contribution - as high as Rs.7.14 lakhs per GP for the state as a whole. In all probability, the beneficiary contribution recorded may not be the actual figure.[164]

c) **Mismatch between actual expenditure percentage and real outcome:** The Performance Audit Wing points out instances of a large number of time and cost over-runs of projects taken up by several GPs. The audit report also draws attention to the practice of GPs depositing funds with external agencies and institutions to carry out work on their behalf and treating those deposits as expenditures. During 1997-2001, the reported cases add up to over 102 crores, out of which Rs.46 crores remained unspent in March 2001 (see Table A8).

The analysis of a sector-wise break-up of the expenditure of the total plan of the 26 sample GPs, with per GP and per capita averages for 1998-99 to 2001-02 (see Table A8), shows that grant in aid spent as a percentage of total plan expenditure was above 80 percent for most years, and in 1999-00 and 2000-01, it was above 87 percent. The contribution of own fund to total plan expenditure ranges from seven to 17 percent with several GPs making no contribution at all.[165] Hence the multiplier effect of grants in aid ranges, roughly, from 1.15 to 1.25. In sum, it is the state plan grant that makes decentralized planning a critical factor in mobilizing and utilizing local resources. According to the guidelines of the State Planning Board, 40 percent of expenditures are for productive sectors, and not more than 30 percent for infrastructure. But the evidence is to the contrary, and this is particularly true for the productive sectors comprising agriculture, animal husbandry and industry. Although the normative proportion is by and large maintained for infrastructure, 70-80 percent of infrastructure expenditures were for roads. Thus, despite local planning and clear guidelines regarding spending patterns, it appears that these priorities may not be maintained in the actual execution of projects. The Performance Audit Wing of the Local Administration Department points out instances of time and cost over runs of projects and to the practice of GPs depositing funds with external agencies and institutions to carry out works on behalf of the GPs and treating them as expenditures (see Table A8).

The state plan grant makes decentralized planning a critical factor in mobilizing and utilizing local resources.

Expenditure disparities: an overview

A district-wise distribution of the minimum, maximum, district average, standard deviation and coefficient of variation with reference to the per capita non-plan expenditure of GPs from 1993-94 to 1998-99 (see Table A9) illustrates the wide gap between the minimum and maximum. This is a gap that widens over the years for the state as a whole. Given the difference among panchayats with regard to resource endowment and fiscal capabilities, inter-panchayat variability widens in a dynamic setting. The next question is whether plan expenditures alter the picture (see Table 3.3). The new regime of decentralized local planning leads to the expectation of greater horizontal equity. Examining variations among GPs with multiple regression analysis, this study analyzed the determinants of expenditure variations.

163 Or 67.8 percent for the state as a whole, ranging from 61 percent in Kannur to 73 percent in Idukki. Excluding CSS and state sponsored schemes will increase the percentage. The contribution of CSS is only 2.8 percent.

164 The Performance Audit Wing of the Local Administration Department reports that these figures do not appear in the accounts of the implementing officers in several GPs. Government of Kerala, 2001b.

165 The actual figures are not reported.

Table 3.3 : Per capita plan grant in aid expenditure and per capita total plan expenditure disparities, sample districts, Kerala, 1998-99

District		Minimum		Maximum		Min Max Ratio		Average (Mean)		District Standard Deviation		Coefficient of Variation	
		Grant in aid	Total AE	Grant in aid	Total AE	Grant in aid	Total AE	Grant in aid	Total AE	Grant in aid	Total AE	Grant in aid	Total AE
1	TVM	38.34	45.84	201.28	334.12	5.25	7.29	121.11	180.66	31.68	62.49	26.16	34.59
2	Kollam	48.93	52.36	263.79	451.30	5.39	8.62	117.73	166.09	39.92	65.30	33.91	39.32
3	Pathanamthitta	21.06	21.06	250.88	428.61	11.91	20.35	133.52	199.01	39.07	79.21	29.26	39.80
4	Alappuzha	20.50	60.88	294.65	573.94	14.37	9.43	204.01	307.61	36.89	96.20	18.08	31.27
5	Ernakulam	36.68	40.12	249.38	798.12	6.80	19.89	127.64	192.55	36.38	99.12	28.50	51.48
6	Idukki	95.04	115.01	459.55	477.26	4.84	4.15	163.31	223.66	63.90	88.71	39.13	39.66
7	Palakkad	56.79	70.75	388.01	438.53	6.83	6.20	145.06	199.05	49.84	76.02	34.36	38.19
8	Kozhikode	52.14	61.86	160.81	306.80	3.08	4.96	106.34	157.50	26.47	55.11	24.89	34.99
9	Wayanad	79.29	124.35	322.48	679.69	4.07	5.47	176.72	267.05	58.03	120.41	32.84	45.09
10	Kannur	60.58	88.12	207.06	549.67	3.42	6.24	110.32	181.16	24.81	83.06	22.49	45.85
State		**20.50**	**21.06**	**459.55**	**798.12**	**22.41**	**37.90**	**135.32**	**199.50**	**50.02**	**91.59**	**36.96**	**49.91**

AE: Actual Expenditure; TVM: Thiruvananthapuram. Min-Max ratio=maximum divided by minimum.
Source: Government of Kerala, 2001a

The determinants of variations in per capita expenditures by GPs

a) **Non-plan expenditure:** Per capita non-plan expenditures in Kerala vary from Rs.30 to Rs.687 around a mean of Rs.127. What explains this large variation? Why do some GPs in Kerala spend more than others? And is there a pattern to the variation? One obvious explanation is revenue availability. But since GPs raise about 45-50 per cent of non-plan expenditures from their own revenues, there is also an element of local choice. The question then is whether the actual pattern of spending shows that places with more capacity spend more, or whether there is also a response to variations in expenditure needs. This study modeled the determinants of variations in per capita non-plan expenditures with five independent variables: population size;[166] land area;[167] proportion of agricultural workers and the poor in the population;[168] proportion of concrete housing structures;[169] and a district variable, to account for the possibility that some districts have a culture of spending more than others. The regression results (see Table A10) for the 615 GPs for which data are available show that about 20 percent of the variation in per capita expenditures can be explained by this model:

[166]This should pick up an effect of economies of scale and should be negatively related to per capita expenditures.

[167]Because the spending levels of GPs are so low, high fixed costs for smaller places should show up in a higher per capita amount of spending. Land area should be positively related to spending level because of the higher cost of serving a larger area.

[168]A greater share of agricultural workers in the population and a greater share of poverty population should drive up costs because of the higher cost of providing services to the poor.

[169]A larger proportion of concrete housing structures should drive up expenditures because one would expect a greater demand for services and a greater capacity to pay for services.

- GPs with a lower population spend significantly more, suggesting a high fixed cost component to per capita expenditures.
- A greater percent of concrete housing units is associated with a significantly higher level of spending, implying that higher taxable capacities stimulate larger per capita GP budgets and/or that more affluent households demand more public services.
- Neither land area nor the concentration of poverty is a significant determinant of the level of per capita non-plan expenditures.
- The district effects are strong, and show that virtually every district in Kerala spends more than Malappuram,[170] even after accounting for these other factors.

b) **Plan expenditures:** Plan expenditures are available for a more limited sample of 495 GPs.[171] Moreover, because of data limitations, only three explanatory variables are used: population size, land area and poverty. The results of this analysis (see Table A11) show that approximately 31 percent of the variation in plan expenditures may be explained. This is more than in the case of non-plan expenditures, suggesting that the distribution of financing for plan expenditures across GPs is more systematic.[172]

- GPs with smaller populations spend more on a per capita basis, suggesting again the high fixed cost factor.
- GPs with a larger land area and with a larger concentration of poverty population spend more on a per capita basis, suggesting an influence of public servicing needs on spending patterns. In general, the determinants of per capita variations in plan expenditures are similar to that in non-plan expenditures. One difference, however, is that the district effects are less pronounced.

c) **Total expenditures:** A measure of total plan plus non-plan expenditures has been developed from the dataset for 495 GPs.[173] The mean per capita amounts for this sample of GPs are non-plan expenditures, Rs.106.9; plan expenditures, Rs.207.6; and total expenditures, Rs.314.5. The regression analysis (see Table A12) includes the three independent variables of population, land area, and the concentration of poverty population. All three variables are significant and district effects are present. In general,

- If a GP has a 10 percent larger population, its per capita spending level can be expected to be about 2.5 percent lower.
- If the land area is 10 percent greater, its expected spending will be about one percent higher.
- If its share of poverty population is 10 percent higher, its expected spending level will be about 0.5 percent higher.

Expenditure: in summary

The expenditure assignments and tasks of the panchayats have expanded considerably since the late nineties. So have the "agency" functions of the GPs. Per capita expenditure has risen from about Rs.51 to about Rs.421 in 1999-00. But the critical factor continues to be own revenue. There is considerable inter-district and intra-district disparity in per capita resource base and per capita expenditure. Finally, accounts of poor expenditure management - including unauthorized withdrawals, cases of fictitious accounting, works left unfinished

[170] Malappuram is the omitted district, and the significance of all district coefficients are interpreted relative to Malappuram.

[171] Plan expenditures here include plan grants from the state but also, certain own funds, state sponsored and centrally sponsored schemes, co-operatives, financial institutions, voluntary service/contributions, beneficiary shares, and some miscellaneous amounts used as plan expenditure

[172] This also fits in with the regression results for plan grants in the subsection on intergovernmental transfers.

[173] Though datasets are being mixed, this aggregate expenditure number may enable a rough estimate of the variation in total spending across GPs.

Village panchayats earlier confined to recurring expenditures for maintenance and civic functions have begun to take up the constitutional task of planning the just economic development of a local area. But own revenue continues to be critical.

after some initial expenditures, failure to follow norms, and the lack of budgetary control over expenditures, indicate the need for greater scrutiny and rationalization of all categories of expenditure, notably planned expenditure. A more efficient, equitable and rational transfer system is necessary to improve local development and local democracy.

Revenue: structure, composition and disparities[174]

Panchayat income: a total picture

The major sources of finance of a GP are tax revenue, non-tax revenue and grants (see Box 3.2; also Figure 2.1, Chapter 2). A summary picture of the composition and trend of income (see Table 3.4) shows that the receipts at the disposal of the 789 panchayats under study increased from over Rs.153.08 crores in 1993-94 to Rs.696.9 crores in 1998-89, an increase of 4.5 times in six years. Though the corresponding increase is only 2.7 times in real terms, it is still a significant increase.

Table 3.5 presents the distribution of per capita and per GP receipts from 1993-94 to 1998-99. A district-wise distribution abstracted from Table 3.5, using undeflated figures, gives a summary picture (see Table 3.6) relating to OSR and total receipts (TR). Examining all the major items of per capita receipts, the most striking aspect is the yawning gap between nominal and real per capita items during the latter years (see Figures A1-A4). There is fluctuation, and the decline is sharpest for per capita central grants. There is a sharp increase in non-statutory grants (predominantly plan grants) from 1996. Here too, the gap between the real and nominal is wide. Table 3.5 shows that the per capita receipt (about Rs.76) and per GP receipt (over Rs.0.19 crore) in 1993-94 rises to Rs.330 and Rs.0.88 crore respectively in 1998-99. In real terms, the growth rate of per capita total receipts is less impressive, even negative in the two years under the pre-plan regime. But the plan campaign regime witnesses significant growth though the momentum is not maintained in 1998-99 and, probably, in subsequent years. The most disturbing aspect then is the poor growth of per capita and per GP own source revenue.

Even if grants for CSS are excluded,[175] the total per capita receipts of panchayats registered a remarkable growth from Rs.59 in 1993-94 to Rs.318 in 1998-99 and in real terms to Rs.191.

Box 3.2 : The receipts of gram panchayats

Several taxes and non-tax revenue sources are assigned to GPs for collection. The GP chooses the rate relevant to each tax within the broad rate band set out by the statutes, and administers the tax and non-tax revenue. A GP enjoys considerable discretion in the spending of this revenue. The balance after meeting recurring expenses is to be diverted to finance plan expenditures. Although the structure of staff remuneration (salary, allowance, pension) is determined by the state government, the GP has to meet the payment out of its own revenue. (The state government pays the entire remuneration of the personnel of the transferred institutions.)

The tax revenue has an own source component and a state component, the latter consisting of assigned taxes (basic tax on land and a four percent surcharge on stamp duty collected under the provisions of the Kerala Stamp Act, 1959 on every transaction of the value of the property transacted); shared tax (the share for GPs called vehicle tax compensation). The assigned and shared taxes are officially referred to as "statutory grants." Besides these, there are a variety of general and specific-purpose grants given by the state and central governments.

Although the GPs in Kerala are permitted to raise loans, they do not constitute a major item of receipts.

Besides the current receipts, the resources available to a panchayat include the opening balance carried over from the previous fiscal year. If the closing balance at the end of the fiscal is higher than the opening balance, there is zero withdrawal. If lower, the difference shows the withdrawal from the opening balance. This difference could be considered an index of fund utilization.

[174] In this first attempt to bring together available data on total revenue of GPs in the state, the emphasis is on per capita figures and ratios of structural components of revenue. While nearly 92 percent of the GPs have an average per capita tax revenue of only Rs. 22.4 in 1998-99, the per capita receipt of a GP (excluding central grants) rises to about Rs. 318. This is certainly significant fiscal decentralization as far as state sub-state devolution is concerned.

[175] These registered a progressive decline in terms of the total proportion (from 22.5 percent in 1993-94 to 3.7 percent in 1998-99) as well as in terms of rate of growth.

Table 3.4 : Distribution of sources of receipts of sample gram panchayats, Kerala, 1993-94 to 1998-99, Rs. in crores

Year	OSR	Statutory Grants	State Grants (Non-statutory)	Central Grants	Debt Head	Loans	Withdrawals	Total Receipts
1993-94	47.9 (47.90)	33.8 (33.8)	25.9 (25.9)	34.5 (34.5)	5.6 (5.6)	0.1 (0.1)	5.2 (5.2)	153.1 (153.1)
1994-95	59.5 (53.13)	25.9 (23.13)	32.0 (28.6)	23.6 (21.1)	6.6 (5.9)	0.0 (0.0)	8.6 (7.7)	156.3 (139.6)
1995-96	64.2 (49.38)	40.9 (31.46)	34.7 (26.7)	26.1 (20.1)	7.7 (5.9)	0.1 (0.1)	5.9 (4.5)	179.7 (138.2)
1996-97	78.0 (54.17)	70.8 (49.17)	101.4 (70.4)	25.3 (17.6)	9.1 (6.3)	0.1 (0.1)	1.9 (1.3)	286.6 (199.0)
1997-98	96.0 (61.54)	67.4 (43.21)	364.5 (233.7)	25.0 (16.0)	11.4 (7.3)	0.0 (0.0)	52.1 (33.4)	616.4 (395.1)
1998-99	119.7 (72.11)	67.2 (40.48)	438.8 (264.3)	25.7 (15.5)	12.7 (7.7)	0.1 (0.1)	32.7 (19.7)	696.9 (419.8)

Percentages

Year	OSR	Statutory Grants	State Grants (Non-statutory)	Central Grants	Debt Head	Loans	Withdrawals	Total Receipts
1993-94	31.3 (31.3)	22.1 (22.1)	16.9 (16.9)	22.5 (22.5)	3.7 (3.7)	0.1 (0.1)	3.4 (3.4)	100.0 (100.0)
1994-95	38.1 (34.0)	16.6 (14.8)	20.5 (18.3)	15.1 (13.5)	4.2 (3.8)	0.0 (0.0)	5.5 (4.9)	100.0 (89.3)
1995-96	35.7 (27.5)	22.8 (17.5)	19.3 (14.8)	14.5 (11.2)	4.3 (3.3)	0.1 (0.1)	3.3 (2.5)	100.0 (76.9)
1996-97	27.2 (18.9)	24.7 (17.2)	35.4 (24.6)	8.8 (6.1)	3.2 (2.2)	0.0 (0.0)	0.7 (0.5)	100.0 (69.4)
1997-98	15.6 (10.0)	10.9 (7.0)	59.1 (37.9)	4.0 (2.6)	1.8 (1.2)	0.0 (0.0)	8.4 (5.4)	100.0 (64.1)
1998-99	17.2 (10.4)	9.6 (5.8)	63.0 (38.0)	3.7 (2.2)	1.8 (1.1)	0.0 (0.0)	4.7 (2.8)	100.0 (60.2)

Note: Figures in parentheses are real income figures after deflating with SDP deflator (1993-94=100). The corresponding growth rates are in parentheses under GR.

