

## Part B: Issues from Indian Public Finance

### Unit 5: State and Local Finances

Reading 2: Report of the Fourteenth Finance Commission, Chapter 9: Local Governments (Sections 9.1-9.28 and 9.45-9.86)

The terms of reference (ToR) for the Finance Commission requires it to recommend "the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State, on the basis of the recommendations made by the Finance Commission of the State."

The Commission is expected to recommend, on the basis of the recommendations of the State Finance Commissions (SFCs), measures to supplement resources of duly constituted panchayats and municipalities. These measures could be recommendations on both grants in aid as well as suggestions for steps to be taken by the States in this regard. The measures are intended to add to the resources of panchayats and municipalities. However, there is no clarity about the criteria or the quantum of the grant that should be recommended as per the ToR.

### Approach of Previous Finance Commissions Framework for Recommendations

The Tenth Finance Commission did not have a ToR for local bodies but it gave an award regarding this as panchayats and municipalities were to discharge the new role assigned to them under the Constitution during its award period. From the Eleventh Finance onwards, all subsequent Finance Commissions had ToR identical to those of this Finance Commission on panchayats and municipalities. In addition, the Eleventh Finance Commission could make its own assessment in the matter in cases where SFC reports were not available.

The previous Finance Commissions could not base their recommendations entirely on the SFC reports for various reasons, such as, variations in the approaches adopted by the SFCs, difference in the periods covered by individual SFCs, non-synchronisation of the SFC report periods with that of the Finance Commission report and the quality of SFC reports. Thus the previous Finance Commissions could only recommend ad-hoc grants and suggest steps that could augment the consolidated fund of States to supplement the resources of local bodies.

### Basis of Horizontal Distribution

The Tenth Finance Commission distributed its award exclusively on the basis of population (based on the 1971 Census) whereas the Eleventh assigned a weight of 40 per cent to population (1991 Census), 10 per cent to area and 20 per cent to distance from highest per capita income. The Twelfth Finance Commission retained the weights used by the Eleventh Finance Commission for each of these three criteria, but used the 2001 population data for distribution instead of 1991. The next Finance Commission increased the weight attached to population to

50 per cent and retained the weight assigned to area at 10 per cent. While they retained the weight assigned to distance from the highest per capita income at 20 per cent for urban local bodies, for rural local bodies this was reduced to 10 per cent and a new criteria- proportion of scheduled caste and scheduled tribe population - with a weight 10 percent was introduced. Apart from these three common criteria, others like index of decentralisation, revenue effort, index of deprivation, index of devolution and Finance Commission grant utilisation index have been used by different Finance Commissions.

In the distribution of grants, factors such as population, area and deprivation related indices take into account the resource needs of the States. Other criteria such as index of decentralisation, index of devolution, revenue mobilisation linked the quantum of grants to the efforts of States to decentralise or to empower the local bodies.

### Performance Requirements Associated with Grants

According to the Tenth Finance Commission, the State Governments should prepare suitable schemes and issue detailed guidelines for utilisation of the grants. The local bodies were required to raise matching contributions for the purpose. No grant amount was to be used for expenditure on salaries and wages. According to the Eleventh Finance Commission, the first charge on the grants should be maintenance of accounts and audit, followed by the development of a financial database. The remaining amounts were to be utilised for maintenance of core services - provision of primary education, primary health care, safe drinking water, street lighting and sanitation including drainage and scavenging facilities, maintenance of cremation and burial grounds, public conveniences and other common property resources. These grants were untied, barring the stipulation prohibiting the payment of salaries and wages. The grants were to be distributed between rural and urban local bodies, on the principles recommended by SFCs.

According to the Twelfth Finance Commission, panchayats should use the grants to improve service delivery relating to water supply and sanitation. In towns with a population of over 100,000, 50 per cent of the grant was to be earmarked for solid waste management schemes in public-private-partnership (PPP) mode. The urban and rural local bodies were also expected to give high priority to expenditure for the creation of database on local body finances and maintenance of accounts through the use of modern technology and management systems.

