

# Summary

### Preface

*The Government of India Task Force on Decentralization (2001) stated, "Decentralization in the context of panchayats means that when authority... is transferred from the state to the local governments, the latter should have the prerogative of taking decisions... (on the) planning and implementation of such activity." This study does not presume fiscal decentralization to be inherently "good" or "bad." Instead, it takes decentralization as a government objective as stated in the 73rd and 74th Constitutional Amendments, and focuses on the process of devolving responsibilities and powers to panchayats. Attempts are made to identify the strengths and shortcomings of the existing system of rural fiscal decentralization; and on this basis, recommendations for policy, organization and implementation changes are made to ensure better delivery of public services.*

*The study addresses the fiscal framework for panchayats in isolation from the other players in the intergovernmental fiscal system - the center, the state, and the municipalities. But in fact, the well being of all these government units are linked. Fiscal stress at one level is likely to affect all other levels. The study remains cognizant of these interrelations.*

*The status of decentralization is specifically examined in two states, Karnataka and Kerala. These states have, relatively speaking, moved ahead on fiscal decentralization. In many ways, Karnataka was ahead of the decentralization reforms initiated in 1992 and may have influenced the national thinking on empowering rural local governments. Karnataka has also taken a proactive stance on decentralization in more recent years. The report of the Working Group on Decentralization recently brought out by the Karnataka Department of Rural Development and Panchayats makes a thorough analysis of the administrative and political aspects of decentralization to identify the shortcomings of the existing system.*

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*Of all the states, Kerala has devolved the most to rural local governments. In 1996, the new state administration devolved 35 percent of the Ninth Plan (1997-2000) budget to local bodies, redesigned the planning process to place local institutions at its center, and initiated the revision of the Panchayat Act, which came into force in 1999. In addition, Kerala's other achievements - such as increased literacy, especially that of women - have had a positive effect on local governance. Clearly, the experience in these two states is relevant for the rest of India. Finally, Karnataka and Kerala are two states that specifically requested World Bank assistance for a review of panchayat finances.*

## Decentralization: an introduction

The worldwide trend towards decentralization has been accompanied by animated discussions about its benefits and costs.

Most countries have placed the strengthening of local governments - or decentralization - on their development policy agenda. But action to endow local governments with significant taxing powers and increased expenditure autonomy has not necessarily matched plans and promises. In fact, the share of expenditures in developing countries made by sub-national governments has not increased in the past two decades.<sup>1</sup> Perhaps the economic conditions have not been right for the adoption of comprehensive decentralization schemes; perhaps political freedoms have been too new in some cases; and perhaps the idea just takes some getting used to. Whatever the reason, there are signs that some countries are now ready to move forward, and the next decade may see as much implementation as rhetoric. India may be a case in point.

In many countries, policy makers see decentralization as a panacea for many of the ills afflicting society. For instance, it is perceived as a means to improve service delivery, involve a greater percent of the population in governance, and increase revenue mobilization.<sup>2</sup> In contrast, arguments against decentralization have focused on the reduced ability of central governments to implement macro-economic stabilization programs; efficiency losses due to the poor

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### Perceived benefits of decentralization:

- ◆ Improved service delivery
- ◆ Greater popular involvement in governance
- ◆ Increased revenue mobilization

### Perceived costs:

- ◆ Reduced central ability to implement macro-economic stabilization programs
  - ◆ Efficiency losses due to poor local level capacity
  - ◆ Potential for increased corruption
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capacity of local governments to undertake the functions assigned to them; and the potential for increased corruption.<sup>3</sup> The issue of the impact of decentralization on efficiency, growth and corruption will probably never be resolved, other than to conclude that it is likely to be country-specific.

The complex phenomenon of decentralization can be classified into three types: deconcentration, delegation and devolution.<sup>4</sup> In deconcentration, the decision-making power is with higher-level government, and the lower level is merely employed to implement the higher level's policies and programs. In delegation, the higher-level government delegates decision-making power to the lower level for specified functions. Only in devolution is decision-making power shared between the higher and lower levels of government, so that genuine decentralization is evident. Such a concept has administrative, political and fiscal dimensions. The effectiveness of decentralization requires the

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<sup>1</sup> Bahl and Wallace, 2003.

<sup>2</sup> Bahl, 1999; Bird, 1999.

<sup>3</sup> Prud'homme, 1995; Tanzi, 1996, 2001.

<sup>4</sup> Parker, 1995.

calibration of these three interdependent dimensions. Without political decentralization, participatory decision-making is not possible. Again, administrative decentralization is necessary to implement political decisions. This is also an important precondition for fiscal decentralization: efficiency in the delivery of public services depends on administrative efficiency and accountability.

## The Indian context: the struggle to decentralize to panchayats

At present, India's decentralization to rural and urban governments is a patchwork of deconcentration, delegation and devolution.

### The Indian background

#### *A large and diverse constituency*

India, a federal union of 28 states, has a population of over a billion people. Uttar Pradesh alone has a population of 131 million, almost the

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Decentralization to the third tier appears to make eminent sense in the Indian context.

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size of Brazil, and several states in India are larger than many countries. In addition to size, there is also the issue of India's

diversity - the country has more than 400 ethnic groups, speaking a variety of languages and dialects. It seems virtually impossible for a constituency of this size and diversity to be represented in an effective and fair way. Not surprisingly, recent surveys on rural poverty projects have showed that government, or its accountability, is practically absent in many villages. Indeed, in a survey of 400 villages, 40 percent of villagers reported that they had never heard of a single government scheme.<sup>5</sup> This is in spite of at least 2000 existing state and central schemes for rural development.

#### *The current situation of Indian decentralization*

As in other democracies, decentralization in India has been a process of advances and retreats, and a

struggle between advocates of conflicting perspectives on governance and development strategy. The political advocates among the supporters have argued that decentralization is essential for appropriate participation in governance; technical experts have supported decentralization as critical to the effective implementation of development programs. The opponents have included politicians who see decentralization as diluting political control by putting power into ill-equipped hands; and administrators, who perceive parallel threats to public management. Since 1957, decentralization advocates have made progress - though slowly and incompletely, attesting to the strength, skills and persistence of the opposition. At every step, there have been delays in legalization and effectiveness measures. Today, two constitutional amendments and affirmative legislation by states underpin decentralization. But the overall picture remains an unfinished agenda: a patchwork of legislation and initiatives that has put local governments in place but failed to endow them with the means to deliver results.

### Political decentralization

#### *The beginnings*

Decentralization to rural and urban governments (panchayats and municipalities) began even before independence. The first attempt at institutionalizing rural local governments - the panchayats - in the government structure was not very successful. Despite Gandhi's commitment to village governments (Gram Swaraj or village-level self-

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1957: the first central initiative to establish local governments

1963: recommendations on fiscal devolution

1978: panchayats recognized as political rather than developmental institutions

1986: the need to amend the Constitution recognized

1993: coming into force of 73rd Constitutional Amendment after ratification by more than half the state assemblies

1993: central initiative to extend 73rd Amendment to tribal areas

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<sup>5</sup> Karnataka Sample Study. See Rao et al, 2004.

rule), the first draft of the Indian Constitution did not make any provisions for panchayats. When the provisions were made, they were confined to the non-justiciable part of the Constitution dealing with the Directive Principles of State Policy. According to Article 40, "the state should take steps to organize village panchayats and endow them with such power and authority as may be necessary to enable them to function as units of self government," but it was not mandatory.

### *Democratic decentralization*

Later, in 1957, the Balwantray Mehta Committee recommended democratic decentralization by setting up Panchayat Raj Institutions (PRIs), and devolving the necessary resources, powers and authority to them. At the block level, these institutions were to ensure proximity to people and economies of scale, and a focus on functions such as rural development and services such as drinking water. Rajasthan became the first state to inaugurate Panchayat Raj in 1959, followed by Andhra Pradesh. By 1959 most states had passed Panchayat Acts.

### *Fiscal decentralization*

Since the Balwantray Mehta Committee did not make provisions for fiscal decentralization, the K. Santhanam Committee was set up in 1963 to look into panchayat finances. Key recommendations included powers to levy a special tax on land revenues and homes; consolidation of all grants at the state level and devolution to PRIs; and the establishment of a Panchayat Raj Finance Corporation to look into the financial resources of PRIs and provide loans and financial assistance to grassroots level governments.

### *Strengthening PRIs*

Given that the recommendations of earlier committees were not fully implemented, the Ashok Mehta Committee (1978) was appointed to again examine measures to strengthen PRIs. Thus the first official recommendation was made to include panchayats in the Constitution. The thrust shifted from the panchayat as a development organization to the panchayat as a political institution. Building

on the recommendations of the Ashok Mehta Committee (see Box 1.1), the states of Karnataka, Andhra Pradesh, West Bengal, and Jammu and Kashmir either revised their existing Panchayat Acts or passed new legislation. For the first time in India, local body elections in West Bengal in 1978 saw the participation of political parties.

#### **Box 1.1: Recommendations of the Ashok Mehta Committee, 1978**

- ♦ The district as the key administrative unit for planning, coordination and resource allocation, and the management of the rural and urban continuum.
- ♦ The PRIs as a two-tier system, with the mandal panchayat (block) at the base and the zilla parishad (district) at the top.
- ♦ Population-based representation of Scheduled Castes (SCs) and Scheduled Tribes (STs) in the election to PRIs.
- ♦ Participation of political parties in elections.
- ♦ Financial devolution consistent with the devolution of developmental functions to the district level.

### *Constitutional recognition*

Possibly in reaction to the slow pace of panchayat empowerment, the L.M. Singhvi Committee (1986) recommended the constitutional recognition of local self-government, and the non-inclusion of political parties in panchayat elections. Subsequently the Constitution (64th Amendment) Bill was drafted and introduced in Parliament. However, the bill failed to get a majority in the Rajya Sabha since it overlooked the states and was perceived as an instrument of the center to deal directly with PRIs. The 74th Amendment Bill (1990) on panchayats and municipalities introduced by the National Front government during its short tenure in office was never taken up for discussion. In September 1991, the Congress government introduced the 72nd (Panchayats) and 73rd (Nagarapalika) constitutional amendment bills, and finally, on April 24, 1993, the Constitutional Amendment formally came into force after ratification by more than half of the state assemblies.<sup>6</sup> When both houses of

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The 73rd Amendment was based on a decentralized, participatory, democratic approach to governance.

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<sup>6</sup> Mahipal, 1997.

parliament passed the bills, the sequence of the bills changed to the 73rd and 74th Amendments respectively.

### *Moving ahead: the 73rd Amendment*

The radical features of the 73rd Amendment (see Box 1.2) tried to address some of the problems encountered by PRIs in previous years by

- a) Granting PRIs constitutional status;
- b) Empowering socially and economically disadvantaged groups such as dalits, adivasis and women;
- c) Ensuring free, fair, and regular elections;
- d) Keeping terms fixed;
- e) Identifying a list of subjects to come under the jurisdiction of PRIs;
- f) Addressing the issue of PRI finances;<sup>7</sup> and
- g) Establishing the gram sabha (village assembly) as the electorate body to which the panchayat would be accountable.

#### **Box 1.2 : The features of the 73rd Amendment**

- ◆ The centrality of the gram sabha to decentralized governance.
- ◆ Uniform three-tier PRI structure with village, block and district levels.
- ◆ Direct election to all seats for all members at all levels.
- ◆ Proportionate reservation of panchayat seats and offices of chairpersons at all levels for SC and ST, with one third reserved for SC/ST women.
- ◆ One third of total seats and chairperson offices reserved for women.
- ◆ Ability of the state legislature to provide seat and office reservations to backward classes.
- ◆ Uniform five-year term for panchayats, with elections before the expiry of term; elections within six months if panchayat dissolved.
- ◆ Protection against dissolution by amendment before the expiry of panchayat term.
- ◆ Disqualification from panchayat membership for those disqualified from election to state legislature.
- ◆ Independent State Election Commission to supervise preparation of electoral rolls and control electoral process.
- ◆ Twenty-nine subjects eligible for devolution to panchayats (see Box A1, Appendices); powers to states regarding which subjects to devolve.
- ◆ Setting up of State Finance Commission (SFC) once in five years to review PRI financial position and make suitable recommendations for fund distribution to panchayats.

### *Reclaiming the state by the citizen*

Thus the 73rd Constitutional Amendment consolidated many of the gains achieved in establishing PRIs, and imposed a political uniformity on the structure and workings of the third tier. The Amendment perceived popular participation as the key in decision-making and service delivery. This goal - of reclaiming the state by the citizen - had become particularly important with weaknesses in the state's delivery mechanisms becoming evident. The Ninth Five-Year Plan (1997-2000) stated: "Past experience has shown that many development projects and programs, having laudable objectives, have failed to deliver the result because of the inadequacies of design and implementation. Time and cost overruns have become widespread and substantial in public sector infrastructure and investment projects. It is common knowledge that the benefits intended to be delivered to the people through development programs in the social sectors have not fully reached the beneficiaries because of the weakness in administrative planning and delivery mechanism."

### *Including the adivasis*

The Constitutional Amendment, however, excluded the adivasis or indigenous people, except for reservations, and the Scheduled Areas.<sup>8</sup> Subsequent to the Bhuria Committee (1994) extending the provisions to the Scheduled Areas and suggesting modifications to strengthen institutions of local self-government, the Adivasi Act, or the Provisions for Extension to Scheduled Areas (PESA) came into effect in 1996. This Act recognizes the vulnerability of the adivasis to any action against their interests by state representatives such as the lower officials of the police, excise, forest and revenue departments. It endorses the communitarian nature of adivasi life with respect to the resource base. Moreover, it recognizes the priority of community rights with respect to individuals, especially in the case of

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The Adivasi Act is remarkable in the Indian context: it recognizes the need to protect tribal people from the possibility of exploitation by state representatives.

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<sup>7</sup> Vyasulu, 1998.

<sup>8</sup> Areas with a majority tribal/indigenous population.

property. On the basis of these principles, the Act placed the gram sabha at the center of the panchayat system of self-rule for the adivasis, going beyond the functions and powers of the gram sabha in non-Scheduled Areas.<sup>9</sup>

### *Creation of the PRI political structure*

The states and union territories amended their respective Panchayat Acts by the deadline - April 1994, one year after the Amendment Act came into force. These amended acts provided for uniformity in terms of three-tier local governments at the district, block and village levels: Zilla Parishads (ZPs), Panchayat Samitis (PSs; also Block Panchayats), and Gram Panchayats (GPs) respectively.<sup>10</sup> States with a population below 200,000 were given the option of not having the middle-level panchayat. The states' positive response was partly because the Constitutional Amendment clearly stipulated the obligations of state governments with regard to political decentralization. The objective was to formally establish the third tier so that it could no longer be created and disbanded at will by the states, and thus enable a uniform three-tier structure in all states.<sup>11</sup> As a result, most Indian states are at exactly the same stage of political decentralization, and representatives of each tier have been democratically elected.

### *Implementation of Amendment provisions*

The implementation of many of the Constitutional Amendment provisions was, however, left to the states, either by delegation or omission. The first task of the states was to approve the Conformity Legislation dealing with powers, functions and procedures for local governments. The Conformity Legislation (Principal Legislation) recognized that there would be new contingencies that would have

to be addressed in the future. Hence it contained clauses that allowed state governments to prescribe new rules without going through the legislative process. These clauses use language such as the "State may by notification" or "subject to such rules as may be made under the proviso to article ... the government may alter, ..." which allows the state to withdraw, curtail, extend, and over-ride the authority of the PRI system. States such as Andhra Pradesh and Karnataka have used the route of delegated legislation in preference to principal legislation. Concerns have been raised about the quality of this process since important matters such as implementation, service delivery, local capacity building, and transfer of responsibilities and powers to rural local bodies have apparently been left to the discretion of the state administration, one of the vested interests often opposing decentralization.<sup>12</sup>

### *Interstate variations in panchayat structure*

The Constitutional Amendment helped make India one of the most politically decentralized countries in the developing world. But because of the flexibility given to states, it also resulted in wide variations in the political structure of panchayats across India. Interstate variations are evident in terms of panchayat size, methods for electing chairpersons (direct or indirect), reservations for backward classes, presence of MPs and MLAs in panchayat affairs, election norms, composition at the district level, and methods for dissolution of panchayats and suspension and removal of chairpersons. Even though there is some variation in the average population size of rural local governments, the small size of the gram panchayat illustrates the intention of bringing government close to the people. Of the two case studies, Kerala established fewer but larger gram panchayats, while Karnataka took the opposite approach.

