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INRM Policy Brief No. 9

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Foreword

The India Resident Mission (INRM) Policy Brief Series is sponsored by the Asian Development Bank (ADB) and is designed as a forum to disseminate findings from policy research work undertaken on the Indian economy. The series is primarily based on papers prepared under the Technical Assistance (TA) 'Policy Research Networking to Strengthen Policy Reforms in India'. The main purpose of the TA was to provide assistance for developing policy research networking capacity, in order to build support for, and consolidate the reform process. The INRM Policy Briefs provide a nontechnical account of important policy issues confronting India.

Tadashi Kondo
Country Director

Decentralization and Local Finance

G. Narendra Kumar

Countries like China have used decentralized governance to improve the quality of services to their citizens and to achieve high economic growth. India is still refining the process. Two major aspects of decentralization are examined here—fiscal decentralization and the status of decentralization.

Decentralization may be considered in terms of (a) diffusion, delegation, and devolution; (b) fiscal, political, and administrative decentralization. The focus of this paper is on fiscal decentralization.

The design of decentralization determines its efficiency. The following could lead to improved efficiency:

- Authority to respond to local needs as well as adequate means of accountability.
- Devolution of functions to a low enough level to improve allocative efficiency.
- Providing channels for citizens to communicate their preferences and get themselves heard in local governments (Bird and Rodriguez).[1]
- Providing channels for the poor to be heard. The poor rarely have an opportunity to invoke the accountability of the political establishment. They lack an effective choice among service providers. Local governments have the advantage of access to

1. R. Bird and E.R. Rodriguez (1999), 'Decentralization and Poverty Alleviation: International Experience and the case of Philippines', *Public Administration and Development* 19: 299–319.

local information and lower transaction costs for poverty alleviation programs. Design and implementation of poverty alleviation programs is therefore best left to the local governments.

Some Critical Issues in Decentralized Governance

Local governments' sources of revenue are own source revenue (among which property tax is an effective source), taxes assigned by the state governments, and a share of state government taxes. A local tax with good potential is a piggyback income tax based on local derivation basis, which reflects the quality of local services and is also easy to administer.

There have been various initiatives in post-independence India to arrive at an understanding of decentralized governance, such as the Balwant Rai Mehta Committee and the Ashok Mehta Committee. Currently, however, the agenda of local government institutions is set by the state governments.

There is considerable variation in the composition of local government entities across states in the devolution of functions to gram panchayats and panchayat samitis and in the manner of election of chairpersons of panchayats. The chairpersons' tenure also varies, ranging from one year (Karnataka), two-and-a-half years (Maharashtra) to five years (other states). The average population of gram panchayats also varies from 329 in Meghalaya to 23,809 in Kerala.

Organizational capacity is also low, with accounting being the key weakness. Enhancement of these capacities leads to increased information generation, which would facilitate public scrutiny at the local level.

As the benefits of economic reforms are inequitably distributed there is a need to decentralize the benefits of economic reforms. A market-based governance system like the Chinese model could boost economic growth, which in turn can catalyze economic reforms.

Local bodies do not charge governments for the agency services they provide, such as implementing poverty alleviation programs, fire services, etc. Many local bodies also assume that the poor lack the capacity or willingness to pay for services rendered.

Decentralization minimizes the diversion and misutilization of funds allocated to local bodies, provided a degree of equity in the community

is achieved, as in West Bengal, where a greater degree of equity was achieved through land reforms.

Factors Hampering Local Self-governance

- Creation of parallel structures which overlap those of local governments.
- Inadequate public participation and women's participation in gram panchayats.
- Absence of functional and fiscal devolution.
- Bureaucracy's dominance over the local government political executive.

Recommendations

Short Term (One to two years)

- Finance should follow function. Local knowledge that the local bodies possess makes them more suitable for many functions. Primary education and primary healthcare are examples.
- The quality of services will improve if organizational capacity is enhanced and an effective management information system established. This requires funds.
- Focus on outcomes rather than outputs gives autonomy to the local body. Transfer of finances should therefore be linked to outcomes rather than to outputs. An effective means for this is devolution of more funds as unspecified grants (untied funds) which would be used to meet the local body's overall socio-economic objectives.
- The cash basis of accounting leads to overspending. An accrual-based system of accounting, where the local bodies balance the revenues and expenditures on each service account, is more useful. This strengthens management control and transforms the system into an instrument for public debate.
- To ensure efficient expenditure management of funds there must be local-level political accountability, reflected in local voting patterns. Informed voter participation presupposes adequate information on governmental performance and public participation in planning and assessment of the quality of services delivered.