The annual growth rate per panchayats rose from 11.8 percent in 1994-95 to 126.3 percent in 1997-98.[176] Thus statutory and central government grants apart, there has, on the whole, been substantial devolution of resources. The OSR of a panchayat is a key factor in building autonomous decentralized governance. The major share in the composition of revenue (excluding central grants) is OSR, with own tax revenue the most important item till 1995-96, when the people's plan campaign was launched and there was a sharp increase in plan grants to local bodies. OSR for the state as a whole, as high as 38 percent in 1994-95, fell to 17 percent in 1998-99.

A disaggregated account of tax and non-tax revenue

A break-up of own tax revenue and non-tax revenue (NTR) helps to place OSR in perspective vis-à-vis total receipts. The district-wise distribution in 1993-94 and 1998-99 shows a relatively stable picture around the state average for percentage of OSR to total revenue. The proportion ranges from 23 percent in Idukki to 34 percent in Thrissur, Kozhikode and Kannur in 1993-94 with a state average of 31 percent. In 1998-99, the corresponding variation is from 12 percent in Thiruvananthapuram and Idukki to 23 percent in

[176] Growth was very much lower in the following year.

Table 3.5 : Distribution of nominal and real per capita and per panchayat receipt by major sources with rate of growth, sample districts, Kerala, 1993-94 to 1998-99

Per Capita (Rs.)

Year	OSR	GR	Statutory Grants	GR	State Grants (Non-Statutory)	GR	Central Grants	GR	Total Receipts	GR
1993-94	23.70 (23.70)	–	16.72 (16.72)	–	12.83 (12.83)	–	17.08 (17.08)	–	75.76 (75.76)	–
1994-95	29.18 (26.05)	23.12 (9.93)	12.72 (11.36)	-23.91 (-32.06)	15.72 (14.03)	22.52 (9.40)	11.58 (10.34)	-32.22 (-39.48)	76.64 (68.43)	1.17 (-9.67)
1995-96	31.20 (24.00)	6.92 (-7.88)	19.89 (15.30)	56.40 (34.74)	16.89 (12.99)	7.44 (-7.44)	12.69 (9.76)	9.57 (-5.60)	87.35 (67.20)	13.98 (-1.80)
1996-97	37.57 (26.09)	20.42 (8.71)	34.09 (23.67)	71.38 (54.72)	48.87 (33.93)	189.36 (161.23)	12.19 (8.46)	-3.93 (-13.27)	138.07 (95.88)	58.06 (42.69)
1997-98	45.83 (29.38)	22.01 (12.62)	32.19 (20.63)	-5.58 (-12.85)	174.03 (111.56)	256.13 (228.74)	11.91 (7.64)	-2.24 (-9.76)	294.27 (188.63)	113.13 (96.74)
1998-99	56.66 (34.13)	23.61 (16.16)	31.80 (19.16)	-1.19 (-7.14)	207.61 (125.07)	19.30 (12.11)	12.15 (7.32)	1.95 (-4.20)	329.74 (198.64)	12.06 (5.31)

Percentages

Year	OSR	GR	Statutory Grants	GR	State Grants (Non-Statutory)	GR	Central Grants	GR	Total Receipts	GR
1993-94	6.07 (6.07)	–	4.28 (4.28)	–	3.29 (3.29)	–	4.38 (4.38)	–	19.40 (19.40)	–
1994-95	7.54 (6.73)	24.23 (10.92)	3.29 (2.93)	-23.23 (-31.45)	4.06 (3.63)	23.63 (10.38)	2.99 (2.67)	-31.61 (-38.93)	19.81 (17.68)	2.08 (-8.86)
1995-96	8.13 (6.26)	7.89 (-7.05)	5.19 (3.99)	57.80 (35.95)	4.40 (3.39)	8.41 (-6.60)	3.31 (2.54)	10.56 (-4.75)	22.78 (17.52)	15.01 (-0.92)
1996-97	9.88 (6.86)	21.50 (9.69)	8.97 (6.23)	72.92 (56.11)	12.86 (8.93)	191.96 (163.58)	3.21 (2.23)	-3.07 (-12.49)	36.33 (25.23)	59.48 (43.98)
1997-98	12.17 (7.80)	23.11 (13.64)	8.54 (5.48)	-4.73 (-12.06)	46.20 (29.61)	259.34 (231.70)	3.16 (2.03)	-1.36 (-8.95)	78.12 (50.08)	115.05 (98.51)
1998-99	15.18 (9.14)	24.72 (17.21)	8.52 (5.13)	-0.30 (-6.31)	55.61 (33.50)	20.37 (13.12)	3.25 (1.96)	2.86 (-3.33)	88.32 (53.21)	13.06 (6.25)

Note: Figures in parentheses are real income figures arrived at by deflating nominal amounts by SDP deflators with 1993-94 as the base year

Ernakulam with a state average of 17 percent. This decline in proportion is not entirely due to the increase in total receipts following plan grants increase, but also due to the slow growth rate in tax revenue. But for the phenomenal growth in non-tax revenue, the OSR would have been much lower. In 1998-99, NTR is way ahead of tax revenue. The per capita NTR in 1998-99 is Rs.29.23 as against per capita tax revenue of Rs.27.43.[177] The tax/non-tax proportion (see Tables A13 and A14), around 70:30 in 1993-94, became 60:40 in 1996-97; in 1998-99, it was 50:50. Has the state fully used its property tax potential? Some indirect evidence would suggest not.[178]

[177] This happened much earlier in several districts. In 1995-96 the annual growth rate of tax revenue has fallen to 0.92 and in several districts (Kozhikode, Kottayam, Pathanamthitta, Wayanad and Thiruvananthapuram) it actually declined. This may be because GP staff had been deployed for duties related to the elections for local bodies. A general strike by panchayat employees may also have affected the performance of some panchayats.

[178] The large construction boom in the state has meant a sharp increase in revenue from the sale of sand in river beds, an important input for construction. Revenues increased from Rs.1.5 crores in 1993-94 to Rs.19 crores in 1998-99 in the GPs studied. And this reflects only a fraction of potential revenue. Coupled with the slow increase or decline of the yield from property tax in some GPs, this suggests that that the revenue potential of property tax has not been fully tapped. Also see the next subsection on tax efforts.

Table 3.6 : District-wise distribution of per capita and per panchayat OSR and total revenue, sample districts, Kerala, 1993-94 and 1998-99

Districts	Per Capita (Rs.)				Per Gram Panchayat (Rs. in lakhs)				of OSR to %Total Revenue	
	1993-94		1998-99		1993-94		1998-99		1993-94	1998-99
	OSR	TR	OSR	TR	OSR	TR	OSR	TR		
Thiruvananthapuram	18.9	63.6	36.9	303.9	5.08	17.14	10.41	85.68	29.66	12.16
Kollam	23.0	70.3	51.0	319.9	7.13	21.80	16.55	103.84	32.69	15.94
Pathanamthitta	25.9	81.0	72.1	381.0	5.23	16.36	15.24	80.47	31.97	18.93
Alappuzha	18.5	57.4	44.5	295.7	4.43	13.76	11.15	74.16	32.16	15.03
Kottayam	22.9	75.6	53.4	314.8	5.04	16.65	12.30	72.51	30.28	16.96
Idukki	19.9	85.1	46.4	389.8	3.87	16.54	9.43	79.20	23.42	11.91
Ernakulam	26.4	79.9	84.4	366.2	6.23	18.81	20.78	90.18	33.10	23.04
Thrissur	27.3	80.9	58.2	338.9	7.03	20.81	15.66	91.14	33.76	17.18
Palakkad	22.1	79.3	58.5	365.4	5.38	19.28	14.87	92.92	27.93	16.01
Malappuram	20.7	66.6	53.2	285.4	6.45	20.74	17.32	92.90	31.11	18.64
Kozhikode	29.8	87.5	63.3	311.4	8.05	23.61	17.87	87.90	34.08	20.34
Wayanad	38.5	122.2	83.6	479.8	11.38	36.10	25.82	148.21	31.54	17.42
Kannur	23.7	70.4	57.8	312.1	5.88	17.50	15.03	81.14	33.61	18.52
Kasargode	22.3	92.0	52.5	353.3	5.73	23.62	14.11	94.85	24.27	14.87
Kerala	23.7	75.8	56.7	329.7	6.07	19.40	15.18	88.32	31.28	17.18

Own source revenue of GPs and state's own revenue

Comparing the state's own revenue with that of the own revenue component of village panchayats (see Table 3.7) helps understand the fiscal decentralization process. The OSR percentage of GPs increased marginally from 2.2

Table 3.7 : Own Source Revenue of gram panchayats and state's own revenue, Kerala, 1993-94 and 1998-99

Variables	1993-94 (Rs. in crores)	1998-99 (Rs. in crores)	Percentage Growth (%)
I. Total State Own Revenue (a+b)	2668	5208	95
(a) State Tax Revenue	2345	4650	98
(b) State Non-Tax Revenue	323	558	73
II. Total Own Source Revenue of GPs (a+b)	60.3	150.23	149
(a) Estimated OTR of Kerala GPs	42.0	72.72	73
(b) Estimated NTR of GPs	18.3	77.51	323
Percentage of OSR to State Own Revenue	2.2	2.9	32
Percentage of OTR of GPs to State Tax Revenue	1.8	1.6	(-) 11
Percentage of NTR of GPs to State Non-Tax Revenue	5.7	13.9	144
Percentage of OSR of GPs to SDP	0.3	0.28	(-)0 .9
Percentage of State Own Revenue to SDP	13.5	9.1	(-) 33

OTR: Own tax revenue. Source: For the items under state own revenue, Government of Kerala, Budget in Brief for the relevant years; for SDP, Government of Kerala, Economic Review for the respective years.

percent in 1993-94 to 2.9 percent in 1998-99. This picture alters significantly when OSR is separated into tax and non-tax components. The proportion of own tax revenue of GPs as a proportion of the total tax revenue of the state actually declined during the period, while NTR surged. Both GPs as well as the state appear to have failed to tap the increase in state domestic product (SDP) during this period, and the failure seems greater on the part of the state.

Population size, area size, location and pattern of revenue distribution

Is there a pattern in the distribution of panchayat receipts, particularly in the case of OSR and state grants (see Tables 3.8 and 3.9)?

- GPs with a population below 10,000 have the highest per capita OSR in all the periods. They invariably attract the highest per capita grant. GPs with a population above 50,000 have the lowest per capita OSR.
- OSR is not directly linked to scale, be it population or area. GPs below an area of 10 sq km have the highest per capita OSR, followed by the next size (10-20 sq km).
- State and center government grants are, by and large, regressively distributed with reference to panchayat population. This is more pronounced in the case of some districts. GPs with a population size above 30,000 almost invariably have a per capita grant below the state average.

Table 3.8 : Per capita own source revenue and per capita grant by population size class, sample districts, Kerala, 1993-96 and 1996-99

No	Average Population Size class	No of Panchayat	OSR-Average per Capita		Per Capita Grant for the year					
			1993-96	1996-99	1993-96			1996-99		
					SG	CG	TG	SG	CG	TG
1	Below 10,000	10	39.4	80.6	50.7	39.5	90.1	234.0	35.1	269.1
2	10,000 -20,000	196	31.1	51.3	23.2	17.7	40.9	157.8	15.7	173.5
3	20,000 - 30,000	355	27.6	48.3	16.2	15.5	31.8	147.0	13.9	160.9
4	30,000 - 40,000	165	26.8	43.4	11.8	11.2	23.0	137.4	9.5	146.9
5	40,000 - 50,000	45	28.9	44.4	9.4	9.0	18.4	133.1	8.2	141.3
6	Above 50,000	18	25.5	38.7	6.8	7.3	14.1	122.5	5.2	127.7
7	Average	789	28.0	46.7	15.1	13.7	28.9	143.9	12.1	156.0

SG: State grant; CG: Central grant; TG: Total grant.

Table 3.9 : Per capita own source revenue and per capita grant by area size class, sample districts, Kerala, 1993-96 and 1996-99

No	Area size sq km	No of Panchayat	OSR-Average per Capita		Per Capita Grant for the year					
			1993-96	1996-99	1993-96			1996-99		
					SG	CG	TG	SG	CG	TG
1	Below 10	42	38.2	57.8	16.9	11.6	28.4	134.8	9.5	144.2
2	10 - 20	265	29.6	49.3	14.5	12.1	26.7	138.1	10.3	148.4
3	20 - 30	247	27.6	46.3	15.2	13.8	29.0	141.6	12.1	153.7
4	30 - 50	130	24.8	41.8	15.2	13.9	29.1	144.6	12.0	156.6
5	50 - 100	69	28.2	48.9	16.4	18.2	34.5	159.5	17.2	176.7
6	Above 100	36	22.3	36.7	14.4	17.1	31.4	171.8	16.7	188.4
7	Average	789	28.0	46.7	15.1	13.7	28.9	143.9	12.1	156.0

Panchayats with a larger area attracted a higher per capita grant during 1996-99.[179]

- The distribution of OSR by geographical region dispels the belief that GPs in the highland region are poorer. The richer highland GPs attract the highest central grant, though the coastland GPs get a higher per capita state grant.

Revenue disparities

An analysis of revenue disparities[180] (see Table A15 for per capita revenue disparities with reference to total revenue of all GPs) shows that

- The highest minimum is in the highland district of Wayanad with a per capita tax minimum of Rs.11.61 in 1997-98. As far as the minimum non-statutory revenue is concerned, the situation is worse.[181] The state average of per capita minimum statutory grants more than doubled from Rs.2.68 in 1993-96 to Rs.5.97 in 1996-99. The sharp rise since 1994-95 is obviously because the state government chose to release more arrears due to GPs and regularized the payments. The high minimum non-statutory grant in 1997-98 and 1998-99 is because of bigger plan allocations.
- The maximum per capita tax and NTR reported (Rs.328 and Rs.462) is indeed a high figure, possibly the highest in the country.
- The least variation is observed in the case of non-statutory grants - as low as 20 percent in 1996-99, reflecting the criteria-based devolution of plan grants during 1997-98 and 1998-99. It is equally important to note that the variation in total receipts declined significantly in the 1996-99 period (29 percent from 47 percent). CSS grants, by and large, indicate high inter-district variations over time.
- NTR and grants show that the number and percentage of GPs below state per capita averages has increased over time. It is lowest for non-statutory grants, with only around 50 percent GPs below the state average. It is highest for NTR, and in 1996-99, 545 GPs (69 percent) were below the state average. But the number of panchayats with per capita total receipts (minus central grants) below the state average declined from 55 percent in 1993-96 to 52.6 percent in 1996-99. This is a significant trend, though much remains to be done in terms of reducing disparities.

Table 3.10 : Percentage of sample blocks with negative growth rates, Kerala, 1994-95 to 1998-99

Year	Nominal (Percentage)	Real (Percentage)
1994 - 95 Range of GR	10.0 - 6.6 (-25.3 - +110.4)	53.0 - 35.0 (-33. - +87.8)
1995 - 96 Range of GR	47.0 - 31.1 (-25.0 - +134.3)	123.0 - 81.4 (-35.4 - +101.9)
1996 - 97 Range of GR	15.0 - 9.9 (-32.0 - +110.2)	48.0 - 31.7 (-38.6 - +89.8)
1997 - 98 Range of GR	32.0 - 21.2 (-25.3 - +167.3	60.0 - 39.7 (-45.7 - +146.7)
1998 - 99 Range of GR	24.0 - 15.9 (-63.0 - +213.3)	39.0 - 25.8 (-65.2 - +194.4)

Note: Figures in parentheses refer to the growth rate (GR) range from the lowest to the highest in the151 blocks.
Source: SSFC Survey.

[179] The grant system is more even with reference to area during the latter part compared to the 1993-96 period.

[180] This has been done by breaking down the simple frequency distribution of the major sources of revenue and total receipts into appropriate class intervals, and examining disparities with minimum and maximum gap, deviation around the mean, and the coefficient of variation.

[181] For most districts NTR picks up in the later years due to the increased yield from sources such as the sale of sand.

Tax efforts of gram panchayats[182]

A disaggregated trend of the growth rate of OSR: the block pattern

The picture of negative growth of per capita OSR, both in nominal and real terms, is summed up in Table 3.10 for the years from 1994-1999. The wide range in the growth rate shows that there is tremendous scope for improvement, and that a system of rewards and penalties would help in fully tapping tax potential. Examining the per capita trend in the OSR of all blocks for a discernable pattern, the findings are that almost the same blocks are in the top 20 percent for per capita OSR for the six years under study.[183] But no pattern could be perceived in the case of the 10-15 percent blocks at the lowest end of the per capita spectrum.