<sup>9</sup> Thus the gram sabha in Scheduled Areas has been entrusted with preserving popular customs and cultural identity; the traditions and customs of the people; safeguarding the community in the management of community resources; ensuring the customary mode of conflict resolution; and being consulted in land acquisition matters.

<sup>10</sup> Although these bodies are named differently in different states, local government at the village level is referred to as GP for ease of reference; block level government as SP; and district level as ZP. The term panchayat is also used to refer to all three levels of rural government unless otherwise specified.

<sup>11</sup> Two in smaller states.

<sup>12</sup> See, for instance, Gulati, 1996; Mathur, 1999; and Rani, 1999.

## Sectoral and administrative decentralization

### *Ambiguous devolution of functions*

Subjects eligible for devolution range from those in "core" or "civic" functions of local governments, such as drinking water, street lighting, garbage collection, and road maintenance, to more specialized and technical subjects such as primary health, primary education and social protection. Almost all the states have transferred subjects to panchayats in varying degrees, and several have transferred all 29 subjects (see Table A1). However, the nominal transfer of subjects is not enough to enable panchayats to perform those functions. In India, most functions are administered as activities and sub-activities. Hence the devolution of subjects has little meaning unless the specific activities included in those functions are identified and devolved. As a result, in many states, activities and sub-activities, although contained in functions transferred to panchayats, continue to be implemented by line agencies.<sup>13</sup> In other states, line departments obtain nominal clearances from the relevant standing committee of the district or block panchayat, but also continue to implement activities.

### *Weak endowment of administrative powers*

Most state acts have specified functions to be devolved to PRIs, but have not been able to transfer administrative or technical controls over locally administered programs. And few states have transferred the staff associated with the devolved subjects. States such as Gujarat, Karnataka, Kerala, Madhya Pradesh, Rajasthan and Uttar Pradesh have taken measures to transfer functionaries but some were faced with strong resistance from unions. Even where transfers have taken place, these were mostly nominal with the powers to fire, hire, promote and transfer those staff still vested in line agencies, with panchayats being reduced to merely paying salaries. As a result, government administration in India remains

centralized - despite being highly decentralized politically.

## Fiscal decentralization planning and state finance commissions

### *State finance commissions*

The Constitutional Amendment provided for the creation of state finance commissions (SFCs) to review and make recommendations on panchayat finances. The governor of each state was required to set up an SFC within a year from the commencement of the 73rd Amendment Act and subsequently at the culmination of every five-year period.<sup>14</sup> The amendment also broadened the terms of reference of the Central Finance Commission (CFC) so that it could recommend measures that would augment the Consolidated Fund of states, and supplement the resources of local bodies. When faced with incomplete SFC recommendations or state hesitation in implementing them, the central finance commissions, the Department of Panchayats of the Government of India, and some state Panchayat and Rural Development Departments have taken additional steps to devolve funds to panchayats. But these efforts have been ad hoc and incomplete, resulting in considerable interstate variation in fiscal decentralization. While states such as Kerala have devolved substantial resources to panchayats, others such as Uttar Pradesh have managed only minimal devolution.

### *Lack of common approach among SFCs*

Most states constituted SFCs which have common terms of reference. The SFCs are required to recommend financial support from the state, and the principles for the determination of taxes, tolls and fees that can be assigned to or appropriated by the local bodies. Once the revenue sharing arrangement is designed, the SFC has to recommend the allocation of the revenue that can be shared among different local bodies, both urban and rural. On the whole, there is no

<sup>13</sup> GOI, 2001.

<sup>14</sup> The State Governor in India is appointed by the President, making SFCs somewhat independent of state governments. But in practice, the states can exert substantial influence over nominations for the SFC. In any case, SFC recommendations are not mandatory and require approval by the state legislature.

common approach followed by all the SFCs; except that most have chosen to stick to the existing tax powers of local governments and suggested the transfer of funds to complement these.

### Assessing the resource requirement of local bodies

SFCs in different states followed different ways of determining the resource requirement of local bodies. But in the absence of clear expenditure assignments, all SFCs encountered problems in such assessment. Many panchayats, especially GPs in states such as Andhra Pradesh, Madhya Pradesh and Rajasthan, neither impose nor collect taxes that they are authorized to because they are perceived to be unpopular with constituents. According to SFCs, other problems faced by the PRIs include the lack of administrative machinery and staff trained in tax collection, and the base of available taxes being too low to generate sufficient revenue.

### Failure to assign tax from the state to local bodies

Doubting the panchayat's ability to assess and collect taxes, SFCs in some states did not assign any tax from the state level to the local bodies. Instead, they were in favor of PRIs being given a higher percentage of the state's shared taxes. Then based on certain criteria, these SFCs decided on how the total share of the state budget was to be divided between PRIs and municipalities, and within each sector. In developing their formulae for transfers to lower-level governments, SFCs were guided by various existing methods.<sup>15</sup>

### Lack of data

The general problem faced by SFCs in recommending a formula is the lack of relevant data. Reliable data is a problem, for instance, with per capita incomes for regions smaller than districts; per capita production of agricultural workers and the numbers of poor families; and the quality of infrastructure for all rural local governments. Faced

**Table 1.1 : Weights in formula for devolution recommended by SFCs, select states**

Indicator	State				
	Karnataka	Kerala	MP	Rajasthan	UP
Population	33.33	75	75	40	80
Area	33.33		25		20
Poverty				50	
Illiteracy rate	11.11				
Population of SC/ST		5			
Population of non-Desert Development Program/non-Drought Prone Area Program (DPAP)/non-Tribal Area Development (TAD) blocks				10	
Persons per bed in govt. hospitals	11.11				
Road length/sq km	11.12				
Financial need		15			
Tax effort		5			
Total	100	100	100	100	100

**Source:** Reports of the (First) State Finance Commissions

<sup>15</sup> One popular approach is the Gadgil formula used for transferring central plan assistance to states. This formula gives a weight of 60 percent to population, 25 percent to per capita income, 7.5 percent to fiscal management and achievement of national objectives, and the remaining 7.5 percent to special problems of states. Another model, which allocates central funds for the employment generation scheme Jawahar Rozgar Yojana (JRY), is based on the rural poor population relative to that of the country. Within a state, the allocation is based on an index of backwardness of the districts. This index gives equal weight to the relative SC/ST population in the district (compared to the state) on the one hand, and the inverse of per capita production of agricultural workers on the other.

with this data problem, different SFCs devised different methods for devolution of plan funds to local bodies (see Table 1.1).

### **Central Finance Commission recommendations for fiscal devolution to panchayats**

As the reports of the SFCs were delayed, the 10th Central Finance Commission (CFC) made an ad hoc provision of 4381 crore rupees (US\$920 million) for panchayats, in equal annual installments from 1996-97 to 1999-00. This was based on the 1971 rural population of 438.1 million and a per capita provision of 100 rupees (US\$2.25). These are intended to be matching grants,<sup>16</sup> and not meant for salaries and wages. For the five year period beginning in the year 2000, the Eleventh Finance Commission (EFC) recommended measures to augment the consolidated funds of the state governments to supplement the resources of the panchayats (see Table 1.2). The EFC grant was also intended for development expenditures and excluded wages and salaries. For the first time, grants to states were conditional on specific monitorable measures of the state's level of decentralization to panchayats.

This study focuses on Karnataka and Kerala - two states where decentralization appears to be ahead of the average state.

## **Decentralization: the Karnataka experience**

### **A long tradition of deconcentration**

The establishment of a "local fund" in 1862 in each of the districts to construct roads and other works was one of the early initiatives in decentralization. The first attempt to evolve a three-tier structure at

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"...(the) power to spend money, power to collect money, discretion in spending money, power to hire, fire and control staff and direct accountability. All of them have to be there, you cannot take a part of this and say that there is real decentralization."

Secretary, Rural Development and Panchayats,  
Government of Karnataka

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district, block and village levels dates back to 1902. In 1918, the Mysore Local Boards and Village Panchayat Act was enacted by the then Government of Mysore in response to the Montague-Chelmsford Committee's recommendations. The Act gave impetus to a significant increase in elected members in panchayats, and, for the first time, their inclusion in the decision-making process.

### **Introduction of three-tier structure**

In 1954 the Local Boards Enquiry Committee recommended a three-tier structure at district, block and village levels. After the reorganization of the state in 1956, a new act was required to standardize varying patterns of local governments in different regions of the state. The enactment of the Mysore Village and Local Board Act of 1959 provided for a greater role for the decentralized levels of government in development activities. It continued the three-tier system with village panchayats and taluk development boards assigned executive functions, and district development councils given an advisory role.

### **Choice of two-tier structure**

The most important initiative towards decentralization, however, was taken with the enactment of the Karnataka Zilla Parishads, Taluk

**Table 1.2 : Constituents of third-tier provision, Eleventh Finance Commission, 2000**

Annual grant 2000-2005 (Rs. in crores)			
Category	Panchayats	Municipalities	Total
Total	1600.00	400.00	2,000.00
Account-Keeping	98.61		98.61
Data base	197.06	2.94	200.00
Maintenance of civic services*	1309.33	397.06	1605.15

\* Primary education, primary health, drinking water, street lighting, sanitation. Source: GOI, 2000

<sup>16</sup> "Requiring suitable matching contributions through the raising of resources."

The 1983 Act was a landmark legislation that provided the 73rd Constitutional Amendment a model for decentralization.

Panchayat Samitis, Mandal Panchayat and Nyaya Panchayat Act of 1983. The Act was implemented from 1987 on, and it evolved into a two-tier structure of decentralization. While the Zilla Parishads (district level) and Mandal Panchayats<sup>17</sup> had the executive authority, the intermediary tier of Taluk Panchayat (TP) Samitis had only a coordinating role.

### Back to the three-tier structure

The 73rd Constitutional Amendment of 1992 brought the standardized system of decentralization to Karnataka. The new Karnataka Panchayat Raj Act of 1993 provided for the three-tier structure of rural local governments at zilla (district), taluk (block) and gram (village) levels. Today there are 27 ZPs, 175 TPs and 5659 GPs in Karnataka. All three levels are vested with executive authority, unlike the 1983 Act, which merely made the TP a coordinating agency.

### Elected bodies

All the three tiers of panchayats are elected bodies, with elections held every five years. Membership to the panchayats is decided on the basis of population.<sup>18</sup> The elections to gram panchayats are to be conducted on a non-party basis, but, in

fact, political parties play an active role. There is population-based reservation of seats for SCs and STs, with a minimum of 18 percent seats prescribed for them. One third of the seats are reserved for women.

### Hierarchical relationships among the three tiers

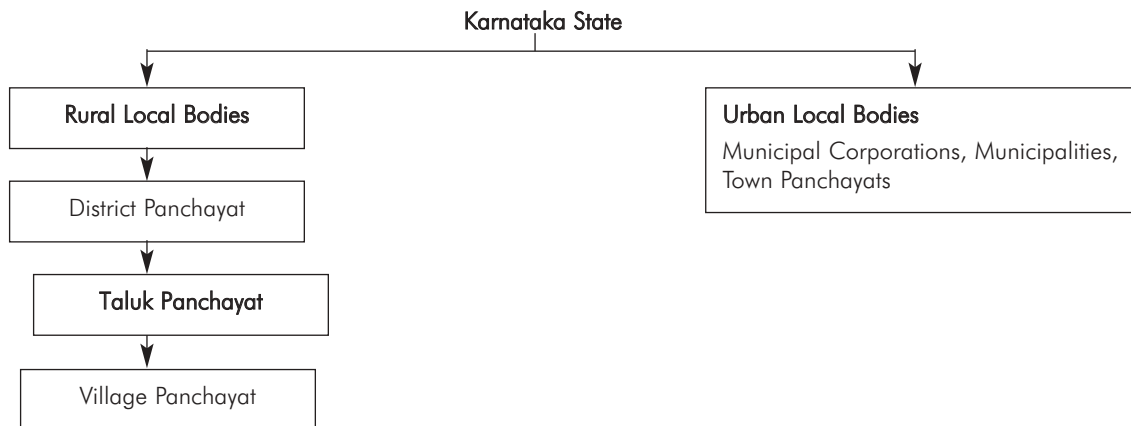
In the current system, all the three tiers of local self-government have executive authority and are supposed to be independent of one another. In practice, however, the administrative regulations, supervision and reporting requirements, and capacity differences have resulted in a hierarchical structure.<sup>19</sup> In effect, TPs have a supervisory role over gram panchayats and ZPs supervise both GPs and TPs (see Figure 1.1).

### The Kerala experience of the Panchayat Raj system

#### A history of progress and regress

The administrative reform committee appointed by the first Kerala government recommended the strengthening of panchayats in the state as viable and basic units of administration and development. Consequently, the Kerala Panchayat Bill (1958) and the District Council Bill (1959) were placed in the state assembly. The functions of the district council envisaged development matters and the council was to eventually become an autonomous executive body. The bills could not be enacted into

Figure 1.1 : Hierarchical decentralization in Karnataka



<sup>17</sup> Conglomeration of villages with 8000-10000 persons.

<sup>18</sup> One member represents about 400 persons in a GP, 10,000 persons in a TP, and 40,000 persons in a DP.

<sup>19</sup> Government of Karnataka, 2002.

law as the state government was dismissed by the central government and the state assembly dissolved. The next government passed the Kerala Panchayat Act of 1960 incorporating several recommendations of the Balwantray Mehta Committee. This Act, besides unifying the laws existing in the Malabar and the Travancore-Cochin state, sought to enlarge the functional domain and financial resource base of the panchayats. But despite the legal expansion of functions, the operational domain of village panchayats was confined, for all practical purposes, to traditional civic functions.

### *Slow advance*

In 1964, the next government that came to power introduced a Kerala Panchayat Union Councils and Zilla Parishad Bill, largely modeled on the recommendations of the Balwantray Mehta Committee (1957). The proposal was to incorporate an intermediate tier at the block level for planning and rural development, called the Union Council, and an advisory council (the zilla parishad) at the district level. This bill was not brought into effect since the state government fell and a period of President's rule followed. After a long spell of central administration, a new government was formed in 1967, and the Kerala Panchayat Bill (1967) was introduced in the state legislature. 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. This too could not become law as the legislative assembly was dissolved in August 1970. Finally, elections were formally held and the district councils came into existence in February 1991. The government that came to power in May 1991 attempted to reverse the process of decentralization. While the Annual Plan budget for 1991-92 for district councils was 250 crore rupees (US\$500 million), the new government reduced it to 1.97 crore rupees

(US\$ 420 million) in the next year. Not only were district councils dissolved, but several other measures were also taken to reverse the process.

### *A "big-bang" decentralization*

It was at this time that the 73rd and 74th Constitutional Amendments were enacted, and the Left Democratic Front, which came to power in May 1996, seized the opportunity to carry forward and institutionalize the process of decentralized planning and governance. Thirty-five percent of the Ninth Plan (1997-2000) budget was devolved to local governments for projects and programs drawn up by them.<sup>20</sup> This decision was followed by two measures to facilitate the decentralization process. The first was a decentralization planning methodology: detailed data collection at the village panchayat level, articulation of village needs in the gram sabha, formulation of sectoral programs and projects with the help of a voluntary corps of experts and officials, drawing up panchayat development reports, and preparation of a shelf of projects from which the gram panchayat would choose. Second, the state government appointed a Committee for Decentralization of Power (the Sen Committee, 1996), which was to review the Kerala Panchayat Raj Act, 1994 and the Kerala Municipality Act, 1994.