Since most local voters get to know about various local government initiatives from local leaders there may be considerable information asymmetry. Efforts to reduce this asymmetry would include the use of e-governance tools such as village information centers and starting of rural newspapers. Putting in place a system for rating the local governments' performance would also be useful.

- E-governance would improve communication between the public and the local government bodies and the quality of the services provided, and in turn improve local bodies' financial viability through improved tax collection.
- To harden budget constraints on local bodies state finance commissions (SFCs) could consider making a normative assessment of various local bodies' tax potential and recommend transferring only the shortfall.
- Increasing the rates of property taxes is suggested. Local economic expansion can also enable local governments to levy other types of taxes, such as a surcharge on personal income tax on a derivation basis and an apportionment of value-added tax (VAT) and some excise duties.
- Maintaining predictability in the amount and timing of equalization transfers will help local governments' financial planning. A rule-based system should be preferred to a discretionary system of transfers.
- Civil society organizations' involvement in local governance can considerably improve the quality of governance. These organizations can assist both in delivering some of the local services and in aligning public opinion with the local governance agenda.
- Initiatives like the social audit in Kerala are required for effectively monitoring and evaluating the quality of services provided by the local bodies.
- Increasing the tenure of the chairperson of local bodies to five years would provide stability of tenure to effectively plan and implement reform initiatives. This is also a demand of the All India Council of Mayors.

Medium Term (Two to three years)

- State governments should constitute a regulator to set the standards of services to be provided by various classes of local bodies and to ensure that the user fees charged by them are commensurate to the quality of services provided.
- The Philippines and China have successfully devolved primary education and primary healthcare to local bodies. (Finding a basis for determining subjects to be devolved is, however, complex.)
- Panchayats may consider contracting out some of their devolved services. One option is to buy infrastructure services instead of themselves investing in infrastructure. Private provision of local services, however, calls for increasing the regulatory capacity of local governments.
- Urban local bodies should fully recover costs on the various services they provide. Higher-level governments should pay them for the agency and government-mandated functions. Subsidy, if any, may be managed through a voucher system, which helps in better targeting of the subsidies and brings about a good match between the benefits and the quality of services provided.
- The size of government needs to be rationalized by hardening budget constraints against state governments. Effective decentralization will help state governments to spread their political risks. This, however, calls for new systems of oversight.
- Hardening of budget constraints on state governments could force them to harden the constraints on local bodies and devolve more functions to them. This might force local bodies to turn to markets for their funds, resulting in an improvement in organizational capacity and the quality of services provided. Several SFCs have also recommended market sourcing of funds.
- Participatory planning can follow the Brazilian example. A participatory exercise for bottom-up district level planning, which has yielded fruitful results in a few pockets of India, needs to be up-scaled.
- The innovative concept of city challenge fund, a mechanism for infrastructure financing, could gainfully be extended to other functions of the local bodies. The concept is to generate sufficient competition among the local bodies for this pool of funds. Projects under this arrangement would be jointly funded by the local bodies either out of their own resources or out of borrowings and by the challenge fund.

- Taking into account the low organizational capacity of about 2.5 lakh rural panchayats in the country and issues of economies of scale, the panchayat samiti, which now has a minimal role, may be made a unit of service provision, with an upward sharing of gram panchayat taxes where necessary, in spite of the issues of diluted accountability to the local population. This is a reiteration of the recommendation of the Balwant Rai Mehta Committee on Panchayati Raj.

Long Term (Four to five years)

- To curb the ill effects of monopoly state governments should introduce competition between the various provider organizations, with the state government itself changing its supplier of services. This would ensure periodic assessment of local bodies' efficiency in supply of services.
- Enhancing local governments' organizational capacity would mean granting them greater autonomy by clearly assigning their various functions. For service areas where local governments' efficiency of service delivery is not proven state governments may enter into service provision agreements with them and evaluate the efficiency of service delivery.

The Working of State Finance Commissions

Ravikant Joshi

This study examines various state finance commissions' (SFCs) performance and the reasons for their differential performance. It also indicates policy options for their improved functioning.

Background

Decentralization is a worldwide movement. Rabinovitch (1999) noted that more than sixty countries have adopted decentralization initiatives and are strengthening them. Of the seventy-five developing countries with populations greater than 5 million, all but twelve claimed to have embarked on some form of transfer of fiscal authority from central and provincial to local governments. These included even inherently centralized countries.

