CHAPTER 7

THE PROBLEM OF MAINTENANCE OF ASSETS

7.1 A substantial number of assets has been transferred from the state government to the LSGIs as part of the functional devolution under the Panchayat Raj and Municipal Legislations. A good number of assets were transfered through a Government order in September 1995 and some more assets were transferred in the wake of the Peoples' Planning Campaign. As a sequel to this Campaign, the devolution of plan funds to the LSGIs was substantially increased, and this in turn was used for building up further assets. The LSGIs today have thus become the custodians of a vast array of assets, and the problem of the maintenance of these assets has acquired a degree of urgency. For convenience of discussion, the assets existing under LSGI jurisdiction at present can be divided into three categories: assets which the LSGIs owned and maintained prior to the transfers following the September 1995 Government Order (for the maintenance of some of these assets they had access to specific revenue sources such as VTC, and grants such as VRM); assets which have been transferred to the LSGIs following the Government Order; and assets which have been built since 1997-8, the year in which enlarged devolution began. Within this last category not all assets have been financed out of plan funds alone; surplus from own revenue and public contribution have also gone with in. The maintenance requirements as well as the sources of funds for maintenance for these three different types of assets need to be discussed separately. But let us first see what exactly is being referred to under the concept of maintenance.

7.2 THE CONCEPT OF MAINTENANCE

7.2.1 "Maintenance" is by no means a simple concept. It gets invariably enmeshed with three other concepts, operational costs, depreciation, and investment, in the sense that it is difficult to demarcate its boundary from those of these three other concepts. The difficulty has a conceptual dimension: we simply cannot tell in many situations how much of an expenditure is maintenance and how much of it is, say, investment. In addition it has an even more overwhelming practical dimension: we often do not know how to tell what is maintenance expenditure, and what is, say, investment expenditure. Strictly speaking the term maintenance refers to the expenditure required to keep an asset running with unimpaired productive potential during its life-time. Operational expenses refer to the expenditures on all other current inputs that are combined with this asset for producing the final good. The term depreciation refers to the amount that has to be set aside during each period, so that when the asset has reached the end of its life-time, a new asset can be purchased to take its place. Finally, (net) investment refers to any *addition* to productive capacity, unlike either depreciation or maintenance.

7.2.2 Of course the life-time of an asset is not independent of the maintenance expenditure that is undertaken upon it; or, putting it differently, different levels of maintenance expenditure, while maintaining approximately the same level of productive potential (or quality of service) of an asset, may cause different lengths of life-time. There is in other words a trade-off between depreciation and maintenance. Notwithstanding this trade off however, there would be some "optimum" level of maintenance expenditure at which the depreciation-cum-maintenance expenditure would be the least. The concept of "maintenance norm" is ideally derived from this consideration. To give an example, if an asset costs Rs.100 (we ignore inflation in this example), and can last 10 years with an annual maintenance expenditure of Rs.10, and 12 years with an annual maintenance expenditure of Rs.15, then clearly the former option is preferable. This is because the expenditure on depreciation-cum-maintenance is Rs.20 per year in the former (10 + 10), and Rs.23 1/3 per year in the latter (15 + 8 1/3).

7.2.3 The logic of this argument is not affected even when there are no *explicit* depreciation provisions, as is the case with LSGI assets. This is because at the end of 12 years in the above example, following the first option (where the asset is replaced after 10 years), we would have spent a cumulative sum of Rs.120 on maintenance and would be having a 2-year old asset with a depreciated value of Rs.80 (which comes from 100 original value minus 20 loss of value owing to depreciation); on the second option we would have spent a cumulative sum over the 12-year period of Rs.180 on maintenance and would be having a brand new asset worth Rs.100 at the end of it. By following the second option then we would have, compared to the first option, spent Rs.60 extra as maintenance over the 12 years and ended up with only Rs.20 worth of extra asset value. This being patently irrational, the first option should be adopted. It follows then that the comparison between the two, or several, options is unaffected by whether depreciation provisions are actually made each year or not. There would be some optimum option on the basis of which the maintenance norms can be ideally calculated.

7.2.4 Of course the concept of life-time of an asset is not unambiguous (since an asset does not just drop dead); nor is the proportion of maintenance expenditure to the value of the asset constant through its life-time. This magnitude typically increases with the age of the asset, and at some point quite steeply. The point at which this steep increase occurs can be taken approximately as the end of its life-time corresponding to that particular stream of maintenance expenditure. (The logic of the example discussed in paragraphs 3 and 4 can be restated in terms of such rising streams instead of the constant streams assumed there). Though in practice the maintenance norms we have are given to us by engineers, and their economic underpinnings are not always clear and not necessarily what they should be, the notion of "maintenance norms" is at least conceptually well-founded.

7.2.5 The conceptual basis of actual estimates of maintenance expenditures however is shaky because it is invariably mixed up with net investment. When the roof of a school building is repaired, this does not occur in pristine purity. Sometimes a boundary wall is added at the same time. While the repair constitutes maintenance expenditure, the addition constitutes net investment. But the two are frequently reported together as maintenance expenditure. This is not just due to lack of knowledge about the distinction. Sometimes drawing the distinction is practically impossible, since it entails a separation that is either impossible or tedious. An example of impossibility of separation is when some maintenance expenditure raises the quality of service of the asset compared even to what it was when the asset was newly installed: here maintenance has got inextricably merged with net investment. A more common case however is where disaggregation is possible but tedious. For instance if in the process of adding a new wing to a hospital which has to be whitewashed, some existing walls also get whitewashed, then keeping track of the latter as maintenance in contrast to the former which is net investment requires a degree of disaggregation that is too tedious to be practically possible. All this, somewhat abstract discussion, has practical implications to which we shall return later.

7.3 *MAINTENANCE EXPENDITURE OUT OF PLAN ASSISTANCE?*

7.3.1 It can be argued that of the three categories of assets, clearly the maintenance requirements of those assets which were with the LSGIs earlier and for whose maintenance specific revenue sources were assigned, such as VTC, should be maintained by them; the state government should have no responsibility in this regard. As for the assets transferred after the 1995 Government Order, the responsibility of meeting the maintenance expenditure must fall on the state government. This is because if these assets had not been transferred, and had remained with government departments, then the responsibility of maintaining these assets would have fallen on the state exchequer. Since these are not income-earning assets, so that their transfer to the LSGIs has not been accompanied by any corresponding transfer of income, the task of meeting their maintenance expenditure must still fall on the state government[1]. When it comes to assets constructed by LSGIs from 1997-8 onwards, clearly the responsibility for the maintenance of the assets whose construction has been financed by the larger devolution of plan funds should also be borne by the government. The reasoning again is that if these funds had not been transferred to the LSGIs then the departments would have used them for their plan projects, for which the government would have had to provide maintenance. (Of course a distinction may be drawn between the assets built out of the *increased* devolution, and assets that would have been constructed out of those plan funds which would have come to the LSGIs anyway, and the government's responsibility for providing maintenance confined only to the former. But, without the increase, the plan funds with LSGIs would have been so meagre that we can ignore this distinction). As for the assets whose construction in the period starting 1997-8 has been financed by sources other than plan funds, clearly the LSGIs would have to look after the maintenance requirements of these assets on their own.

7.3.2 As a matter of fact however even with regard to the assets existing with the LSGIs earlier to the large-scale transfers, the actual maintenance expenditure was woefully small. The first State Finance Commission had noted that with respect to roads, the most important

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[1] *While this principle is perhaps accepted at present, the amount of actual maintenance expenditure undertaken is too minuscule to confirm this acceptance. The total maintenance grant to LSGIs in the budget during the four years 1996-7 to 2000-1 has been, respectively, Rs.3.74 cr., Rs.5.05 cr., Rs.5.77 cr. and Rs.3.53cr.*

asset owned by LSGIs in the pre-1996-7 period, against the maintenance expenditure requirement of Rs.102.88 crores, only Rs.30 crores were being spent.[2] Of these Rs.30 crores, Rs.23 crores came from VTC and VRM. The LSGIs' own resources contributed only about Rs.7 crores. Thus, for the proper maintenance even of these assets, the state government has to meet the bulk of the maintenance requirement, while ensuring that the LSGIs do not spend in other ways what it provides for maintenance. In return it need not make any VTC payments to the LSGIs. (The first Finance Commission's recommendation that the VTC and VRM should be merged has been accepted by the government).

7.3.3 Of course it may be argued that with such a large share of plan funds being set aside for the LSGIs, they should now meet their own maintenance requirements. But this argument is wrong for several reasons: first, using plan funds for purposes of meeting non-plan current expenditure, which is what maintenance expenditure amounts to, is wrong in principle and would set an unhealthy precedent. Secondly, it would defeat the very purpose of democratic decentralisation, which is to let people prioritise investments allocation based on local needs. Maintenance expenditure, though essential, does not really involve any choice. If financed out of plan funds it precludes plan projects, and *ipso facto* any choice in the matter of plan projects. Thirdly, plan

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[2] The fact that the "norm" used by the Commission relates to 1996-7 while the actual expenditure figures relate to 1993-4 makes little difference to the argument. Likewise the questions raised in the text below about the accuracy of the estimate of Rs.102.88 crores do not invalidate the Commission's general point about the inadequacy of the actual maintenance expenditure undertaken

assistance from the state government to the LSGIs, as a proportion of the state government's total tax revenue, has already shown a decline in the last couple of years: from 19.12 percent in 1997-8 and 19.52 percent in 1998-9 it came down to 15.6 percent (RE) in 1999-2000 and 13.3 percent (BE) in 2000-01. As the state government has faced a somewhat tighter fiscal situation owing to a stagnation in central grants-in-aid and increased expenditure on implementing the Pay Commission recommendations, its plan outlay has suffered, and even though the 35 percent "norm" has been maintained, the devolution of plan funds to LSGIs as a proportion of tax revenue has gone down. If in this situation, maintenance requirements on LSGI assets have to come out of the plan funds, then the size of the LSGI plans would in effect become a sort of residual which would mean an attenuation of local planning. Fourthly, since maintenance requirement on LSGI assets is going to increase in the coming years, relative to other variables, owing to the fact that maintenance expenditure on some of the newly constructed LSGI assets, negligible till now, will have to begin and be sustained on a rising scale, the attenuation of local level planning involved in making LSGIs finance their maintenance needs out of plan funds, would be far greater than appears at first sight. The following paragraphs highlight some of the issues.