### *Setting up a legal framework*

The Sen Committee submitted a series of reports that contained far reaching institutional and structural changes and a series of amendments to the 1994 legislation to ensure the functional, financial and administrative autonomy of local bodies. Legislation affecting various line department functions (such as education, health, cooperation, drinking water and irrigation) and parastatals were amended. This was accompanied by the establishment of support institutions such as the ombudsman, the Appellate Tribunals, and the State Development Council presided by the Chief Minister, to make the decentralization process more effective and sustainable.

<sup>20</sup> In the Eighth Plan (1991-96), untied funds were only 2.35 percent of plan funds devolved to panchayats.

## The intergovernmental fiscal system: the cases of Karnataka and Kerala

Studying data on fiscal outcomes and institutional arrangements helps understand the strengths and weaknesses of the system of rural local government finance. To accomplish this, the study focuses on the Karnataka and Kerala experiences of fiscal decentralization.

Both Karnataka and Kerala appear to have empowered local governments in place (see Table 1.3). But several issues continue to prevent their panchayats from performing:<sup>21</sup>

- Issues of the enabling environment:** limited availability of information on local government finance, overlapping functions, proliferation of schemes, expenditure compression due to fiscal strains at the state level;
- Issues of design:** tied transfers, unpredictability of transfers, lack of transparency of transfers, limited discretion, limited tax bases, low collection, high collection costs;
- Issues of management and implementation:** poor financial management practices in fund flow and accounting.

## Issues of the enabling environment: information on local finances

The case studies encountered several impediments to obtaining an accurate picture of the finances of rural local governments (see Box 1.3).

The data in local financial records makes it difficult to tell a transparent story about local financial performance.

### Box 1.3 : Getting data on panchayat finances: the Karnataka example

The collection of reliable data at the local government level presented a formidable challenge to the Karnataka case study. The greatest difficulty was collecting information at the GP level.

- ◆ Only budget estimates were available at the district and block levels, not actual transfers.
- ◆ No mechanism to compile information on revenue collections from sources assigned to panchayats.
- ◆ Collection of actual transfers hampered by unsatisfactory bookkeeping at local level: even DPs do not have complete information on devolution to TPs and GPs.
- ◆ No uniform standards in account maintenance.
- ◆ 5659 government units at the GP level alone, with limited capacity to maintain a consistent information base; lack of conceptual clarity regarding sources of revenue, expenditure and transfers.

Source: Rao et al, 2004

**Table 1.3 : Karnataka and Kerala: salient facts**

	Karnataka	Kerala
Population	52 million	31 million
Rural local governments	5870	1157
Zilla parishads	27	14
Block panchayats	175	53 municipalities
Gram panchayats	5659	991
Total elected number, rural governments	84,886; 44 percent women; two local elections and two SFCs since 73rd Amendment	12117
Devolution of subjects to panchayats	All 29 subjects	All 29 functions, but functionaries and funds devolved for only 15 functions (see Table A2, Appendices)
Channeling of public expenditure through panchayats	About 20 percent	About 30 percent of plan expenditure and 18 percent of total state budgets

Source: Rao et al 2004, Oommen et al 2004

<sup>21</sup> These issues do not affect Karnataka and Kerala equally. Detailed analyses of each state are contained in Chapter 2 (Karnataka) (Rao et al, 2004) and Chapter 3 (Kerala) (Oommen et al, 2004).

a) *Recording of budget allocation, not cash received*

Local government in both Karnataka and Kerala tend to report budgeted amounts of intergovernmental transfers, but not the actual amounts received. Thus the data report unreasonably large closing balances at the panchayat level. In Karnataka, the reported average closing balance of panchayats exceeds an amount equivalent to more than 50 percent of annual expenditures. In Kerala, the closing balances hover around 70 percent and show an increasing trend over time. But it is unreasonable to expect that two states with significant deficits would let such amounts accumulate unused in panchayat accounts.

b) *Bunching of state transfers at the end of the fiscal year*

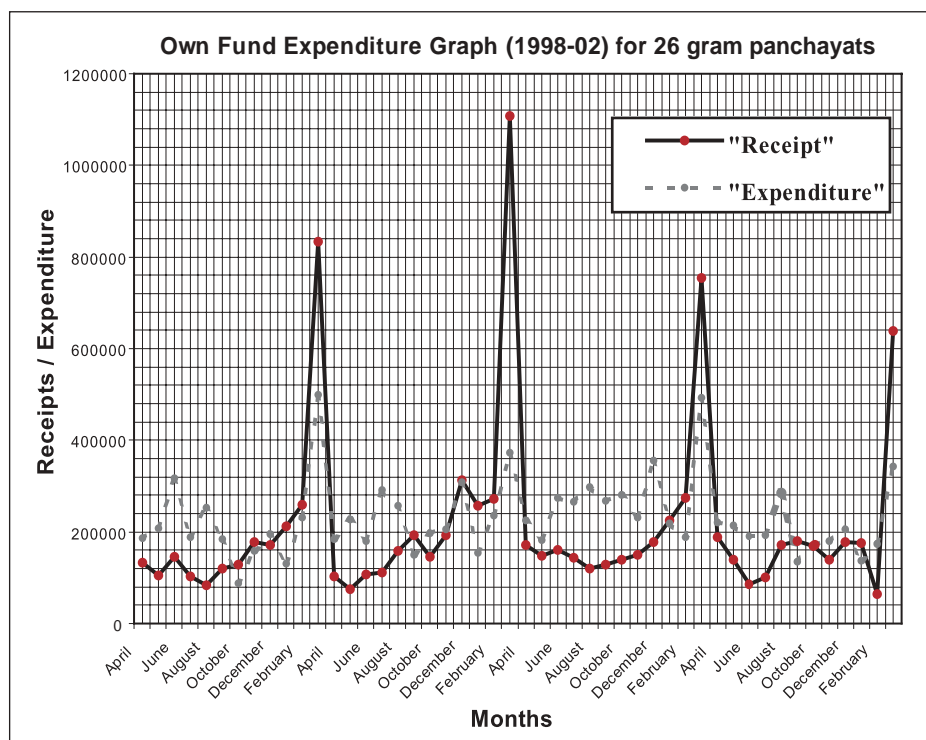
While plan grants to panchayats are supposed to be released quarterly, the bulk of the allotments tend to be made at the end of the fiscal year (see Figure 1.2). Panchayats can only spend these funds in the

following fiscal year. Since budgeted state grants have been increasing over time, the result of this year-end bunching is an increasing year-end cash surplus. Thus annual revenue and expenditure figures reported in "official" data do not reflect the amount of revenues and expenditures on the basis of which panchayats make decisions in any given fiscal year.

c) *Panchayat checks not honored because of state-level liquidity constraints*

The funds allocated or transferred to panchayats are not in cash. Thus even if allotments to local governments are shown as expenditures by the state government, there is no real flow of funds from state to local governments. In times of fiscal crisis the state manages its day-to-day expenditure commitments through Ways and Means restrictions. Only priority payments, which in actual terms have come to mean salaries, pensions and repayment of loans, get cleared on time. The payment of expenditures is staggered, and the delay is directly proportional to the intensity of the fiscal crisis.<sup>22</sup> As

Figure 1.2 : Monthly receipts and expenditures of sample panchayats, Kerala, 1998-02



Source: Oommen et al, 2004

<sup>22</sup> When the State's fiscal crisis worsens, it resorts to overdraft as permitted by the Government of India and dips frequently into what is called the public account, which is a costly and temporary source of revenue. Since local governments issue treasury checks rather than through treasury bills, their problem is aggravated.

soon as an expenditure liability is incurred, local governments issue a treasury check to the person/agency concerned. When the liquidity position of the state worsens, these checks are not honored. A symptom of this problem is that the gap between the date of the check and the date of payment has been increasing over time.

*d) Liabilities not properly accounted for*

The closing/opening balances consist of accounts payable, which include current as well as past liabilities. Once they are taken into account, the high closing balances are reduced. The annual financial statements prepared by gram panchayats for audit purposes contain a section on liabilities and assets; but this is not a universal or compulsorily required practice. While some GPs supply the information, others do not. Even those who supply the data do not furnish the entire range of information.

*e) Cumbersome procedures that hinder disbursement*

Several specific-purpose grants (such as the village roads maintenance grant or minor irrigation grant), as well as other conditional grants are not fully spent because of cumbersome procedures. The problems include the lack of proper technical and administrative sanctions; improper planning; non-availability of materials; and a delay in raising matching resources, resulting in the delayed launching of a program/project and underutilization and/or non-utilization of funds. The departments may also allot lump sum funds to GPs without specifying the projects, programs and plan of expenditure. Some allotments may be irrelevant for the GP in question,<sup>23</sup> resulting in the accumulation of unspent revenues.

*f) Outdated list of beneficiaries*

For targeted funds in welfare programs, the list of beneficiaries issued by the states is often outdated. This is particularly true for pension payments in Kerala: while many pensioners are deceased or have moved to a different jurisdiction, state lists remain unchanged. Thus panchayats are unable

to issue payments to these individuals and unpaid amounts accumulate in year-end balances.

*g) Lack of uniform financial reporting practices*

The concepts of revenues, expenditures and transfers are often unclear and not followed uniformly by panchayats. In some cases, for example, "revenue from property taxes" is reported to include water charges; in other cases, "expenditure" does not include payments for electricity, which are deducted at source from the transfers. Thus widely differing reporting practices among local governments creates serious conceptual and comparability problems.<sup>24</sup>

*The effects of unreliable information*

In sum, the absence of reliable information on the revenues and expenditures of local bodies is a striking weakness in the fiscal management in both case study states, and this raises questions about both state-led and center-led fiscal decentralization programs. Equally, it reflects on the validity of central and state finance commission recommendations. The Eleventh Finance Commission, for example, has reported that local governments in Karnataka accounted for about a third of total state government spending or about 6.5 percent of Gross State Domestic Products (GSDP) in 1997-98. However, the true share of rural local governments in state government expenditures is estimated to be much lower at 21.8 percent in 2001-02 and 18.5 percent in 2002-03. Similarly, both the First and Second State Finance Commissions made detailed recommendations on fiscal devolution based on apparently questionable data. Inadequate information also leads to fiscal planning problems at the local level, with panchayats unaware of the revenue amount available to them. Thus any concept of planning, budgeting and hard budget constraints may be irrelevant to the panchayat's behavior. Given the unpredictability of revenues, panchayats spend as they go along, issuing checks that they know may not be promptly honored.

<sup>23</sup> For example, the fisheries department allotting funds to highland GPs that do not require them.

<sup>24</sup> To get a consistent dataset, this study carried out an exercise of compiling information from each of the local bodies using uniform definitions.

### Issues of the enabling environment: overlapping functions and proliferation of schemes

Decentralization in most states in India is characterized by overlapping functions and proliferation of schemes. The overlap of expenditure responsibilities between different levels of government has three important implications.

- a) It allows state governments to offload selected schemes, personnel and administrative powers to panchayats, to any degree that the state chooses.
- b) It reduces lines of accountability to voters. If people do not know which level of government is responsible for providing what, be it drinking water or electrification, they will have difficulties in putting pressure on delivery of services through voting or other forms of participation.
- c) It increases administrative costs, since bureaucracies need to be maintained in different government tiers to do essentially similar things.

#### The case of Karnataka

In the formal sense, Karnataka has transferred the functions for all 29 subjects to panchayats and has transferred the corresponding functionaries and funds. According to this indicator, Karnataka is the most decentralized state in India (see Table A1). However,

- a) As in most other states, these transferred functions are not exclusive to panchayats, and the state government carries out the functions concurrently with the local government. The extent of overlapping in Karnataka is perhaps best revealed in the distribution of responsibilities over schemes (see Table A2). In all devolved subjects there are at least two levels of government involved, and in some, such as welfare, the five tiers of government are responsible for the implementation of as many as 72 separate schemes. Despite the passing of

the new Act in 1993 (subsequent to the 73rd Constitutional Amendment) the earlier system - of clubbing several schemes to constitute the "district sector" plans to be transferred to the then zilla parishads along with employees and funds - has continued with only marginal changes.<sup>25</sup>

- b) Although transferred, state employees are not accountable to districts and taluks. Overlapping functions (concurrent responsibilities) allow state governments to maintain previous lines of accountability of state employees. While decentralization in Karnataka consists of a nominal transfer of employees along with schemes and funds to implement them, the main line of accountability of employees remains with state agencies. Employees continue to receive salaries from the state, their promotion and transfers are decided at the state level, and elected representatives at the local level have little power to exercise control over them. Local governments cannot appoint personnel, prioritize their expenditure plans, or even design the various schemes they are supposed to implement.<sup>26</sup>
- c) Overlapping functions also contribute to the proliferation of schemes, a serious problem in Karnataka (see Box 1.4) as in most other states. In 2001-02 there were as many as eight central

#### Box 1.4 : The proliferation of schemes in Karnataka

There are several reasons for proliferation:

- ◆ Decentralization has been carried out by taking the line of least resistance: personnel and funds under both plan and non-plan heads were transferred without structural revision to local bodies.
- ◆ A large number of schemes reflects tokenism and populism to appease certain sections of the population by spreading expenditure benefits across many interest groups.
- ◆ The large number of schemes provides a justification for a larger bureaucracy.

Source: Rao et al, 2004.

<sup>25</sup> The only difference between the 1983 Act and the 1993 Act is that in the former, TPs were only a coordinating tier and did not have executive powers. Thus the 1987 transfer was readjusted through notifications (16.7.1994 and 23.7.1994) to divide the schemes between ZPs and TPs.

<sup>26</sup> At the same time, state employees on transfer to local governments implement not only those programs transferred to local governments, but also those executed by autonomous boards or directly by the state government. In a system with these characteristics, it is possible for the same project to be financed twice by two different sources.

schemes and another 47 state schemes (excluding 17 schemes under the tribal sub-plan) for the welfare of the SCs and STs, and 22 schemes for the backward classes.

### *The issues in Kerala*

The issues are different in Kerala. The Kerala Panchayat Raj (Amendment) Act (1999) has provided for the specific demarcation of functions devolved to gram panchayats, block panchayats and district panchayats to the level of activity and sub-activity, and this has been complemented by sector-specific legislation. Hence there is less scope for overlapping and for duplication of efforts and resources. The important question is the extent to which the Act is being implemented (see Box 1.5). Though Kerala has definitely moved ahead in empowering local governments, the state still has a long way to go in identifying expenditure assignments. Much of the expenditure to support "local" functions still resides outside the local government budget:

- A significant proportion of centrally sponsored schemes (CSS) in areas functionally devolved to panchayats are still being implemented outside the panchayat system. While the amount of funds flowing through CSS has increased, the share being channeled through panchayats has actually declined in one of the two panchayats studied, Tholicode.
- The MP's local area development fund spends an amount equivalent to the CSS outside the system for functions assigned to panchayats.

- State government schemes outside the panchayat system for functions devolved to panchayats increased from 25 percent in 1995-96 to 38 percent in 2000-01 in Tholicode.<sup>27</sup>
- At the district level, 60 percent of the funds for devolved functions are still being implemented outside the PRI system; CSS account for two-thirds of this amount.
- Public health and sanitation appear to be the only sectors completely devolved to panchayats.

### **Issues of design: transfers**

#### *Finance commission recommendations for devolution of revenue*

The First State Finance Commission made the recommendation to devolve 36 percent of the state's own revenues (excluding loans and central transfers) to rural and urban local bodies. The share of rural local bodies was recommended at 30.6 percent of the state's own revenues. The shares of GPs, TPs and ZPs were placed at 25 percent, 25 percent and 40 percent respectively. The Commission recommended the distribution of the funds among the various panchayat units on the basis of three indicators with equal weights attached: population, area, and social and economic indicators of backwardness such as illiteracy rate and number of persons per hospital bed.