India embarked on democratic decentralization (giving status, more powers, functions, and resources to local governments) through the 73rd and 74th Constitution Amendment Acts in 1992. This legislation has not, however, changed the structure of fiscal federalism in the country. The state legislature continues to enjoy absolute discretion to endow municipalities with such authority. Municipalities are to take nothing from the general sovereignty except what is expressly granted.

As a result, significant interstate variations occur in local governments' functional and fiscal domain. Broadly, they are of three kinds:

- large functional and fiscal domain (e.g. Gujarat and Maharashtra);

- larger fiscal domain but narrow functional jurisdiction (e.g. Rajasthan and Manipur); and
- larger functional jurisdiction but a narrower fiscal base.

The illustrative list of functions considered appropriate for local government provided in the Constitution amendments include planning for economic and social development, urban poverty alleviation, and even urban forestry. The amendments also limited the state governments' right to suspend democratic local government. Most importantly, they provided for periodic revision of state–local fiscal relations through the mechanism of SFCs. Every state government is required to constitute once in five years a finance commission to review local governments' financial position and recommend the principles that should govern—

- the distribution between the state and local governments of the net proceeds of the taxes, duties, tolls, and fees leviable by the state;
- the determination of the taxes, duties, tolls, and fees that may be assigned to or appropriated by local governments; and
- the grants-in-aid to local governments from the consolidated fund of the state.

SFCs are also expected to

- review the finances of municipalities;
- estimate their future financial requirements; and
- suggest measures for strengthening their finances.

The new Article 280(3)(c) also requires the central finance commission (CFC) to suggest measures needed to augment the consolidated fund of a state to supplement local governments' resources on the basis of the SFCs' recommendations.

In assessing the SFCs' functioning, the following issues are examined here:

- how far SFCs have followed their mandate;
- how far the status of local bodies has changed;
- SFCs' approaches in addressing state–local fiscal relationship;
- working of SFCs; and
- implementation of SFC recommendations.

Current State of Local Finance

The report of the Twelfth Finance Commission indicates that for the period 1998-99 to 2002-3 the share of own revenue through internal resource mobilization (IRM) of all tiers of panchayats was 6.40% of their total revenues. It is an improvement over the earlier share of 4.17% estimated for 1990-91 to 1997-98 by the National Institute of Rural Development, Hyderabad (NIRD). The annual per capita IRM in some states was Rs. 8 only.

In 2001-2 municipalities' revenues by way of levy of taxes, duties, fees, and fines was estimated at Rs. 12,748 crore, accounting for 3.07% of publicly raised resources and 0.63% of the combined gross domestic product (GSDP). The share of the central government and all state governments combined was 57.5% and 39.5% respectively.

The average share of transfers from state governments in municipalities' revenues was 31.7% (2001-2). Municipalities' dependence on state government revenues for running of local services was 83.71% for Jammu and Kashmir, 83.33% for Rajasthan, and 74.48% for Uttar Pradesh.

Urban local governments' average per capita expenditure (daily) ranges between Rs. 0.20 and Rs. 2.25. This would partly explain the low level of services by urban local bodies.

The impoverished status of local finance could be on account of (a) low elasticity and buoyancy of local taxes; (b) poor administration of tax and other powers by local governments; and (c) local governments' lack of autonomy in tax rate setting, rate revision, and other spheres of their functioning.

Status Report of SFCs

In all states except Bihar, the First SFCs have submitted their report. State governments except Jammu and Kashmir have also submitted the action taken report (ATR) to the legislature. Twenty-five states were liable to constitute the second SFC but only six have done so. (Mizoram, Nagaland, and Meghalaya are not required to constitute SFC as these Schedule VI states have traditional local institutions of self-government.) Three states have submitted their reports. Seven states have since submitted their ATR on the second SFC to the state legislature. Andhra Pradesh, Kerala, and Punjab have constituted the Third SFC.

SFCs' Functioning: An Assessment

General Issues

States have shown reluctance in setting up SFCs, in providing them with administrative or technical assistance and information access, and in implementing SFC recommendations.