7.3.4 If a certain proportion x of the value of an asset has to be spent each year for its maintenance, then the total maintenance expenditure M_t upon this asset in any year t is given by

$$M_t = x . (I_1 + I_2 + I_3 + \ldots\ldots I_{t-1})$$

where I denotes gross investment, the subscript refers to the year when a particular addition to the asset (represented by the corresponding investment) started functioning, t-1 the previous year (the asset's life-time T is assumed to be not less than t).[3] There are however some assets, of which roads are a prime example, for which the pattern of maintenance expenditure has a singular complexity. Roads too require a certain amount of expenditure on repairs every year; but, in addition, surfaced roads require re-topping every three to five years. Since, with such maintenance and re-topping, surfaced roads can last a very long time, both these types of expenditure should be counted as maintenance expenditure. Our perception of maintenance expenditure then has to be modified in the case of surfaced roads

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[3] *With this definition we have two formulae representing simple logical truisms in a universe where gross investment grows at a steady rate g. If the asset (assumed for simplicity to be a single homogeneous one), which it creates, has, as before, a life of T years and requires x percent of its value as maintenance expenditure each year, then the ratio of total maintenance expenditure to gross investment in any year becomes a constant*

$$M_t / I_t = (x/g).\{1 - 1 / (1+g)^{T-1}\}$$

after a minimum period of T years of operating the asset has passed. Before T years have passed, the ratio of maintenance expenditure to gross investment during any year t , such that 1 < t < T, is given by

$$(x/g).\{1 - 1 / (1+g)^{t-1} \}$$

which, for any x and g, keeps increasing until it reaches the value given in the first formula. The first formula therefore gives an upper limit for the ratio. If the ratio of maintenance expenditure to the value of the asset increases over the life of the asset, then x in the first formula has to be interpreted as a weighted average. In the second formula maintenance expenditure as a proportion of gross investment would then rise even faster, both because t rises and because x also rises with time. Now, even if gross investment creates an assortment of assets, and not just one single asset, as long as they have similar life-spans and similar patterns of maintenance requirement (as proportion of value of asset) through life, both formulae remain valid.

(whose maintenance is of overriding practical importance in Kerala). If a surfaced road needs re-topping every T years, if the expenditure on re-topping per unit of investment (however measured) is given by y, and the expenditure on repair per unit of investment is given by x, then the total maintenance expenditure on surfaced roads in any year t is

$$M_t = x.(I_1 + I_2 + \ldots..I_{t-1}) + (y-x).I_{t-T.}$$

For unsurfaced roads of course the first definition of maintenance givenabove would continue to hold.

7.3.5 Now, on the basis of "norms" mentioned below, the maintenance expenditure at 2000-1 prices for the road length that existed with the LSGIs prior to September 1995, or has been transferred to them after September 1995, comes to about Rs.109 crores (the calculations are given below). In addition, on the basis of assuming that about 5000 kms. of surfaced roads are, on average, newly constructed each year by the LSGIs out of plan funds from 1999-00 onwards (we know that about 8000 kms. were constructed in the two years 1997-8 and 1998-9), and that all such new roads are constructed entirely by converting existing un-surfaced roads into surfaced roads (an assumption that turns out to be not very consequential), the additional maintenance requirement for this road length comes to about Rs.159 crores for the year 2005-6[4]. In that year in other words, Rs.268 crores would be needed for the maintenance of roads alone. The maintenance expenditure on assets, either already with LSGIs

[4] *The assumption of 5000kms of extra roads each year is perhaps on the high side. Knowledgeable persons we have spoken to believe that 4000 km. is a more plausible figure. On the other hand however Planning Board estimates suggest that 17600 kms of new roads have already been built in the three-year period 1997-8 to 1999-00, as against 13000 assumed by us. If 4000 km is taken to be the average annual addition after 1999-00, the number of extra kms of road-length assumed by us for the terminal year 2005-6 still remains valid (though its distribution over time would be different from what we assume).*

prior to Septemebr 1995 or transferred to them thereafter, comes to about Rs.30 crores at 2000-1 prices. On the assumption that plan assistance to LSGIs in 2001-2 would be raised one percentage point to 14.2 percent of total tax revenue, and would grow (like total tax revenue)at 5 percent per annum in real terms thereafter, the magnitude of maintenance expenditure (at 2 percent of capital cost) on newly created, plan-assistance-financed assets would be a further Rs.88 crores at 2000-1 prices in 2005-6. The total maintenance requirement of the LSGIs for these particular assets in that year would thus be Rs.386 crores which would absorb 25 percent of plan assistance on our assumptions. Moreover if LSGIs are allowed to use plan assistance for maintenance, then they would use such funds even for maintaining those assets which have been constructed in the post-1997-8 period out of funds other than plan assistance. In such a case the share of maintenance in plan assistance would go up to 41 percent. The conclusion is inescapable that if LSGIs are given the freedom to use plan assistance for maintenance, and if they are serious about maintenance, then they will end up using up to two-fifths of such assistance even as early as 2005-6, and still higher and higher proportions beyond that date. This clearly is an untenable situation. On the other hand if they are not serious about maintenance, then that too becomes an untenable situation. The object is both to prevent erosion in plan size and to ensure the maintenance of assets. And this can be served only if the state government takes the responsibility of financing the maintenance requirement of the bulk of the LSGI assets. The only exception would be those assets which have been constructed in the post-Campaign period by LSGIs with funds other than what the government has provided. Even as the government takes the responsibility of financing the maintenance expenditure on a whole range of LSGI assets, it must be emphasised to the LSGIs that the maintenance of the remaining assets would have to be financed from their own sources, other than plan assistance. In other words the habit of treating plan funds as a cornucopia that can finance all kinds of expenditures should be actively discouraged[5]. We shall return to this issue in the second part of our report.

7.3.6 According to our perception then, what the government has to meet by way of maintenance expenditure, consists of two components: one component for a fixed stock of assets either possessed by LSGIs earlier or transferred to them after the 1995 GO; this would be a constant component (except to the extent that the maintenance requirement itself might grow with the age of the assets). The other component is for assets constructed out of plan assistance in the period since 1997-8; this would be a growing component since the stock of assets whose maintenance has to be covered would itself be growing.

7.4 *ESTIMATES OF MAINTENANCE REQUIREMENTS*

7.4.1 There is a serious paucity of reliable data for making a proper estimate of maintenance requirements. Even though a comprehensive list of assets transferred to the LSGIs is now available, the age-structure of the transferred assets is not known. What is more, even on the road length owned by the LSGIs there are vastly differing estimates. Thus, the first Finance Commission had shown a total road length of 112491 kms. with the LSGIs

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[5]. This argument also applies to the view that re-topping of roads should be counted as part of plan, rather than maintenance, expenditure. This view is both conceptually questionable, given the meaning of the term "maintenance" discussed earlier, and practically inadvisable, since it would entail a big drain on plan outlay. To be sure, if the maintenance expenditure undertaken by LSGIs on roads is separately met by the State government, as we suggest, then this would only encourage still more extravagant road building. But this problem has to be addressed separately, by placing tighter constraints, if need be, on road-building. If LSGIs are both left free (within the 30 / 40 percent ceiling) to go on building roads and have to re-top these roads from plan outlay, then the problem of unwise use of plan funds would only get compounded.

as on 31.3.1996 (including 3437 kms. of PWD roads transferred), of which 105553 kms. were with Grama Panchayats. On the other hand data given to us by the Directorate of Panchayats show that Grama Panchayats own only 77359. 49 kms. of road length as on 31.3.1999. This decline of 28000-odd kms, in four years is wholly inexplicable. Under the cirucumstances we have assumed in our estimates that the total road-length shown by the first Finance Commission is correct, and that the increase in the road-length of surfaced roads that has occurred since 31.3.1996 has been through the surfacing of hitherto un-surfaced roads[6].

7.4.2 The first Finance Commission had estimated the maintenance expenditure required on the 112491 kms. of roads with LSGIs at Rs.102.88 crores on the basis of maintenance norms for different road surfaces which were derived from figures given by the Ministry of Surface Transport of the Government of India. There are however two problems with the estimate of the first Finance Commission. First, it does not take into account the question of re-topping at all. Its estimate relates exclusively to annual repairs in the sense of patchwork. Secondly, the norm it takes for the maintenance of un-surfaced roads, which is Rs7500 per km. per year at the prevailing prices, is extremely high. We have been told by several knowledgeable persons that even at today's price a sum of Rs.2000 would be quite adequate for the annual maintenance expenditure per km. of earthen and gravelled road. We attempt to rectify the estimates on both these counts. For re-topping, the PWD rates are Rs.6.5 lakhs per km. of Black-Topped road, and Rs.7.25 lakhs per km. of WBM road where the road width is 15 metres. Since village roads are 3.8 metres wide, we have, with proportionate adjustment, Rs.1.65 lakhs

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[6]. Dropping this last assumption and taking the entire increase since 31.3. 1996 as a net increase (consisting of surfaced roads) would not make much difference to our estimates

per km. of B-T road and Rs. 1.84 lakhs per km. of WBM roads as the re-topping expenditure. As for costs of repair, we take the first Finance Commission's figures for B-T and WBM roads adjusted for a 30 percent price increase[7], and Rs.2000 per km. for un-surfaced roads at today's prevailing prices. Applying these norms to the figures given by the first Finance Commission's data on road lengths, taking four years as the interval for re-topping (and making allowance for the fact that if a road is being re-topped in a given year, it does not need repairs in addition in the same year), we get a total annual maintenance requirement of Rs.108.6 crores at 2000-1 prices on the road-length existing with LSGIs on 31.3.1996, i.e. prior to the 1997-8 plan assistance increase.