#### *SFC recommendations in Karnataka and Kerala*

Rather than implementing the recommendation of the first SFC, Karnataka State decided to distribute

#### **Box 1.5 : Examining the empirical question of implementation in Kerala**

The Kerala study investigated activities under the financial control of panchayats for devolved functions. Two panchayats with marked differences in size and geography were examined. The focus was on gram panchayats since devolution is primarily to this tier. In general, it was very difficult to map the function/resource linkages because of incomplete data on expenditures. In the case of gram panchayats, the evidence from the two panchayats studied (Tholicode and Karakulum) was that functional devolution has been implemented to a large extent. For example:

- The total expenditure of panchayats increased by seven times between 1995-96 and 2000-01, as did own revenues (in most gram panchayats).
- While the two panchayats handled 31.5 percent and 26 percent respectively of the funds corresponding to assigned functions in 1995-96, the GP shares had increased to 68 percent and 74 percent respectively in 2000-01.

**Source:** Oommen et al, 2004

<sup>27</sup> This is because the Tribal Department has taken over an ayurvedic dispensary that had been transferred to the panchayats.

equal amounts to the gram, block and ZPs. At the end of the year 2000-01, the state government decided to cut the general-purpose grants in the wake of fiscal pressure. Kerala has implemented the SFC recommendations to consolidate schemes into multiple-purpose transfers. But as in Karnataka, SFC recommendations have fallen short in several areas. Panchayat finances seem to have been viewed separately from the entire intergovernmental fiscal system. Eventually, the design of the transfer system will have to take an integrated picture of the resources of the state, which includes the resources of the local bodies. But in Kerala, (and in most states in India) there has not been much decentralization of resources corresponding to the decentralization of expenditures. The State Finance Commission has a mandate to address this mismatch between functions and funds, but also a mandate to reappraise the transfer system as a whole every five years. The resources of the state as well as the expenditure responsibilities of the state will have to be seen from an integrated perspective. The local bodies and state government have to be viewed as partners in the total intergovernmental fiscal system. The First State Finance Commission of Kerala (1996), by confining its analysis and recommendation mainly to non-plan activities, failed to take this total picture into account.

The Second Finance Commission<sup>28</sup> recommended the devolution of 40 percent of non-loan gross own revenue receipts (NLGORR) to panchayats. It modified the index of backwardness to include the SC and ST population. According to its recommendations, 80 percent (32 percent of NLGORR) would be assigned to the rural local bodies and the remaining 20 percent (eight percent of NLGORR) to urban local bodies. It retained the non-plan allocation according to the prevailing ratios, and applied the indicators and weights only

for the allocation of plan funds. The plan funds were to be distributed to ZPs and TPs in the ratio of 65:35, and the prevailing practice of giving GPs lump sum grants continued. But in terms of analytical underpinning or information base, the Second Finance Commission did not go beyond the First Finance Commission. It took the prevailing pattern of expenditures as given and endorsed the existing transfer system including the lump sum allocation. The Commission did not consider the additional cost disabilities of urban local bodies for providing public services, or their fiscal performance. Finally, the Eleventh Finance Commission (EFC)<sup>29</sup> at the center recommended the basis of allocation of funds to the PRIs in various states from the central government revenues.<sup>30</sup>

Regardless of the revenue sources made available to local governments, transfers<sup>31</sup> from central to local governments will undoubtedly continue to be an important feature of the public finances of Indian states. Transfers are needed if services have to be provided by local governments without adequate fiscal capacity; if there are externalities associated with these services; or if a country wishes to account for inter-regional differences in public servicing. A well-designed system of intergovernmental transfers almost inevitably constitutes an essential component of any decentralization strategy.

### *Transfers in Karnataka*

In Karnataka, the story of transfers is similar to that of schemes.

- a) **Nominal transfer of schemes despite inadequate financial allocation:** Rural fiscal decentralization in Karnataka has entailed the transfer of numerous schemes to district and taluk panchayats along with corresponding personnel. But this is in spite of inadequate financial allocation for implementation.

<sup>28</sup> 1999-01 (Kerala) and 2002-03 (Karnataka).

<sup>29</sup> The EFC recommendations are for a five-year period, i.e. from 1999-2000 to 2003-04.

<sup>30</sup> Karnataka, for example, was entitled to Rs.394.08 crores for a period of five years from 2000-01. The gram panchayats were entitled to 70 percent of these funds, blocks 20 percent and zilla panchayats 10 percent. The allocation is based on population. PRIs are expected to use these funds to ensure the maintenance of basic essential services.

<sup>31</sup> Any revenue for which the local government does not have the discretion to set the tax rate has been classified as a "transfer." Thus the shared and assigned taxes in Karnataka and Kerala are treated as transfers in this Report.

- b) **Separation of financing from design and implementation:** For state schemes, financing is by the states and implementation by the panchayats or the state. Often the state government does not have an incentive to finance shared cost programs implemented by panchayats, and when there is financial difficulty, the state reduces its contribution.
- c) **General-purpose transfers to gram panchayats:** Some transfers to GPs by the state government are statutory grants for broad-based development purposes, and grants given on the recommendation of the EFC.
- d) **Small size of transfers to GPs:** In the aggregate, rural local bodies in Karnataka received Rs.1631 (US\$35) per capita or 8.3 percent of GDDP. Of this, 41 percent was for plan purposes (mostly investments) and the remaining non-plan (mostly salaries and recurrent costs). Among the three tiers of panchayats, the GPs received only 4.3 percent of total transfers and the entire amount was on plan account. The shares of TPs and ZPs were 44 percent and 52 percent respectively. In both TPs and ZPs, the non-plan component of transfers was substantially higher (see Figure 1.3) because the rural local bodies are involved mainly in dispensing salaries of schoolteachers and health workers. Per capita

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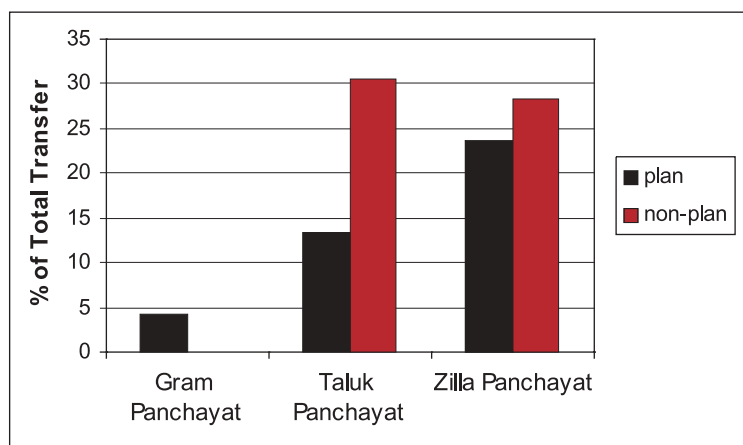
The transfer system in Karnataka does not appear to serve either allocative efficiency or equity. The empirical analysis shows that per capita transfers to GPs are not related to any important indicators of fiscal capacity; hence the system design fails to offset fiscal disabilities. Even transfers meant to alleviate poverty do not seem related to the proportion of poor households.

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transfers to GPs in the four districts averaged just about Rs.70.4 or 0.34 percent of GDDP. The major component of transfer comprises the devolution of funds for anti-poverty programs.

- e) **No systematic pattern in per capita transfers to rural local governments:** Although per capita transfers were lowest in the richest of the four sample districts in Karnataka (Udupi), they were highest in Bagalkot and not in the poorest district, Bidar.<sup>32</sup> Fiscal devolution made to meet expenditure requirements of various schemes, rather than fiscal disability or inequality, appears to be the determining distributive impact. This is true not only of aggregate expenditures but also of expenditures on individual functions.
- f) **Concentration on a small number of sectors:** Almost 56 percent of the ZP transfers were focused on just education, medical and public health and water supply sectors. Seventy-two percent of the transfers to TPs are for the education sector alone.<sup>33</sup>

Figure 1.3 : Transfers to sample rural local bodies in Karnataka, 2000-01



Source: Rao et al, 2004

<sup>32</sup> Rao et al, 2004.

<sup>33</sup> The high proportion of expenditures is due to the fact that TPs and ZPs have the responsibility of disbursing the salaries of schoolteachers and distributing grants to aided schools.

- g) **TPs and ZPs mere disbursing agencies for higher-level governments:** The bulk of the transfers to rural local governments are given to ZPs and TPs. The lack of independent sources of revenue, and the total dependence of ZPs and TPs on transfers, makes the entire fiscal decentralization process hostage to the transfer system. The scheme-based devolution and micro-allocation of resources even within the schemes robs the districts and taluks of any leeway in making allocation decisions according to their priorities.
- h) **Transfer design not based on actual information:** Rural local governments at all three levels receive transfers mostly for specific purposes. In fact, the transfers are linked to various schemes, and obtaining information on disbursements, and the implementation aspects of these schemes, is virtually impossible.
- i) **Lump sum grants from state government most important transfer received by GPs:** These transfers - multiple-purpose grants for rural development - amount to about a third of total transfers to GPs, and give them scope to prioritize and allocate expenditures. The transfers made to GPs constitute only four percent of total transfers to PRIs, but they finance almost 75 percent of the total expenditures incurred by the GPs.
- j) **No discernable pattern in the distribution of transfers to GPs:** Transfers are not equalizing. The general-purpose transfers do not seem to be related to differences in either fiscal capacity or expenditure need; and specific-purpose transfers do not seem to have been designed to improve standards of public services in areas where the standards are poor.
- k) **More transfers for richer GPs:** Transfers have not been designed to offset fiscal disabilities. Nor is the transfer system related to the proportion of households below the poverty line.

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GPs are, arguably, the only meaningful tier of rural decentralization; yet they have no meaningful role. Their low level of participation in financing and delivering local public services probably explains the poor attendance at gram sabhas. Strengthening the resource base of the panchayats - assigning more important revenue handles and larger untied transfers - is critical for grassroots-level decentralization.

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- l) **Distribution of transfers dominated by district effects:** Taluk effects do not show any discernable pattern.
- m) **Central transfers not distributed according to poverty:** An important component of the transfer system is the central transfers (with a 15 percent contribution from the state) for poverty alleviation, particularly through employment creation. However, except for Bagalkot, per capita transfer has no relationship with the proportion of poor households in the district. This casts serious doubts on the design of even specific-purpose transfers such as those for poverty alleviation.<sup>34</sup>

#### *Kerala: the picture on transfers*

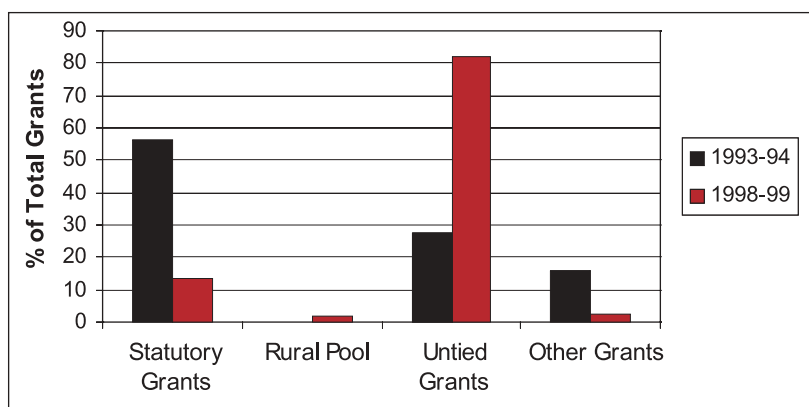
The Kerala case is quite different from Karnataka. The most notable feature of Kerala's fiscal decentralization is the large share of untied grants - about 82.3 percent in 1998-99 - in the structure of transfers to gram panchayats.

- a) **Fall in statutory grants:** The Kerala government grants to local bodies consist of non-plan and plan categories. Non-plan grants are broadly divided into statutory<sup>35</sup> and non-statutory grants. Statutory grants occupied a major share in the earlier transfer system, but they had been pushed down to a lower position by 1998-99 (see Figure 1.4). From around 20.6 percent of the total receipts during 1993-96, they fell to 12.8 percent during 1996-99.
- b) **Consolidation of schemes into untied grants:** As far as non-statutory grants for GPs are concerned, there are only two non-plan grants from state governments, the Rural Pool and level crossing

<sup>34</sup> Rao et al, 2004.

<sup>35</sup> The statutory grants consist of assigned taxes in the form of a 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. The entire amount collected under assigned tax is meant to be given to the panchayats after deducting collection charges (3/8th to GPs, 3/10th to BPs and 1/5th to DPs.)

Figure 1.4 : Broad structure and composition of grants, Kerala, 1993-94 to 1998-99



Note: For 789 GPs. Source: SSFC Survey, 1999-01

grants in aid. The Rural Pool was introduced in February 1998 following the recommendations of the First State Finance Commission to consolidate a bewildering variety of small ad hoc grants and putting them on a more rational and predictable basis. Thus in contrast to Karnataka, Kerala was able to consolidate schemes into a smaller number of transfers.

- c) **Creation of local government entitlements through budgetary process:** The plan grant system started from 1997-98. Broadly speaking, the two instruments are general plan grants in aid for local development purposes and specific-purpose grants in aid for transferred responsibilities (plan as well as non-plan).
- d) **Central and state schemes less important:** Apart from plan grants and grants for transferred schemes and institutions, the local bodies also receive grants through sponsored schemes where

the local bodies act as agents of the central and state governments. Plan grants and sponsored schemes together form about 35-40 percent of the state plan. For sponsored schemes, the sponsoring government/department issues broad guidelines. Even so, the panchayat decides the location of the project and selection of the beneficiaries, besides being responsible for implementation.

## Issues of design: own revenues

### Karnataka

#### Low revenue collections

Taluks and districts do not have tax powers. By and large, TPs and ZPs have negligible own sources of revenue and depend on grants from higher-level governments. GPs have some revenue powers. According to the Karnataka Panchayat Act (1993) the GPs can levy tax on land and buildings that are not subject to agricultural assessment - within the limits of their respective geographical area, and subject to the exemptions and maximum rate specified by the state government. GPs may also levy water rates for the supply of water for drinking and other purposes. But the majority of the GPs studied in had low revenue collections.<sup>37</sup>

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The failure to have a good local revenue system can be explained by two essentially political reasons. "The upper level governments in almost all developing countries are always under fiscal pressure. So they almost never give any significant access to the major revenue sources of income and consumption to local and regional governments. Second, most local governments do not want additional revenue powers. What they really want is money."

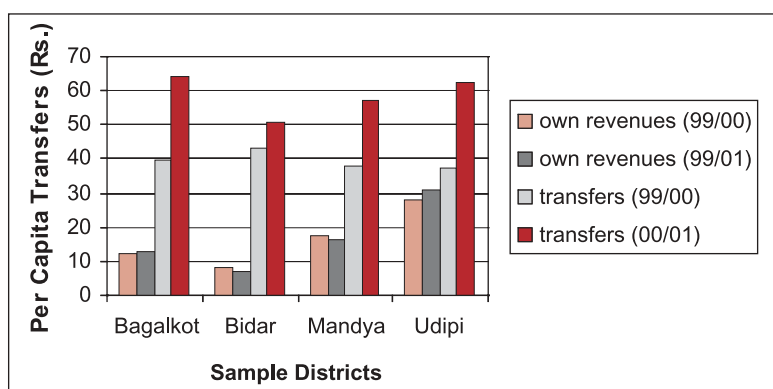
Bird, 2001

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<sup>36</sup> The vertical share for the Rural Pool grant was strengthened by adding a specific share of assigned tax. The Rural Pool grant is allocated 90 percent on the basis of population and 10 percent on the basis of area.

<sup>37</sup> Even in the most developed district in the sample, Udipi, own revenues collected in 2000-01 were just about Rs. 31 or 0.13 percent of District Domestic Product (DDP). See Rao et al, 2004.