- At least six states have not yet set up their Second SFC. Five states have not yet submitted ATRs. The Twelfth Finance Commission observed, '... most states are yet to appreciate the importance' of the SFC as an institution.
- The SFCs' composition is far from ideal. In one state a serving bureaucrat headed the SFC. The Eleventh Finance Commission attributed the poor quality of SFC reports partly to the SFCs' composition. The Twelfth Finance Commission concurred.
- Statutory mechanisms are lacking for monitoring the implementation of the SFCs' recommendations. A permanent setup to ensure continuity between the SFCs is also lacking. In noting this, the Eleventh Finance Commission has recommended setting up of an SFC Cell.
- All SFCs have unequivocally noted the lack of a reliable database with regret. The Eleventh Finance Commission had provided special funds for this purpose.
- The Twelfth Finance Commission should have reviewed the third-generation SFC reports for basing its recommendations on local finance but it has not.
- The SFCs' recommendations have failed to bring about any perceptible change in urban local governments' finances. During 1997-98 to 2000-1 states transferred only an average of 4.47% of their own revenues to urban local bodies.

Policy and Structure

- SFCs' reports favor revenue sharing and grants-in-aid rather than tax assignments.
- They also favor the creation of a divisible pool of resources at the state level by adopting the concept of global sharing and then allocating it to local bodies.
- For quantum of revenue sharing two methods are recommended, one based on the estimation of gross financial requirements drawing upon past trends, the second being a normative approach. Most SFCs have followed the first method, Tamil Nadu, and Karnataka to some extent, being exceptions.
- SFCs favor creating formula-based fiscal allocation framework. Also, they have tried to create a multilevel fiscal allocation framework. But the problem is in creating a just structure. Most SFCs have followed an isolated approach for urban and rural local bodies.
- For vertical/horizontal distribution among local governments, too, the SFCs' perceptions and recommendations diverge widely. SFCs have tried to form a composite index for distributing resources but the selection of indicators is debatable.
- As regards tied vs. untied fund concept SFCs have recommended fiscal devolution in the form of tied funds, exceptions being West Bengal and Karnataka.
- Regarding autonomy, financial management, and budgeting no clear recommendations appear to have been made (Bird 1998).
- As regards sharing resources between tiers of rural local governments—village panchayat vs. intermediate panchayats—SFCs have taken different views. For example, gram panchayat received less than 5% against 25% allotted in Karnataka; West Bengal allotted the highest share to gram panchayat, amounting to 50 to 60%.
- Regarding current and future spending responsibilities Mathur (2000) says: '[T]heir recommendations are not based on a clear statement of the spending responsibilities of local bodies. Indeed, the absence of attention to the elementary principle that expenditure assignment must precede any tax or revenue assignment has turned most of the SFC exercises suspect.'
- An equalization grant mechanism is lacking.
- There is no attempt to measure nonformula-based devolution and total local expenditure.
- Uniform block grants are made without linkage to population, size, or service responsibility.

- There are no performance- or efficiency-based criteria for fiscal allocation.
- Input on policy of debt financing is absent.
- Commitment to create fiscal accountability is also missing.

At policy level, SFCs have followed different approaches to these aspects. While variation in approaches is inevitable considering the vastly different local situations, its long-term implications need to be carefully monitored. Variation in approaches will result in asymmetrical decentralization in different states, at different paces, and through different routes.

Implementation

- Many state governments have ignored the primary recommendations for pooled sharing of state resources.
- State governments have also ignored a large number of recommendations on other matters.
- Policy measures have also been taken in contravention of SFC recommendations. For example, (a) treating CFC grant as part of SFC devolution; (b) delayed devolution of CFC grant to local bodies; (c) continuation of nonformula-based discretionary devolution; (d) change in the purpose of devolution grants; (e) nonimplementation of equalization grant scheme.
- Deductions for outstanding dues from urban local bodies are made in lump sum from the overall sum (gross SFC grant). This mechanism favors local bodies that have higher amounts payable.
- State governments have ignored SFCs' recommendations about reforms incentive schemes to motivate local governments to undertake essential reforms.

Recommendations

Primarily, recommendations are ignored or inadequately implemented by state governments. Policy options to improve matters belong to the short term (one to two years), medium term (two to three years), and long term (four to five years).