7.4.3 As regards the assets transferred, the first Finance Commission had quite rightly suggested that the basis for calculating maintenance expenditure should be, not the original cost of the building but its current replacement cost. We have accordingly tried to calculate the current replacement cost of this list of buildings on the basis of certain assumptions: an LP School has seven rooms (20' by 20') and a veranda 5' wide running its entire length; a UP School has 8 such rooms with a corresponding veranda; a High School has 2 labs (40' by 40') in addition to what a UP School has; and PHCs, Dispensaries, Veterinary Centres and Krishi Bhavans have 4 rooms each (20' by 20'). We have assumed Rs.400 per sq.ft. as the current construction cost, 2 percent of capital cost as maintenance expenditure for schools and hospitals and 3 percent for other buildings. What our

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[7] This is not too far from an alternative estimate we can make. That is as follows. For annual repairs we can take the PWD norms of Rs.150 per sq.metre as the cost of patchwork, and 4 2/3 percent of surface area as the necessary extent of patchwork per annum. This gives us an estimate for repairs on B-T roads which is Rs.26619 per km. of road length. Our estimates based on adding 30 percent for price increase to the first FC's figure assume Rs.25090 per km.

illustrative calculations indicate is that the total amount of maintenance requirement on *this* part of the asset stock of the LSGIs is very small compared to that on roads. We surmise in the basis of our calculations that a sum of about Rs.30 crores would perhaps be adequate for the maintenance needs of the transferred assets (i.e. more accurate information on the age-structure would not add all that much to the total). This sum (of Rs. 140 crores approximately) is unlikely to increase much in real terms in the coming years. True, there would be some increase in the maintenance requirement with the ageing of the assets. But it is only for schools and hospitals that we have assumed a 2 percent maintenance cost; for the others we have taken 3 percent which is the government's norm for ordinary old buildings. The increase in maintenance requirement owing to asset aging will add only a small sum.

7.4.4 What would increase is the maintenance requirement of assets newly constructed after 1997-8 out of the increased plan assistance. Let us take the State Planning Board figure of about 8000 km. of new roads in the first two years of the increased devolution[8], and assume 5000 km. of extra roads each year thereafter. If we take a re-topping interval of four years for these roads (taking cognisance of the view held by many that they are of slightly inferior quality compared to the old PWD-built roads) then the extra amounts needed for the maintenance of these newly constructed roads (after deducting the saving in expenditure arising from the fact that the un-surfaced roads, now converted to surfaced roads, would no longer need to be maintained), come to as follows.

2001-2	Rs. 69.95 crores
2002-3	Rs. 129.97 crores
2003-4	Rs. 134.91 crores
2004-5	Rs. 147.25 crores
2005-6	Rs. 158.70 crores

7.4.5 On the assumption that approximately 40 percent of the total plan assistance has taken the form of assets whose maintenance would require about 2 percent of capital cost per annum we get a figure for the maintenance of such assets at around Rs.35 crores in 2001-2 and Rs.88 crores in 2005-6 at 2000-1 prices (the latter on the assumption, already stated, that plan assistance as percentage of total tax revenue goes up by one point from its current level to 14.2 percent in 2001-2 and remains there, while total tax revenue grows at 5 percent per annum from 2000-1 onwards). It follows then that the extra maintenance requirement on account of the newly-constructed assets goes up from Rs. 105 crores in 2001-2 to about Rs.247 crores in 2005-6.

7.4.6 Taking the two components together we can say that the total maintenance requirement on account of all the LSGI assets whose maintenance should in our view be the responsibility of the state government, goes up from Rs.245 crores in 2001-2 to Rs. 387 crores in 2005-6 at 2000-1 prices. If we assume the state government's total tax revenue at 2000-1 prices to grow at about 5 percent per annum from 2000-1 onwards, which is roughly equivalent to the SDP growth rate, then the maintenance requirement on account of all these assets, new as well as old, as a proportion of the tax revenue of the state, would increase from 2.72 percent in 2001-2 to 3.55 percent in 2005-6. The former figure is more firmly based than the latter. In arriving at the latter figure we have had to make assumptions about the size of plan assistance in the years to come which may not materialise. On the other hand, the assumption that the ratio of plan assistance to total tax revenue can be raised by at least one percentage point during the next year and kept at that level until 2005 appears to be an eminently reasonable one, in view of the fact that this ratio was as high as 19.1 percent in 1997-98 and 19.5 percent in 1998-99. Likewise the assumption that real revenue would grow at 5 percent per annum is by no means a far-fetched one. If this happens then the government's maintenance commitments as visualised by us would increase from an estimated 2.72 percent of the total tax revenue in 2001-2 to 3.55 percent in 2005-6.

7.5 *RECOMMENDATIONS REGARDING MAINTENANCE EXPENDITURE*

7.5.1 To keep the procedure simple, we are of the view that each year the government should set aside an amount equivalent to 3 percent of its total tax revenue for distribution among LSGIs for meeting their maintenance requirements[8]. Since it was felt

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8. This would mean a slight surplus relative to requirements in the first couple of years but a deficit in the later years. And if it is felt that the correct re-topping interval on newly-constructed LSGI roads should be five rather than four years (so that the re-topping exercise in effect gets postponed by a year), then the surplus would be larger for the first couple of years. On the other hand however it should be remembered that our estimate of Rs.140 crores as maintenance expenditure on transferred assets assumes a steady state of maintenance, i.e. the absence of any backlog with regard to maintenance. Given the fact that there is actually likely to be a backlog, the surplus may be only illusory. Moreover, if there is any surplus, as long as it is spent on the assets for which it is meant, even if it entails some capacity addition (which, as mentioned earlier, is often indistinguishable from maintenance), there can be no possible harm in it. It is the diversion of funds, destined to be spent on assets, towards sundry current expenditures that is questionable, not diversion of the reverse kind (after current expenditures are met). Besides we are also allowing the expenditure of up to 10 percent of the Maintenance Transfer for meeting operational costs. See paragraphs 7.5.13 and 7.5.14 below.

by the Commission that earmarking a share of total tax revenue including the share in central taxes might not be appropriate, we would like to present our recommendation in terms a share in the tax revenue raised by the state. On average an approximate ratio of 3:1 has been maintained in recent years between the state's own tax revenue mobilisation and its share of central taxes. Given this fact we would like to recommend that the state government should put aside 4 percent of the tax revenue raised by itself each year over the next five year period for distribution among the LSGIs for meeting their maintenance requirement. LSGIs should not accordingly have the option, that they now enjoy of spending 10 percent of their plan funds for purposes of maintenance.

7.5.2 We would however like to present our final recommendation in yet another way. Since it is important that LSGIs know at the beginning of the financial year the exact amount of maintenance funds they are going to get, it would be more appropriate if we relate these to the latest audited Actuals. These, at the time of preparing the budget for the year t , are known only for the year t-2 . On the basis of the projected trends it turns out that 4 percent of the current year's revenue of the state government amounts to about 5.5 percent of the own revenue two years back. Our precise recommendation therefore is that *the state government should make available to the LSGIs each year an amount of maintenance grant amounting to 5.5 percent of the latest audited Actuals of own tax revenue.*

7.5.3 This amount consisting of two parts, one constant and the other changing, must also be distributed according to two distinct criteria. Of the total amount so earmarked, Rs. 140 crores at 2000-1 prices should be distributed in accordance with the distribution of old and transferred assets among the LSGIs, for whose maintenance it is meant. The remainder has to be distributed in accordance with the distribution of newly created assets out of plan assistance among the LSGIs. Since the latter would correspond roughly to the distribution of plan assistance itself, the distribution of this part of the maintenance transfer should mirror exactly the distribution of plan assistance. Of course we are introducing a break in the pattern of distribution of plan assistance, by bringing in the revenue effort criterion in addition to those being used earlier. As a result, the distribution henceforth would be somewhat different from what it has been till now, so that if this part of the maintenance fund is distributed according to our criterion then it may diverge from the maintenance requirement on newly constructed assets which would have been determined till now by the way plan assistance has been distributed so far. But this divergence is unlikely to be very significant and may in fact provide further inducement for undertaking a revenue effort. Besides, simplicity has to be an important consideration. Our recommendation for the *inter se* distribution of the maintenance fund then is as follows: an amount equivalent to Rs.140 crores at 2000-1 prices has to be distributed keeping in mind the distribution of a stock of assets. The remainder is to be distributed in exactly the same way as plan assistance. The adoption of this dual criterion would ensure that neither the Block and District Panchayats whose share in the stock of assets is larger than their share in plan assistance, nor Grama Panchayats for whom the opposite is true, would have any cause for complaint.