The Thirteenth Finance Commission provided grants for rural and urban local bodies in two parts - a general basic grant and a general performance grant. No conditions were set for accessing the basic grant. However, six conditions were set for panchayats to access the performance grant and nine conditions in the case of urban local bodies. All these conditions had to be met in each of the award years. In the case of States with Schedule V and VI areas, and the area exempted from the purview of Part IX and Part IX-A of the Constitution, a special area grant was provided without distinguishing between rural and urban areas. This grant also had two components – a special area basic grant and a special area performance grant. Four conditions had to be met to avail the latter. In case States were unable to draw their performance grant, the amount not drawn was to be redistributed in a specified manner. Both the general

basic grant and the general performance grant were allocated to rural and urban local bodies on the basis of the 2001 population figures.

## Accounts and Audit

Previous Finance Commissions have highlighted the lack of reliable financial data on panchayats and municipalities and the difficulty in realistically assessing the requirement of resources for carrying out core functions and development expenditure. According to the Eleventh Finance Commission, the need for improvement of accounts as, over a period of time, progressively larger funds would flow to local bodies, and suggested the heads of account under which funds flow to local bodies should be streamlined. It also recommended that the Comptroller and Auditor General of India (C&AG) should be entrusted with the responsibility of exercising control and supervision over the maintenance of accounts and audit of all tiers of rural and urban local bodies and that the C&AG's audit report should be placed before a committee of the state legislature. It also recommended grants to States for the compilation of accounts and creation of a database on local body finances. The maintenance of accounts of local bodies and entrusting technical guidance and supervision over audit to the C&AG were among the conditions that States had to fulfil in order to draw the performance grants recommended by the Thirteenth Finance Commission.

## Treatment of Excluded Areas

The previous Finance Commissions did consider the provision of grants to areas not covered by the 73rd and 74th amendments to the Constitution. While providing grants to these excluded areas, the Tenth Finance Commission noted that even in the States not required to have panchayats, the additional amounts would be required to be given to supplement the resources of similar local level representative bodies. According to the recommendations of the Eleventh Finance Commission, award for excluded areas should be made available to the respective States only after the relevant legislative measures for extension of the provisions of the 73rd and 74th amendments to such areas are completed. The Twelfth Finance Commission did not indicate separate grants for normal and excluded areas and left it to the States to distribute the grants between them. After considering Parts IX and IX-A, Articles 244, 280 and 275 of the Constitution, the Thirteenth Finance Commission also recommended grants for excluded areas.

## Measures for Augmenting States' Consolidated Funds

The Eleventh Finance Commission suggested imposition of taxes on land and farm incomes, surcharge or cess on state taxes, levy of professions tax, improving efficiency of collection of property tax, assignment of a buoyant tax in lieu of octroi when it is abolished, levy of service charges and periodic revision therein to increase the Consolidated Funds of States. The Twelfth Finance Commission identified fourteen best practices in order to increase the Consolidated Fund of States. The Thirteenth Finance Commission suggested that the States follow some

steps for augmentation of funds. It also suggested that the departments of the Union and State Governments could pay appropriate service charges to local bodies for civic services.

## Views of Stakeholders

### Views of the State Governments

States appreciated the grants for local bodies recommended by the previous Finance Commissions and were in favour of these being enhanced.

The criteria for horizontal distribution suggested by the States include area, index of devolution or decentralisation, scheduled caste and scheduled tribe population, income distance, Finance Commission grant utilisation, poverty ratio, fiscal discipline, index of deprivation, revenue effort, per capita transfer of funds, proportion of own resources transferred to local bodies, population and average population growth between 1971 and 2011.

The conditions attached to grants either be dropped or reduced in number. A few suggested that the conditions stipulated should have flexibility in their application to accommodate local conditions. If conditions were to be imposed, these could relate to timely release of grants to local bodies, entrusting technical guidance and supervision over audit to the C&AG and limiting the use of grants for core services and the existing time limit for the release of grants to local bodies be increased. The conditions imposed for accessing these grants should be linked to the performance of the local body only, with flexibility given for local conditions. Only a few conditions should be used and releases should be in proportion to the number of conditions fulfilled, rather than being linked to the fulfilment of all the conditions. The bulk of the local body grants should be in the form of a general grant and only a smaller percentage should be given as a performance grant. The limit on professions tax should be raised by Parliament and the local bodies should be allowed to recover service charges from Union Government properties.