Short Term

- All states need to constitute permanent administrative units to deal with SFC matters, in line with the recommendations of the Twelfth Finance Commission.
- A detailed calendar regarding various events and stages associated with the SFC must be drawn up. This calendar should be followed meticulously to overcome problems of nonsynchronization of the award periods of SFCs with those of the CFCs and five-year plans.
- SFC recommendations must be accepted and implemented in their entirety. Improvement in the states' fiscal health will make enough resources available to devolve to the local bodies.
- Most SFCs currently estimate local bodies' gross financial requirements based on past trends and decide on the percentage in the divisible pool. SFCs need to increasingly adopt the normative approach for this. Along with their recommendations, SFCs should provide fiscal accountability norms for local bodies.
- As regards improving the composition of SFCs, the Twelfth Finance Commission's specific recommendation (Para 8.33) is: 'It is necessary that the states constitute SFCs with people of eminence and competence, instead of viewing formation of SFCs as a mere constitutional formality. In the matter of composition of SFCs, states may well be advised to follow central legislations and rules which prescribe the qualifications for the chairpersons and members and frame similar rules.'

Medium Term

- SFCs' recommendations mostly favor revenue sharing and grants-in-aid rather than tax assignments. This soft approach is not healthy. Tax assignments should be given adequate importance in the context of two realities: one, deteriorating fiscal health of state finances and two, tax assignments being a better instrument of decentralization.
- As regards principles of revenue sharing SFCs should uniformly adopt the concept of global sharing to form the divisible pool on the basis of nonloan gross own revenue receipts (NLGORR, Karnataka model) coupled with 5–10% share in central devolution to the state (Tamil Nadu model).

- Various SFCs have different methods for arriving at the share of urban and rural local bodies in the divisible pool. The ideal set of indices as the basis for allocation requires further knowledge and research.
- Create a system of performance-based incentive grants.
- Put in place an equalization concept to correct distortions in horizontal resource sharing.

Long Term

- Create statutory mechanisms for monitoring implementation of SFCs' recommendations.
- Systemic use of nonformula-based grants throws the system out of gear. Since nonformula-based transfers may be part of a democratic setup capping their extent could be considered.

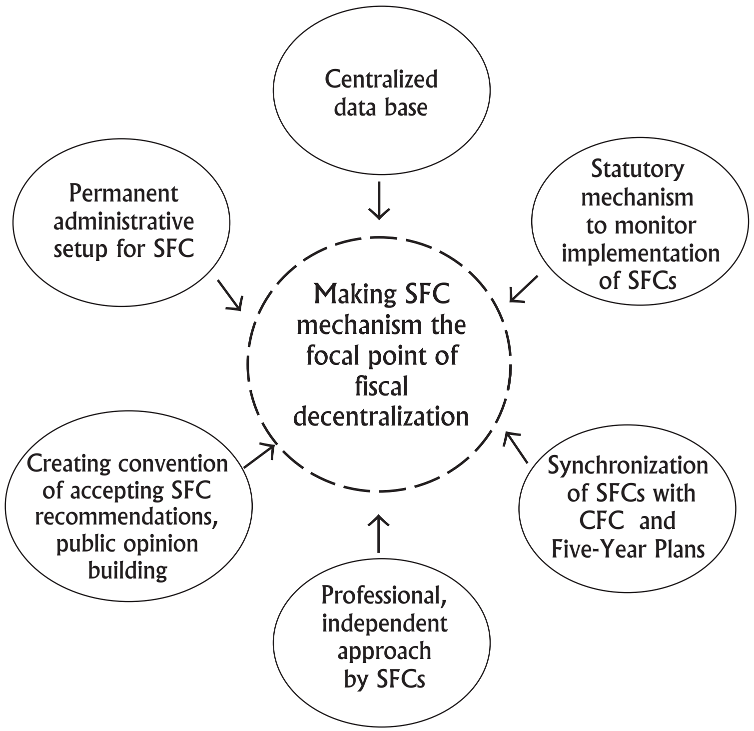

Figure 1. Making SFC mechanism the focal point of fiscal decentralization

- Fiscal responsibility norms should be fixed and an index of self-reliance for local bodies must be created.
- Hard budgetary constraints must be placed on local bodies.
- State governments themselves must begin with improving own fiscal health.
- Separate intergovernmental transfer systems should be put in place for urban and rural local governments.

Figure 1 presents the gist of the main recommendations graphically.

Summing up

SFCs have failed to live up to their constitutional role. However, the reports of the Second SFCs show that the system is coming of age.

The Eleventh and Twelfth Finance Commissions have extensively discussed the weaknesses in the working of SFCs and their reports. Poor implementation of policy is the crux of the problem. Since the SFC mechanism was thrust upon states through constitutional amendments they are indifferent to it. Unless all states come together with the central government in the lead with a positive approach to the SFC mechanism the entire fiscal devolution mechanism can get derailed.

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