7.5.4 At present 3437 kms. of roads which have been handed over to the District Panchayats are being maintained by the PWD. If the entire maintenance of the transferred assets is going to be the responsibility of the LSGIs themselves, then the District Panchayats should get the amount equivalent to the maintenance expenditure on these 3437 kms of roads. Likewise at present while assets have been handed over to the LSGIs, the maintenance of these assets often remains with the respective Departments. The responsibility for the maintenance of all such transferred assets should from now on be transferred to the LSGIs, since we are asking for funds to be made available to them for this purpose.

7.5.5 While the distribution of a part of the maintenance fund in accordance with that of plan assistance is easy to arrange, the distribution of the other part, the Rs.140 crores at 2000-1 prices, in accordance with the maintenance requirements of old and transferred assets, would be more difficult to effect. We would therefore suggest the following procedure *only for the fixed component of the maintenance transfer.* Out of the total of Rs.140 crores at 2000-1 prices (which has to be translated to current prices every year), one-seventh should be kept aside for the District Panchayats and Block Panchayats. Five percent of this amount (i.e. 1 /140 th of the total amount) should be given to the Block Panchayats for equal division among them. The other 95 percent should go to the District Panchayats which would now have the responsibility of maintaining 3437 kms of surfaced road-length (including re-topping at four year intervals). The remainder of the Rs.140 crores (at 2000-1 prices) should be distributed among the Grama Panchayats and the Municipalities. The mode of distribution of the respective amounts among the District Panchayats and among the Grama Panchayats and Municipalities will be initially according to the following formula. The maintenance amount for District Panchayats should be split between road and non-road assets on a 50:50 basis. The former should be distributed on the basis of road length and the latter on the basis of certain "norms" (given below) applied to the value of non-road assets. For Grama Panchyats and Municipalities, exactly the same formula should hold except that the distribution of the maintenance amount between road and non-road assets should be in the ratio 7:1 (correspondingly roughly to their estimated requirements). For the distribution of the maintenance amount on roads the existing criteria based on Babu Paul Committee report should be followed. For the other part, the "norms" mentioned below could be applied to the data on the magnitude of transferred assets to get an *inter se* distribution. To be sure, what any particular LSGI would get out of Rs.140 crores (at 2000-1 prices), distributed in this manner, may be very different from what it objectively needs for the maintenance of the old and transferred assets at its command in accordance with the given "norms". Ideally, to get at a genuine correspondence between the two vectors, namely, what the LSGIs get for the maintenance of these assets and what they objectively need, there should be an iterative procedure of the following kind.

7.5.6 In the first year, as the total maintenance expenditure amounting to Rs.140 crores (at 2000-1 prices) is distributed according to the above criteria, the government can simultaneously announce these maintenance expenditure "norms" (e.g. rupees per sq.ft. of buildings and per km. of road length etc.) on the basis of which those LSGIs which feel that they have got less than their due would put in claims for more. At that point, the validity of their claims will have to be verified by the government (and in the process a proper inventory of their pre-existing and transferred assets built up). Now, suppose the sum of valid extra claims comes to Rs.10 crores. Then, in the second year, since the total maintenance transfer would increase to a larger figure owing to price increase (say to Rs.154 crores, if prices rise by 10 percent), these extra claims can be met out of this increase. In the second year then Rs.10 crores would be given to those particular LSGIs which had got less in the first year, and Rs.144 crores (154 – 10), distributed among *all* the LSGIs (including those who have been given the extra Rs.10 crores) in a new ratio (where the Rs.10 crores get added to the weights of those who have been given this sum). If on the other hand the sum of extra claims exceeds the increase in the provision in the second year, say the valid extra claims come to Rs. 20 crores against an increase in provision of Rs.14 crores, then the Rs.14 crores would have to be rationed out among the claimants, with each getting 70 percent of the extra claims, and being asked to put in fresh claims for the remainder next year. When the available funds exceed the claims at the old norms, this excess can be distributed in accordance with the latest prevailing weights. And at this point the norms can be revised to take account of price increases in the interim, on the basis of which fresh claims would be put forward.

7.5.7 When a situation arises where *all* LSGIs put in valid extra claims, we have reached the end of the iterations. Once these claims have been accommodated in the manner described above, the pattern of weights prevailing at that point can be used for all subsequent distribution of the fixed amount (of Rs.140 crores at 2000-1 prices). In this manner we start with incomplete information, and hence only a rough and ready index of weights for *inter se* distribution, but we keep revising the index as we go along on the basis of information provided by the LSGIs themselves (and verified as authentic by the government), and simultaneously building up the information base. This way eventually we should get at the "true" index of weights (i.e. the iterations will converge to the "true' index), provided we start in the neighbourhood of the "true" index.

7.5.8 In case this procedure, which relies heavily on the assumption that *a posteriori* verification would be authentic, is found to be administratively infeasible, the more simple and obvious alternative is to cut out iterations, and take the initial *inter se* distribution as the final one as well. In this case a careful *a priori* calculation, based on the available data on transferred assets, supplemented by further verification through visits and the eliciting of additional information through questionnaires, may be made of the maintenance requirements, especially of the transferred non-road assets. Rs.30 crores can be distributed on the basis of these calculations and the Rs.110 crores (both figures at 2000-1 prices) can be distributed on the basis of the Babu Paul Committee recommendations, and the matter can be left at that.

7.5.9 The scheme of iterations has several additional advantages: first, it is flexible in the sense that it can be stopped after any round if we are not too finicky. For instance when the very first round of excess claims have been accommodated, and available funds have shown an excess over claims (and hence distributed according to the latest prevailing weights), the iterations may be stopped. The latest prevailing weights can then be taken as final, for the sake of convenience. Secondly, it is flexible in yet another sense: the upward revision in the maintenance norms (to reflect price increases) can be calibrated in accordance with the capacity of the administration. Since all claims have to be verified by the administration, a sharp increase in the norms would put a greater burden on the administration than a small increase in the norms. Thirdly, the scheme works even if the original estimate of Rs.140 crores (at 2000-1 prices) as maintenance expenditure requirement on old and transferred assets is inaccurate. What the scheme achieves is the following: if the amount is "too little" or "too much", this "too little-ness" or "too much-ness" is evenly distributed across LSGIs. Notwithstanding the advantages of the scheme of iterations however, it was felt by us that on practical considerations a once-for-all formula of *inter se* distribution would be better. We would therefore recommend the latter.

7.5.10 A possible criticism of our proposal is that it requires an identification of pre-existing or transferred assets separate from those newly constructed. But even though by looking at a house one cannot say whether it is newly-constructed or whether it has been transferred, or looking at a road-length one cannot be sure whether it was pre-existing with the LSGI or has been constructed out of the plan assistance (especially since such assistance might have been used to re-top an old road), nonetheless records are available on the basis of which the authenticity of maintenance claims on pre-existing or transferred assets can be verified. Besides, this whole system of dual criterion that we are suggesting is a transitional arrangement anyway: in the future when the weight of the maintenance expenditure on pre-existing or transferred assets in the total would have gone down (it being a fixed part of a growing amount), this dual criterion can be replaced by a single one, viz. distributing maintenance assistance entirely in the same proportion as plan assistance.

7.5.11 It remains to identify the verifying authority and to fix the initial norms. This authority should vest with the Ministry of Local Self Government of the state administration. The initial norms can be as follows

(i) Maintenance on Buildings Constructed Before 1.4.67	3 % of capital cost
(ii) Maintenance on Buildings Constructed After 1.4.67	2 % of capital cost
(iii) Current Construction Cost	Rs.400 per sq.ft.
(iv) Frequency of Re-topping of Surfaced Roads	Once in Five Years
(v) Repair Expenditure: B-T Roads Annually	Rs.25090 per km.
(vi) Repair expenditure: (WBM) Roads Annually	Rs.23140/km.
(vii) Repair Expenditure: Un-surfaced Roads Annually	Rs.2000/km.
(viii) Cost of Re-topping B-T Roads (3.8 m. width)	Rs.1.65 lakhs/km.
(ix) Cost of Re-Topping WBM Roads (3.8m width)	Rs.1.84 lakhs/km.

These figures would have to be updated from time to time to take account of inflation.

7.5.12 The procedure we are suggesting can be summed up for convenience as follows:

(i) Set aside, in each year's budget, 5.5 percent of the tax revenue raised by the state government during the latest year for which audited accounts are available, for transfer to LSGIs as a maintenance fund.

(ii) On the basis of a price-index work out what Rs.140 crores at 2000-1 prices amount to for the coming year for which the provision is being made in the budget. (The deflator for the construction sector employed in SDP calculations can be used for the purpose and the Department of Economics and Statistics can be asked to give a quick estimate of its increase during the preceding 12-month period at the time of the formulation of the state budget, and this increase can be assumed to hold over the next twelve months).

(iii) Of this sum, one-seventh is to be kept aside for District and Block Panchayats, and divided between them in the ratio of 19:1. The Block Panchayats should have the amount equally divided among them. The District Panchayats should have half the amount divided among them in exactly the same ratio as the 3437 km. road length is distributed., and the other half on the basis of "norms" applied to estimated non-road asset values.

(iv) The remaining six-sevenths of this sum is to be distributed among the Grama Panchayats and the Municipalities and Corporations; seven-eighths of this is to be distributed on the basis of the Babu Paul Committee recommendations and the remaining one-eighth on the basis of "norms" applied to estimated asset values.

(v) The remaining part of the maintenance fund, i.e. the excess of 5.5 percent of the state's own tax revenue two years ago over Rs.140 crores at 2000-1 prices, is to be distributed exactly in the same ratio as the plan assistance.