Growth rate of major taxes

Table 3.11 presents the trend in the per capita value of the major panchayat taxes and the rate of growth corresponding to each. Between 1993-94 and 1998-99, the trends for property tax, profession tax and entertainment tax,[184] along with the trend for total OTR, indicate a sharp rise only in profession tax. Per capita property tax growth rate was negative in two years and as low as -4.1 percent in 1995-96. The district-wise distribution of the sample GPs with negative growth rate for 1996-99 shows 101 GPs with a negative growth in per capita property tax, 44 GPs with a negative growth rate in profession tax, and 225 GPs with a negative growth in entertainment tax. Given the inflow of foreign money into Kerala and the boom in building construction,[185] per capita property tax should have been much higher. Also, the five-year revision of tax rate has not occurred since 1993.[186] And out of 50 GPs selected from the sample survey, only three (six percent) chose the maximum rate (ten percent) permitted by the state statute in fixing the property tax; 46 percent chose

Table 3.11 : Per capita growth rate of major taxes, sample districts, Kerala, 1993-94 to 1998-99

Year	Property Tax	GR	Prof. Tax	GR	Advertisement Tax	GR	Entertai-ment Tax	GR	Own Tax	GR
1993-94	8.79 (8.79)	0.00 (0.00)	4.76 (4.76)	0.00 (0.00)	0.03 (0.03)	0.00 (0.00)	2.48 (2.48)	0.00 (0.00)	16.48 (16.48)	0.00. (0.00)
1994-95	10.48 (9.36)	19.23 (6.45)	5.91 (5.28)	24.16 (10.86)	0.03 (0.03)	0.00 (-10.71)	2.82 (2.52)	13.71 (1.53)	19.75 (17.63)	19.84 (7.00)
1995-96	10.05 (7.73)	-4.10 (-17.38)	6.19 (4.76)	4.74 (-9.76)	0.01 (0.01)	-66.67 (-71.28)	3.01 (2.32)	6.74 (-8.04)	19.76 (15.20)	0.05 (-13.80)
1996-97	11.42 (7.93)	13.63 (2.58)	7.24 (5.03)	16.96 (5.59)	0.02 (0.01)	100.00 (80.56)	3.34 (2.32)	10.96 (0.18)	22.57 (15.67)	14.22 (3.12)
1997-98	11.23 (7.20)	-1.66 (-9.23)	8.43 (5.40)	16.44 (7.48)	0.02 (0.01)	0.00 (-7.69)	3.71 (2.38)	11.08 (2.53)	23.93 (15.34)	6.03 (-2.13)
1998-99	13.35 (8.04)	18.88 (11.72)	9.8 (5.90)	16.25 (9.25)	0.03 (0.02)	50.00 (40.96)	3.62 (2.18)	-2.43 (-8.30)	27.43 (16.52)	14.63 (7.72)

[182] Tax effort has to be related to some measure of tax potential or taxable capacity. In view of the difficulty of obtaining reliable data on taxable capacity at the GP level, this study uses proxy variables. References to benchmarks such as state/district/block average over time can also be used as supplementary measures of relative tax effort. Two case studies of tax potential and tax collections were made to gauge the empirical situation besides using a couple of regressions to measure tax effort.

[183] These high per capita blocks have a high urban bias, or are "gulf pockets" - blocks with villages receiving foreign remittances, or industrial or trade centers.

[184] Which together account for over 97 percent of the total tax revenue.

[185] Inaugurating the Global Investor Meet at Kochi in 2003, Prime Minister A.B. Vajpayee said that non-resident Keralites bring in around five billion dollars of foreign exchange a year, a sizeable proportion of which has been spent on house construction (The Hindu, Thiruvananthapuram, January 19, 2003). Around 85-92 percent of the gross fixed capital formation in the state during the last two decades has been due to construction activities (Government of Kerala 2001a).

[186] These revisions generally raise property tax yield by 20-25 percent.

the minimum rate of six percent; and 44 percent a rate above six and below 10 percent. As long as a large number of GPs tend to choose the minimum rate, tax yield will be relatively smaller.

Relative tax effort: intra-district comparisons

Another measure of relative tax effort (ignoring inter-regional differences in taxable capacity) is to make intra-district comparisons with reference to the district average, and inter-district comparisons with reference to the state average over time (see Table A16).

- The district average per capita tax ranges from Rs.14.4 for Thiruvananthapuram to Rs.24.4 for Wayanad during 1993-96. In 1996-99 too, these districts show the minimum and maximum. The percentage of GPs falling below their respective district averages increased in seven districts in 1996-99 compared to 1993-96. Four districts maintained the status quo, and the situation did not improve in three districts.
- The percentage of GPs falling below the average state per capita tax in 1993-96 ranged from 44.7 percent in Thrissur to 82.8 percent in Thiruvananthapuram. Almost the same pattern continued in 1996-99. The percentage of GPs falling below the state average increased in eight districts, and the situation improved in only four districts. While 524 GPs out of 789 (66 percent) were below the state average, the number rose to 536 and the proportion to 68 percent in 1996-99.[187]
- For non-tax per capita revenue in 1993-96, the range is from Rs.4.7 (Alappuzha) to Rs.20.5 (Wayanad). For 1996-99 the range is from Rs. 12.87 (Thiruvananthapuram) to Rs.43 (Wayanad). Six districts with per capita NTR above the state average continued to hold their position in 1996-99. In 1993-96, 524 GPs (about 66 percent) had per capita NTR below the state average; the number rose to 545 and the percentage to 69 percent in 1996-99.

Table 3.12 : District-wise distribution of tax effort using regression, sample districts, Kerala

No.	District	Predicted Values	Actual Values	Index of Tax effort
1	Thiruvananthapuram	27.4	20.05	0.7
2	Kollam	31.4	25.19	0.8
3	Pathanamthitta	28.0	18.69	0.7
4	Alappuzha	32.2	27.16	0.8
5	Kottayam	30.1	30.10	1.0
6	Idukki	29	24.30	0.8
7	Ernakulam	28	33.10	1.2
8	Thrissur	32.6	31.50	1.0
9	Palakkad	31.3	28.46	0.9
10	Malappuram	31	29.96	1.0
11	Kozhikode	34.3	27.00	0.8
12	Wayanad	32.8	37.85	1.2
13	Kannur	30.6	29.16	1.0
14	Kasargode	30.3	26.67	0.9
KERALA		30.4	27.43	0.9

[187] How to reduce this dispersion from the average is a key policy question. As already noted, a system of rewards and punishment seems to be the relevant suggestion.

- The tax and non-tax performance of GPs has not been uniform, and there has been considerable variation among districts and among blocks. That the number of GPs falling below the state average has increased over time for both tax and non-tax revenue indicates a fall in overall tax effort, besides an increase of dispersion and inequity in the distribution of revenue burden over time.

District income/district own tax revenue ratio

Income is a widely accepted index of the ability to pay or taxable capacity.[188] Examining the district income data from 1993-94 to 1998-99, the aggregate tax revenue of the GPs studied in each of these districts, and the corresponding ratio, it is clear that the ratio has generally declined in almost all districts, particularly after 1995-96. Table 3.12 presents a district-wise distribution of tax effort using the regression model. The trend shows that GPs have failed to mobilize resources commensurate with the growth in income. The hypothesis that grants have an adverse effect on the tax effort of local bodies did not hold.[189]

Tax potential and tax collected: some case studies

Do the tax revenues obtained from the various taxes correspond to their real potential? Two relevant case studies[190] tell us more about the tax effort scenario.

a) **Case study 1: undertaxation in six GPs:** Six GPs were selected for the study from the two regions of Travancore-Cochin and Malabar on the basis of proximity to urban areas, typical agriculture-dominated area, and predominantly backward area with high SC/ST population.[191] The survey data revealed that 30 to 70 percent of the houses exempted could easily come under the category of taxable households. More specifically, the findings on the degree of non-utilization of tax potential of the property tax, profession tax and entertainment tax in 1998-99 were as follows:

   - Table 3.13 shows the tax potential (estimated largely on the basis of the exemptions and

Table 3.13 : Potential and actual collection of property tax in the six case study panchayats, Kerala, 1998-99

No.	Name of Panchayats	Tax Potential (Rs. in lakhs)	Actual Collection (Rs. in lakhs)	Percentage of Realization
1	Kuttichal	4.89	1.28	26.18
2	Noolpuzha	3.65	1.88	51.51
3	Thakazhy	5.51	2.03	36.84
4	Thirunavaya	13.05	3.54	27.13
5	Thrikkakara	33.24	16.16	48.62
6	Elanthur	17.21	6.18	35.91
All GPs		77.55	31.07	40.06

[188] How to reduce this dispersion from the average is a key policy question. As already noted, a system of rewards and punishment seems to be the relevant suggestion.

[189] Figures of income at the GP level are not available. But district income measured as income originating has been calculated by the Department of Economics and Statistics, Government of Kerala.

[190] The correlation coefficient between growth rates of per capita OSR (index of revenue effort) and per capita total grants is 0.117.

[191] The first case study is based on six panchayats distributed equally over the Travancore-Cochin and Malabar region. The study was carried out by R.P. Nair (Kerala Statistical Institute) as part of an independent project (results unpublished). The second case study is based on Vellanad GP, the only panchayat in Kerala being fully computerized. The computerization of GPs, including the preparation of the software package, is by the Information Kerala Mission (IKM), a Government of Kerala undertaking.

omissions of households) and the actual property tax collected in 1998-99.[192] Underutilization of tax potential ranges from 26 percent in Kuttichal to nearly 52 percent in Noolpuzha, and only 40 percent of the tax potential is tapped.

- None of the GPs has a complete and up-to-date list of employees liable to pay profession tax. The estimated number[193] of persons paying profession tax shows the high magnitude of evasion: 53 percent of potential taxpayers do not pay profession tax.
- The average percentage of realization of profession tax for all six GPs is almost the same as that of property tax.[194] The estimated number of persons who ought to pay profession tax is more than double the number who actually pay taxes.
- The percentage of realization of the potential of the entertainment tax is less than that of profession and property tax, indicating the possibility of corruption and evasion.

b) **Case study 2: tax potential and tax collection in Vellanad GP:** The case study findings emphasize the potential loss of revenue due to poor or indifferent tax administration. Out of 10613 buildings in Vellanad GP, only 5380 (nearly 51 percent) are assessed for property tax. Out of these, about 91 percent are in the lowest tax brackets. The total estimated loss from property tax due to taxable buildings omitted from the tax net for 2001-02 is Rs.184790; and underassessment Rs.152491, a total of around Rs.3.37 lakhs against the actual collection of Rs.273724 for 2001-02. Undertaxation of properties works out to 55.25 percent on the assumption of a tax potential of Rs.6.1 lakhs. The Vellanad GP study also provides some insights into the existing situation of profession tax. The GP has included only 46 institutions for profession tax for nine years since 1993, whereas the Information Kerala Mission (IKM) has identified around 1200 potential institutions. Even the included institutions were not adequately subjected to tax assessment, with the number of assessed employees varying between the first and second half-yearly installments. There is significant loss due to underassessment, and an estimate of revenue loss due to omissions has not been made. In summary, the two case studies add to the other findings of this study to indicate that given the state's poor financial situation, it cannot afford to ignore the loss of potential revenue. The overall findings (see Box 3.3) indicate the importance of GPs increasing their tax efforts.

Box 3.3 : The need to increase the tax efforts of gram panchayats

The case studies show that tax effort in Kerala needs to be considerably improved, at least to bring to par those GPs that fall below the state average. There are large gaps in mobilizing revenue. The growth rate of per capita own tax and non-tax revenue shows considerable inter-district and intra-district variations, with the situation getting worse. Over 65-70 percent of the GPs are below the state per capita average tax. This means that any growth in revenue is due to the more affluent panchayats or those close to urban areas. The conclusion is that there is significant room to increase GP tax effort, and that the tax administration of GPs requires considerable streamlining and strengthening.

A regression analysis for GPs

The analysis of fiscal capacity and tax effort at the GP level is important since GPs can set rates for local taxes and charges, and since they are responsible for collections. A cross-section analysis of variations in revenue performance among GPs in Kerala for 1998-1999 indicates wide variation in per capita OSR. Why do some places raise more revenues than others? One way to answer this question is to look for statistical relationships between these fiscal outcomes and community characteristics - population and geographical area; percentage of SC/ST population; percentage of concrete houses; percent of work force employed in the agricultural sector; and

[192] The potential is worked out at a minimum assumed rate depending on the type of the panchayat: Rs. 100 for tribal-dominated panchayat, Rs. 250 for near urban panchayat; and Rs.150 for others. This is a conservative estimate.

[193] The number of employees in each panchayat was estimated based on the enterprises survey conducted as part of the study.

[194] The percentage ranges from 29 percent in the Thakazhy panchayat (Alappuzha) to 46.8 percent in the semi-urban panchayat Thrikkakara (Ernakulam district).

the possibility of a district effect. With such a model, 24 percent of the variation in per capita own source tax revenues can be explained for the 615 GPs for which data are available. GPs with a larger percent of concrete houses and a smaller share of employment in the agricultural sector raise a significantly higher level of per capita own tax revenues. GPs with a larger population and a smaller land area raise significantly more revenues. The percent of SC/ST population is not significantly related to revenue raising. Though only about one-fourth of the variation in per capita OSR can be explained, the basic hypotheses about why the level of revenue raising varies among GPs seems to be borne out. Places with more taxable capacity, on balance, use that taxable capacity to increase budgetary resources. There is also evidence of district effects.[195] The regression results suggest that the per capita level of NTR is not systematically related to the level of fiscal capacity. Only about 10 percent of the variation in per capita total own revenues could be explained. Among the independent variables, the percent of concrete houses is significantly and positively related to the level of per capita own total revenues. None of the other independent variables is a significant determinant.

A high closing balance: separating myth from truth

The essence of prudent public finance lies in maintaining a reasonable balance between income and expenditure. This is particularly important for a local government in a federal system where finance is not only related to resource raising effort and expenditure, but also to timing, size and flow of transfers. Since fiscal deficit is an ongoing problem in Kerala, it is difficult to imagine that a GP accumulates balances. We have seen that a majority of GPs face a current revenue deficit. With the devolution of functions and finance and administrative autonomy under way, what is the structure and trend of fiscal balances of GPs? The experience of this transition process is valuable for shaping a stable system of decentralized governance.

The structure of fiscal balance: some conceptual clarifications

The balance at the end of the fiscal year, usually called closing balance (CB), is the difference between total receipts (TR) accrued and expenditure incurred during the period. This closing balance becomes the opening balance (OB) of the following year, and together with the current receipts, forms the total resources available to the GP. In the context of the structure of finances of Kerala GPs, the OB, which apparently consists of unspent balances, includes liabilities that remain unpaid because of restrictions and conditionalities attached to certain categories of expenditures. Figure 3.2 describes the broad conceptual framework relevant to the understanding of panchayat fiscal balance in Kerala.

The phenomenon of high balances[196]

A district-wise distribution of the summary of the VPF account fiscal balance from 1993-94 to 1998-99 (see Table A17) shows that the closing balance of GPs, as a percentage of total receipts, has been high in almost all the years for most GPs. If the CB were seen with reference to expenditure, the percentage would be higher. The average CB total as a ratio of total receipts ranges from 24 percent in Wayanad in 1998-99 to over 58 percent in Kottayam in 1996-97. In 1996-97, the year in which the people's campaign for decentralization was launched, there was a sharp rise in the percentage with a state average above 50 percent.[197] Table 3.14, based on the sample survey,[198] shows that the percentage of

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[195] Either there is a cultural or leadership difference; or the residents see more public service benefits and are more willing to pay taxes; or these districts have a greater tax paying capacity that is not picked up by the other independent variables.

[196] The analysis uses both SSFC data and the sample data. The former covers only the VPF and CSS while the latter consists of all the five accounts (with plan fund data confined to grant in aid) besides the monthly break-up of the VPF account for the four fiscal years covered based on the sample survey. The monthly data are collected to empirically verify the practice of bunching of receipts and expenditure at the end of the fiscal year (March).

[197] Possibly the GPs, suddenly catapulted into the new regime, spent time and energy on the "campaign," thus delaying some routine VPF expenditures. Also, in a year when no firm rules were issued, some of the plan money may have been used to meet part of the traditional VPF expenditure.

[198] Comparable continuous data is not available.