Grants for provision as well as maintenance of basic civic amenities should be given. Support for the construction of panchayat buildings, information technology (IT) infrastructure, e-governance, capacity building and honorarium for elected representatives. Other purposes for which support was sought included preparation of financial database, improving tax collections, accounting systems, public health and education.

For urban areas support for basic civic services as well as support for traffic management and parking lots, implementing e-governance, construction of municipal buildings, fire services, disaster management, public health and preparation of master plans.

### Views of Representatives of Local Bodies

The grants given to panchayats and municipalities should be untied. The local body representatives sought funds for the improvement of basic services - water supply, sanitation, sewerage, storm water drainage, solid waste management, roads and street lighting, parks and playgrounds, burial and cremation grounds. Shortage of staff was another issue highlighted by them. Support specifically for training and capacity building of their staff, for construction of

training centres, for IT infrastructure, internet connectivity, buildings for panchayats as well as their repair and maintenance, salary for staff and honorarium for elected members has been sought by the panchayat representatives. Support for capacity building and training, public transport and infrastructure such as flyovers and roads, parks and playgrounds, maintenance of assets, salary for staff and honorarium for elected members and the need for special dispensation for pilgrim centres and for the protection of heritage sites has been sought.

The municipal and panchayat representatives suggested that the grant for local bodies should be determined as a percentage of the divisible pool. While the municipal representatives favoured setting the share at 5 per cent, suggestions from the panchayat representatives on this ranged from 6 per cent to 20 per cent.

The local body representatives also demanded that they should be allowed to levy service charges on the Union Government's properties and that the limit on professions tax should be raised so that their revenues can increase further.

## Consultations with State Finance Commissions

States had constituted SFCs at different times and with varying regularity. As a result, the latest SFC constituted across States (barring one state) ranged from the second SFC to the fifth SFC. In certain States, the latest reports submitted by the SFC were still under consideration by State Governments. In other States, the SFCs were yet to submit their reports. The State Governments rejected SFC reports without recording reasons. Even when the recommendations were accepted, the timeframe for implementation was not specified in the Action Taken Report presented to the legislature. The financial recommendations get acted upon while those dealing with systemic improvements are seldom addressed. The lack of coordination between the finance department and those dealing with rural and urban affairs hinders the implementation of measures for augmentation of resources suggested by the SFC.

The basic services for support could include water supply, sanitation, solid waste management, drainage, public toilets, street lighting and maintenance of roads. The basic grant by the Finance Commission should be untied and should be allocated within each State according to the formula laid down by the respective SFC. If performance grants are given, there should be a few conditions and these should be transparent. Revenue incentivizing measures have not been very successful. For such measures to be successful, the corpus for incentive grants should be large enough to induce the local bodies to act in this direction. The Finance Commission could support several measures to improve the capacity of local bodies, including funding municipal cadres, setting up of training institutes and IT infrastructure. Other measures suggested included providing support for preparation of simple accounts and data formats, benchmarking of basic services and setting up of data collection centres in State Governments. Promotion of accountability and transparency is important and social audits and public disclosure need to be encouraged.

## Issues and Recommendations

### Data Collection

There has been a lack of reliable data of local bodies as sought by the previous Finance Commissions from States. Since there has difficulty in obtaining the data in a useable form from all panchayats and municipalities, thus, the State Governments have been requested to collect information on a sample of the local bodies. The quality of the data that was supplied varied across States and was not in a useable form.

### Relying on the reports of the State Finance Commissions

Previous Finance Commissions had to make their recommendations independent of the SFC reports. The Constitution be amended either to delete the requirement for the Finance Commission to base its recommendations on SFC reports or to require it to recommend merely keeping in view the SFC reports but not based on them but the Constitution has not been amended so far.