7.5.13 The LSGIs should not in general be allowed to spend the amount they receive as maintenance transfer for any other purpose. There is however a problem here. Since, as argued earlier, the expenditure on maintenance cannot be distinguished from net investment in many cases, the LSGIs would perforce get embroiled in tedious, almost theological, hair-splitting if they seek scrupulously to follow this injunction. The only practical way of avoiding this and yet ensuring that the maintenance transfer is not illegitimately used, is to insist that the total amount of such transfer should be spent exclusively (subject to one qualification mentioned below) on the assets for which they are meant. Ideally, the amount meant for the maintenance of transferred and old assets should be spent on these assets alone and on nothing else, and the amount meant for the maintenance of newly constructed assets should be spent on only these assets and on nothing else. But, ensuring that maintenance transfers within each category are spent exclusively on assets belonging to that category, would be practically impossible. What can however be ensured is that the total amount transferred for maintenance is spent only on assets that require maintenance. (Of course, in the process, some of the maintenance transfer would be used for the maintenance of assets newly-constructed from sources other than plan funds. But this is a problem which can be ignored for the time being). What is most important is that maintenance transfers to LSGIs should not be diverted either towards entirely new projects or for arbitrary current expenditures. If this much is assured through proper audit, then it can be left to the peoples' intervention to ensure that the maintenance amounts are spent as far as possible on maintenance. Once it is known that adequate amounts are available for the maintenance of assets, then any observed poverty in the quality of these assets would arouse popular anger which is the best means of ensuring that the LSGIs follow the straight and narrow path of rectitude.

7.5.14 We now come to the qualification mentioned in para 7.5.11. There is a widespread feeling that the present practice of making LSGIs rely exclusively on the supplies of medicines and books and consumables made available by the state government is an inefficient one; likewise the practice of making the state government meet a host of current costs such as rent, telephone bills, the repair and fuel consumption bills on vehicles, electricity and water charges etc. is both cumbersome and inefficient. In this context we propose in Chapter 8 that the state government should be freed from the obligation of having to meet any operational expenses other than on medicines and books and consumables. To meet these other costs, the LSGIs should make their own provisions; and even in the matter of medicines and books and consumables where we recommend a continuation of the present system, the LSGIs should be allowed to make their own *additional* purchases at the margin. For all this, however, the LSGIs need some funds. *We recommend that they should be allowed to spend up to a ceiling of 10 percent of the Maintenance Transfer for meeting current expenses.* While we strongly oppose the practice of diverting maintenance transfers for current uses, we make this exception only as a transitional arrangement, to provide a bridge from the existing system to a new one. By the time the next Finance Commission comes into being, how the proposed system works would have become clear, and appropriate rectifications can be made so that operational expenditure and maintenance expenditure are kept strictly separate, and the former does not lay claim to what is earmarked for the latter.

7.5.15 To recapitulate, we are allowing LSGIs to use maintenance funds for operational expenses up to a ceiling of 10 percent; in addition we are allowing them some leeway in selecting the assets for maintanance expenditure in a particular year. This is because maintenance too is undertaken in practice in a bunched manner. It is not as if little bits are spent regularly on the repair and maintenance of particular assets; rather, sizeable sums are spent every once in a while for the maintenance of particular assets. The candidates on whom such sums are spent differ from year to year.

7.5.16 Earmarking a part of the state's own tax revenue for transfer to LSGIs for the maintenance of their assets would no doubt entail a certain additional strain on the state's finances. The whole purpose of the exercise however would be lost if this strain is sought to be met by cutting back on plan outlay. If we disapprove of the use of plan funds for maintenance at the LSGIs' level, then we are equally opposed to the use of what in effect would have been the state's plan outlay for the purpose of maintaining LSGI assets. Any such reduction in the state's plan outlay would also entail a reduction in plan assistance to the LSGIs (under the one-third formula suggested by us), so that a part of what the latter would gain through maintenance transfers would be lost through reduced plan assistance. The funds for the maintenance transfers therefore have to be found independently. One way of ensuring that plan assistance to LSGIs is not adversely affected by the maintenance transfers, is to suggest that a certain minimum proportion of tax revenue should go as plan assistance, in the same way as we have done for maintenance assistance. But if we do so, then, together with our stipulation of one-third transfer of plan outlay to LSGIs, it would amount to fixing the minimum size of the state's plan outlay itself (as a proportion of its tax revenue) which is outside our terms of reference. Our expectation is that plan assistance to LSGIs which has fallen to 13.3 percent of total tax revenue in 2000-01 (BE) would be raised by at least one percentage point and whould be kept at least at that level for the next quinquennium.

7.5.17 That still leaves the question: how is the state government to find the resources to make this extra transfer to the LSGIs? The amount is not much, since against payments to be made as maintenance transfer we have to offset the savings the government would be making by not paying VTC, by not paying the PWD for the maintenance of 3437 km. of road-length, by not paying the (very small amount of) maintenance grants currently used by Departments for maintaining assets falling within the jurisdiction of LSGIs, and by not paying the operational expenses except for the purchase of medicines, books and consumables. Even so, funds have to be found for this. How the government can do so is an issue that falls outside our terms of reference. It seems to us nonetheless that that if the service sector in Kerala, which has been the fastest-growing sector, could be brought under the ambit of taxation to a greater extent than has been the case till now, then the state which has a good record of revenue mobilisation would do still better.

CHAPTER 8

NON-PLAN, NON-MAINTENANCE TRANSFERS

8.1 Traditionally, transfers from the state government to the LSGIs have been grouped under two separate heads: plan transfers and non-plan transfers. We have discussed plan transfers in Chapter 6. In Chapter 7 we have introduced a new category, namely transfers for the maintenance of certain LSGI assets, or "maintenance transfers" for short. In the current chapter we shall discuss what was traditionally referred to as "non-plan transfers" and what we shall call "non-plan, non-maintenance transfers" to emphasise that we are no longer discussing "maintenance transfers" (which logically must also fall under the general rubric of "non-plan"). At the time of the first Finance Commission Report, the bulk of the "non-plan transfers" referred exclusively to the transfers of shared and assigned taxes and a host of specific and general purpose grants to LSGIs. And these "non-plan" transfers were divided into two parts: statutory transfers and non-statutory transfers. The former referred to the transfers on account of the assigned taxes (Basic Tax, and Surcharge on Duty on Transfer of Property) and shared taxes (Motor Vehicle Tax), while the non-statutory transfers included a host of grants (a possible 18 in the case of panchayats and a possible 10 in the case of municipalities). Now, on account of the shifting of a whole array of assets and responsibilities to the LSGIs whose operational costs have to be financed by the state government, there is an additional and significant element of transfers whose magnitude even exceeds what comes to LSGIs through shared and assigned taxes and sundry grants. An entirely new category, which had appeared only in an embryonic form at the time of the first Finance Commission has now grown to an extent where it even dwarfs what traditionally constituted "non-plan transfers". This category in turn has two distinct parts: one is listed in the budget under the Minor Head "191: Assistance to Local Bodies and Municipalities/ Municipal Corporations". We shall refer to this part as the "191 Non-Plan Transfers" (since Plan Transfers are also listed under 191). The other part consists of the amounts that are made available to the LSGIs on account of meeting the operational costs, i.e. the salaries and material input costs, on transferred assets. We shall refer to these transfers as "Operational Cost Transfers". Finally, we shall refer to the transfers on account of tax devolution and minor grants as "Tax-Cum-Minor Grants Transfers". It follows then that we are talking of four distinct kinds of "non-plan transfers": the "Tax-Cum-Minor Grants Transfers" (which were the predominant element until 1995-6), "191 Non-Plan Transfers" (which are a result of the shifting of several responsibilities to the LSGIs), "Operational Cost Transfers" (which are a result of shifting assets to LSGIs), and "Maintenance Transfers" (which we wish to bring into being).

8.2 At the time of the first Finance Commission, the transfers through these minor grants, or what the Commission had called "the non-plan, non-statutory transfers", were many in number, minuscule in amount, and divided, in addition, into general and specific purpose grants. The Commission had therefore made a number of suggestions for simplifying the system and making it more meaningful. One was to make all of them general purpose grants. The other was to ensure that the total of such transfers should constitute 1 percent of total state revenue (appropriately defined for the purpose), and should go into two pools, the rural and the urban, according to the weights of the rural and urban populations in the total population of the state. In addition, the rural pool was to have 25 percent of the Basic Tax from panchayat areas, and 25 percent of the Surcharge on Stamp Duty from panchayat areas, while the urban pool was to have 100 percent of the (newly-proposed) Basic Tax and 25 percent of the Surcharge on Stamp Duty collected from urban non-Corporation areas (the Corporations were to be simply given the taxes collected from their areas). In the event the government accepted the other suggestions but not the one relating to 1 percent of total state revenue, which essentially meant retaining the tail without the sting. It accepted the idea of the rural and urban pools, but these pools could not be nourished by 1 percent of state revenue.

8.3 Today we once again have a complex and intricate system of "Tax-Cum-Minor Grants" transfers whose complexity and intricacy is entirely unnecessary. There is a rural pool, which undoubtedly had a rationale at the time of the first Finance Commission's report, but whose rationale is much reduced after the ushering in of democratic decentralisation. It represents, besides, a rather meagre sum. To make up this meagre sum, even more meagre streams from various tax transfers have to be joined together; and their respective sizes too are determined by elaborate formulae.