Table 3.14 : Structure of fiscal balance of 26 sample gram panchayats for five accounts, Kerala, 1998-99 to 2001-02

Year	Opening Balance	Current Receipts	Total Receipts	Total Expenditure	Closing Balance	CB as % of TR
Village Panchayat Fund (VPF)						
1998-99	46252884	64474610	110727494	68668984	42058510	38.0
1999-00	42058510	78894266	120952776	71874577	49078199	40.6
2000-01	49078199	67467555	116545754	85221202	31324552	26.9
2001-02	31324552	57988819	89313371	63656284	25657087	28.7
Plan Grants						
1998-99	7733111	139376427	147109538	84078368	63031170	42.8
1999-00	63031170	118708514	181739684	138935728	42803956	23.6
2000-01	42803956	110470259	153274215	113850586	39423629	25.7
2001-02	39423629	89013000	128436629	65269689	63166940	49.2
Grants for Transferred Institutions and Schemes						
1998-99	25187031	26984379	52171410	31333807	20837603	39.9
1999-00	20837603	27631976	48469579	27421091	21048488	43.4
2000-01	21048488	29379715	50428203	30228201	20200002	40.1
2001-02	20200002	25050190	45250192	25579258	19670934	43.5
Pension Schemes						
1998-99	1772625	14905952	16678577	10086475	6592102	39.5
1999-00	6592102	17326736	23918838	17052536	6866302	28.7
2000-01	6866302	31310139	38176441	19999606	18176835	47.6
2001-02	18176835	23523598	41700433	26993640	14706793	35.3
Centrally Sponsored Schemes						
1998-99	3991050	10494422	14485472	9449573	5035899	34.8
1999-00	5035899	10805536	15841435	8544518	7296917	46.1
2000-01	7296917	11787546	19084463	8010934	11073529	58.0
2001-02	11073529	13867098	24940627	11209940	13730687	55.1

Source: Sample Survey, 1998-99 to 2001-02

closing balance to total receipts has fallen below 29 percent in the VPF account for 2000-01 and 2001-02. But the problem is still evident, particularly for accounts relating to transferred institutions, plan grants and pension funds for most of the years examined.

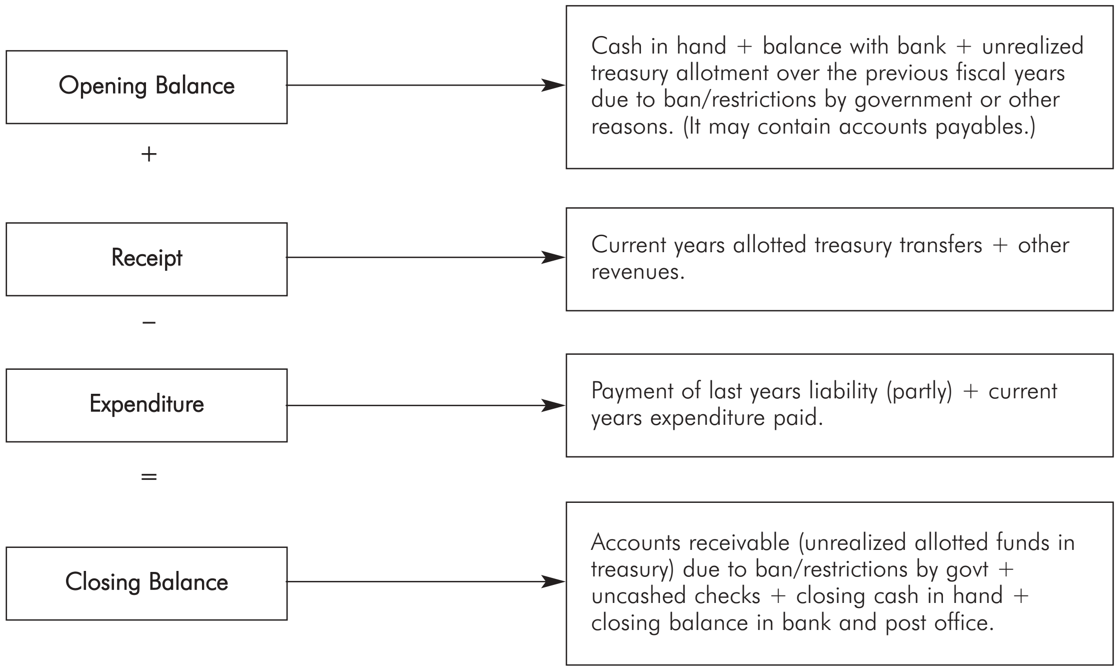
Explaining high closing balances

Although each account may have its own problem, it is possible to offer some general explanations of the phenomenon of high closing balances.

a) **The failure to explicitly take liabilities into account:**

- The closing/opening balances consist of accounts payable, which include current as well as past liabilities. Once these are taken into account, the high closing balance may even turn negative

Figure 3.2 : The conceptual framework of gram panchayat fiscal balance, Kerala



(see Table A18).[199] The annual financial statements prepared by GPs for audit purposes do contain a section on liabilities and assets. But most GPs do not fill this column since there is no compulsion or universal practice. Moreover, the accounts relating to assets and liabilities are not used as instruments of financial control, monitoring and evaluation.

- The lack of appropriate sanctions, planning, viable projects and availability of materials, and the delay in raising matching resources,[200] can delay the launching of a project, resulting in the underutilization and/or non-utilization of funds.[201]
- For plan grants (see Table A18 (ii)) the problem of high balances is less acute, particularly after liabilities were taken into account. But there are instances where it is still as high as 46 and 48 percent. One possible explanation is that projects may be taken up and initial expenditures incurred, committing the panchayat funds to those items. Some of these projects may, however, continue to remain unfinished for years, while a few are, reportedly, even fictitious.
- The problem is more acute for transferred institutions and schemes (see Table A18 (iii). The departments often allot lump sum funds to GPs without specifying projects or plan of expenditure. Some allotments may be irrelevant for the GP in question.[202]

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[199]The five tables in Table 18A were prepared after cross checking with the cash book/pass book and other accounts of ten GPs spread over eight districts, and they show that liabilities constitute an important factor in high closing balances. Table18A(i), for instance, shows that except for Pangode and Rayamangalam GPs in 1999-00, high balances do not seem to be a problem once the various liabilities are accounted for. After deducting liabilities, the effective closing balance (ECB) actually turns negative for some GPs.

[200]The GP or beneficiaries have to raise matching resources to implement a project in some cases.

[201]The Accountant General's Report on Vizhinjam GP (1997-98 to 1999-2000) observes: "The verification of the files revealed that Rs.1,28,500 was used for the removal of the garbage from the panchayat area diverting the amount from Rs. 25 lakhs sanctioned for specific purpose. The balance amount of Rs.23,71,500 is still kept idle in the PD account for the last two years for want of an appropriate project." (AG's Report for 1997-98 - 1999-00, (Mimeo) p.4).

[202]For example, the fisheries department allotting funds to highland GPs that do not require them.

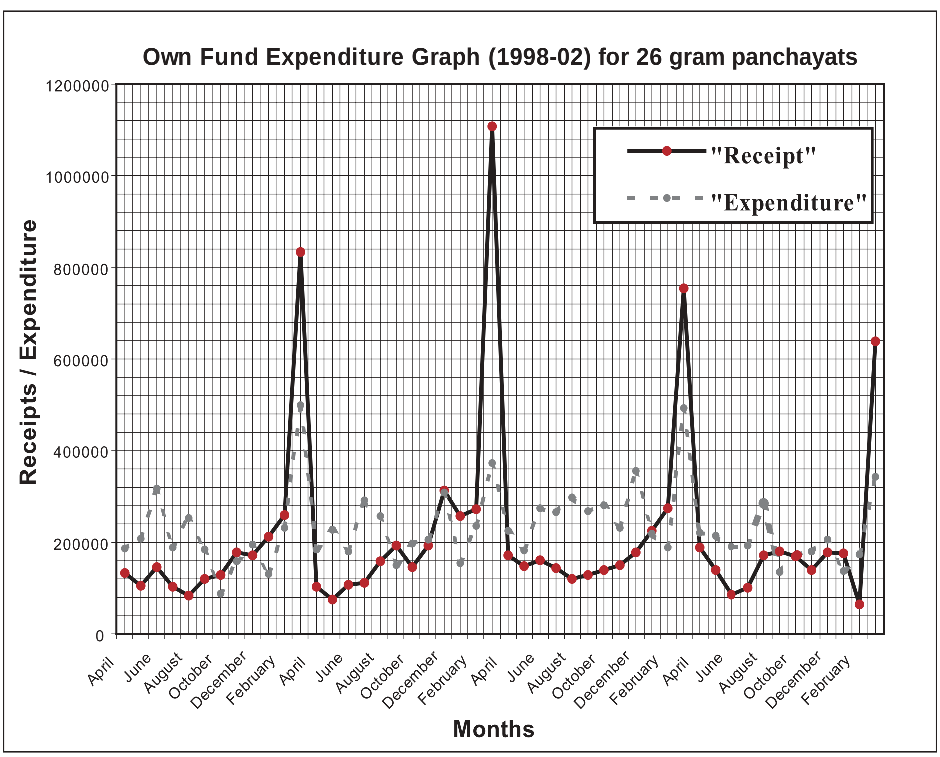
- The pension fund[203] (see Table A18(iv)) forms only five to six percent of the total finance of a GP. When the state is in financial difficulty, actual allotment may lag behind by a year or two. The numbers and names in the lists of state government departments and panchayats do not always tally. The names of deceased pensioners are seldom removed.

b) **The bunching of the inflow of receipts towards the end of the fiscal year:** The bunching of receipts at the end of the fiscal year introduces distortions in the flow of income and expenditure of the GPs. It affects all the four accounts for which GPs receive funds from the state. For the VPF, this is applicable to grants as well as revenues. Auction amounts, for example for sand mining and markets, are generally credited to panchayat accounts only by February or March. The peak collection of tax (such as building tax and profession tax) also takes place during these closing months. Although plan grants are supposed to be delivered in quarterly installments, the last two installments are generally paid at the close of the year. The monthly average receipts and expenditure trend of the VPF account for 26 GPs for four years from 1998-99 to 2001-02 (see Figure 3.3) indicates the surge of receipts in March and the subsequent slide downward.

> The local bodies of Kerala in general, and the panchayats in particular, face the problem of an even resource flow that will lead to a smooth expenditure pattern.

c) **Treasury restrictions and bans:** The state's financial situation has also affected normal treasury transaction in recent years. In 2000-01, for example, the treasury was closed to the public for 210 days, and there were bans and restrictions against payment from the treasury. In such a situation, actual expenditure may remain unrealized even when funds are allotted. Though less frequent, treasury bans and restrictions continue to present a problem.

Figure 3.3 : Structure of fiscal balance of 26 sample gram panchayats for five accounts, Kerala, 1998-2002



[203] Strictly speaking the pension fund should not be part of this context: it is an agency function undertaken on behalf of the state government.

The case of centrally sponsored schemes

A steady increase in the percentage of the closing balance of CSS has been apparent since Kerala launched its decentralized planning project. In 1998-99, it was 43 percent for the state as a whole; in 2000-01, as high as 58 percent, and 55 percent in 2001-02. In a state where GPs draw up projects reflecting the felt needs of the people as part of the decentralized planning exercise, it appears only natural that all-India programs such as food-for-work and sanitation schemes with a low per unit cost may prove to be redundant where the expectations and norms of the people are higher. The evidence (for example, in Table 18A(v)) corroborates this expectation.

High closing balances: in summary

No government can always achieve a neat budgetary balance of income and expenditure. In the case of local bodies in Kerala, carrying forward unspent balances mean high balances as long as the rate of expenditure is lower than the rate of increase in receipts. The question is whether this is a structural malady, or a phenomenon caused by accounting formalities and procedures, or a mismatch in the timing of receipt flow and expenditures, or other policy and planning deficiencies. The data and analysis in this study indicate that the problem is a combination of factors, a problem that must be resolved if the present transition stage of decentralization is to move ahead meaningfully.

Intergovernmental transfers and panchayats

Transfers and the question of imbalances

Intergovernmental transfers cannot be treated as a simple exercise in filling vertical gaps and using special transfers to reduce horizontal imbalances. Such an approach misses several aspects related to the objectives, processes, performance and shared responsibilities of each government within the federal setup. Since every transfer helps to fill the gap, it is the objective to be served that is important. One crude way to measure vertical imbalances is to examine the proportion of OSR to total expenditure. Table 3.15 shows that in 1993-94, the coefficient of vertical imbalance based on the traditional pattern of expenditure (non-plan) and revenue (including assigned taxes) is 0.29. It rises to 0.75 in 1998-99 when all the expenditures are taken into account. If non-plan expenditure alone is considered, the coefficient shrinks to 0.27 in 1998-99. Reckoned in terms of the traditional type of expenditure, the vertical gap narrows. But the coefficient increases when expenditure on account of local plans, transferred institutions and schemes etc., which have increased from the mid-nineties, are also taken into account. In a fully decentralized regime, the perspective is different - along with functions, finance must also be devolved or provided. When the state government decided to devolve 35-40 percent of state plan to the local bodies, it virtually created a divisible grant pool. This is more of a political decision than a percentage based on any scientific function-finance mapping. It is the decentralized process that leads

Table 3.15 : The coefficient of vertical imbalance, Kerala, 1993-94 and 1998-99, Rs. in lakhs

Items	*1993-94*	*1998-99*
OSR	*4788.7*	*11973.7*
OSR + Assigned Taxes	*7382.4*	*15649.8*
Total Expenditure	*10334.0*	*61786.6*[1] *(21426.1)*
Coefficient of Vertical Imbalance (a)	*0.54*	*0.81*
Coefficient of Vertical Imbalance (b)	*0.29*	*0.75* *(0.27)*

Note: The coefficient of vertical imbalance may be defined as 1-OSR/TE where OSR means own source revenue and TE total expenditure. Two variants of this are attempted: OSR without including the assigned taxes, and OSR including assigned taxes. Although collected by the state government assigned taxes belong by statute to GPs. Source: 1/ the total expenditure figures for 1998-99 are worked out for 789 GPs (because all the other data are with reference to 789 GPs) using the total expenditure per GP figure estimated from the sample survey. All other figures are from the SSFC Survey data.

Table 3.16 : District-wise distribution of minimum-maximum ratio of major receipt items, sample districts, Kerala, 1993-96 and 1996-99

District	Own Tax Revenue		Non Tax Revenue		Statutory Grant		Non Statutory Grant		Total Receipts	
	1993-96	1996-99	1993-96	1996-99	1993-96	1996-99	1993-96	1996-99	1993-96	1996-99
Thiruvananthapuram	15.8	19.3	101.3	23.0	4.1	6.5	5.2	2.2	3.9	2.2
Kollam	13.1	12.8	77.1	36.3	4.5	8.2	7.3	2.2	4.5	2.7
Pathanamthitta	11.1	11.4	74.6	40.9	4.6	8.2	#DIV/0!	1.9	5.6	2.5
Alappuzha	11.1	11.7	20.7	13.3	3.4	4.0	7.7	1.6	4.4	1.9
Kottayam	12.0	9.3	54.5	121.9	4.9	4.2	8.4	2.1	3.7	3.0
Idukki	96.0	137.0	624.4	397.7	33.6	28.7	13.6	4.8	13.7	6.7
Ernakulam	24.9	23.8	84.5	121.4	5.9	11.4	10.7	1.8	8.3	3.5
Thrissur	13.5	12.4	174.2	144.2	8.6	13.5	6.8	2.1	6.4	2.9
Palakkad	30.7	32.1	76.5	127.7	9.3	16.5	6.3	2.2	12.9	4.2
Malappuram	14.7	22.2	70.6	111.5	3.7	6.8	48.1	1.7	7.3	2.8
Kozhikode	7.5	7.8	63.4	74.1	3.6	6.5	8.9	2.1	3.9	2.7
Wayanad	8.7	10.1	10.3	7.4	2.9	10.1	#DIV/0!	1.6	4.3	1.6
Kannur	8.1	12.5	74.3	79.4	4.2	5.8	5.8	2.3	4.7	3.0
Kasargode	5.1	4.5	31.4	131.6	2.5	5.1	6.3	2.4	2.4	2.2
Kerala	**181.8**	**275.5**	**1088.6**	**1146.4**	**33.6**	**46.7**	**#DIV/0!**	**4.8**	**15.7**	**6.7**

to the ballooning of the aggregate expenditure, and the "vertical gap" highlights the need for augmenting OSR.