The Constitution allows the SFCs to determine their procedures. Therefore, they are free to choose their approach towards the determination of the requirement of local body finances within the respective States. Given the wide socio-economic, geographic diversity and also variation in the roles that are assigned to panchayats and municipalities across States, the diverse and often State-specific recommendations of SFCs may not provide a uniform basis for recommendations applicable to all States

Measures for augmenting the Consolidated Fund of the State to supplement resources of panchayats and municipalities is to be done on the basis of the recommendations of the SFCs. This means that either recommending grants using the data available in the SFC reports, or addressing the common concerns raised in them on grants or other measures. Financial data in the SFC reports could not be used fully due to the fact that reports available were for different periods.

### Analysis of SFC reports

A common issue that emerges from SFC reports is the need to have reliable data on the finances of local bodies in order to enable all stakeholders to make informed decisions. For this, the compilation of accounts and their audit assumes importance. Another common issue is that the local bodies need to be encouraged to generate own revenues and to improve the quality of basic services they deliver.

### Giving Priority to Basic Services

Improvements in the quality of basic services are likely to lead to an increase in the willingness of citizens to pay for the services. The measures recommended, including the grants to the local bodies, should go towards supporting and strengthening the delivery of basic services - water supply, sanitation including septage management, sewerage, storm water drainage and solid

waste management, street lighting, local body roads and footpaths, parks, playgrounds, burial and cremation grounds. The local bodies should be required to spend the grants only on the basic services within the functions assigned to them under relevant legislations.

## Accounts and Audit

The Commission is of the opinion that proper accounts are the starting point for financial accountability. Non-maintenance or delayed compilation of annual accounts means compromised accountability. It also implies that reliable financial data for determining the need for resources for local bodies is not available. It has been more than twenty years that municipalities and panchayats were sought to be empowered, through a Constitutional amendment, to act as institutions of local self-governance and also to provide certain basic services to citizens. It is inconceivable, and certainly not desirable, that local bodies seek an ever increasing share of public moneys and yet continue to keep themselves beyond the ambit of accountability and responsibility for the public money placed with them.

On account of the efforts of the past Finance Commissions, there has been progress in the keeping of accounts and audit under the technical guidance and support of the C&AG but further progress in this regard is still needed. It is necessary to continue the efforts initiated by past Finance Commissions for improving the maintenance of accounts, their audit and disclosure. The books of accounts prepared by the local bodies should distinctly capture income on account of own taxes and non-taxes, assigned taxes, devolution and grants from the State, grants from the Finance Commission and grants for any agency functions assigned by the Union and State Governments. The technical guidance and support arrangements by the C&AG should be continued and the States should take action to facilitate local bodies to compile accounts and have them audited in time.

## Grants to Local Bodies

### Criteria for determination of grants to panchayats and municipalities

Under the Constitution, the State legislature has the discretion to assign functions to panchayats and municipalities. The overall scheme of the Constitutional provisions give primacy to the role of the States in this regard, by placing local government squarely in the State list. There exists significant diversity in the legal, institutional and financial aspects of assignment of functions to panchayats and municipalities. Neither the ToR nor the Constitution permits the Finance Commission to play any role in the devolution of powers to panchayats and municipalities or to promote a particular model of decentralisation.

The Commission have used criteria that reflect needs in order to determine the grants to panchayats and municipalities, namely population and area. The delivery of basic civic services is related to the current population to be served within the administrative jurisdiction of the local body. Area is also relevant from the viewpoint of the costs of delivering such services. Therefore, distribution of grants to the States using 2011 population data with weight of 90 per cent and area with weight of 10 per cent. The grant to each State will be divided into two - a

grant to duly constituted gram panchayats and a grant to duly constituted municipalities, on the basis of urban and rural population of that State using the data of Census 2011.

## Quantum of grants

The local bodies need to spend not only on the provision of basic services to the people, but also require support for administrative infrastructure and capacity building. In deciding the quantum of the grant, stability and predictability of resources that should flow to the local bodies have been given importance. A level of support that will provide financial stability to the local bodies through assured transfers for planning and delivering of basic services smoothly and effectively is also recommended.

The total size of the grant to be Rs. 2,87,436 crore for the period 2015-20, constituting an assistance of Rs. 488 per capita per annum at an aggregate level. Of this, the grant recommended to panchayats is Rs. 2,00,292.2 crore and that to municipalities is Rs. 87,143.8 crore. The grant assessed for each State for each year is fixed. This will ensure stable flow of resources at predictable intervals. The grants recommended should enhance resources available with gram panchayats and municipalities to enable them to discharge their statutorily assigned functions.