8.4 This is not all. Quite apart from the question of complexity and intricacy, the whole conception of assigned taxes and shared taxes is open to question. If the financial relationship between the state government and the LSGIs is to be characterised by sharing, then it is not clear why this sharing should take the form of some particular taxes being destined for LSGIs and others for the state government, and why the revenue of only some particular taxes should be shared between the two in certain ratios. This conception, apart from its complexity and lack of rationale, is also foreign to the underlying philosophy of democratic decentralisation. This visualises not a tussle between the state government and the LSGIs, not an antagonistic relationship, but a relationship aimed at constituting a total democratic structure more meaningful than what exists now. We are talking after all of two entities, each of which has an administration headed by elected representatives of the people. The conception of success of the overall structure must be defined in terms of the degree of empowerment of the people. An important component of the index of success of institutions at one level therefore must be the degree to which they strengthen the institutions at the other level. We have to get over the mindset of visualising the problem of resource sharing between the two levels as if two self-centred, self-absorbed, hedonistic entities are squabbling over shares in a piece of cake (with the role of the Finance Commission being that of an arbitrator reconciling these conflicting claims). In short the old formulae for sharing, which meant assigning particular tax revenues to particular levels, have to be replaced.

8.5 There is an additional reason for our suggesting this. If we look into the fiscal future of Kerala, there can scarcely be any doubt that the state will have no option but to rely increasingly on taxation of the service sector. It is more than likely that such a shift would give a greater buoyancy to the tax-revenue of the state government, compared to the tax revenue of the LSGIs, if the latter continue to depend exclusively on a certain limited number of assigned taxes. An overcoming of this dichotomy will inevitably come on to the agenda. Sooner or later in other words we have to move away from the system of basing LSGI finances on a set of assigned taxes, towards one where the LSGIs and the state government share the proceeds of the entire tax revenue raised by the latter. If this be so, then we may as well move to a system of tax-sharing right from now. We are basing our recommendations on the existing set of taxes. We hope that future State Finance Commissions would take into account new taxes which may get imposed, so that the principle of total tax-sharing is continued.

8.6 The magnitudes of non-plan transfers to LSGIs which have occurred under two of the several heads, viz.191-Transfers and Tax-Minor Grant Transfers, are given in table 8.1.

Table 8.1

Non-Plan transfers to LSGIs (Rs.Crores)

	1995-6	1996-7	1997-8	1998-9	1999-00 RE	2000-1 BE
(i)Under 191	*17.1*	*151.2*	*178.0*	*229*	*236.0**	*245.2 **
(ii) Others	*87.4*	*148.8*	*160.4*	*155.8*	*199.3*	*179.7*
Of which						
a. Basic Tax	*5.25*	*14.2*	*11.6*	*16.0*	*7.0*	*7.7*
b. V.T.C.	*20.8*	*32.8*	*50.9*	*50.2*	*78.9*	*58.6*
c. Surcharge on Duty on Property Transfer	*54.3*	*83.5*	*77.9*	*75.9*	*100.0*	*100.0*

** See footnote 1.*

Source: Budget Documents

Note: Comparison across the years is problematical because of systemic changes over the period and also because figures for the last two years represent only estimates.

8.7 The category “others” in Table 8.1 comprises what we have referred to as “Tax-Cum-Minor Grants Transfers”. For the last three years, when the VRM grant was discontinued, this category consists of the following items:

(i) the three main tax sources

(ii) a grant of Rs. 8.4 crores (in 1999-00 and also in 2000-01) to District Panchayats (who got Rs. 2.3 crores) and Block Panchayats (who got Rs.6.1 crores) for meeting their revenue expenditures[1]

(iii) Rs. 3.5 crores as "Grant-in-Aid Assistance to Panchayats", and several minor grants for the maintenance of minor irrigation, water supply, railway crossing etc. which together came to Rs. 1.49 crores in 1999-00 and Rs.1.54 crores in 2000-01.

8.8 These figures exclude, as they rightly should, the expenditure on account of the state government's Panchayat administration at the state and district levels, and the expenditure on Panchayat publication and training programmes undertaken by the state government.

8.9 In view of what has been said above, we recommend that in lieu of the present arrangement of specifically assigned and shared taxes and of sundry grants, a certain proportion of the state government's own tax revenue (excluding its share in central taxes) should be set aside for transfer to the LSGIs. In the preceding chapter we have already provided for "Maintenance Transfers", i.e. non-plan assistance from the state government to the LSGIs for the maintenance of transferred assets, of old assets which were with them, and of newly constructed assets from 1997-8. While doing so the state government need not pay any VTC to the LSGIs, since the purpose of VTC and VRM was to finance maintenance expenditure for roads under the jurisdiction of the LSGIs. Now, if the state government did not have to pay VTC, then the amount of "Tax-Cum-Minor Grant

[1] . *Since this particular item also appears under the non-plan expenditure listed in Appendix 4, in order to avoid double counting we have removed it from our total of "191 Non-Plan Expenditure". For 1999-2000 and 2000-1 therefore the totals of "191 Non-plan expenditure" do not correspond to the figures available in published official statistics.*

Transfers" that it would have made available to the LSGIs during the last six years is given in Table 8.2

Table 8.2

Tax-Cum-Grants Transfers (Excluding VTC)

Year	Tax-Cum-Grants Transfers (Rs.Cr.)	State's Tax-Revenue (excluding share in Central taxes) Rs.Cr.	(ii) / (iii) %
(i)	*(ii)*	*(iii)*	*(iv)*
1995-96	*66.6*	*3383*	*1.97*
1996-97	*116.0*	*3899*	*2.98*
1997-98	*109.5*	*4501*	*2.43*
1998-99	*105.6*	*4650*	*2.27*
1999-00 (RE)	*120.4*	*5472*	*2.20*
2000-01 (BE)	*121.1*	*6440*	*1.88*

8.10 The average figure for the percentage of the state's own tax revenue transferred each year on account of taxes and minor grants comes to 2.29 percent for the entire six-year period. In fact if we leave out 2000-1, for which we have only budget estimates anyway, then the figure for the preceding two years is remarkably close to this average. It would appear then that an amount approximately equivalent to 2 ¼ percent of the state government's own tax revenue (excluding its share in central taxes) has been handed over each year, in recent years, to the LSGIs on account of tax assignments, tax sharing and the minor grants (other than through the VTC). We recommend that 2.5 percent, of the total tax revenue of the state government (excluding its share in central taxes), should henceforth be set aside for distribution to the LSGIs. On the other hand the government should retain the entire tax proceeds from those taxes which it either collects on behalf of the LSGIs or shares with them currently. The reason for our suggesting a slightly higher percentage (2.5 as opposed to 2.25) of own tax revenue for devolution to LSGIs under the head "Tax-Cum-Minor Grants Transfers" (which we wish to re-christen as "General Purpose Transfers" or "General Purpose Grant") will become clear later. But the increase is marginal. Our main concern is simply a rationalisation and simplification of the existing system.

8.11 It is more convenient however if the transfer on this score is expressed as a percentage not of the current year's tax revenue of the state government, but of the tax revenue of the latest year for which the Actuals are available (which in effect means the tax revenue two years ago), so that a precise figure appears in the current year's budget of the state government. Assuming a 16.8 percent growth rate of own tax revenue (which happens to be the "norm" prescribed by the CFC for the state), 2.5 percent of the current year's own tax revenue would amount to 3.5 percent of the own tax revenue two years ago. Our precise recommendation therefore is that *an amount equivalent to 3.5 percent of the state's tax revenue (excluding its share in central taxes) of the latest year for which certified accounts by the Accountant General are available should be transferred each year by the state government to the LSGIs in lieu of the current system of transfers of taxes and grants to them.*

8.12 The Commission's recommendations amount to a radical departure from assigning and sharing of specific taxes to sharing of revenue from all the own taxes of the State Government. Of course assigned taxes and specific shared taxes have a certain sanctity coming out of their long history and universal practice. And more importantly they are legal entitlements, which over a period of time have come to be seen as a matter of right for LSGIs enshrined as legislation and protected by it. The LSGIs have a historic as well as legal right over these sources of revenue. They have been used to it for so long that it has become an integral part not only of their fiscal system but also of their expectations of revenue. Thus any move away from this system has to be done with caution and care. Not even in the slightest way should there be any erosion in the legal entitlement of LSGIs. In fact there should be a strengthening of them. In deciding the quantum as well as in the precedure of sharing the state taxes there cannot be any discretion whatsoever; it cannot be in the nature of a grant left to the executive to decide nor can it be left even to the annual Finance Act. It has to become an unambiguous part of the Panchayat Raj and Municipal legislation, additionally safeguarded by policy commitment to allay all misgivings. There fore, when the Commission recommends a shift away from the present system of specific taxes assigned or shared to a general sharing of all taxes, there need not be any doubt or fear about the potency of the new entitlement. In fact by suggesting a general share of all taxes, the entitlements are broadened and deepened. It has the added symbolic significance suggestive of LSGIs standing shoulder to shoulder with the State Government in sharing responsibilities and revenue. It is as if the local governments have grown in importance to claim a general share of all taxes rather than just three specific taxes.

8.13 We recommend the following principle of *inter se* distribution of this amount between the different tiers of the LSGIs. The District Panchayats and the Block Panchayats, which have no sources of income as yet, rely exclusively on state government grant for their house-keeping expenditure. Since the size of the household to be kept is not uniform their share should be determined on a normative basis. The total amount earmarked for them should be set apart and distributed among them according to their genuine requirments which should be determined on the basis of prescribed norms. The share of Municipalities, Corporations, and Village Panchayats, each taken as a group, should in principle be fixed at the levels which have been observed in recent years. There is however an important additional consideration, namely, the significant boundary changes that have taken place of late. Two new Corporations, Kollam and Thrissur, have been created out of Municipalities, with the addition of certain Panchayats. Likewise the Thiruvananthapuram Corporation has been expanded with the addition of certain Panchayats. And there have been other changes involving the incorporation of Panchayat areas into Municipalities. In view of these changes, the distribution of the General Purpose Grant across tiers can no longer conform to the historically observed shares; suitable adjustments have to be made. Taking this fact into account we recommend the following distribution of the General Purpose Grant across tiers[2], after setting apart the share of District and Block Panchayats.