As far as horizontal imbalances are concerned, there is significant inter-panchayat disparity in per capita OSR as well as per capita expenditures.[204] Table 3.16 sums up a district-wise distribution of the minimum to maximum ratio of major items of per capita income of GPs. The gap is high for OSR, in particular non-tax revenue, where the maximum is as high as 1146 times the minimum for a three-year average (1996-99).[205] More disturbing is that the inter-district ratios (for the same three-year average) for per capita tax and NTR as well as for statutory grants have increased. The ratio within districts is not high except in Idukki for NTR. That state plan grants have significantly reduced inter-district disparities for available resources is also confirmed by the standard deviation and coefficient of variation. This provides some evidence that well-designed intergovernmental transfers can indeed help ensure greater horizontal equity. Per capita expenditure disparities among GPs in Kerala are less than per capita OSR disparities. This suggests some degree of equalization, but does not necessarily mean that the quality of services available in the various panchayats has been equalized. The minimum-maximum ratio, which was only 21 times in 1994-95, rose to 37.4 in 1998-99 for per capita non-plan expenditure.[206] But the situation changes dramatically when plan grants and total plan expenditure are taken into consideration.

The existing transfer system: structure and pattern

Using SSFC and grant in aid data, Table 3.17 presents the broad structure of the transfer system,

[204] See earlier subsections on revenue and expenditure.

[205] The big difference in NTR is due to items like sale of sands, and not all panchayats are equally endowed with riverbeds.

[206] The intra-district disparity reckoned in terms of minimum-maximum ratio is highest in Idukki when we consider non-plan expenditure.

Table 3.17 : Structure and composition of grants to gram panchayats, Kerala, 1993-94 and 1998-99, Rs. in lakhs

No.	Items	1993-94		1998-99	
		Amount 1/ (Rs)	Percentage	Amount (Rs)	Percentage
1.	*Statutory Grants*	*3378.00*	*56.6*	*6721.50*	*13.3*
2.	*Rural Pool*	-	-	*986.10*	*1.9*
3.	*Untied Grants/Plan Grants*	*1635.70*	*27.4*	*41611.00*	*82.3*
4.	*Other Grants*	*955.4*	*16.0*	*1279.2*	*2.5*
Total	*5969.1*	*100.00*	*50597.8*	*100.00*	
Percentage of State grants to Total Receipts		-	*50.3*	-	*75.4*

[1] Amount refers to 789 GPs only.

comparing two points of time (1993-94 and 1998-99). The state government grants to local bodies consist of non-plan and plan categories. Non-plan grants are broadly divided into statutory and non-statutory grants. Statutory grants, around 20.6 percent of the total receipts during 1993-96, fell to 12.8 percent during 1996-99. The per capita statutory grant, however, rose from Rs.16.7 in 1993-94 to Rs.34 in 1996-97 and declined to Rs.31.8 in 1998-99. It remains an important component of the intergovernmental transfer system. Non-statutory grants for GPs are non-plan grants from state governments, the Rural Pool and the level crossing grant in aid. The Rural Pool, introduced in 1998 following the recommendations of the First State Finance Commission (1996) to consolidate a variety of small ad hoc grants, is not a major item in the transfer scheme today.

Plan grants were instituted to respond to the needs of the newly decentralized fiscal system in 1997-98.[207] Broadly speaking, there are two instruments at present: general plan grant in aid for local development purposes, and specific-purpose grant in aid for transferred responsibilities (plan as well as non-plan). The plan grant, which constitutes over 80 percent of transfers, is allocated on the basis of a formula (see Table A19). A unique system of earmarking funds for local governments has been introduced in the case of specific-purpose grants in aid for transferred functions.[208] Once the assembly approves the budget, the head of the department cannot divert the fund. Thus a local government entitlement has been created through the budgetary process. Apart from plan grants and grants for transferred schemes and institutions, the local bodies also receive grants through sponsored schemes for which they act as agents of the central and state governments. Plan grants and the sponsored schemes together form about 35-40 percent of the state plan. Broad guidelines are issued by the sponsoring government/department for sponsored schemes, but the panchayat decides the location of the project and the selection of beneficiaries in addition to implementation.

The state plan grants have three components: general-purpose grant, grants earmarked for the welfare of SCs/STs (the special component plan or SCP), and the grants given by the Eleventh Finance Commission (EFC). The SCP is divided between PRIs and urban local bodies (ULBs) in proportion to SC/ST population (88.14:11.86). The SCP is divided among GPs, BPs and DPs in the ratio of 60:20:20. One crore rupees is set apart for monitoring and evaluation. The balance outstanding, comprising general-purpose and EFC grants minus the amount for monitoring, is divided among PRIs and ULBs in proportion to the distribution of the general or non-SC/ST population

[207] Prior to that, untied grants were given to GPs (from 1990). These were to be used for plan and development purposes.

[208] A minor head, "91-Assistance to local bodies," is added to every departmental head of account in the state government budget, which is considered the fund earmarked to the local government. This was slightly modified in 2003-04.

(82.43:17.57). From the portion given as general-purpose grant, a sum of Rs.2.35 crores is set apart as a performance-based incentive grant for GPs. The balance is distributed among GPs, BPs and DPs in the ratio 70:15:15 respectively. The EFC grant is to be utilized for improving the accounting system, building the database and for improving primary education, primary health care, drinking water supply and other essential functions of GPs.[209]

A general critique of the transfer system

The nature and magnitude of the intergovernmental transfer system has undergone considerable change with the initiation of the decentralization process in Kerala in the mid-nineties (see Box 3.4). The per capita state grant (excluding statutory grants) increased from Rs.12.83 in 1993-94 to Rs.207.61 in 1998-99, and the per panchayat grant from around Rs. 3.2 lakhs to 47 lakhs - an increase of nearly 15 times within a span of six years.[210] *The estimated total transfers to GPs in 1993-94, including statutory grants, is around 75 crores - about 0.40 percent of the SDP and 2.8 percent of the state's OSR. This increased to Rs.636 crores in 1998-99, about 1.2 percent of SDP and 12.2 percent of the state's OSR. Given the virtually unconditional character of this grant, this is indeed progress towards decentralization. But such progress has also enhanced the need for accountability and for instituting measures to prevent leakages.*

a) Given the importance of the statutory grants, and the continuation of several grants,

- Clubbing assigned taxes and shared taxes together and treating them as statutory entitlement is conceptually untidy. Taxes such as land revenue belong to the domain of panchayats, and should be left to them.[211]
- The Vehicle Tax Compensation (VTC) per GP works out to only Rs.8600 in 1998-99, not adequate for the road maintenance expenditure of any panchayat in the state. Under the new dispensation, the issue of maintenance needs to be considered a part of state-local devolution, and linked with improving the quality of assets and the delivery of public services.
- The entire structure of grants has been in the process of change. For instance, plan grants now account for over 80 percent of total grants, altering statutory/non-statutory composition. The entire system of transfers involving grants and tax sharing needs to be re-examined in the context of the evolving decentralization process and the function-resource matrix. The SFCs of the future need to address this major issue.

b) Has the grant system affected or slackened the revenue efforts of panchayats? Though there is no unequivocal evidence to corroborate a negative correlation (see the subsection on tax efforts) the evidence is that the tax potential of panchayats - particularly for property tax, profession tax and entertainment tax - remain underutilized.

Box 3.4 : The structure and pattern of transfer arrangements, Kerala

The estimated percentage of total state grants to total receipts (excluding central grants) was 50 percent in 1993-94, and 75 percent in 1998-99. When the central grants for these years are included, the proportions are 61.5 percent in 1993-94 and 76.3 percent in 1998-99. The central grants declined significantly in absolute terms (the per GP central grants went down from Rs. 4.3 lakhs in 1993-94 to Rs. 3.2 lakhs in 1998-99). The increase in the state grant component is not necessarily evidence of an increase in the dependency of local bodies. It may be seen as part of greater decentralization because local bodies have been given increased revenue resources. But if the state government payment of salary and allowances of staff in the offices/institutions brought under the PRIs is taken into account, the resulting picture appears to be that of increasing dependence.

[209] The distribution of these grants among local bodies also uses the formula for general-purpose plan distribution (see Table A19).

[210] As estimated by this study.

[211] The land revenue collection of Kerala in 1990-91 (Rs. 11.1 crores), 0.83 percent of the total tax revenue of the year, was only 0.59 percent in 2001-02. The GP is ideally the best agency to impose the relevant rates and implement them. But that means greater financial autonomy and fiscal decentralization.

c) Do plan grants and decentralization affect local priorities? An important aspect of the state plan grant, which constitutes over 80 percent of the total transfers, is that they do not affect the priorities of the local bodies and the local people. Tied and conditional grants generally affect the resource allocation of the local bodies, especially when some matching provisions are also stipulated. The decentralized planning process of Kerala has a built-in mechanism to identify the people's felt needs, because the first step in annual plan formulation is to convene a gram sabha meeting specifically for this purpose. On the basis of the preferences expressed in the gram sabha, every local government prepares a development report, which is then shaped into technically and economically viable projects through 12 sectoral task forces. The District Planning Committee (DPC) generally does not interfere with this task; it coordinates and oversees the use of statutory guidelines.

> The grant system does not affect people's priorities, though there is scope for making the system more reflective of people's choices.

d) Plan grants constitute the major share of transfers, and an evaluation of the transfer system depends to a large extent on the approach to the allocation of plan grants. In addition to approach, the present system of criteria and the weightage attached to criteria (see Table A19) needs some improvement:

> Revenue effort has to be made an important criterion in the distribution of transfers. But the state government also has to provide adequate autonomy to the lower tiers to alter their rules and rates regarding taxes, licenses and fees.

- The whole question of transfers to local bodies is considerably dependent on plan size, which in turn is dependent on numerous variables.[212] The question then is whether transfers should be related to the total revenue of the state or its plan outlay.
- Heavy weightage is attached to population in the distribution of plan grants. But population is not necessarily an indicator of need or economic activity in a state where the fertility rate is heading towards unity.
- Ensuring the efficient utilization of transfers is an important aspect, and ensuring accountability at the panchayat level needs greater attention. Social audit, initiated with great expectations, is now seldom used as an instrument of public accountability.
- One important way to ensure accountability is to step up panchayat/local body effort in raising internal resources.
- In view of the advance Kerala has made in measuring poverty at the GP level, the question of refining and using the poverty index as a criterion may have to be examined.
- Annual local plans are formulated almost routinely, but the gap between theory and practice has been growing. In several panchayats, ward-wise allocations and priorities are reportedly determined by individuals or political pressure groups. Criteria-based allocation is necessary even at the ward level.

> Transfers should work towards equalizing the financial capacities of panchayats/local bodies. This principle of equalization of expenditure assumes importance in ensuring a minimum standard of public services.

- A minimum standard quality of public services must be provided. Reducing financial expenditure disparities might be a necessary condition, but it is not sufficient to ensure spatial equity. Only an appropriate corrective system can remedy the situation.
- Though not related to the criteria of transfers, the timing of resource flow affects the efficient utilization of resources at the ground level.

[212] Such as the BCR of the state, additional resource mobilization of the state, the central government's resource crunch, adjustment on previous loan liabilities, etc.

- The 35-40 percent divisible pool is not based on any scientific assessment of expenditure responsibilities, projected needs, or other normative considerations.

Are intergovernmental transfers equalizing?

The possibilities include equalizing differences among GPs in expenditure needs, or taxable capacity, or the gap between taxable capacity and expenditure needs. The choice among these goals may be determined more by the availability of data than by state government policy. This study's examination of inter-GP variations[213] through a cross section regression analysis for individual GPs is aimed at explaining why some GPs receive more in per capita grants than others, and if there is a pattern that favors lower income panchayats. If equalization is present, there should be a positive relationship between per capita grants and the concentration of the poor in the population, measured here as the percent of SC/ST in the population.[214]

> While equity is a stated goal of the state government in its resource allocation policy, the equalization goals are not clear. Nor is the use of transfers as an instrument of equalization.

a) **Statutory grants:** These shared and assigned taxes are distributed among GPs on the basis of origin of collections and, in the case of motor vehicle taxes, by road mileage. Only about 16 percent of the variation in per capita statutory grants can be explained (see Table A20), suggesting a considerable degree of random distribution. Surprisingly, there is some indication of equalization in that the level of per capita grants received is greater in GPs where the poverty rate is higher.[215] There is no evidence that per capita statutory grants are distributed to favor larger or smaller places.

b) **Non-plan state grants:** The range in this category of grants is from nil to Rs.288 per capita, around a mean of Rs.11. The regression results (see Table A21) indicate that relatively little of this wide variation among GPs can be explained, suggesting that the distribution of per capita state grants is quite random, or that the right explanatory variables have not been included. The equalization hypothesis is not verified: the poverty rate is not a significant determinant of per capita state grants, nor is the percent of employment in agriculture. The percent of concrete houses is positively associated with per capita grants received; hence there appears to be some evidence of a counter equalizing influence. With regard to expenditure needs, places with a larger population receive a significantly lower per capita amount of grants, suggesting the possibility that grants are distributed in part on a basis of equal shares to cover fixed costs. There is no evidence of a "district effect" in the distribution of per capita non-plan grants.

c) **Plan grants:** The distribution of plan grants appears to be equalizing. To test this in a more systematic way, the multiple regression model was used to explain the variation in per capita plan grants[216] for the 615 GPs for which complete data were available. The results (see Table A22) indicate that about 80 percent of the variation in per capita plan grants can be explained. The system of grant allocation is, clearly, equalizing: GPs with a greater concentration of SC/ST population receive significantly more in per capita plan grants, while those with a larger population and a greater concentration of concrete houses receive less. As in the case of the other fiscal

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[213]For all components, though only budget data were available for plan grants.

[214]The percent of workers in the agricultural sector would also indicate a more limited taxable capacity, and the presence of equalization would be consistent with a positive coefficient. The percent of concrete houses would suggest a greater degree of wealth and equalization would suggest a negative relationship with per capita grants. Population is also used as an independent variable. A larger population might indicate more public service needs; hence, equalization would suggest a positive coefficient. However, the cost of providing minimum service levels may be higher for smaller places, hence a negative coefficient with per capita grants may be expected.

[215]More grants are also received where the percent of employment in agriculture is greater.

[216]Data for plan grants are budgeted rather than actual.

outcomes, there appear to be significant district effects.

d) **Central grants:** The GPs also receive grants from the central government, ostensibly to alleviate poverty; hence they should be equalizing. The regression results (see Table A23) bear out this hypothesis. There is a strong positive relationship between the percent of SC/ST population in a GP and the level of per capita central grants received. There is a strong negative relationship between per capita central grants received and population size. In other words, central grants favor smaller places. As in the case of state general grants, there are significant district effects.

Fiscal transfers: in summary

The broad objective of transfers from the central and state governments to local governments is to promote local democracy and development with efficiency and spatial equity. But despite the "big-bang" initiative of Kerala, these objectives still need to be sharpened into precise instruments and targets. Even so, it is significant that plan grants which constitute the major chunk of transfers has been equalizing. Effective monitoring is necessary; so is relating the allocation of plan grants to the quality of performance. The stability of decentralized governance depends to a large extent on the way the transfer system is fashioned in the future.

> The resources and expenditure responsibilities of the state have to be seen from an integrated perspective, with local bodies and the state government as partners with a specific division of labor.

The accountability mechanism

The people's plan campaign of Kerala has introduced various innovative methods to make panchayats accountable to the community. The tools, including the social audit, the ombudsman, the right to information and the citizen's charter, have made an impact, but they need to be institutionalized.

The concept and its dimensions

Accountability in government is generally understood to mean that public servants are "answerable" for their actions. In a democracy, accountability is "a pre-condition for trust in government."[217] The dimensions of the accountability of PRIs can be examined along the following lines: the standard of accountability (accountability for what?); agent of accountability (accountability to whom?); and means of accountability (how is accountability ensured?).[218]

Standard of accountability

The relevant concepts are integrity, fair play, responsiveness and performance.

- **Integrity:** The most important aspect of the traditional notion of accountability of public institutions is the maintenance of financial propriety and the checking of corrupt practices among public officials/elected representatives.
- **Fair play:** Fair play is an essential attribute of government in a democracy, where all public agencies are expected to follow the principles of the rule of law. Hence PRIs must be held accountable for the fair and legal discharge of their regulatory and developmental responsibilities.
- **Responsiveness:** In a democracy, people want to ensure that the government is responsive to their needs. The expectations of congruence between government functions and the felt needs of a community are higher in the case of the local government, since it is the level closest to the people.
- **Performance:** Public institutions are answerable for the efficient and effective use of public resources. Efficiency refers to the ratio of quantity of services provided/public goods produced to the cost. In other words, it is a ratio of output to input and gives an indication of whether resources are being utilized economically. Effectiveness refers to the degree to which a service or a public good

[217] Wolf, 2000.