Grants have been recommended in two parts - a basic grant and a performance grant for duly constituted gram panchayats and municipalities. In the case of gram panchayats, 90 per cent of the grant will be the basic grant and 10 per cent will be the performance grant. In the case of municipalities, the division between basic and performance grant will be on a 80:20 basis.

## Basic grants

The own resources of gram panchayats and municipalities are meagre. They are required, as per the relevant statutes, to deliver a number of core services to their constituents. In addition, they have been assigned numerous agency functions by Union and State Governments. However, they depend on devolution from the State Government and grants from the State and Union Governments for providing core services. The purpose of the basic grant is to provide a measure of unconditional support to the gram panchayats and municipalities for delivering the basic functions assigned to them under their respective statutes. The grant provided is intended to be used to improve the status of basic civic services including water supply, sanitation including septage management, sewerage and solid waste management, storm water drainage, maintenance of community assets, maintenance of roads, footpaths and street-lighting, and burial and cremation grounds.

The grants should go to gram panchayats, which are directly responsible for the delivery of basic services, without any share for other levels. The State Governments are expected to take care of the needs of the other levels. The earmarked basic grants for gram panchayats will be distributed among them, using the formula prescribed by the respective SFCs for the distribution of resources. Similarly, the basic grant for urban local bodies will be divided into tier-wise shares and distributed across each tier, namely the municipal corporations, municipalities (the tier II urban local bodies) and the nagar panchayats (the tier III local bodies)



using the formula given by the respective SFCs. The State Governments should apply the distribution formula of the most recent SFC, whose recommendations have been accepted.

In case there is non availability of the SFC formula, then the share of each gram panchayat as specified above should be distributed across the entities using 2011 population with a weight of 90 per cent and area with a weight of 10 per cent. In the case of urban local bodies, the share of each of the three tiers will be determined on the basis of population of 2011 with a weight of 90 per cent and area with a weight of 10 per cent, and then distributed among the entities in each tier in proportion to the population of 2011 and area in the ratio of 90:10.

## Performance Grants

The data on gram panchayat revenues provided by the States showed that in one State the gram panchayats played an advisory role and had no powers to collect tax or non-tax revenue and in four others they had powers to collect revenues but were not doing so. Of the remaining States, two accounted for most of the revenues collected at the gram panchayat level. For the local bodies to function effectively as institutions of local self-governance, it is important that they augment their own sources of revenue.

A common issue raised by most SFCs is that their work was hampered by lack of reliable data on receipts and expenditure at the local body level. The studies commissioned on panchayats and municipal finances faced similar problems. Therefore, performance grants were provided to address the following issues: (i) making available reliable data on local bodies' receipt and expenditure through audited accounts; and (ii) improvement in own revenues. In addition, the urban local bodies will have to measure and publish service level benchmarks for basic services. These performance grants will be disbursed from the second year of award period, that is, 2016-17 onwards, so as to enable sufficient time to State Governments and the local bodies to put in place a scheme and mechanism for implementation. The details of the performance grants are given in the paragraphs that follow.

### Performance Grant - Rural

To be eligible for performance grants, the gram panchayats will have to submit audited annual accounts that relate to a year not earlier than two years preceding the year in which the gram panchayat seeks to claim the performance grant. It will also have to show an increase in the own revenues of the local body over the preceding year, as reflected in the audited accounts. For example, the audited accounts required for performance grants in 2016-17 will be for the year 2014-15; for performance grants in 2017-18, the audited accounts will be for the year 2015-16; for performance grants in 2018-19, the audited accounts will be for 2016-17; and for performance grants in 2019-20, the audited accounts will be for 2017-18.