Figure 1.5 : Level of revenues in sample gram panchayats in Karnataka, 1999-2000 and 2000-01



Source: Rao et al, 2004

### No broad tax bases

Own source revenue is crucial in any scheme for a meaningful fiscal role for GPs. But GPs raised only about 19.2 percent of their total revenue in 2000-01

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Measures to augment the own revenues of GPs are critical for fiscal decentralization.

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from own sources, and the share of own revenue in total revenue declined from about 27 percent in 1999-2000 to 21 percent in 2000-01 (see Figure 1.5). One reason for this low revenue yield may be that productive tax bases are not assigned to them. At the same time, property tax - the only potentially important tax assigned to GPs - suffers from undervaluation, poor administrative capacity and poor collection effort. A concerted effort has to be made in this area to achieve satisfactory standards of local public services in rural areas, and expand the role of decentralized units beyond that of implementing agencies.

### Low level collection of property tax

Despite its importance for GPs, the collection of property tax amounted to only about eight rupees per capita in 2000-01, a marginal decline from the previous year. The most important problem is that the property tax is, in effect, a voluntary tax. GPs do

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Without measures for the GPs to enforce property tax, no effort to introduce more scientific valuations and build administrative capacity will help improve revenue productivity.

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not have a machinery to enforce the tax. There is variation among local governments, though, suggesting

that there is scope for increased collection. In more developed districts, higher revenue collections do not come from property tax, but from other sources, mainly rental revenue from property let out. This implies that there may be revenue handles other than property tax.

### Cost of tax collection

In a situation where GP collections are so low, the net return to government has to be assessed over and above collection costs. The problem, though, is measuring the cost of collecting local taxes (and user charges). In this respect, the Karnataka case study is revealing: the cost of tax collection is unduly high for both property tax and total own revenues in GPs in all four districts. On an average, about 72 percent of revenue was spent on tax collection; in the case of property tax, the cost of collection was 57 per cent of the collected revenue. Also, the ratio of collection cost to revenue has shown a sharp increase in 2000-01 compared to the previous year (see Figure 1.6).

### Variations in revenue collection

Significant differences in the ratio of collection cost to revenues collected in the four districts<sup>38</sup> help explain the determinants of GP revenue performance:

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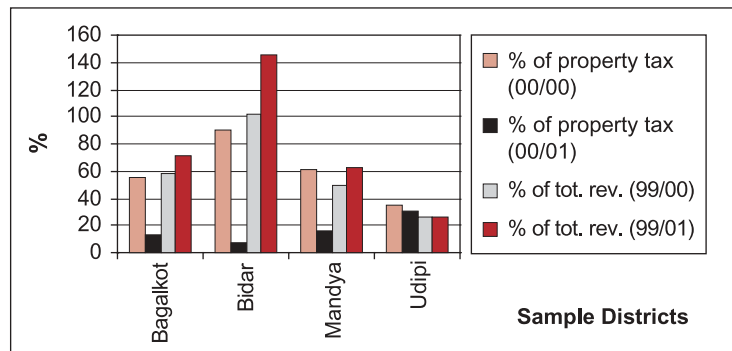
Does the fact that some GPs performed better than others mean that poor performers could improve?

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- ♦ The level of development of panchayats does not explain own revenues.

<sup>38</sup> In fact, in Bidar, the cost of collection was more than the tax collected for both property tax and own revenues.

Figure 1.6 : Percent of cost of collection to revenue, sample districts, Karnataka, 1999-2000 to 2000-01



\* Consists of salary of bill collector and waterman. Source: Rao et al, 2004

- ♦ Accessibility to markets is an important determinant of revenues.
- ♦ So is public perception about service delivery.
- ♦ Transfers stimulate rather than substitute for own revenues.

### Kerala

#### Decline in own source revenue to total revenue

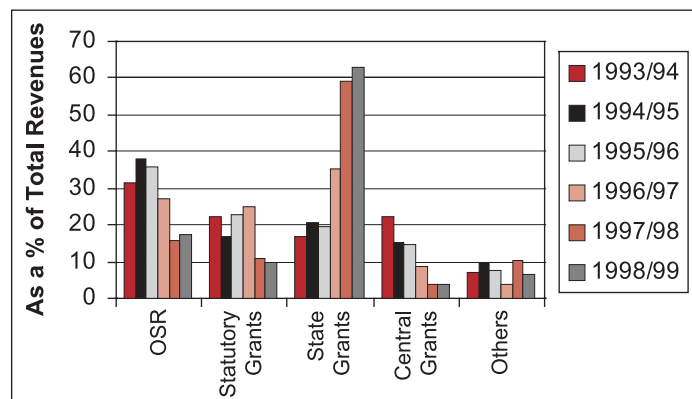
The dominant revenue sources are a variety of general and specific-purpose grants given by the state and central governments (see Figure 1.7). Overall, GP revenues have increased substantially in the past decade, from Rs.0.21 crore (2.1 million) during the 1993-96 period to 0.68 crore (6.8 million) during 1996-99. The corresponding increase in per capita total receipts was from Rs.80 to Rs.255. But district-wise distribution in 1993-94 and 1998-99 shows a decline in the percentage of

own source revenue to total revenue. This decline is not entirely due to the increase in plan grant; it is also due to the slow growth rate in tax revenue (see Figure 1.8).

#### Non-tax revenue vs. tax revenue

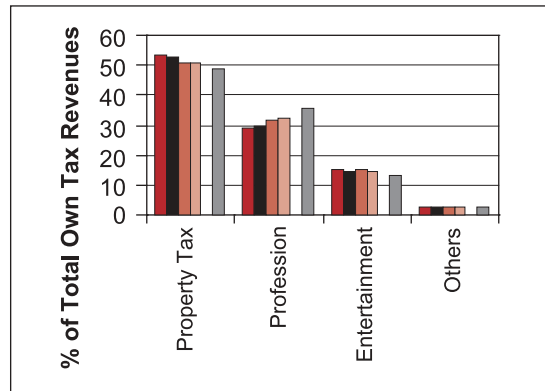
In 1995-96 the annual growth rate of tax revenue fell to 0.92 and actually declined in several districts. In contrast, non-tax instruments appeared to be more responsive to the economic activities of the state in the construction, trade and other service sectors (see Figure 1.9). The tax/non-tax proportion, which was around 70:30 in 1993-94, became 60:40 in 1996-97; and in 1998-99 the relative importance was reversed. In fact, the higher level of non-tax revenue is a longstanding pattern for several districts.

Figure 1.7 : Distribution of the sources of income of sample gram panchayats, Kerala, 1993-94 to 1998-99



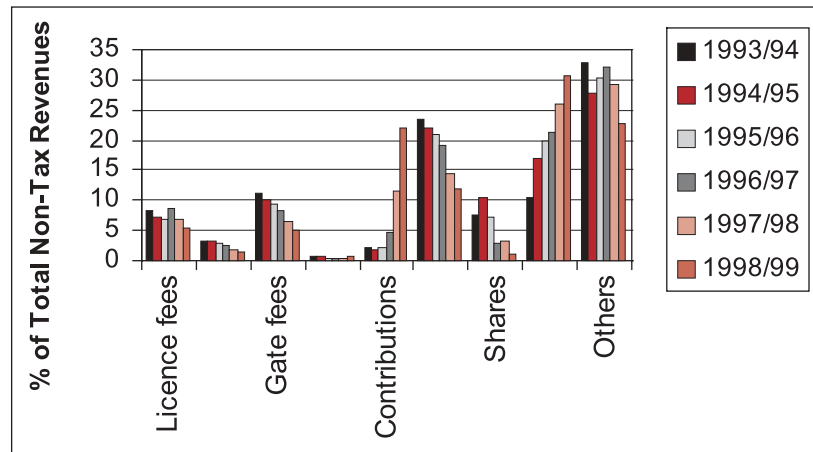
OSR = Own Source Revenue. Note: All the income data are actuals except plan grants, which are budgeted. So state grant data for these years are exaggerated since the amount is seldom fully spent. Source: Oommen et al, 2004

Figure 1.8 : Detailed break-up of own tax revenue, sample districts, Kerala, 1993-94 to 1998-99



Source: Oommen et al, 2004

Figure 1.9 : Detailed break-up of non-tax revenue, sample districts, Kerala, 1993-94 to 1998-99



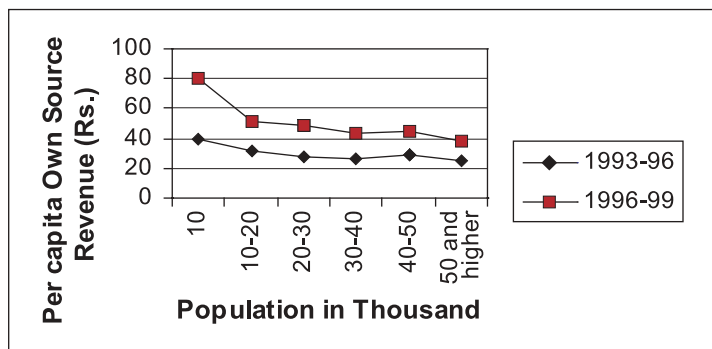
Source: Oommen et al, 2004

**Taxing powers not used to increase tax revenues**

GPs have three major sources of tax revenue: property tax, profession tax and entertainment tax. The minimum and maximum rates of these taxes are fixed by the state government, with the individual GP free to set the actual rate. However, none of these sources has generated significant revenue growth, though revenue from the profession tax has increased fastest. Has the state fully used its property tax potential? Some direct and indirect evidence would suggest not. Given the large construction boom in the state, there has been a sharp increase in revenue from rivers, an important input for construction. This, coupled with the slow increase (or decline) in the yield from property tax in some GPs, suggests that the revenue potential of property tax has not

been fully tapped. Except for the year 1995-96, total tax revenue increased (see Figure 1.10). But per capita property tax growth rate was negative in two years and in 1995-96 as low as -4.1 percent.

Figure 1.10 : Per capita own source revenue by population size and class, sample districts, Kerala, 1993-96 to 1996-99



Source: Oommen et al, 2004

### Underutilization of taxes

As in Karnataka, property tax effort is weak. Given the inflow of foreign money into Kerala and the

boom in construction, per capita property tax should have been much higher.<sup>39</sup> One reason is that the five yearly revision of tax rate has not occurred since 1993.<sup>40</sup> Another is that out of 50 GPs selected in the sample survey, only three had chosen the maximum property tax rate permitted by the state statute (10 percent), and 23 had chosen the minimum rate (six percent). The data show that on a conservative estimate, only 40 percent of the tax potential is tapped. The profession tax is also considerably underutilized, and the realization of entertainment tax is even less.

### Wide variations in per capita own source revenues

Per capita taxes range from four rupees to Rs.327 around a mean of Rs.27, while per capita tax plus non-tax revenues range from nine rupees to Rs.586 around a mean of Rs.57. Why do some places raise more revenues than others? An analysis of the statistical relationships between these fiscal outcomes and community characteristics indicates that a "district effect" may be in operation. Even after taking account of their taxable capacity, some districts may have political leadership that stimulates more tax effort, or citizens more willing to pay higher taxes. The latter may occur because the population sees the benefits of the higher levels of public services received, or because they understand the need for taxation to provide social and economic infrastructure. Or some districts may do a more professional job with tax administration than others.

### Issues of design: panchayat expenditures Karnataka

#### Reduction of funds due to fiscal compression

Decentralized expenditure is one of the easier targets in reducing state government expenditures.

The medium term plan for fiscal adjustment, the reduction of fiscal deficits to three percent in

Local plan allocation is the prime target for expenditure reduction.

Karnataka by 2004-05, has led to the crowding out of state government allocations to local bodies. The state government has tried to limit the expenditure growth in 2002-03 to 10 percent over the budget estimate of 2001-02, mainly by compressing plan expenditure at the panchayat level. The share of plan allocation by rural local governments in total state expenditures was reduced from 8.3 percent in 2001-02 to 5.1 percent in 2002-03, and the share of plan allocation to rural local bodies in the state's annual plan outlay declined from 27.8 percent to 18.1 percent during the year. This is partly explained by a change in expenditure classification; spending on many of the completed plan schemes are considered non-plan. But the proportion of non-plan expenditures to total state government expenditures does not show a commensurate increase: it actually shows a decline from 13.6 percent in 2001-02 to 12.8 percent in 2002-03. In fact, compression in plan outlay accounted for nearly the entire compression in expenditure.

#### Steady erosion in assistance for developmental spending

There has been a steady decline in the district plan outlay as a ratio of total state expenditures (see Figure 1.11) for the 1991-2003 period. The state plan outlay in the district sector declined from 21.4 percent in 1990-91 to eight percent in 2002-03, and allocation to central schemes as a share of total state plan outlay declined from 18 percent to about 10 percent during the period.

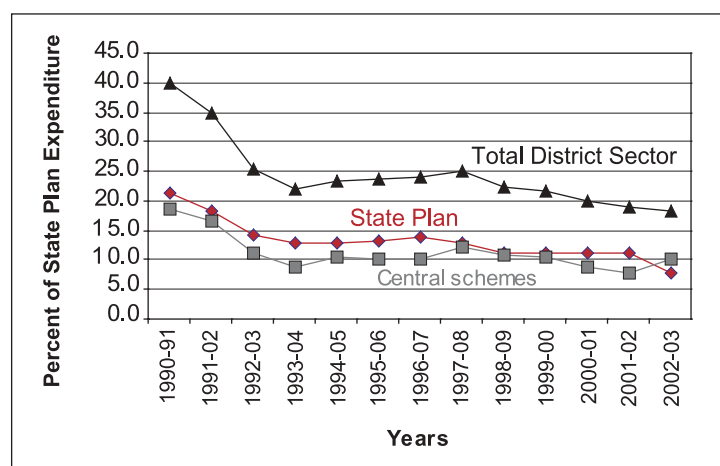
#### Concentration on sectors/schemes

Most expenditures are concentrated in a few sectors, with single-purpose transfers dominating,

<sup>39</sup> Inaugurating the Global Investor Meet at Kochi on January 18, 2003, Prime Minister A. B. Vajpayee said that non-resident Keralites bring in around five billion dollars of foreign exchange every year, and a sizeable proportion has been spent on housing construction (see The Hindu, Thiruvananthapuram, January 19, 2003). According to the Government of Kerala, around 85-92 percent of the gross fixed capital formation in the state during the last two decades has been due to construction activities. See Government of Kerala, 2001.

<sup>40</sup> These revisions generally raise property tax yield by 20-25 percent.

Figure 1.11 : Plan expenditures of rural local governments, sample districts, Karnataka, 1990-91 to 2002-03



Source: Rao et al, 2004

and negligible own revenues. In 2002-03, the budget on rural development and rural employment alone accounted for 36 percent of expenditures. And predictably, most expenditure is scheme-bound. In 2001-02, just three schemes<sup>41</sup> accounted for 87 percent of the central schemes in TPs or about 39 percent of the total plan budget for TPs. In 2002-2003, the two former schemes and SGRY (Sampoorna Gram Rozgar Yojana) accounted for 85 percent of the central plan outlay in the TPs or 54 percent of the TP plan outlay. Among the state sector plan schemes implemented in TPs, a preschool feeding program was the most important. As far as non-plan is concerned, the disbursement of schoolteachers' salaries and providing grants to schools are the most important activities. The story is similar in the case of ZPs. In 2002-03, of the 253 plan and 182 non-plan schemes implemented by them, just nine schemes (or 3.7 percent) have more than five crore rupees (US\$1 million) outlay each, and these account for two-thirds of plan outlay. The schemes provide ZPs and TPs with resources but not with discretion.

### Salaries as the largest share of expenditures

The developmental role of rural local bodies is largely confined to meeting the pre-decentralization commitments of the state. Almost 80 percent of the outlay is for the disbursal of

salaries or for the distribution of transfer payments to individuals and institutions. Another 16 percent is spent on specified schemes. This leaves only three percent to be spent according to the preferences of the panchayats. For the 16 percent that is spent on schemes, there is limited discretion. But panchayats do not have the flexibility to abolish schemes, even if they have outlived their usefulness. Also, panchayats cannot prioritize the provision of public services according to their own preferences. It must be said, however, that gram panchayats do have some autonomy. The important expenditure categories at the GP level include spending on core services,<sup>42</sup> public works, the Jawahar Gram Samridhi Yojana (JGSY) and office expenditures. In 2000-01, in the four districts taken together, spending on core services constituted 31 percent of the total expenditures of GPs.