[218] Haque, 2000.

corresponds or contributes to the outcome of the program, the outcome being derived from the felt needs of the people.

Agent of accountability

Traditionally, PRIs in India have been subjected to control by higher-level government. Since PRIs depend to a great extent on grants, this kind of upward accountability is inevitable, and with the rise in the volume of funding from the state government to the PRIs, the upward accountability system requires to be further strengthened. The strengthening of the overseeing activity of the state government, however, should not lead to the centralization of authority and the reduction of autonomy, flexibility and innovation at the local level. A local government institution (LGI) is not accountable to the state government alone. Indeed, its primary accountability is to the local community. Equally important for managerial purposes is the accountability of individuals who have decision-making authority over the use of resources within the accountable institutions. There is a formal system of discipline and control within the organization for bureaucrats. As far as political executives are concerned, their primary answerability is to the people - not once in five years when they go to seek votes, but on a day-to-day basis. This principle is clearly recognized by the Kerala Panchayat Act.

> A primary accountability relationship between the panchayat and the local community has been legally established in Kerala, with the Kerala Panchayat Act conferring substantial overseeing functions to the gram sabha.

Means of accountability

a) **Integrity:** The traditional method adopted by PRIs in India to achieve integrity consists of

- A statutory audit of accounts by an independent authority prescribed by law.
- Sanctions for deviation from norms, such as levy of surcharge on officials or political executives, suspension or removal of chairpersons, and in an extreme case, supersession of the elected body.
- Canceling the resolution of an LGI by some legally empowered authority such as the district collector.
- Inspection of LGIs by state government officers.
- Approval of budget estimates of LGIs by legally empowered officials.

Such a method of upper-level governments holding local governments in check has many limitations. First, autonomy is the hallmark of local government, and a bureaucratic type of accountability relationship - on which the effectiveness of this method depends - does not always work. Second, the system relies too much on reporting from below, and on the examination of this reporting by the bureaucracy, which lack the time and capacity for anything more than checking procedural lapses. This underscores the need for locating the sources of control over the action of political actors in the political system rather than the bureaucratic system. Empowerment of the opposition members of the LGI serves this purpose partially.[219] One fundamental condition necessary for ensuring the integrity of officials and elected representatives of local government is transparency.

b) **Fair play:** To ensure fair play, matters such as the preparation and approval of the budget, procedures for tendering and purchase, the manner of keeping accounts, selection of beneficiaries, assessment of property tax, and issuing building permits must be in accordance with transparent procedures. External and internal checks will also need to be institutionalized. Kerala's watchdog institution, the ombudsman, is a powerful external check on the arbitrary use of the power and resources of a public agency. The internal check for PRIs is provided by the citizen's charter.

c) **Responsiveness:** The responsiveness of government is a valued, but often neglected, right of citizens in a democracy. The local

[219] For example, by involving opposition members in Accounts/Audit Committees, Purchase/Tender Committees, and high power committees formed at the district level to examine the Audit reports of panchayats and recommend corrective/punitive measures.

government has relatively greater scope of being responsive to the people. In fact, local governments have the responsibility to institutionalize a process that permits the participation of the local community and civil society organizations, including those of the marginalized, in making decisions at various stages of a development activity. Some of the specific tools and processes that can lead to the responsiveness of PRIs are the empowerment of the gram sabha and neighborhood committees, the involvement of civil society organizations, public meetings, and the assigning of responsibilities to various people's committees such as beneficiary committees, social audit committees or standing committees of the gram sabha.

d) **Performance measurement:** The performance indicators of a PRI depict its economic use of resources (efficiency) and its achievement of the designed objectives (effectiveness, measured in terms of cost, quality and outcome of an activity/program consisting of several activities). Since these designed objectives correspond to the felt needs of the community, the effectiveness indicator is also an index of responsiveness of the LGI. If a system of measuring performance indicators can be institutionalized, it can be linked to a system of incentives and disincentives to enable the higher-level government to administer an effective grant policy. It is also an effective tool for citizens to evaluate the performance of the LGI. Besides, such a quantitative measurement of performance is a check on the possibility of misuse of power.

> Performance measurement is an important tool for both upward and downward accountability.

Local government accountability in Kerala

The accounting system: status

This study reviews the accountability system of Kerala's PRIs within the preceding conceptual framework.[220] Financial reporting forms the basis of accountability in any institution, and a detailed study was undertaken to understand the status of the present accounting system of GPs. The accounts rules currently in force in GPs were framed more then forty years back on the assumption that GPs would handle moderate funds and simple financial transactions. The sudden increase in the volume of functions and fund flow[221] has placed the capacity of GPs under severe strain. In addition, the state government has issued numerous orders regulating the use of additional funds flowing under the accelerated decentralization program. The net result is that GPs have an extremely complicated accounting system: they operate multiple accounts; five main divisions of accounts; and deal with state government funds from five sources, and expenditure made by 12 or more officers.

Rules, which form the basis of budgeting and account keeping, do not capture much of present-day reality. Also, accounts are kept on a cash basis, without a suitable accrual system of accounting for government organizations, or a double entry system of book keeping. There has been no computerization of work despite the increase of paper work. What does all this mean for financial reporting, which forms the basis of a sound accountability system? This issue requires further study, but some of the major consequences of an inadequate accounting system are as follows:

- The budgeting exercise has been reduced to a routine activity. It is prepared in an unscientific manner so that it does not serve as an instrument of financial control and management. The lack of linkage between the annual plan and the budget makes the monitoring of plan projects difficult.

[220] The findings are based on primary and secondary sources, available literature on the subject, discussions with panchayat functionaries and state government officials, records of panchayat offices, and observation of meetings such as those of the panchayat committees. In addition, case studies on social audit and beneficiary committees were conducted. Considering the media's role, a study was conducted on media interest in LGI activities by a freelance journalist, Reshmi. Also see K. Pushparajan's background paper for this study, "Accountability system of Panchayat Raj Institutions."

[221] See Section 3.

- The faulty classification of accounts blurs the distinction between revenue and capital expenditure.
- An immediate outcome of the faulty classification of accounts is the lack of reliable information on the assets to be maintained by panchayats. Successive SFCs have had to assess the maintenance burden of PRIs on the basis of unreliable figures.
- The status of the closing balance under different account heads is not clear.[222]
- The prevailing accounting system makes it difficult to identify the unit costs of individual projects and core services, and the economic viability of remunerative projects.

The management system

The basis of the panchayat management system was the principle of complete separation of political and executive wings (see Figure 3.4). But such a clear-cut division is no longer possible, as the president of the panchayat discharges considerable executive responsibility. Formally, the government-appointed secretary, supported by a small clerical staff, is the chief executive. The secretary is generally responsible for financial transactions but does not have any financial powers. The authority to incur expenditure, select contractors or suppliers, and issue administrative sanctions rests with the GP's elected members collectively, and the secretary implements their decisions. But the president, though not involved in administrative or financial matters, has the responsibility to oversee the efficient functioning of the panchayat bureaucracy, and the secretary reports to the president. The span of control of the GP president has become quite wide.[223] Thus the president has executive functions, but is not directly responsible, except as a member of the collective body of the panchayat, for any financial or administrative irregularity. This seems to be an anomalous situation in which executive power is held while remaining immune to direct responsibility. The vice-president, who is also the chairperson of the finance standing committee, has the statutory duty to examine the monthly accounts of the panchayat and report to the committee. He is also responsible for the preparation of the budget and for overseeing the function of budgetary control. However, these important managerial functions appear to be neglected.

The role of audit

According to the statutes, PRIs are audited by the Local Fund Auditor (LFA), which has the power to fix responsibility on any official or elected representative and impose surcharge on them to recover any loss to the panchayat. In the case of serious financial irregularity, the state government has the power to supersede the panchayat committee and order fresh elections for the remaining term. But like the traditional government audit, the approach of the LFA to panchayat resources is too legalistic. Concern for strict observance of financial rules, or government orders, is not always matched by concern for cost, efficiency or performance audit. Thus the LFA audit is often not fruitful. Its suggestions for corrective action are not given due consideration, possibly because it is not difficult to evade responsibility for procedural lapses. But in the case of the value-for-money audit, which focuses on results, it is not so easy to disown responsibility.

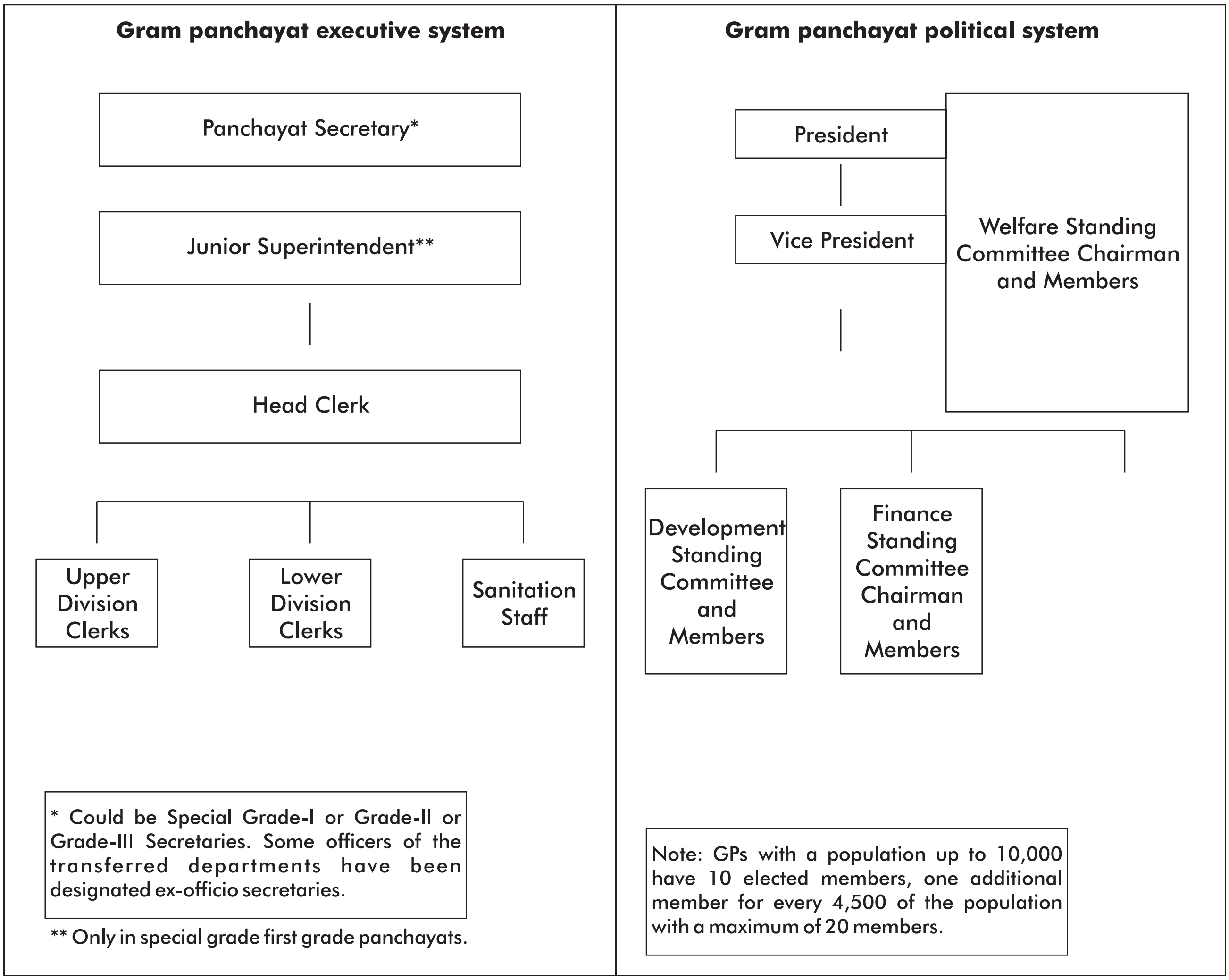
> The audit is the most important instrument the state government has to demand accountability from the decision-making authorities of the panchayat. But it is difficult to implement disciplinary measures.

The annual audit of accounts, in whatever form, does act as a check against the misuse of resources in a public institution. But for the last several years, the annual LFA audit has fallen into arrears. In fact, this began at the time when the fund flow to the panchayats was accelerated after

[222] See the subsection on high closing balances in Section 3.

[223] Apart from the secretary, generally about 10 officials from the transferred departments report to the president. Many of them have been designated as ex-officio secretaries and discharge substantial functions relating to administration and finance. Although there are three chairpersons presiding over three standing committees of the GP only one has real executive functions.

Figure 3.4 : The organizational structure of the gram panchayat, Kerala



the introduction of the people's plan campaign. One possible reason is the failure to submit annual financial statements (AFS) in time to the LFA. The panchayats, in turn, claim that appropriate accounting guidelines for plan grants in aid was delayed. Regardless of the reason, the arrears in the statutory audit of panchayat is a serious lapse.

Innovative tools and methods of accountability

One of the important contributions made by the people's plan campaign is the introduction of the concept of downward accountability of PRIs. In pre-campaign days, the PRI's accountability to the people was almost non-existent. During the operation of the people's plan campaign, the government gradually introduced a number of innovative measures (see Box 3.5) to increase the control of the electorate over the panchayat, and to enable the panchayats to be more responsive to the electorate.

Box 3.5 : Innovative tools of accountability introduced in Kerala

- Social audit through the empowerment of the gram sabha, neighborhood committee and monitoring committee
- Performance audit
- Beneficiary committees to execute public works schemes
- Introducing transparency by
  - Conferring right to information on citizens.
  - Prescribing rules for selection of beneficiaries.
  - Providing for the citizen's charter.
- Creating a watchdog institution, the ombudsman, to ensure fair play in the functioning of panchayats.

Social audit

The Panchayat Act gives the gram sabhas various powers, including the right to select beneficiaries, and to comment on the budget estimates, annual financial statements, audit reports and administrative reports of GPs. Over and above these statutory powers, the people's plan campaign has expanded the scope of popular involvement in plan preparation, implementation, and monitoring and evaluation of projects and programs. Apart from the gram sabha, neighborhood committees, ward conventions, development seminars, task forces and committees have been used to ensure transparency, integrity, responsiveness and efficiency in the performance of panchayats. All these, designed to expand the public sphere, were expected to introduce participatory governance at the local level. Evaluating some of the successful experiments in the social audit of PRIs would help understand its strength in ensuring the accountability of public institutions, and help examine the question of institutionalizing a process of social audit of panchayats. To this end, case studies were conducted[224] in three panchayats of Thiruvananthapuram district - Vithura, Vellanad, and Kunnathukal, where citizens conducted an innovative social audit.

a) **Vithura:** *Many people's committees such as neighborhood groups (NHGs), ward development committees, panchayat level academic committees, panchayat level women's committees, monitoring committees and children's committees were formed. A panchayat level people's committee for social audit was also set up for a combination of concurrent monitoring and post-completion evaluation/ audit of panchayat functions. The basic structure of the Vithura social audit mechanism was as follows: three persons from each gram sabha*[225] *were elected members of the social audit committee. At the panchayat level, they were divided in three groups, each looking into one of the three sectors of panchayats development program (productive, service and infrastructure sectors). The audit reports of the committee were presented to the gram sabha, with all the concerned officers present to answer the queries of people with relevant documents.*

b) **Nellanad:** In the second year of the people's plan campaign, it was decided that all public works would be through the beneficiary committees. The members were trained, and a committee of technical experts assisted them in technical and accounts matters. The beneficiary committees undertaking the works were also subjected to social audit.[226] The audit reports of the committee were given to the concerned NHGs, and they were allowed to examine the project estimate, statement of income and expenditure, quotations, vouchers, bills, pass book as well as the reports of the monitoring committee. In the second phase, the scope of the social audit was expanded to the programs beyond the public works, and the format of presentation of the social audit report changed. The report of the social audit team was presented in a specially convened meeting, including representatives of each gram sabha and 20 representatives of NHGs. This is people's audit in every respect.

c) **Kunnathukal:** *In 1999, this GP decided to subject all its agricultural projects to social audit. Details of the agricultural projects implemented, together with the list of beneficiaries, were printed and made available to the public. A social audit conference was held, with beneficiaries specially invited to the meeting. The turnout was as large as 1435, with 815 of them women. Guided by trained facilitators, they had group discussions on the*

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[224]The studies were conducted by Joy Elamon .

[225]It may be noted that in Kerala there is a gram sabha for every ward. This means Vithura has 33 social audit committee members at the panchayat level be cause Vithura has 11 wards.