The underlying objective of the grant is to initiate action at the grassroots level for compilation of data so that all stakeholders have access to reliable information for decision making. At the same time, it enhances accountability of the local self-government institutions to the public. The revenue generation by gram panchayats is at different levels. Therefore, it may be better that the detailed procedure for disbursement of the performance grant to gram panchayats based on

revenue improvement be designed by the State Governments concerned, keeping in view the two conditions given above. The operational criteria, including the quantum of incentive to be given, is left to the discretion of the State Governments. In case some amount of the performance grant remains after disbursement to the eligible gram panchayats, this undisbursed amount should be distributed on an equitable basis among all the eligible gram panchayats. The scheme for disbursement of the performance grant will be notified by the State Governments latest by March 2016, in order to enable the preparation of the eligibility list of local bodies entitled to them. The concerned Ministries of the Union Government will also be informed in order to facilitate release of the instalment of performance grants.

#### Performance Grant - urban

As in the case of the performance grant for gram panchayats, a detailed procedure for the disbursal of the performance grant to urban local bodies would have to be designed by the State Government concerned, subject to certain eligibility criteria. To be eligible, the urban local body will have to submit audited annual accounts that relate to a year not earlier than two years preceding the year in which it seeks to claim the performance grant. It will also have to show an increase in own revenues over the preceding year, as reflected in these audited accounts. In addition, it must publish the service level benchmarks relating to basic urban services each year for the period of the award and make it publicly available. The service level benchmarks of the Ministry of Urban Development may be used for this purpose. The improvement in revenues will be determined on the basis of these audited accounts and on no other basis. For computing the increase in own revenues in a particular year, the proceeds from octroi and entry tax must be excluded. In case some amount of the performance grant remains after disbursement to the eligible urban local bodies, the undisbursed amount should be distributed on an equitable basis among all the eligible urban local bodies that had fulfilled the conditions for getting the performance grant.

#### Trust-Based Approach to Release of Grants

No further conditions or directions other than those indicated by us should be imposed either by the Union or the State Government for the release of funds.

The grants recommended shall be released in two instalments each year in June and October. This will enable timely flows to local bodies during the year, enabling them to plan and execute the works better. 50 per cent of the basic grant for the year be released to the State as the first instalment of the year. The remaining basic grant and the full performance grant for the year may be released as the second instalment for the year. The States should release the grants to the gram panchayats and municipalities within fifteen days of it being credited to their account by the Union Government. In case of delay, the State Government must release the instalment with interest paid from its own funds.

Central to the trust-based approach adopted is the understanding that the local bodies will discharge their statutory functions with all due care. The publishing of service level data and preparation and audit of accounts will provide the necessary transparency and accountability

in this regard. Stern action should be ensured if irregularities in the application of funds are noticed or pointed out.

### Strengthening Role of SFCs

There is wide variation in the assignment of functions, funds and functionaries across States. Given this diversity of functional assignments to local bodies across States, it is not feasible for the Finance Commission to carry out a detailed assessment of the finances of local bodies in each State nor has such a role been assigned to it under the ToR or the Constitution. The Constitution envisages that the needs of local bodies within the State shall be assessed in detail by the SFC, which will recommend the required transfer of resources from the State to them. Therefore, it is appropriate that the needs of local bodies are assessed in detail by the SFC.

The SFC chairpersons have pointed out that despite the passage of time, SFCs in many States continue to work with a lot of disadvantages. There is a need for States to facilitate the effective working of SFCs. Therefore, the State Governments should strengthen SFCs. This would involve timely constitution, proper administrative support and adequate resources for smooth functioning and timely placement of the SFC report before State legislatures, with action taken notes.

### Measures to Augment the Consolidated Fund of States

The ToR mandates to identify and recommend measures needed to augment the Consolidated Fund of States. In addition to the grants that have been recommended, the actionable measures that the State Governments and the local bodies can take to improve their own revenues, based on the examination of SFC reports have been suggested. There is certainly a need to streamline revenue administration in the States in order to improve own resources of panchayats and municipalities

States have classified levies assigned to local bodies as compulsory or optional. However, the classification is different across States. Per capita income from both tax and non-tax sources also varies widely. In the case of own revenue collections by local bodies, the bulk of overall collections were accounted for by local bodies in a few States. There is considerable scope for the local bodies to improve revenues from own sources by taking steps as recommended by the SFCs and the Finance Commissions.