### Greater impact of transfers on investments in public works

On an average, 37 percent of the GPs had per capita expenditures of less than Rs.20. But there is wide variation in the per capita expenditures of the GPs in the four districts studied. Multiple regression analysis to explain this variation shows that the marginal effect of transfers on per capita public works expenditures is significantly higher than that of own source revenues.

<sup>41</sup> Operation Black Board, Integrated Child Development and Indira Awas Yojana (IAY).

<sup>42</sup> Water supply, sanitation and streetlights.

### *Lower expenditure on anti-poverty programs by poor GPs*

The proportion of below poverty line (BPL) households is not significant in three districts, but in Bagalkot it is negative and significant. This implies that GPs with a higher proportion of the poor actually incurred lower per capita JGSY expenditures. The share of the SC/ST population is significant in three districts, but not in Udupi. These results present a mixed picture, but do not indicate that JGSY grants are distributed more heavily to local governments with a greater concentration of poverty.

### *The greater impact of own revenues on core services*

Expenditure on core services constitute about 31 percent of GP expenditures. Data analysis indicates that the only factors that explain inter-GP expenditure differences are own per capita revenues, per capita transfers and proportion of lump sum transfers. The marginal effect of own revenues is substantially higher than that of per capita transfers.

### *Very low GP expenditures*

The analysis also shows that the level of expenditures incurred at the GP level is extremely low both in per capita terms (Rs.68.5) and as a ratio of DDP (0.3 percent). Even as a ratio of total expenditure of rural local governments, the role of GPs is quite limited. In addition, the overwhelming proportion of expenditure is incurred for specific purposes such as JGSY, the welfare of SCs, and salaries. While these are necessary, it should be noted that they are directed at a small section of the GP's population. Thus the GP's activities do not evoke significant response from the majority of people.

### *No strong evidence of equalization*

In general, per capita expenditures were higher in the more affluent districts. The frequency distribution of GPs according to per capita expenditure classification shows that over 88 percent of GPs in the most affluent district (Udupi) had a per capita expenditure of more than Rs.60. The corresponding percentage in Bidar, the least affluent district, was 36. The differences in per capita expenditures were particularly pronounced

in the case of expenditures on core services. Interestingly, expenditures for an important anti-poverty intervention (JGSY) are not related to the proportion of BPL households. Overall, the distribution of expenditures among GPs does not show a pattern of equity.

## *Kerala*

### *Sharp increase in expenditure decentralization*

Unlike Karnataka, the total percentage of GP expenditure to state expenditure has more than doubled, illustrating the strides Kerala has made towards the decentralization of expenditure. Table 1.4 compares the figures for 1993-94, before the commencement of the decentralization process, and 1998-99, the second year after the launching of the "people's plan campaign." The percentage of total expenditure of GPs to state domestic product for 1993-94 was 0.8 percent. This rose to 1.44 percent in 1998-99. The actual GP expenditure increased from over Rs.161 crore to Rs.776 crore, an increase of 4.8 times, and the percentage of GP expenditure to state expenditure increased from 3.5 percent to 7.3 percent.

### *Constant total current expenditures*

The composition of GP expenditures (see Table 1.5) for the 1998-2002 period shows that total current expenditures of gram panchayats as a percentage of total non-plan (own fund) expenditure remained constant, ranging between 65-68 percent except for the last year studied (1998-99), when it rose to over 72 percent. The establishment cost, consisting of management and salary, works out to about 35-37 percent of the total own fund expenditure; and around 50-53 percent of the revenue expenditure for most years. The single largest component of revenue expenditure was the expenditure on public works, which, except for the last year, ranged between 25-27 percent. Per capita maintenance expenditure has more than doubled.

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The inadequate maintenance of assets created is an important cause of the poor quality of life in rural India. The results for Kerala appear to confirm that PRIs could make a 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.

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**Table 1.4 : Expenditure decentralization, Kerala, 1993-94 and 1998-99 (Rs. in crores)**

Items	1993-94	1998-99
1. Total expenditure of GP		
(a) Including CSS	161.5	776
(b) Excluding CSS	129.7	740
2. State Domestic Product* (Current prices)	18837	53552
3. Total State Expenditure	4656	10611
4. Percentage of GP expenditure to SDP		
(a) Including CSS	0.8	1.44
(b) Excluding CSS	0.6	1.38
5. Percentage of GP expenditure to total state		
(a) Including CSS	3.5	7.3
(b) 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 they cover only VPF expenditures and not plan fund, expenditures incurred by transferred institutions, pension funds, and CSS. Source: RBI, 2002

### Revenue deficits

In 1993-94, 48 percent of GPs had a revenue deficit,<sup>43</sup> ranging in 1993-94 from 25 percent in Kozhikode district to 77 percent in Thiruvananthapuram district. The highest proportion of GPs with revenue deficit at the state level (69 percent) is recorded in 1997-98 when the people's plan implementation was well under way. By and large, more than 50 percent of GPs have failed to meet their revenue expenditure even after accounting for shared and assigned taxes.<sup>44</sup>

### Expanding volume of expenditures incurred/managed

With increasing functional devolution to GPs, the expenditure responsibilities of panchayats have increased. Among the sample of 26 GPs, not one generated a surplus from own revenue (including assigned tax grants) consistently for the four years between 1999 and 2002. In the last year (2001-02), only five GPs had surpluses.

**Table 1.5 : 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/ Schemes	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
<b>Total</b>	<b>7831431</b>	<b>328.2</b>	<b>10143387</b>	<b>421.3</b>	<b>9893765</b>	<b>407.2</b>	<b>7404961</b>	<b>302.1</b>

\* Refers only to expenditure out of plan grants. Source: Oommen et al, 2004

<sup>43</sup> Defined here as the deficiency in revenue to meet salary, office expenses and routine maintenance expenditures. Revenue in this case is defined as the sum of own source revenue and statutory grants.

<sup>44</sup> But only 3.4 percent of GPs cannot meet the running expenditure of core services even in the worst of times.

### Widening expenditure disparities

The gap between the minimum and maximum expenditure is expanding.<sup>45</sup> 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? And is there a pattern to the variation? One

explanation is revenue availability, but since GPs raise about 45 percent of non-plan expenditures from their own revenues, there is also an element of local choice. The question 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. Modeling the determinants of variations in per capita non-plan expenditures with five independent variables<sup>46</sup> suggests that for 615 GPs, about 20 percent of the variation in per capita expenditures can be explained. GPs with smaller populations spend significantly more, suggesting a high fixed cost component in 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.

Plan expenditures are available for a more limited sample of 495 GPs. Because of data limitations, only three explanatory variables were used - population size, land area, and poverty. The results of this analysis show that approximately 31 percent of the variations in plan expenditure can be explained. This is more than in the case of non-plan

expenditures, suggesting a more systematic distribution of financing for plan expenditures across GPs. GPs with smaller populations spend more on a per capita basis, again suggesting the high fixed cost factor. GPs with a larger land area and a larger concentration of poverty population spend more on a per capita basis, suggesting the influence of public servicing needs on spending patterns. In general, the determinants of per capita variations in plan expenditures are very similar to that in non-plan expenditures. One difference is that the district effects are less pronounced. Finally, despite data sets being mixed, this aggregate expenditure number may enable a rough estimate of the variation in total spending across GPs (see Box 1.6).

#### Box 1.6 : Measuring total plan plus non-plan expenditures

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 includes population, land area and the concentration of poverty population. All three variables are significant and have the expected signs. 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 2.5 percent lower. If the land area is 10 percent greater, its expected spending is about one percent higher. If its share of poverty population is 10 percent higher, its spending expected level is about 0.5 percent higher.

Source: Oommen et al, 2004

### Issues of management and implementation

#### Flow of funds, accounting and reporting, and accountability mechanisms

The discussion in this section deals with both traditional mechanisms that cover planning, budgeting, fund flows and accounting, and new mechanisms (gram sabhas, social audits, beneficiary committees, ombudsman and media).<sup>47</sup> For the latter, the focus is on Kerala,

<sup>45</sup> The difference in non-plan per capita expenditure between the highest and lowest district was Rs.288 in 1994 and Rs.798 in 1999.

<sup>46</sup> Population size, land area, the share of agricultural workers in the population, the share of poverty population and the proportion of concrete housing structures. In addition, a district variable has been included to account for the possibility that some districts have more of a culture of spending than others.

<sup>47</sup> The findings are based on facts derived from the primary and secondary sources used in this study, available literature on the subject, discussions with panchayat functionaries and officials of the state government, records of and visits to the panchayat offices and observation of meetings of the panchayat committees. Case studies on social audits and beneficiary committees were also carried out. Finally, considering the media's indirect role in ensuring accountability in government, the study also researched the interest of the media in local government activities. Financial reporting forms the basis of accountability of any institution. Hence a detailed study was undertaken to understand the status of the accounting systems of the gram panchayats in both Karnataka and Kerala.

given the more sophisticated mechanisms the state has evolved.

### *Restriction of actual funds from state financial management systems to PRIs*

- ♦ In Karnataka, PRI authority to use resources lapses when not drawn from the treasury account in the fiscal year released.<sup>48</sup> Hence unused authority (which is not cash) inflates the apparent account balances of PRIs in the treasury. And multiple layers in the transfer of funds to PRIs delay flows. The recipients are not aware of the amounts remitted from one layer to another, and funds are dependent on the vagaries of the Ways and Means position of the state.
- ♦ In Kerala, the restriction of flows to PRIs, including plan funds, has been aggravated by the state's fiscal position during the last two years. Even if the panchayats have transfers credited to their treasury accounts, they may not have real resources, unless the state finance department decides to release them. Thus despite a transparent and formula-based system for entitlements to panchayats, the inability to transfer real resources on time reduces the usefulness of such a system.

### *Outmoded accounting and reporting systems*

Duplication and overlapping responsibilities confuse authority and accountability; they also complicate and delay reporting and reconciliation. All systems are cash-based, and different drawing officers at the upper two tiers of local government maintain multiple cashbooks for the same panchayat fund account with the treasury. As a result, no one knows the balances on a day-to-day basis. A general ledger is not part of the system, making it even more difficult to reconcile receipts and payments from multiple sources and departments.<sup>49</sup>

- ♦ In Karnataka, the multiplicity of accounts, accounting centers, accountants and reporting streams results in delays of several months in preparing and transmitting compiled monthly accounts, and limits the overseeing role of

authorized bodies such as the Finance, Audit and Planning Committee. This situation is further complicated by the multiplicity of budget items through which transfers are made to PRIs. The panchayat accounts are also incomplete because of the various ways in which payments of electricity bills are reflected, adding to the idiosyncrasies of the system. One reflection of how unrealistic the system is that GPs are nominally required to maintain 58 different registers - including registers of ticket seating, trees and unserviceable articles.

- ♦ In Kerala, old systems are under stress and new ones have not yet emerged to take their place. An outdated local government accounting system has been overwhelmed by the requirements of decentralization. Since 1996-1997, panchayat funds have increased by nearly 300 percent, and the state government's grants to gram panchayats have increased by nearly 900 percent. In addition to volume, the state government has issued numerous orders regulating the use of additional funds flowing under the accelerated decentralization program. The impact of these regulations is that gram panchayats have to cope with an extremely complicated accounting system.

### *The consequences of inadequate accounting*

Under these circumstances, it is not surprising that panchayats do not fully capture the extent of the financial resources they handle. Indeed, some of the possible consequences (see Box 1.7) of these inadequacies are of serious concern since they affect fiscal and financial management. Budgeting has been reduced to a routine, devoid of analysis to guide priority expenditure or policy making. There is no linkage between the annual plan and the budget, so that the monitoring of plan projects becomes difficult. The faulty classification of accounts blurs the distinction between routine and capital expenditure. An immediate outcome is the lack of reliable information about the assets to be maintained by

<sup>48</sup> The exception is plan funds that have extensions up to the end of the first quarter of the following fiscal year.

<sup>49</sup> Fifty-six in Kerala and 43 in Karnataka.

the panchayats. The prevailing accounting system makes it difficult to determine the unit costs of individual projects and various services such as water supply, street lighting and sanitation. It is equally difficult to know whether remunerative projects are economically viable.

### *The impact on reporting and accountabilities*

The Local Fund Audit Act (1994) requires the preparation of annual financial statements within four months of the end of the financial year. This requirement, however, is not being met in GPs. Also, the GP Secretary prepares the annual financial statements without involving the Panchayat Committee. In fact, annual accounts are often not prepared at any level. The four different bodies that audit panchayat accounts do not follow a uniform methodology; nor is their work timely or their follow-up reports organized. For instance, though the Kerala Panchayat Raj

Audit Rules (1997) requires the gram sabhas to discuss audit reports and take follow-up action for all three tiers, this is not being implemented effectively. Besides, the legislature committees do not scrutinize the annual report of the Local Fund Audit Department.

### *The Performance Audit Authority*

Against this disappointing background picture, the new system offers a potentially hopeful institution - the Performance Audit Authority (PAA) that may make an important contribution to

The potentially hopeful item in a largely disappointing picture is the Performance Audit Authority (PAA), though it is not working as well as expected.

Kerala's decentralization program.<sup>50</sup> Since its inception, it has reported annually to the state government, pointing out major deficiencies in the financial management of local governments. The PAA has, however, been criticized for focusing on past rather than current accounts and on compliance with formal financial rules; and for acting as an external inspection agency rather than a guide to local bodies. Given the necessity of systemic reforms, there appears to be a good case for the PAA to advocate reform at the state level, rather than replicating the traditional audit function assigned to others.

### *The new transparency system in Kerala: social audits*

The Act gives gram sabhas several powers, including the right to select beneficiaries and to comment on budget estimates, annual financial statements, audit reports and the administrative reports of GPs. These powers have expanded the scope of popular involvement in plan preparation, implementation, and monitoring and evaluation of projects. Apart from the gram sabha, neighborhood committees, ward conventions, development seminars, task forces and committees of experts are also used to ensure transparency,

#### **Box 1.7 : The consequences of poor accounting codes and rules: the Kerala example**

Although the Kerala Panchayat Raj Act (1994) requires panchayats to prepare an annual statement of all receipts and expenditures, such a consolidation of revenues and expenditures does not take place in any of the three tiers.

- ♦ In GPs, there is a separation between own funds and plan funds in consolidation and reporting. Their annual financial statement does not have reliable information on assets and liabilities since plan funds or funds received for CSS are not included.
- ♦ BPs and DPs do not prepare an annual financial statement. As a result, neither tier has a single-point source of information for the financial position of the local bodies.
- ♦ The utilization certificates furnished to the Planning Board and the aggregate statements incorporated in the subsequent year's draft plan document are poor substitutes for an annual financial statement. These utilization reports do not reveal the assets created using plan funds or own funds in the case of GPs. In the absence of consolidated accounts and financial statements, it is difficult for the Panchayat Committee (not to mention the general public) to know the extent of receipts and expenditures as well as the financial position of the local body.

<sup>50</sup> The institution is headed by the State Performance Audit Officer (SPA0) 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 units in every district -- in all, 66 audit teams attached to the different district offices. The audit team is expected to advise LGs after studying their accounts and identifying deficiencies. The team also visits major work sites to assess the physical progress of work in terms of quantity and quality. If necessary, the team may recommend further investigation of the work by appropriate technical persons. The Audit team is expected to visit all gram panchayats once in three months and other local bodies twice a year.

integrity, responsiveness and efficiency in the performance of panchayats. The objective is to expand the "public sphere" by introducing participatory governance at the local level and people's evaluation of the functioning of panchayats. Three case studies<sup>51</sup> investigating the impact of social audits suggest that the transition to a new culture - in which people demand accountability from local government, and the panchayats willingly submit to social audit - is not going to be easy (see Box 1.8).