[226]For instance, the committee examined the projects for quality, maintenance of accounts and time taken for completion. It also checked whether members of the beneficiary committees and the public had access to information about the projects during the implementation stage.

information provided by the panchayat. The discussion focused on issues such as the eligibility of the beneficiaries; whether beneficiaries actually received the benefits mentioned in the document; whether they had to pay bribes to get the benefits; and suggestions for further action (see Box 3.6).

Box 3.6 : The social audit conference in Kunnathukal Panchayat

- The way in which the information was presented made it difficult for people to verify the documents. The conference suggested that from the next year, information should be presented ward-wise.
- It was found that one person had received benefits for drinking water as well as for irrigation. The conference recommended that the person concerned should be barred from receiving benefits for the next five years.
- Only agriculture related projects were brought under social audit. It was recommended that other sectors should also be covered by social audit.

Evaluating the social audit experiment

Despite the positive findings of the case studies, they raise some unresolved issues about institutionalizing a system of social audit for the downward accountability of PRIs.

a) **Sustainability:** Though there was continuity in one of the three panchayats, the other two were unable to sustain the experiment. The process of social audit was discontinued in one panchayat after a post-election change in leadership; and in the other, the same party came back to power, but the new leaders were not supportive of social audit.

b) **BPs and DPs:** Unlike GPs, the activities of BPs and DPs are not transparent.

c) **The need for a champion:** In all the three cases, success was linked with the dedicated work of volunteers, social workers and government officers. Like many other community initiatives, social audit requires champions and motivators.

d) **The role of NGOs:** NGOs played a crucial role - they motivated the elected representatives, formulated guidelines and facilitated committee discussions and works.

e) **Routine versus campaign:** Most of the experiments were carried out as popular campaigns. But once the campaign was over, it became difficult to sustain participatory functioning.

Performance audit

The performance audit authority (PAA)[227] was created to assist panchayats in building their financial management capacity and conducting the internal audit. The audit team is expected to advise the LGIs after studying their accounts and records, and visiting the major work sites. The audit team is expected to visit all GPs once in three months and other local bodies twice a year. It took some time to organize the work of performance audit organization. The service of the State Performance Audit Officer (SPAO) could only be obtained from the year 2000. Since the statutory audit of the local bodies was in arrears, the performance audit organization had to take up the audit of the past years. Apparently this work has been completed for around 80 percent of the local bodies; and the PAA has been submitting annual reports regularly to the state government, pointing out major irregularities/deficiencies in financial management of different local bodies. Despite the PAA's regular inspection of accounts, a few problems persist:

> The performance audit organization has been following the conventional method of examination of accounts and has not yet made an attempt at value-for-money audit.

- Though its primary duty is to examine current accounts, so far the performance audit has only been concerned with a post-mortem examination of accounts.
- The conventional method of statutory audit is being used, and the focus is on formal compliance with financial rules.
- It has been acting as an external inspecting agency, not as a guide to improve the financial management function of local bodies.

[227] The PAA is headed by the SPAO who is a member of the Indian Audit and Accounts Service. He reports to the secretary to the Department of Local Self-government. The State Performance Audit Office has its units in every district headed by the Assistant Director of Panchayats.

- There seems to be a communication gap between the panchayat committee and the performance audit office.
- There is a low level of awareness among panchayats about the utility of the PAA, and its reports are not given the importance they deserve, possibly because the reports have dealt with the accounts of the past years when the present panchayat committee was not in position.[228]

Beneficiary committee

The idea of the beneficiary committees is that those who will benefit from a project form a committee and execute the work on the basis of the design and estimates prepared by the panchayat and approved by an expert committee. This committee is to be given preference to contractors when it volunteers to take up a work. But according to some assessments, the results have been disappointing.[229] In fact, the overall assessment was that only about 25 percent of beneficiary committees functioned effectively.[230] The reasons for this included opposition from the officials and contractors' lobby; lack of support from panchayats; lack of technical and managerial expertise; and lack of popular, collective effort and support.

The major advantages of project implementation through beneficiary committees are transparency and continuous social auditing. But the result of this innovative measure has been far below expectations.

Right to information

The right to informative initiatives include:

- Access to official information and records: Under the Kerala Panchayat Raj (Amendment) Act (1999), any citizen is entitled to obtain copies of official documents[231] from the panchayat office on payment of a small fee. On receipt of a formal request from a member of the public, copies of specific documents have to be supplied within 15 days, with delays subject to fines imposed on the concerned panchayat officer.
- It is mandatory for the panchayats to set up billboards in each ward with information on projects being implemented.
- A meeting of beneficiaries is compulsory prior to construction work, and the beneficiaries are to be given information about the work, including its estimate and the specification. Also, vital information has to be displayed at the work site.
- The GP's plan document is prepared through a participatory process and the gram sabha has the right to decide which project should be included. Also, the draft plan document prepared by the panchayat committee is distributed in the gram sabha meeting.

But despite the introduction of these measures, the right-to-information initiatives do not appear to have made any significant contribution to the transparent functioning of panchayats.[232] The reasons for this ineffectiveness include the failure of civil society institutions to play a role; lack of popular awareness and interest; the reluctance of the panchayat to provide information;[233] the failure to sustain activism beyond the campaign period; and the failure of the government to provide equipment such as photocopying machines.

Selection of beneficiaries

Overall, the success story of the new transparency system appears to be the selection of beneficiaries under the gram sabha's scrutiny. The transparency of the procedure and the authentication of the priority list by the gram

228 Though the objections pointed out on the basis of past records may also have relevance for the present.

229 Chatukulam and John, 2002.

230 Pillai et al, 2000.

231 The documents include all records on the selection of individual beneficiaries of different schemes and public works undertaken by the local body including approved estimates, tender papers, measurement books, bills and vouchers.

232 Chatukulam and John, 2002.

233 CapDeck, 2002.

Box 3.7 : A success story in ensuring fairness and integrity

a) The criteria for eligibility for the schemes are determined; in the case of state or centrally sponsored schemes these are pre-determined. Panchayats determine the criteria for local level schemes, subject to the approval of the DPC.

b) Applications are invited on the basis of the approved criteria/norms.

c) Applications are verified and ranked on the basis of the objective criteria.

d) The ranked draft list of the beneficiaries is presented in the ward-level gram sabha meetings. The gram sabha fixes the priority among the applicants.

e) The gram panchayat prepares a priority list of beneficiaries for the entire panchayat area on the basis of the recommendations of all the ward-level gram sabhas.

f) The draft list approved by the panchayat is published for public inspection and submission of objections within a fixed period.

g) Objections are verified and the panchayat records its views before accepting or rejecting an application. The final list is published for inspection by the public, and also presented at the next gram sabha meeting.

sabha seem to be the two crucial factors behind its success. The innovative procedure for the selection of beneficiaries consists of a seven-step process (see Box 3.7).

Citizen's charter

The Kerala Panchayat Raj Act requires panchayats to circulate a citizen's charter of services they provide, the procedure for access to these services, the time period within which such services should be made available, and the remedies available if there is failure to deliver. This provision, however, still remains on paper, and panchayats are yet to streamline their functions to fulfill promises regarding specific services.

Ombudsman

The ombudsman is an important institutional framework to ensure the accountability of LGIs, and the SSFC has acknowledged that this institution could help check corruption.[234] It is too soon to evaluate the impact of this institution but some problems are evident: lack of popular awareness and information; a lone member in the office, resulting in delays in processing complaints; cumbersome procedures; and the difficulty of filing appeal against decisions since the tribunal specified in the Act has not yet been established.

The role of the gram sabha

There has been a conscious attempt to endow the gram sabha with the character of an institution, based on the communitarian principle. This principle was carried forward to the NHGs to make the gram sabha strong and functional. During the campaign phase, many gram sabhas lived up to the expectations; but this has not been sustained.[235] Ideally, the gram sabha should meet at least once in three months, and should form sub-committees to facilitate the process of decision-making. But most gram sabhas have not set up sub-committees. There is lack of awareness among the citizens about the powers and functions of gram sabha. Attendance in the meetings is not satisfactory and audit reports are not generally placed in the meeting. Even the full budget is not reported. The lists containing the names of persons eligible for benefits under various poverty alleviation programs are not placed before gram sabha for vetting. The village assembly, which formed the main plank of downward accountability of GPs, is, as a result, gradually losing its importance.

> The village assembly, which formed the main plank of downward accountability of gram panchayats, is gradually losing its importance.

Role of media

The media is an important pillar of a sound democratic structure. Given its importance in preparing the public to demand accountability, this study examined the role of the media in shaping public opinion about LGIs. A case study[236] of the local editions of three widely circulated

[234] SSFC, 2002.

[235] CapDeck, 2002.

[236] Every issue of these dailies for the year 1998 was studied.

newspapers, one in English, and two in Malayalam, concluded that the mainstream newspapers had little interest in news of local bodies. The total space allotted to such news was a little over 3.5 percent of the total space. News of DPs attracted more attention than that of GPs, with the latter claiming only around 23 percent space; news on BPs was almost absent. English newspapers showed less interest in local news. Within the limited space given to the local bodies, official news occupied the biggest share. Critical reports with analytical insights did not occupy more than one-fourth space devoted to the local bodies. Finally, reports on the problems of marginalized groups such as tribals and women were practically absent.

The accountability of panchayats: some issues and suggestions

The review of accountability mechanisms suggests two major findings:

- The ongoing monitoring of financial management is made difficult by the weaknesses in the local governments' accounting system and annual audits. Moreover, the fear that large-scale irregularities in financial transactions may invite disciplinary action by the state government is diminishing, because reports on such misdemeanors come out long after the concerned politicians or officials have left the panchayat organization.
- Kerala is the only state in the country where full recognition has been given to the principle that the primary accountability of the local government institutions is towards the local community. But much remains to be done to institutionalize the various innovative accountability tools and methods introduced during the people's plan campaign.

Performance management

The value-for-money audit, which is not in place anywhere in India, requires the measurement of performance. The purpose of measurement is to assess and to report in quantitative terms the performance of a public agency, so that it can be compared with some normative criteria.

a) **Efficiency and effectiveness of development projects:** Efficiency and effectiveness indicators are necessary to evaluate development projects planned and executed by a panchayat, because a substantial portion of the plan investment of the state as a whole is executed at the LGI level. A preliminary exercise[237] conducted by this study for two sub-sectors of the panchayat's annual development plan indicates that the performance of a public agency can be measured in quantitative terms (see Tables 3.18 and 3.19).

b) **Resource mobilization efforts:** Though tax efforts comprise a large part of the panchayats' resource mobilization, there are also other sources of NTR, including user charges, beneficiary contribution, and donation in cash or in kind (land, material or labor). All these need to be taken together to assess the total resources generated locally by the panchayat.[238]

c) **Efforts made to promote participation and to institutionalize transparency:** A tentative list of indicators include
   - The number of gram sabha meetings held;
   - Attendance in gram sabha meetings;

[237] Drinking water supply and sanitation, and roads and buildings. To measure performance, indicators were developed for efficiency (an output-input ratio) and effectiveness (the relationship between output and outcome). Input was measured in terms of direct financial investment made for a particular project. Output refers to the physical achievement of a project. Outcome was defined as the objectives of the project, and the objectives were measured in terms of quality of output, number and the category of beneficiaries, and performance of the project.

[238] Percentage increase or decrease in the total resources generated during the year under review over the previous year is a measure of performance in resource mobilization. Because of its simplicity, percentage measure is widely used. Another method that is also widely used is the ratio between the revenue income and revenue expenditure, given the assumption that the local government must meet its revenue expenditure from its revenue income [See section 3.4].

- Circulation of LFA and performance audit reports among the public and the gram sabha;
- Communication of information regarding public works to the public;
- Launching and implementation of the citizen's charter;
- Authentication of BPL list/ beneficiary lists by the gram sabha;
- Percentage of projects included in the annual plan on the recommendation of the gram sabha;
- Conducting of social audit and placing of report before the gram sabha; and
- Percentage of beneficiary contribution in total local resource mobilization.

Awarding scores to each of these indicators and developing an index will help show the efforts made by a panchayat in discharging its obligations.

A system of incentives and disincentives linked to performance

Any evaluation of panchayat performance needs to be linked to a system of incentives and disincentives, as well as the grant system. The evaluation results must be disseminated to the public so that citizens are aware of how their local government is functioning. The PAA could be made responsible for the task of performance measurement on a regular basis, with the assistance of experts and/or NGOs. Finally, value-for-money auditing could be introduced on the basis of the efficiency and effectiveness of panchayats. Some incentive mechanism has to be developed to give social audit also a fair trial.

Enhancing fiscal decentralization: conclusions from the Kerala experience

Kerala has responded to the 73rd and 74th Amendments with various significant initiatives. But like any pioneer with no role models, the state continues to face several problems in successfully implementing fiscal decentralization.

The Kerala experience: an overview

How far has Kerala gone on the road to fiscal decentralization during the post-Amendment regime? Measured in terms of some revenue and expenditure ratios (see Table 3.20), it is apparent that Kerala has made significant advances. The share of local bodies in total expenditure rose from 4.2 percent in 1993-94 to 12 percent in 1998-99, with the increase predominantly accounted for by GPs. The average volume of expenditure handled by a GP rose from around Rs.17 lakhs in 1993-94 to Rs.80 lakhs in 1998-99, and to over a crore in

Table 3.18 : Efficiency measurement

Outputs compared to design							*Output as compared to other norms*		
	Output	*% of design*	*Allotted fund*	*Fund spent (cost of 1)*	*Spent fund as % of alloted fund*	*Cost per unit*	*Cost per unit as % of design*	*Cost per unit as % of district average*	*Cost per unit as % of previous years*
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Design									
Actual									

Note: The row "actual" lists the indicators. In this row, column 2 measures actual output in relation to the designed output; column 5 gives the ratio of fund that can be utilized; column 6 captures the relationship between input and output, fund spent in column 9 being assumed as total cost of producing the output recorded in column 1. Since the ratio in column 6 of row 2 measures economy, this can be compared with some norms. Column7 compares between the design and the actual, column 8 between the LGI under scrutiny with the average of other LGIs in the same district and column9 shows whether the LGI is performing better or worse than its last year's performance. For comparison in column 9, some weightage may be given for price increase.

Table 3.19 : Effectiveness measurement

	Output	Beneficiaries		Beneficiaries as % of design		Quality	Gestation period	Gest. Per. as % of design	Index of effective-ness
		Total	SC/ST	Total	SC/ST				
	(1)	(2a)	(2b)	(3a)	(3b)	(4)	(5)	(6)	(7)
Design									
Actual									

Note: Columns 2a and 2b record number of persons benefits have reached and they are compared with the designed targets in column 3a and 3b. Benefits to the SC/ST groups are to be shown separately. Column 4 refers to quality. This can be measured in two ways. One is subjective measurement in terms of citizens' satisfaction. The beneficiaries or a representative sample comment on the quality of work, on a 5-point scale: very good, good, average, below average, bad. An index based on the average response is recorded in Row 2 of column 4. The other way to judge quality is recording observations by trained observers or independent technical persons. Both the ratings can be considered in the case of important projects. Gestation period can be compared with design in column6. In column 7 an index can be constructed on the basis of factors such as benefits, particularly benefits to SCs/STs, quality and gestation period. If the efficiency measure can be accommodated along with the above parameters, the effectiveness index will be a composite index representing performance in terms of both economy and productivity.

1999-00. But several problems persist. Among these are the need for greater revenue mobilization at the local level; capacity building; and strengthening the accountability system. Due to the devolution of more functions, funds and functionaries down the line, the accounting traditionally confined to the VPF, and the related accountability system, were placed under severe strain. Under the new dispensation, local plan expenditure, including that of transferred institutions, work out to around 60 per cent of total expenditure. Building capacity calls for the institutionalization of the gram sabha and the bottom-up planning process on the one hand; and the accountability mechanism on the other.

The expenditure of local bodies, particularly the GPs, indicates that local level development activity has received impetus in Kerala. But much remains to be done to institutionalize effective fiscal decentralization.

Policy measures: revenue, expenditure, transfers, accountability

Tax revenue

The progress in revenue decentralization does not match the advance in expenditure decentralization and some policy measures - such as reviewing tax assignments, imposing or increasing user charges, and stepping up measures

Revenue mobilization can be significantly enhanced by better tax effort.