Table 8.3

Proposed Distribution of General Purpose Grant Between Tiers

Tier	Share in Total (%)
Grama Panchayats	*78.5*
Municipalities	*8.5*
Corporations	*13.0*

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2. The basis of these calculations should be clarified. Since each of these tiers would be getting a separate grant for the maintenance of their old assets and transferred assets, there would be no need to transfer VTC to them any longer. As far as the Municipalities and Corporations are concerned, they get very little government (non-tax) grants of the sort that Panchayats get. The first Finance Commission had recommended that urban local bodies too should be eligible for Basic Tax Grants which should then be put into the urban pool. Though this suggestion was accepted by the government, appropriate legislation is in the process of being enacted, so that no actual Basic Tax has yet accrued to the urban LSGIs either directly or indirectly (via the urban pool). Likewise since the urban pool has not yet taken shape, the deduction of 25 percent of the Surcharge on Stamp Duty in urban areas, which is supposed to go into this pool, has not yet taken place. It follows that for the urban LSGIs, once VTC is excluded, the surcharge on stamp duty coming their way is the sole form of "Tax-Cum-Minor Grants Transfer". The budgetary allocations on this score, as a proportion of the total "Tax-Cum-Minor Grants Transfers" excluding VTC, were on average about 18 percent over the period since 1997-8, and these were approximately evenly divided between Municipalities and Corporations. The observed shares of the different tiers obtained on this basis are then adjusted to take account of the boundary changes to give us the figures of table 8.3.

8.14 As regards the *inter se* distribution among tiers, GPs, Municipalities and Corporations, our recommendation is the following. For Municipalities and Corporations the *inter se* distribution should be entirely on the basis of population. As regards Grama Panchayats, out of the total amount earmarked, Rs.10 crores should go towards filling the deficits of certain poor GPs in meeting establishment expenses (as is the practice now). The remainder should be distributed on the basis of population. For District and Block Panchayats, they may be grouped, based on requirements, and allocations made on normative basis, including expenditure ceilings for certain categories like telephone charges, P.O.L, travelling allowance and extraordinary items.

8.15 The really novel element in our recommendations in this chapter is the proposal that the *inter se* distribution, within the group of Grama Panchayats, to the individual Panchayats should be on the basis of population; and the same principle should be adopted for Municipalities and Corporations. At present, 75 percent of the basic tax collected in the Panchayat areas is distributed according to where it is collected from, and only 25 percent goes into the rural pool from which the criteria of distribution are in keeping with certain specified norms. The entire surcharge on stamp duty collected from urban areas is distributed according to where it is collected from (since the urban pool into which 25 percent of it should go, has not yet come into existence). And the distribution of VTC is supposed in principle to be in keeping with maintenance needs. The tax revenues transferred for non-maintenance purposes at present are therefore distributed, to a significant extent, on the criterion of place of collection. The shift to population as the basis of distribution marks a radical departure. This shift can be justified as follows. Once we move away from the notion of “assigned taxes”, the criterion of place of collection ceases to be relevant. True we could still mimic that criterion (as we have implicitly done in fixing the share of

Corporations and Municipalities), but the only justification for doing so would to avoid any sudden financial hardships to any particular local bodies, such as a sudden shift to a different criterion of distribution would entail. But this is an argument of pragmatism not of principle. If the pragmatic concerns could be taken care of in some other way, then we could move to some alternative criterion which is more reasonable in principle. Since plan assistance which constitutes the bulk of the transfers is already being distributed according to a set of complex and carefully-worked out norms, population is the obvious simple basis for distributing the "General Purpose Transfers".

8.16 But the move to this simple criterion may create hardships for particular LSGIs in the transitional period. They may suddenly find themselves with reduced incomes. True, they are getting substantial plan assistance and would be getting, on our recommendations, a significant amount of funds for the maintenance of assets. It may therefore be thought that a certain transitional reduction in incomes should not be a cause for concern. But precisely because we are of the view that maintenance grants should not be used indiscriminately for other purposes, and that plan funds should not be used for current expenditure needs, we feel it necessary to ensure that no income fall occurs in the period of transition; otherwise we would be condoning, indeed encouraging, financial impropriety. It is for obviating any such hardships that we have recommended a small rise in the proportion of "Tax-Cum-Minor Grant Transfers" (excluding VTC), now christened "General Purpose Transfers", from its current figure of about 2 ¼ percent of the state's own tax revenue to 2 ½ percent. This extra ¼ percent would come to about Rs.15 crores (out of a total own tax revenue estimate of Rs.6440 crores) in 2000-1, but it would result in a streamlining and simplification of the system in a relatively painless manner, in the sense that no individual LSGI would experience an *absolute* shortfall in its receipts on account of these transfers.

8.17 One consequence of our recommendations is that the rural and the urban pools would have to go. In fact they would no longer be necessary. The rationale of having the rural and the urban pools was precisely to provide some relief from the relentless logic of the "place of collection" criterion in distributing these tax transfers. Many LSGIs, from whose territorial jurisdiction not much tax could be collected, required succour, and the pools were meant to provide such succour. By providing for these pools, the first Finance Commission had already taken a few steps away from the "place of collection" criterion which in turn derives from the logic of "assigned taxes". We have only taken that movement to its logical conclusion. Of course, a certain practical awkwardness is introduced in the process. Several legislations to give effect to the recommendations of the first Finance Commission have already been enacted or are in the process of being enacted. Our recommendations being introduced at this stage would make many of these legislations irrelevant, unnecessary or infructuous. But the awkwardness here is in part an inevitable product of the inordinately long time-lags with which Finance Commission's recommendations are implemented, and in part a result of the peculiarity of any period of transition, such as what characterises the process of decentralisation in Kerala. Many things have happened between the first Finance Commission and the second, and in taking cognisance of these our report necessarily has to differ qualitatively in many spheres from that of the first Commission. But once this remarkable period of transition is over, subsequent Finance Commissions can build on their predecessors' reports to a greater extent (and thus provide greater continuity) than we have been able to do.

8.18 We now come to the question of "191 Non-Plan Transfers" which is yet another component of "Non-Plan, Non-Maintenance Transfers". An idea of what this component covers can be had from Table 8.4 which gives information on the budgeted expenditure for 2000-1 on some important items under this head.

Table 8.4

Some Important Items of 191 Non-Plan expenditure 2000-1

Item	Expenditure (Rs.Crores)
1. Special Pension Scheme for Physically And Mentally-handicapped	*13.97*
2 Destitute Pension	*19.78*
3 Agricultural Workers' Pension	*37.20*
4 Old Age Pension	*3.07*
5 Mid-day Meals	*29.50*
6 Unemployment Allowance	*70.00*
7 Flood Damage Repairs, Renewal of Communications, Special repair to Communications etc	*23.25*
8 Medical materials and Supplies	*8.40*
9 Production Incentive to Paddy-Growers	*10.00*
10 Assistance to BPs and DPs	*8.40*
Total of these items	*223.57*
Total 191 Non-Plan	*253.63*

8.19 Clearly the bulk of the 191 non-plan transfers consists of social expenditure of different kinds, for which the responsibility has now been shifted to the LSGIs. These, with the sole exception of the "Assistance to BPs and DPs" (for whom we have made alternative provisions), should continue exactly as before. We refrain from making any recommendations regarding the minimum provisions on these heads, though the stipulation of such a minimum is essential to take account of both inflation and the inevitable increase in the number of intended beneficiaries, in the belief that the pressure of public opinion would automatically enforce such a minimum.

8.20 The "Operating Cost Transfers", as mentioned earlier, have two components: the payment of salaries to the staff employed on assets transferred to LSGIs, and the provision of current inputs, e.g. medicines, books and consumables in schools, electricity and water charges, rent, telephone charges etc., for the transferred assets. The salaries, for reasons discussed in paras 2.9 and 2.10, must continue to be paid by the state government; we do not wish to change the current system in any way. As regards the transfers for current inputs there are at least three separate problems with the present system: first, in the health and education sectors, the transfers to a significant extent are made in kind rather than in cash, which introduces inflexibility into the system (and hence irrationality of the sort where there may be too much of one kind of medicine and too little of another). Secondly, even apart from such micro-level disproportionality, the very fact of having to depend on a distant entity, namely the state government department, for supplies, introduces inflexibility into the system which is undesirable. Thirdly, since in a whole range of other sectors, the transfers, though they may not be in kind, are many but minuscule, the system has a cumbersomeness which is avoidable. Having said all this however we also recognise that messing about with a system which is already in place and working with some degree of success, is always a risky affair. Besides, the transfers in kind, in the health sector at least, have some rationale in terms of the advantages of bulk purchase, and of providing a centralised direction and thrust to the public healthcare system. There is also a danger in allowing the state government to wash its hands completely of vital social sectors like education and health by entrusting the task of purchasing current inputs entirely to the LSGIs. Taking all these considerations into account, we recommend the following with regard to "Operating Cost Transfers": *first, the state government should continue to provide for medicines and books and consumables in schools exactly the way it has been doing till now; secondly, the LSGIs should be permitted to make extra purchases of medicines and books and consumables which they may consider necessary at any point of time; thirdly, the state government should be absolved from the responsibility of meeting all other current costs such as telephone, electricity and water charges, vehicle operating costs and rents in these two sectors as well as and in other sectors, and for these costs the LSGIs should make their own provisions; fourthly, these provisions and the extra expenditure on health and education materials, can be financed, upto a ceiling of 10 percent, from the "Maintenance Transfers" made available to the LSGIs.*