#### Box 1.8 : Institutionalizing a system of social audits

The case studies make it clear that social audits, like many other community initiatives, need more champions. Initial successes in two of three panchayats were not sustained. In one, the process of social audit came to a halt once the leadership changed after elections. In another, the same party returned to power, but the new leaders did not support social audits. In only one place was there some continuity. In all three cases, dedicated persons took the initiative and provided leadership. In one panchayat, it was a team of volunteers who motivated the panchayat president to carry out the social audit. In another, a social worker motivated the president. In the third panchayat, an officer was instrumental in motivating the people, elected representatives and other officials in support of the social audit. NGOs played a crucial role in the process. They helped motivate the elected representatives, formulated the guidelines, and facilitated committee work.

#### Other aspects of the new transparency system

Although these case studies focused on gram panchayats, it appears that the activities of block and district panchayats are even less transparent. Other aspects of the new transparency system implemented in Kerala are also not working as well as they could:

a) **Beneficiary committees:** The idea is that persons to benefit from a project form a committee from among themselves, and execute the work on the basis of a design and estimates prepared by the panchayat and approved by an expert committee. Whenever beneficiary committee volunteers are willing to undertake a project, they are given preference

over a contractor. A major advantage of project implementation through beneficiary committees should be transparency and continuous social auditing. However, the overall assessment was that only about 25 percent of beneficiary committees functioned effectively and demonstrated results in terms of quality of work and cost effectiveness.<sup>52</sup> Reasons for this poor performance include stiff opposition from the officials and contractors' lobby; lack of support from panchayats; lack of technical and managerial support; and the lack of collective action.

- b) **The right-to-information initiative:** The Kerala Panchayat Raj (Amendment) Act (1999) had several provisions to encourage transparency and accountability of public officials, including the right of citizens to access public documents, and the rule for panchayats to establish billboards in each ward with important information regarding schemes and projects being implemented. But the right-to-information initiatives have not yet made a significant contribution to transparency.<sup>53</sup> Reasons cited include the lack of participation by civil society institutions; lack of awareness; and the lack of equipment.<sup>54</sup>
- c) **Failure to implement the citizen's charter:** The Kerala Panchayat Raj Act also includes a provision for panchayats to prepare and publish a citizen's charter indicating the services they provide, the procedure to access services, and the time period within which such services should be made available, and remedies available to citizens if the panchayat fails to deliver. This provision, however, still remains on paper.
- d) **Ineffective ombudsman:** The ombudsman is an important institution created to ensure the accountability of local government. Though it is too soon to evaluate its impact, several problems are already apparent. These include

<sup>51</sup> As part of the Kerala case study. See Oommen et al, 2004.

<sup>52</sup> Pillai et al, 2000.

<sup>53</sup> Chatukulam and John, 2002.

<sup>54</sup> Such as photocopier machines for copying documents.

lack of awareness; a lone member in the ombudsman's office, resulting in delays; and the failure to establish the Appeal

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

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Tribunal creating difficulties in appealing against the ombudsman's decision.

- e) **Unfulfilled gram sabha expectations:** The statutory gram sabha has the authority to suggest development schemes to be included in the annual plan, to decide on the specific locations of public utilities, to authenticate the lists of beneficiaries of development schemes and social security measures, and to oversee the construction works undertaken by the panchayat. It is also required to review the budget and the audit reports. While the role of the gram sabha in beneficiary selection appears to be positive, it has not been as successful in meeting other mandates, or at least in maintaining the tempo of the initial phase. The loss of momentum is explained by infrequent meetings of the gram sabhas; failure to report budgets and audits; and low attendance and interest.
- f) **The media's lack of interest:** Since the media has an important role in encouraging the public to demand accountability, this study reviewed the local editions of three widely circulated newspapers.<sup>55</sup> The key finding was that the mainstream newspapers have very little interest in news concerning local bodies. Space allotted to local bodies news for the entire year was only a little over 3.5 percent of the total space available.<sup>56</sup>

### *A success story in ensuring fairness and integrity*

Overall, the success story of the new transparency system in Kerala 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 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:

- 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 District Planning Committee.
- 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.

In sum, the review of both traditional and innovative mechanisms suggests two major findings:

- ♦ The traditional control mechanism of the state government over the panchayats appears to be somewhat relaxed. The ongoing monitoring of financial management is hampered by the weaknesses in the local governments' accounting system and annual audits. Moreover, the fear that large-scale irregularities in financial transactions may invite

<sup>55</sup> One in English, and two in Malayalam. Every issue of these dailies for the year 1998 was studied.

<sup>56</sup> Among the news items that appeared, district panchayat news attracted more attention than that of gram panchayats, the latter claiming only around 23 percent space given to the panchayats. News on block panchayats was almost absent. English newspapers showed less interest in local news compared with the vernacular press.

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 tools and methods introduced during the people's plan campaign to make the panchayat accountable to the community.

### Improving accountability

Thus the first critical steps towards improving accountability seem to be the following:

- a) **Updating fundamental accounting systems and re-instituting good financial accountability practices:** Modified double entry accounting and a new, appropriate chart of accounts seem to be necessary. Computerization of these new systems would be a logical accompaniment. The assignment of accounting responsibility should be clear, and the staff given appropriate training in new systems and procedures. Instituting meaningful consequences would help ensure the timely production and submission of accounts for review. Finally, the various agencies with audit functions should agree on methodology and assignment of non-duplicating responsibility.
- b) **Emphasizing downward accountability:** Kerala is correct in emphasizing downward accountability, and should not be discouraged by setbacks and the slow pace of implementation. The changes required are far-reaching and difficult, involving social, cultural and political changes. One important link between the traditional and the new accountability systems is the preparation and approval of budgets, and reporting on expenditures and financial performance. This major point needs renewed emphasis.
- c) **Motivating local communities to use accountability mechanisms:** Without being sufficiently motivated, local communities are

unlikely to take advantage of the participatory and downward accountability mechanisms that Kerala's decentralization laws provide. This motivation appears closely linked to five related conditions: the substantial impact of GPs' responsibilities on the lives of the community; sufficient resources to fulfill these responsibilities; a significant portion of the necessary resources from the community; the community's awareness of the first three conditions; and the community's awareness of the significant impact they can have on the planning and delivery of services.

It is within the capacities of states to fulfill these five conditions. For such potential to be translated into reality, the requirements are political commitment and a well-designed set of plans and programs. The program is best instituted in stages, as it involves significant social and behavioral changes, as well as the institutional and policy changes outlined in this Report. For example, a process of confidence building is necessary for communities to be willing to pay significant taxes and user charges for services received from GPs. That confidence may be best built through effective GP performance. This in turn requires capacity building at both state and local levels. In sum, a careful strategy and implementation plan for a reform program is essential.

### The decentralization agenda: principles, practices, policy

India has a strong historical commitment to rural decentralization, and PRIs, the political structures, are in place. But panchayats have not yet lived up to their potential because fiscal decentralization remains incomplete.

### Applying the features of a well-functioning intergovernmental system to the Indian context

An overall assessment of the system of rural local government finance in India raises the question of how well it matches current thinking on a well-functioning intergovernmental

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There are some mechanisms in place for the accountability of elected local government officials to voters. But low expenditure and limited financial control undermine efficacy.

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fiscal system. While there is no one "best" system, many analysts believe that the following general principles are supportive of a workable fiscal decentralization scheme.<sup>57</sup>

***a) Addressing all key components of a decentralized fiscal system***

Key components include significant expenditure responsibility and discretion, independent revenue raising powers, an elected local council, and local officers and employees who are accountable to elected local councils. The primary benefits of fiscal decentralization come about because elected councils become accountable to local voters. When this happens, the quality of public services should improve, local voters should become more willing to pay for services, and citizens' participation in governance should increase. The question in most cases is whether all the pieces necessary to guarantee the capturing of these benefits are in place. Some, but not all aspects of a good fiscal decentralization program are in place in India. Gram panchayat councils are elected, the gram panchayats are small enough to be close to the people, and there is some local taxing power. However, the gram panchayats comprise the smallest component of the rural local government sector, and spend only about Rs.68 per capita in Karnataka and Rs.129 per capita in Kerala. This low level of expenditure, together with limited control over the purpose of these expenditures, suggests that local voters have reason not to be very interested in budget outcomes. Most local government employees are bound to higher-level governments in terms of hiring, firing and compensation decisions, hence may not view themselves as accountable to the elected local councils or, ultimately, to the local voters. In short, some of the important components necessary for a well-functioning intergovernmental system for rural government finance have not yet been incorporated into the system. This may explain why the institutions set up to enable local participation, such as the gram sabha, have not taken hold.

***b) Finance should follow function***

Expenditure assignment must be clear and must lead decisions about revenue raising powers. In the Indian system, 29 expenditure functions of local government ("objects") are named in the Constitution. However, state governments may treat these as exclusive or concurrent local government functions. Both Karnataka and Kerala have made the latter choice. To complicate matters, expenditures for central schemes and for MP development projects are made outside the local government system. This confuses the service delivery role of local governments and the estimation of local government financing requirements. Nevertheless, the states have identified "vertical shares" for rural local governments without a clear understanding of expenditure needs. The state government in Karnataka, for instance, devolves as much as 30 percent of its revenues for spending by rural local governments though it does not have an information base on local finances.

***c) Strong ability to monitor and evaluate the intergovernmental fiscal system***

This implies that the state governments should have an analytic cell that would track the performance of the system regularly. A fiscal information system for local governments needs to be in place, but there is no such analytic cell in either Karnataka or Kerala. Periodic state finance commissions are provided for, but in neither state do these commissions work with adequate staff. Moreover, there is no data system in either state that allows the tracking of local government finances. Uniform fiscal data is not regularly submitted to the state, accounting formats vary from place to place, and there are serious flaws in the methods of reporting data. A comparison of the reported data used by the state finance commission in Karnataka, and that gathered for purposes of this study, show significant differences, and would lead to dramatically different conclusions about problems and reform options. Finally, while gram panchayats are required to prepare budgets and financial statements, block and district governments are not.

<sup>57</sup> Bahl, 2001; Bird, 2001.

#### **d) A structure that treats the urban and rural sectors differently**

Ideally, the system should reflect the more limited expenditure delivery capacity and tax base of the rural local governments. The Indian system does differentiate between the urban and rural local governments in its system of fiscal federalism, and the states appear to treat these sectors differently.

#### **e) Assignment of revenue powers to local governments**

This links revenue and expenditure decisions at the margin and promotes greater efficiency in the provision of public services.<sup>58</sup> It also creates a sense of ownership in the local population, thereby promoting accountability of the elected local officials to the voters. In the Indian system, gram panchayats have independent revenue-raising powers for land and property taxes for a number of minor levies and user charges. The property tax should be the mainstay of the local public financing system; but property tax collection rates are not high in either state. The local governments in the two states do not use their rate-setting powers fully. In Karnataka, 85 percent of the gram panchayats in the four sample districts raised less than Rs. 25 per capita, and the average collection rate was less than 25 percent. For some local governments, the costs of collecting the tax approached the level of revenues derived. The picture on tax effort appears to be only marginally better in Kerala. Given the low level of locally raised revenues, it is unlikely that the desired level of accountability has been reached.

#### **f) Higher-level governments following the rules they make for rural local governments**

This is important for local governments to plan their finances effectively, and submit to a hard budget constraint. But both states fall short in this aspect. In particular, the failure of the state treasuries to release full and timely funds for intergovernmental transfers compromises local government fiscal operations. Moreover, Karnataka reduced its overall allocation of grants to rural local governments in the late 1990s in the face of its budget crisis.

#### **g) A simple system**

Since rural local governments have limited capacity to plan and deliver services, and since the local community and leaders are new to the business of accountability, it is important that the system be kept simple. But the Indian system of rural local government finances is anything but simple. The intergovernmental transfers system in Karnataka consists of over 400 different grants to local governments, each with a different set of earmarks and management. Thus it is very difficult to understand the system and hold either local or higher-level government accountable for the effectiveness of these programs.

#### **h) Intergovernmental transfers to match clearly specified objectives**

The system of intergovernmental transfer in India falls short in this aspect, at least in Karnataka. The goals of the system are not clear; nor do they follow the recommendations of the state finance commissions. Karnataka does not distribute transfers on an equalizing basis. In fact, there is no discernable relationship between per capita grants to gram panchayats and available measures of fiscal capacity or expenditure needs. The system of intergovernmental transfers is not structured in a transparent way. Separate guidelines have been issued for each of the 428 central and state schemes, most of which are earmarked for the district and block levels. The gram panchayats in Kerala receive block grants and are given some discretion in deciding how the money might be spent, but overall, the amount allocated to the gram panchayats is only about four percent of total transfers to rural local governments. The transparency situation in Kerala appears to be different from

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A decentralized system relies heavily on general-purpose grants with relatively few conditions. An equalizing system uses a formula-based grant to distribute more funds to poorer places. A more centrally controlled system relies on conditional grants that specify exact uses, and monitors these uses. In addition to design issues, there is the issue of transparency. The system of transfers should have a minimum of ad hoc provisions and should be easily understood.

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<sup>58</sup> Bird, 2001; Breton, 1995.

Karnataka, and the commitment to fiscal decentralization seems to show up in the structure of the intergovernmental transfer system. Nearly 90 percent of the grants to gram panchayats are allocated on a largely unconditional basis. The distribution is by formula, roughly reflecting expenditure needs (population and land area allocators).

### *j) Policies that consider impacts on all three levels of government*

Central-state relations cannot be separated completely from state-local relations. If the central government adopts policies that stimulate state governments to incur deficits, then these revenue shortfalls are likely to be passed on to their local governments. The state deficits in both Kerala and Karnataka have led to expenditure reduction programs, which have been translated into reduced intergovernmental transfers to rural local governments.

### *j) Hard budget constraint on local governments*

The dataset gathered for this study show that most gram panchayats in Karnataka and Kerala run deficits on current account. Local governments do not use their budgets as a planning document; they are not funded fully or continuously through the year; there is considerable uncertainty regarding revenue flow; and they may incur deficits by deferring payment of expenditure liabilities.

### *k) Recognizing the changing nature of systems*

While some degree of certainty is necessary for efficient local government planning, it is also important for the system to be flexible as the needs and capacities of the rural local government sector change. The Indian system gets good marks here, in that it has both union and state finance commissions charged with the periodic review of the existing system. But while the central finance commissions have had an important impact on central-state fiscal relations, the state finance commissions (at least in Karnataka) have remained generally ignored.

## **Policy agenda**

India has a historical commitment to rural decentralization, and Panchayat Raj Institutions are

strongly in place. But panchayats have not yet lived up to their potential because fiscal decentralization remains incomplete. What is in place is a patchwork of measures that reflect what has been possible - politically and bureaucratically. What then, is the way ahead? Political realities will, of course, continue to dominate, and textbook recipes can never be literally implemented. But using an "ideal" framework as a reference point, this section recommends possible directions in which India could move to better capture the benefits of a system of fiscal decentralization.

## **Clarify expenditure assignments**

- a) **Clarify expenditure assignments between state and panchayats:** The present system is confusing. It contains duplications and overlapping responsibilities, and does not signal local populations about the functions for which they may hold local governments accountable. The problem in India, and particularly in Kerala and Karnataka, is that functions seem to have been transferred without adequate regard for roles and activities within those functions. For example, while panchayats may be assigned responsibility over water and sanitation, states may want to ensure that certain health standards are met, or that the disadvantaged sections of society are served. Thus it becomes necessary to unbundle the general subjects prescribed in the Constitution, and assign responsibilities at a more detailed level of activity and sub-activity. For example, some level of government may be primarily responsible for service delivery, while higher levels assume more of a regulatory and monitoring role.
- b) **Clarify expenditure assignments among the three tiers of PRIs:** The division of responsibility among the three tiers of rural local government could be rethought in terms of externalities, economics of scale and the demand for local control. The present division is untenable in some cases. For example, all the three levels of PRIs in many states share the responsibility for primary school construction, and each level receives a transfer to this effect. There is also

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Expenditure assignments between state and panchayats need to be clarified by unbundling the general subjects prescribed in the Constitution, and assigning responsibilities at a more detailed level of activity and sub-activity. Expenditure assignments among the three tiers of PRIs also need to be clarified for externalities, economics of scale and the demand for local control. The Indian situation suggests that the most practicable option is to accept that districts and blocks are essentially deconcentrated agencies of the state government, and to concentrate for the present on empowering village panchayats.