Table 3.20 : Some revenue and expenditure ratios, Kerala, 1993-94 to 1998-99, Rs. in crores

Variables	*1993-94*	*1998-99*
A. 1. Total State Own Revenue	2668	5208
2. Total Own Revenue of Local Bodies (PRIs and ULBs)	109	238
3. Percentage of Own Revenue of Local bodies to Total State Own Revenue and local bodies' own revenue combined	3.9%	4.3%
B. 1. Total State expenditure	4656	10611
2. Total expenditure of Local Bodies	206	1453
3. Percentage of the total expenditure of local bodies to combined expenditures of state and local bodies.	4.2%	12.0%

A = Revenue B=Expenditure. PRI data as estimated by study and ULB data, SFC sources.

to augment tax efforts - have to be addressed. This study has presented substantial evidence of inadequate tax efforts.

- Own source revenue (OSR), a key factor in building autonomous decentralized governance, fell from 38 percent of total revenue in 1994-95 to 17 percent in 1998-99. The OSR of GPs as a percentage of SDP fell from 0.3 per cent in 1993-94 to 0.28 per cent in 1998-99, a decline of 6.6 per cent. On separating OSR into tax and non-tax components, it becomes clear that the tax revenues of SDP in GPs, which was around 0.22 per cent of state domestic product (SDP) in 1993-94, declined to 0.14 per cent, a decline of over 36 per cent. Tax effort has been poor by this reckoning. In 1995-96, more than 80 percent of the GPs considered at the block level had negative growth rate in real OSR. The per capita OSR fell below the state average in seven out of the 14 districts in 1998-99.
- Property tax, profession tax and entertainment tax alone contributed over 97 percent of the tax revenue between 1993-94 and 1998-99. This shows that the tax structure has not been diversified over the years; several other taxes such as advertisement tax, show tax, land conversion tax and land cess tax could have been more efficiently tapped.
- Property tax contributed over 53 percent of tax revenue in 1993-94, but fell below 47 percent in 1997-98. It registered negative growth in two of the six years under study. Negative growth was observed during the 1990's for property tax in 101 GPs, profession tax in 44 GPs and entertainment tax in 225 GPs (out of 789 GPs studied).[239] Most GPs do not have a complete and updated list of employees liable to profession tax and property tax. Such a situation is untenable in a state where rural areas have witnessed an unprecedented building boom in the 1980s and 1990s.

Tax mapping

Even simple tax mapping along with appropriate computerization would enhance revenue significantly (see Box 3.8).

> **Box 3.8 : Some suggestions for tax reform and tax mapping**
>
> A. *Introduction of tax reforms* such as plinth area-based annual valuing of property, seating capacity-based entertainment tax, and presumptive assessment of profession tax for certain categories of professionals.
>
> - Laying down a policy framework for user charge assessment and realization.
> - Linking NTR sources of local government to inflation through an appropriate price index with provision for enhancement at periodic intervals.
> - Introducing performance-based incentives in the devolution of funds to motivate local governments to mobilize local resources.
> - Issuing rules for advertisement tax and service tax. (The local government could introduce service tax to recover the full or partial cost of services provided).
> - Fixing only the floor rates of taxes in local government laws.
>
> B. *Tax mapping methodologies*
>
> - Preparing cadastral maps based on field measurement data and revenue records.
> - Preparing assessment registers, demand registers and arrear demand registers from existing records in the local body.
> - Finalizing collection particulars based on accounts data.
> - Building a common identification code and linking various tax and non-tax collections to the citizen, his or her property and a land parcel for complete and unambiguous identification.

Equalizing feature in the state grant formula

The broad pattern of variation among GPs does not show a relationship between per capita OSR and population size. GPs with a population below 10,000 have the highest per capita revenue and GPs with a population above 50,000 the lowest. The per capita OSR distribution by natural geographical regions also dispels the notion that highland GPs are poor. The regression analysis of over 600 GPs conducted by this study indicates that per capita OSR tends to be higher in more populous places, and in those where land area is smaller and the percent of concrete housing units is greater. This seems to provide some evidence that per capita OSR is higher where taxable capacity is higher, suggesting the need for an equalizing feature in the state grant formula.

[239] These trends are calculated from a comparison of averages for 1993-1996 and 1996-1999.

Non-tax revenue

That NTR outdistanced tax revenue collection in 1998-99 despite no substantial revision in the rates of licenses and fees reflects the buoyancy due to growing economic activities, but also the slack in tax effort. While the average per capita own tax revenue has not even doubled in 1998-99 compared to 1993-94, that of NTR has grown by more than four times. All the same, some available evidence suggests that NTR could have been much higher.[240]

Expenditure

The total revenue expenditure is around 68 percent of total expenditure in 1995-96, the year before the plan campaign was launched. By and large this was true for earlier years. About 50-53 percent of the revenue expenditure comprised establishment cost (management and salaries). As more functions, funds, institutions and functionaries are devolved, establishment cost and total revenue expenditure are bound to increase. If the revenue expenditure of 1998-99 is related with the total expenditure as estimated from the sample survey, it is possible to conclude that the revenue component has shrunk to roughly 25 percent of total expenditure. This is an understatement. First, it ignores the fact that the state government continues to bear the salary, allowance and pensions of all officers transferred to the GPs. Second, the plan grant necessitates considerable revenue expenditure. Third, non-plan transfers are made by the state to the transferred institutions and schemes.

Expenditure related policy initiatives

It is clear then that a few policy initiatives are called for, including the scientific reassessment of establishment cost under the new dispensation through a functional review of local governments and staff requirements; and the classification of expenditures, into, for example, revenue and capital, and plan and non-plan.

a) **Scientific re-examination of entire maintenance expenditure:** One major way to promote spatial equity and a better quality of life - the main rationale for decentralized governance - is by improving the delivery of sources and the maintenance of the quality of assets created. The per capita maintenance expenditure of GPs doubled from Rs.15.6 in 1993-94 to Rs.33.7 in 1997-98. The percentage of total maintenance expenditure remained around 45 percent of revenue expenditure, and the expenditure on core functions around 11-13 percent of revenue expenditure. The transfer system will have to ensure a critical minimum of services and the maintenance of standard quality in the delivery of these services in each panchayat.

b) **Using the accounting system as a financial instrument:** The rules governing the preparation of the budget were framed in the early 1960s for the VPF, and they are totally inadequate for the present day. The budget is neither realistic nor comprehensive. The annual financial statement prepared for the audit department is not integrated with the budget system. There is no linkage between sources and uses of annual plan funds and budget. Other accounts also stay independent. Also, there is no distinction between revenue and capital except in the VPF account, and this is rendered superfluous with plan funds increasingly being routed for productive proposes. There is no reliable information regarding the stock of assets. Any transfer system is efficient only to the extent that the budget and accounting system is realistic, and allows for financial control and management.

A comprehensive district perspective plan

There is great need for a comprehensive perspective plan for a district, with the plans of lower tiers forming the building blocks. Planning is a major exercise that calls for the involvement of the public, experts and political leadership. While these can provide a consolidated perspective of a vision of development, the annual plan would be the operational component. Kerala's experience, for instance, in resource mapping at the local level, geographical information systems and watershed

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240 For example, although the income from sale of sand increased 12.6 times from 1993-94 to 1998-99, not even a fraction of this accrues as revenue. (Also see The Hindu, Thiruvananthapuram edition, June 23, 2003.)

planning should be consolidated; and efforts made to build a perspective plan for every local body. A medium-term revenue and expenditure framework could evolve out of this exercise for the local bodies, which framework in turn can be a useful component of the state plan. This would be of great help in developing any meaningful fiscal reform package.

Transfer arrangements

Sustainable local democracy depends a great deal on an efficient and equitable transfer system. The total grants to GPs have grown from Rs.75 crores in 1993-94 to Rs.636 crores in 1998-99; as a proportion of the states' own revenue registers, this is an increase from 2.8 per cent to 12.2 per cent. The per capita average receipt of 87 percent of GPs is around Rs.300. The total transfers to all local bodies work out to over Rs.1200 crores. The local bodies have spent as much as Rs.3912 crores of plan grants during the five years from 1997 to 2001. These are substantial sums compared to those in the pre-plan and pre-Amendment regimes. But monitoring and evaluation has to made part of the transfer.

Defining transfer level and structure

The coefficient of vertical imbalance, defined as one minus the ratio of own revenue to total expenditure, could serve as a measure of the fiscal gap. This could be used to define the level and structure of transfer. Transfers call for the definition of a divisible pool that takes note of the expenditure responsibilities of various tiers of local governments, and the resources required for a planned reduction of inter-jurisdictional imbalances. Examining the vertical gap vis-à-vis the estimated total expenditure of GPs in 1998-99, the coefficient of vertical imbalance is 0.75 compared to 0.29 in 1993-94. Again, the need for increasing the own revenue base is clear. Given the present trend in tax effort, this imbalance could have increased since 1998-99. The critical need to augment the own revenue resources of PRIs and impose a hard budget constraint is obvious. The case for relating transfers to revenue effort is crucial.[241]

Ensuring horizontal equity

Ensuring horizontal equity is an important objective of transfers in India in general, and Kerala in particular. The average minimum per capita OSR for 1996-99 is at a minimum of Rs.1.25 and a maximum of Rs.382, indicating the significant disparity in resource endowment. In general, places with a greater taxable capacity raise more per capita OSR. Moreover, the disparities seem to have widened in the nineties, and per capita non-plan grants and per capita statutory grants do not appear to equalize these differences. While non-plan expenditure disparities have increased over the years, the evidence suggests that plan grants in aid distributed through a formula have been far more equitable. Plan grants show a decided bias in favor of the GP with a heavier concentration of poor families. Whether this raises the poorest GP to an adequate level is unclear, but it seems reasonable to suggest that those GPs with per capita OSR and per capita expenditure in the lowest one or two deciles should receive special consideration as part of a fiscal equalization grant scheme.

A predictable, even flow

A rational transfer system should be predictable and ensure an even flow throughout the fiscal period. This is especially important in view of the existing situation in which grant receipts are bunched at the end of the fiscal year, distorting the spending pattern and contributing to high closing/opening balances. At present, the income-expenditure pattern is so uneven that the fiscal balance fluctuates from a 200 percent deficit in August to a 40 percent surplus in March. Closing treasuries for business on working days or imposing oral or written instructions to restrict treasury transactions have exacerbated the problem. Resolving the problems of the state-local transfer system in Kerala and resolving the fiscal problems of the state

> The most suitable fiscal arrangement would ensure some balance between the flow of receipts and expenditure, spread throughout the fiscal period.

[241] This cannot and must not apply to the nearly four percent of GPs which cannot meet even the running expenses of their core functions.

government are, clearly, connected issues. (See Box 3.9 for elements of a designed devolution package.)

Box 3.9 : Designing a devolution package

The basic elements include the following indicators:

- Spelling out the underlying principles
  - Transparency
  - Efficiency
  - Equity
  - Autonomy
  - Stability, predictability and adequacy
- Spelling out the objectives
  - Reducing vertical and horizontal imbalances and working towards equalizing the financial capabilities and service levels of the village panchayats.
  - Facilitating local planning for economic development and social justice.
  - Promoting decentralized governance and local democracy.
- Working out the approximate size and broad structure of the transfers

Modifying existing transfers

Existing transfers need to be modified by changing the practice of tax sharing and multiplicity of grants into a divisible pool based on valid norms. In 1998-99, the total transfers made up approximately 22 percent of the own revenue of the state excluding assigned taxes. As a proportion of the total tax revenue of the state, this is 25 percent. The SFCs of the state will have to arrive at the relevant size based on a scientific mapping of the function-fund matrices of different tiers, and an examination of their relation to the state's own revenue and tax revenue. The divisible pool could have three components, Pool A, B and C. Once the size of the divisible pool is determined, the inter-sectoral distribution (to PRIs and ULBs) needs to be based on the relative population proportion.

a) **Pool A - plan grant:** Plan size should reflect expenditure responsibilities of the local bodies, which in turn should have some links with the total state plan size. In reality, the size of a state plan may be pruned because of the failure to generate adequate BCR, or because of negative dividends from public sector enterprises, or failure in additional resource mobilization. But a local plan entitlement should not suffer. Thus local bodies should have a claim on the state's own revenue rather than on the size of the state plan. The implications will have to be worked out in detail. The expenditure framework derived from a medium/long term perspective plan approved by the DPC[242] could also offer guidelines to finalize details regarding Pool A.

b) **Pool B - maintenance grant:** The maintenance entitlement component could be built on a scientific evaluation of the per unit cost of major services of standard quality (allowing for some variations for remote areas and mountainous regions). The proportion could be decided on the basis of a strategy of user services, the principle of ability to pay, and willingness to pay. The maintenance grant should become an entitlement only for those panchayats that have a clear and detailed record of assets.

c) **Pool C - assigned taxes:** Pool C could comprise assigned taxes. The entire amount of revenue derived, less collection charges, should go to the panchayats/local bodies on a predictable time frame. Here the interse distribution could be based on population, collection and some criterion of backwardness.

Accountability

On the basis of this study's review, several measures need to be taken to strengthen the accountability system.

- The accounting and the budgeting systems of PRIs need overhauling so that appropriate financial reporting is made possible for various purposes such as ongoing monitoring,

[242]Only 14 states have constituted such committees, and it seems to be functional only in Kerala. There seems to be a case for abolishing the District Planning Committee in favor of a district administration (in the place of the District Panchayat which is the apex rural local body). What is needed is to abolish the block panchayat, and strengthen, expand and empower the GPs while retaining a district level body for the coordination and consolidation of development. Given the long tradition of the district, this two-tier arrangement may be a more natural institutional setup.

performance evaluation and cost of providing individual services. The possibility of introducing the modified double entry system of accounting has to be considered, and the book keeping function computerized.

- Redesigning the internal management structure of GPs would enable the president, who performs many executive functions, to share responsibility with other office bearers associated with such functions. Given the volume of work, a cabinet system seems called for, with the president and the chairpersons of the standing committees forming a team along the lines of the Mayor-in-Council of West Bengal. The line of control of the panchayat bureaucracy, especially that of those from the transferred departments, should be made unambiguous.
- The creation of an institution such as the Public Accounts Committee, with substantial representation of panchayat members of the opposition parties, has to be considered to examine audit observations in detail.
- The statutory audit has to be kept up-to-date. A target has to be fixed for the preparation of the final accounts within two months after the close of financial year. Ideally the audit should be done within six months thereafter.
- Solving the current problems faced by the ombudsman would facilitate the institution's functioning.
- The relevant institution of the Performance Audit Authority needs to be considered afresh. It should not be a fault-finding body but an institution that seeks to rectify defects to put decentralized governance on a viable footing.
- Various unique features of Kerala's Panchayat Raj system, such as the the overseeing functions of the gram sabha, right to information, social audit, transparent method of beneficiary selection and the citizen's charter, should be retained. They should be taken into consideration in evaluating the performance of panchayats, and performance in turn be linked with a system of incentives and disincentives.
- Value-for-money audit for LGIs would make them accountable for observing rules and norms and for results. Such an audit would help ensure both the upward and downward accountability of panchayats.

> The entire fiscal reform process - at local and state levels - has to be a simultaneous and integrated process.

In summary: reforming the budgetary process, budget structure, accounts and accountability mechanism

Fiscal decentralization means devolving more taxing and spending powers to the lower tiers of government. This study has tried to capture the process of the viable integration of the third stratum into Indian fiscal federalism. The reform process the study conclusions point towards could be counter-productive if independent of the reform of the state fiscal system. The entire fiscal reform package needs to occur as a simultaneous and integrated process involving the union, state and local governments.

a) **Timing of transfers:** The transfer of each item in the divisible pool should be timed to avoid radical fluctuations and bunching at the end of the year. The practice of GPs collecting their revenues at the end of the year must also be discouraged through some punitive clause.

b) **Interse distribution:** An inter-ward distribution formula needs to be designed, taking into account population, local revenue collection per capita, and a poverty index such as that used by the poverty eradication mission, Kudumbasree.[243]

c) **Introduction of a framework for public-private partnership:** The local governments must provide adequate space for the community (including NGOs) to participate in the development of their neighborhood and locality. Solid waste management, street

[243] Kudumbasree is organized under the Local Administration Department of the Government of Kerala, which identifies BPL families on the basis of a 4/9 criteria. The criteria, however, need re-examination and modification.

sweeping, debris removal, garbage collection, and the cleaning of markets could be left to the private sector when possible. At the same time, panchayats and reliable NGOs need to be entrusted with antipoverty programs to protect the interests of disadvantaged sections.

d) **Local governments and borrowing:** Given the state government's revenue deficit, the question of hard budget constraints must govern state as well as local governments. The practice of a higher government guaranteeing the debt repayment of a lower government can prove to be a serious problem. Launching bankable projects with a self-liquidating possibility should not be restricted; but in the present financial context, how soon PRIs can be permitted market-borrowing facilities is a matter for serious consideration.