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the issue of local autonomy as opposed to central control in the division of responsibilities. Karnataka, for example, has favored districts (and most recently blocks), to which most functions have been transferred; but at the same time, it has protected the autonomy of gram panchayats. Kerala, in contrast, has placed more emphasis on the gram panchayat, but maintained a significant role for the district because this is the key tier for the delivery of centrally sponsored programs. In both states, the gram panchayat plays the smaller role in the overall system of rural local government finances.

- c) **Enabling districts and blocks to be effective service agents:** In principle, responsibilities for activities and sub-activities could be assigned within the 29 subjects based on considerations of the public good, existence of externalities, the desire to match local preferences, and merit of services. In this framework, villages could be entrusted with drinking water and sanitation, blocks with watershed management (because it usually affects more than one village), and districts with larger watersheds. Again, for health and other sectors, village governments could have responsibility for village clinics, or for maintaining health profiles of the population since they have better access to information. Districts could be made responsible for hospitals. In poverty programs, districts could be responsible for targeting and monitoring guidelines, while village governments could do the beneficiary selection. In the present system, districts and blocks are, for all practical purposes, service agents of higher-levels governments. They have no revenue raising

powers, and are described by local officials in Karnataka as "post offices." The legitimate question that needs to be addressed then is whether districts and taluks should be treated as part of the local government system, or whether they should become, more formally, spending agents for higher-level governments. Once it is accepted that districts and blocks will primarily play the roles of service agents for state and central governments, the first and foremost task is to clarify the lines of accountability of functionaries.

- d) **Empowering village panchayats:** Gram panchayats, at least in Karnataka and Kerala, are the only meaningful tier of local government. Gram panchayats have two important advantages over higher levels of government. They can best reflect people's preferences and needs at the local level; and thus, with the right incentives, can do a better job in meeting those needs. They have better information on local conditions. However, they are weak institutions at present and need time for capacity to be built. The priority is to give them sufficient autonomy and resources to respond to local needs, and use their knowledge of local conditions to improve public programs. States should avoid devolving responsibilities to panchayats for schemes designed from above, transferring to them staff that they did not recruit and cannot fire, or asking them to spend their resources maintaining assets that they did not create.
- e) **Moving away from a hierarchical structure for panchayats:** It is important to move away from a hierarchical structure for panchayats because of the large administrative burden it creates, and because it reinforces the upward accountability that decentralization is supposed to reverse. In Karnataka, for example, funds are given to the district sector to be passed to the block and then to the gram panchayat. Instead, each panchayat tier should have its own sphere of operation, and be empowered to deal directly with the state or even the center. If blocks are to have responsibility for school construction and manage corresponding

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Line agencies which are supposed to implement the schemes for the district should not be required to implement state government schemes. Similarly, various development boards could be wound up and the schemes they implement either transferred to the district or the state government, based on their comparative advantage. The amount of money released as a consequence could be as high as Rs.1155 crore annually (US\$250 million).

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schemes, then districts should not be given the same role. Building on what is happening in most states with the exception of Rajasthan, states may want to consider downplaying the role of blocks as service agents, since this seems to be the weakest of the three tiers as far as state policies are concerned. In such a framework, the district would primarily assume the service agent function, while the true decentralized form of government would be the gram. Without a stake in the management of funds or service delivery, the block could assume a useful independent monitoring and coordination roles, a path several states are trying to pursue.

### Consolidate schemes

Analysis indicates that there are a number of schemes that are within the implementation capacity realm of panchayats, and that there is no need for the state government to directly implement them. First, there are many schemes within the state sector that are implemented through the district, or through the same line agencies that implement the schemes for the district. These could certainly be transferred to panchayats. As far as the district (and block) sector plan schemes initiated by the state government are concerned, the state government should, in the first instance, take all those schemes with more than 10 crore rupees outlay (US\$2 million). These programs could be consolidated. All other schemes could be consolidated within departments for greater flexibility in prioritizing spending decisions. The abolition of these small schemes will release the money spent on these schemes, which should be made available to the respective departments within the panchayats. This would help provide greater discretion and autonomy to the panchayat in providing public services.

### Augment panchayat resources

While panchayats have the powers to perform the role of true governments, they do not have enough resources to do so. So a key priority is to augment gram panchayat resources without increasing the fiscal burden on the state or central treasuries.

- a) **Consolidate some schemes into untied funds for gram panchayats:** Any reform in fiscal decentralization in Karnataka should attempt to consolidate multiple schemes into meaningful ones to untie the funds, and enable gram panchayats to provide public services more efficiently. Conceptually, 100 percent financing could come from the central government for programs it considers meritorious; for these, the state/local governments could be implementing agencies. But shared cost programs should also be initiated in cases that both central and state governments consider meritorious. State governments could fund schemes they consider meritorious and which are not assisted by the central government. For those assignments clearly in the realm of gram panchayats, corresponding schemes should be consolidated into untied transfers. For those activities in the realm of both gram panchayats and state governments, state funds could be provided as matching grants to ensure responsibility and ownership of local governments. Consolidating central schemes and CSS into untied funds for local governments would help avoid fragmentation and administrative burden.
- b) **Improve own revenues of gram panchayats:** Reforming the tax system and user charges levied by the GPs is the most important element of fiscal decentralization reform. Systemic

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Some schemes, such as centrally sponsored schemes, have to be consolidated into untied funds for gram panchayats. The own revenues of gram panchayats can be improved through systemic changes in both policies and institutions so that capacity - to design, administer and enforce existing gram panchayat taxes - is enhanced. Other priorities are improving collection efficiency and the policy environment for property tax, modernizing the valuation system, and broadening the tax base.

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changes in both policies and institutions to build capacity to design, administer and enforce existing gram panchayat taxes will ensure a meaningful role for GPs in the state's fiscal system. Another priority is to improve collection efficiency. Only then can states consider broadening the tax powers of panchayats.

- c) **Improve policy environment for property tax:** To reform the property tax system, closer examination of the base, the rate structure and the administration system is necessary. All the GPs are empowered to levy the tax on non-agricultural land and property within their jurisdiction. However, property tax is generally levied only on residential property. Often, this is simply a lump sum tax paid by each household at a nominal rate. The tax has not been revised for over 30 years. Not surprisingly, revenue collections from the tax are hardly adequate to provide worthwhile local public services. This applies as well to Kerala, where flaws in the design of the property tax system have prevented panchayats from benefiting from the real estate boom in the state. That the potential is high if the system is improved can be seen from the fast growth rate of panchayat income from river sand, a key input into construction.
- d) **Modernize valuation system:** A modernized system should be instituted to value the house property in the GPs. To begin with, the GPs may be classified into three categories depending upon the development of the district, block, and proximity to the district/block headquarters. Next, each GP should do a full inventory of houses within its boundaries, and then assess value on the basis of location and physical characteristics of the structure.
- e) **Improve collection of property tax:** In a situation where local governments do not have enforcement capacity, tax collection is bound to be poor. This underlines the urgency of rationalizing the tax system, creating a proper mechanism to reform the structure and operation of the tax, and empowering GPs with the capacity to tax. Since property tax is the only major source of revenue for panchayats,

augmenting revenues from the tax is critical for fiscal decentralization and ensuring a meaningful fiscal role for GPs. This calls for creating a policy environment, and building capacity at the GP level, to enforce the tax. The most important measure to improve revenue productivity involves modernizing the registration and valuation system of properties; building capacity to administer the tax; instituting an effective enforcement mechanism; and showing a willingness to raise the tax rate.

- f) **Improve collection of user fees and charges:** Unless proper user charges are levied, efficient operation of water supply will suffer for want of proper maintenance. However, this can be done only when water connections are given to individual households. In many cases, water is supplied through public taps and it is not possible to collect user charges in such cases. This is particularly true of GPs in Udupi in the Karnataka sample. Another important revenue source in GPs is rents. A number of GPs proximate to urban agglomerations have been able to collect substantial revenue by renting shops, marriage halls and other similar structures.
- g) **Broaden tax base:** States should also consider broadening the tax base of panchayats. The obvious candidate is land revenue, basically a tax on agricultural land. The relevant question is whether the rural elite will voluntarily pay land revenue in a situation where GPs do not have any enforcement powers. However, the revenue potential is large: agricultural land benefits from many services provided by panchayats, such as roads, markets, and the management of water sources. The land tax would also be a highly progressive tax, with the rich paying more taxes.

### Redesign transfers

- a) **Clear and transparent way to determine aggregate transfers, relative shares of urban and rural local governments and allocations to tiers of urban and rural local governments:** In determining the aggregate volume of devolution and the relative shares of different governmental units, the SFCs have used a

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The finance commissions need to be professionalized to evolve the appropriate method of determining the requirements of different types and tiers of local governments. Unbundling the transfer system from scheme-based transfers would help local governments make allocations according to their priorities. Criteria-based allocation is necessary even at the ward level. A minimum standard of public service quality can be achieved by ensuring that transfers equalize the financial capacities of local bodies.

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simplistic approach. There has been no attempt to satisfactorily estimate the expenditures needed to carry out the functions assigned to the local governments. The finance commissions need to be professionalized to evolve an appropriate methodology to determine the requirements of different types and tiers of local governments.

b) **Unbundle transfer system from scheme-based transfers and provide local governments autonomy to make priority-based allocations:**

The entire fiscal decentralization process has ensured that the panchayats are mere disbursing agents of higher-level governments. Even specific-purpose transfers can help augment service levels and ensure equity if the transfer system is well designed. The critical element of reform is to unbundle the transfer system from scheme-based transfers into broad programs, and impart flexibility and autonomy for the local governments to make allocations based on their priorities.

c) **Relate transfers to need and capacity:** The empirical analysis at the GP level brings out the shortcomings of the transfer system's design. The random nature of the transfer system brings to the fore the major weakness of not serving allocative efficiency or equity. The easiest way to give transfers is on the basis of population and SC/ST population. With time, as data on reliable developmental indicators are compiled, transfers could also be related to other proxies of revenue capacity and expenditure need. Given that the basic services at the GP level consists of provision of water supply, sanitation and streetlights, a simple formula with population could be initially used.

If additional fiscal disabilities are detected due to the SC/ST population factor, it could be given additional weight.

d) **Make transfers predictable:** The absence of reliable local government financial information undermines any attempt at planning or budgeting at the panchayat level. Reducing uncertainty in the transfer system would go a long way in improving management at the panchayat level. The timing of resource flow is an important aspect that affects the efficient utilization of resources at the ground level. The bunching of transfers at the end of the fiscal is not necessarily due to the state's fiscal crisis. For example, while basic tax grants are often given in installments at the end of the year, the stamp duty statutory grant is distributed in regular installments. Although the plan grants are to be given in four installments, the last two are frequently bunched at the end of the year. This has to be rectified.

e) **Relate transfers to state revenues, not to state outlays:** The whole question of transfers to local bodies as being largely a share of the plan size (itself dependent on several imponderables) raises the fundamental question of whether transfers should be related to the total revenue of the state or its plan outlay.

f) **Improved weightage to backwardness:** In view of the great 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.

g) **Criteria-based allocation even at the ward level:** Although annual plans are routinely formulated, the gap between theory and practice has been growing. Criteria-based allocation is necessary even at the ward level, given the considerable existing political pressures at the local level.

h) **Ensure minimum standard quality of public services:** The principle of equalization of expenditure - that transfers should work towards equalizing the financial capacities of panchayats/local bodies - is particularly relevant here.

### Create information system on local finances

Building a reliable information system is the key to designing and implementing an efficient equalizing program. In the first instance, it is necessary to institute the information system on the finances of GPs, TPs and ZPs, based on the prevailing system of book keeping. For the future, it is also necessary to evolve a standard system of book keeping by the panchayats, and develop capacity to collect comparable information using informal concepts and definitions. The Rural Development Panchayat Raj (RDPR) is already compiling information on various economic and demographic variables. For the first time, the Institute for Social and Economic Change (ISEC), in collaboration with the RDPR, has also compiled information on the fiscal variables for all ZPs, TPs and GPs. The data collected need to be made comparable and classified. These efforts will also have to be regular and systematic so that each state has a robust data bank on rural fiscal decentralization.

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It is crucial to compile important economic and demographic information and data for variables at the GP level. Subsequently, a standard system of book keeping by the panchayats has to be evolved. Capacity development is essential for the collection of comparable information using informal concepts and definitions.

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### Improve accountability

a) **Timely consolidation of accounts:** The preparation of monthly accounts and annual accounts should emanate from the consolidated receipts and payments/trial balances of ZPs and TPs based on the statements of all drawing officials. The treasury should function only as a banker, with the closing balance of ZP/TP books reconciled on

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The PRIs' accounting and budgeting system needs overhauling. The internal management structure of gram panchayats should be redesigned, and the line of control of the panchayat bureaucracy, especially of the transferred departments, made clear. Positive mechanisms for downward accountability in the Kerala Panchayat Raj system - the right to information, overseeing functions of gram sabhas, social audit, a transparent method of beneficiary selection, and the citizen's charter - need to be retained and encouraged. These features can be used to evaluate the performance of panchayats and link it to a system of incentives and disincentives.

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a monthly basis with the figures of the treasury. The TPs should prepare their own monthly and annual accounts.

- b) **Mainstream accounting:** There is need to bring in mainstream accounting by introducing general ledgers and sub-ledgers, and simplifying the chart of accounts. Annual accounts should have schedules of various assets and liabilities, and income and expenditure, including lists of properties and fixed assets owned by PRIs. Schedules for other major accounts such as loans and deposits are also needed. Having a sub-ledger/subsidiary ledger for suppliers and contractors accounts will enable PRIs to monitor and administer individual contracts effectively.
- c) **Overhaul PRIs' accounting and budgeting system:** The accounting system and the presentation of the budget needs to be redesigned so that appropriate financial reporting is made possible for various purposes - such as ongoing monitoring, performance evaluation, or the cost of providing individual services. Computerizing the book keeping function of panchayats will help in keeping up-to-date and transparent accounts. Simplification of accounting procedure and capacity building of accounting staff is a necessity.
- d) **Redesign internal management structure of gram panchayats:** The president needs to share the responsibility associated with the many executive functions he performs. Besides, considering the volume of work in a gram panchayat, it may be worthwhile to introduce a "cabinet system of functioning," with the president and the chairpersons of the standing committees forming a team on the model of the Mayor-in-Council of West Bengal. The line of control of the panchayat bureaucracy, especially of the transferred departments, should be made clear.
- e) **Improve auditing:** It may be worth setting up an observer institution on the lines of the Public Accounts Committee with a substantial representation of panchayat members of the opposition parties. A target has to be fixed for preparing the final accounts within two months after the close of financial year. Ideally, the audit

should be done within the next six months. The useful institution of the Performance Audit Authority needs to be considered afresh to evaluate the performance of the panchayats and provide them with suitable advice for improvement. Value-for-money audits could also be introduced for local government institutions so they are accountable not only for observing rules and norms, but also for results. Such audits will help ensure both upward and downward accountability of panchayats.

f) **Positive incentives for mechanisms for downward accountability:** Various unique features of Kerala's Panchayat Raj system, such as the right to information, overseeing functions of gram sabhas, social audit, a transparent method of beneficiary selection, and the citizen's charter, should be retained and encouraged. They should also be used in evaluating panchayat performance, which, in turn, could be linked to a system of incentives and disincentives.