8.21 These recommendations have the virtue of introducing a degree of flexibility into the system at the margin while retaining its basic existing structure. They also reduce its cumbersomeness by absolving the state government from the responsibility of having to meet current costs in a whole range of sectors, a move which has the additional merit of providing it slight fiscal relief. Above all however our recommendations are designed to anticipate a problem that is likely to arise in the future, which has to do with the operational expenditure on assets that the LSGIs would be constructing out of their enhanced plan assistance. Until now the newly-constructed assets of the LSGIs have generally not been of a kind that requires any large-scale operational expenditure. But this is going to change in the coming years. At that point not only would some provision have to be made for such expenditures, but steps taken to ensure that the LSGIs' demand on this score does not become too heavy: this would require some constraints on their choice of assets and some fixing of norms to avoid profligacy in operational expenses for any given choice of assets. An alternative course, more in tune with democratic decentralisation, might be to have a certain sum, earmarked for operational expenditures and arrived at according to certain macro norms, distributed among the LSGIs in the same ratio as plan assistance. The LSGIs can then be left free to choose their assets, i.e. make their plans, keeping *two* budget constraints (in the sense of state government assistance) in mind, one relating to plan assistance, and the other relating to operational assistance. (Needless to say, they can use their own funds to spend in excess of these constraints). These issues of course are not of great immediate concern: in the next five years, which constitute our time-horizon, the LSGIs are likely to continue emphasising the construction of those assets, e.g. roads, bridges, houses etc., which do not require any significant operational expenditures (as distinct from maintenance for which we have made provisions); it is only future Finance Commissions that would be exercised over such issues. Nonetheless we have opened a window towards a possible "two-constraints" solution by allowing LSGIs (for the time being) to spend up to 10 percent of the Maintenance Transfers for meeting operational costs. Since Maintenance Transfers are to constitute approximately 4 percent of the state government's own tax revenue in any year (which we have translated as 5.5 percent of the state government's own tax revenue two years ago), we are implicitly putting in place a system where a certain percentage of the state government's current own tax revenue (0.4 in this case) is transferred to LSGIs for meeting their operational costs. Future Finance Commissions may well consider building on this foundation while changing the ratios in question.

CHAPTER 9

ENHANCING OWN REVENUES OF LSGIs

9.1 As of now, only the Village Panchayats and the ULBs have the power to levy taxes, fees and fines. Though, theoretically Block and District Panchayats can realize user charges, donations and contributions, the scope for raising any significant amount from these sources is rather limited now. The Commission is not recommending any additional sources of revenue for these LSGIs now.

9.2 However there is every reason to improve the revenue-raising capacity of the Village Panchayats and ULBs, for own income gives full freedom of use. In order to improve civic services, an obligatory function of these LSGIs, own funds are essential. Also own funds could be used to take up innovative programmes, which may not be possible under Plan guidelines.

9.3 A peculiar feature of the local government legislation of Kerala is that there is a striking similarity between the Kerala Panchayat Raj Act 1994 and the Kerala Municipality Act 1994. In fact after the fundamental amendments made in 1999, there is hardly any difference between the two Acts. This is true of financial matters relating to the urban and rural local governments. Therefore the State Finance Commission would be making recommendations common to both urban and rural LSGIs, and in those special cases, which relate only to urban or rural LSGIs, they will be suitably denoted. The recommendations are arranged in the same order as the description of the sources of own revenue in Chapter3.

9.4 TAX REVENUE

9.4.1 (1) **Property Tax:** With the change over of Property Tax assessment from rental value calculation to plinth area based assessment, it is expected that instances of under-assessment and corruption in assessment would be reduced considerably. Empirical studies are being done to determine the rates, factor values and suitable methodology of assessment; which would then be issued in the form of rules. The Commission would recommend a transparent system of self-assessment with a proviso that for concealing or under-reporting of plinth area, there should be a penal provision to collect tax at ten times the normal rate. This penal provision should be equally applicable to any misreporting by verifying or inspecting authorities even if detected later by a supervisory or vigilance authority.

9.4.1.1 The Commission would urge the Government to complete the switch over to the new system latest by 1st June 2001. Early action is warranted because of the fact that new LSGIs have just assumed office and at this point of time they would have the moral authority to take difficult decisions regarding tax assessment. The Commission would suggest the following scheme for classifying buildings and fixing the tax.

(a) Zone – Four zones based on location.

(b) Type of Building

(1) Ordinary Building.

(2) Medium Type Building.

(3) Luxury Building

(c) Type of use

(1) Commercial

(2) Non-commercial

(d) The relative weights for Zones could be 1, 1.5, 2, 2.5.

(e) The relative weights for the types of building could be 1:1.5:2

(f) Relative weights between non-commercial and commercial use could be in the ratio 1: 3.

(g) The deductions for age and owner occupation may be as provided for in the Kerala Municipality Act.

9.4.1.2 It is possible that when the changeover happens some of the existing under-assessed buildings would have to pay taxes several times the existing amounts. It is also possible that a few of the buildings would have to pay much less tax than at present. The Commission would strongly recommend that on no account should there be a cap on increases or limit to decreases in respect of any building, for what is due as per law has to be paid. Past failures in assessment cannot be legitimatized when a new system is designed. In order to avoid unnecessary and ill-informed criticism, it is suggested that massive publicity campaign be initiated immediately, pointing out the virtues of a simplified taxation system, which would free the citizen from dependence on the mercies of the taxing and appellate authorities.

9.4.1.3 It has been brought to the notice of SFC that, in some cases at least, owners of buildings under construction approach the assessing authority immediately after the skeleton of the building is complete and seek to get a door number in order to apply for electricity and water connections which would be helpful in carrying out the remaining part of the construction. Assessing an incomplete building would naturally lead to under-assessment and there is no way of tracking its completion. Therefore it is recommended that a dual system of numbering be resorted to. In such cases, a provisional number would be given to a partially completed building and a final number would be given to only the fully completed building. There should be a system to monitor final assessment of buildings having provisional numbers.

9.4.2 **(2)** **Profession Tax**. As regards Profession Tax, the Commission strongly endorses the recommendation of the Eleventh Finance Commission to raise the ceiling on the tax even while removing it from the Constitution and making it part of a Central Legislation. Discussions with elected representatives and officials have convinced the Commission that there is tremendous scope for extending the coverage of Profession Tax even within existing constraints. It is noticed that other than the salaried class who are working in the public or private sectors, self-employed groups like professionals and traders are very rarely taxed. In this connection the Commission recommends introduction of a presumptive Profession Tax for certain occupations as detailed in Annexure 9.1

9.4.2.1 The Commission would like to reiterate the recommendation made by the First SFC to have a tax mapping system. This may be done immediately in about ten Village Panchayats, five Municipalities and one Corporation and then later expanded to cover all local governments.

9.4.3 **(3) Entertainment Tax**. Here again, the Commission would reiterate the recommendation of the First SFC to go in for tax assessment on the basis of seating capacity and occupancy ratio. Detailed suggestions on the assessment procedure would be given in the second part of the Report after conducting a quick field study and after evaluating the systems prevalent in Tamil Nadu and Andhra Pradesh.

9.4.3.1 In the meanwhile the Commission would suggest implementation of the recommendation of the First SFC to make Cable TV liable for Entertainment Tax and also to bring Internet Services within the definition of entertainment.

9.4.4 **(4) Advertisement Tax.** The Commission feels that there is much scope for collection of Advertisement Tax in a state like Kerala where marketing of consumer goods is quite widespread even in rural areas. But the collection figures show that this source of tax is not even partially tapped by the LSGIs. The Commission recommends the following:

(i) Government may fix the minimum rate of taxation for different types of advertisement for different locations.

(ii) Advertisement Tax Rules may be issued by Government setting out the guidelines for the LSGIs to assess the tax.

(iii) Penal provisions for 'escaped tax' should be at least five times the normal tax.

Show Tax

The unified Show Tax may be revised as follows:

	Minimum Tax (in Rupees)	
	Panchayat	ULB
1) Regular cinematograph exhibitions at licenced theatres	*15/-*	*25/-*
2) Other cinematograph exhibitions	*30/-*	*40/-*
3) Regular shows other than cinemas.	*30/-*	*40/-*
4) Other exhibitions	*75/-*	*100/-*

There should be a system of authenticating advertisement by the LSGIs so that unauthorised advertisements can easily be detected.

9.4.5 **(5)** **Land Conversion Tax.** Conversion of land use imposes additional burden on LSGIs, which have to provide civic services and other basic amenities. Therefore the Commission recommends expansion of the existing Conversion Cess into a Land Conversion Tax. For the purposes of this tax conversion may be defined as change of land use from agriculture to non-agriculture, which would include conversion for the purpose of house plots, building construction etc.

9.4.5.1 It is recommended that Conversion Tax, which is essentially a one-time charge, may be collected on the capital value of the land converted as indicated by the minimum value to be fixed by the Government. (Till such time the minimum value is notified, the valuation may be got done by the Tahsildars). In the case of authorised conversion of paddy fields as per provisions of the Kerala Land Utilisation Order five percent of the capital value may be realized as Conversion Tax. However, exemption from the Land Conversion Tax may be given if the extent of paddy land converted is five cents or less and the building put up is less than 50 sq. metres in area. If no building is put up within six months of the conversion, then no exemption need be given.

9.4.5.2 In respect of other kinds of conversion the tax may be fixed as two and a half percent of the capital value with the same kind of exemption as suggested for conversion of paddy land.

9.4.6 **(6) Service Tax.** At present the tax is optional for Village Panchayats and it is an integral part of the Property Tax in the case of ULBs. In the context of decentralisation, which enjoins LSGIs to perform certain functions declared as mandatory. Service Tax should be made compulsory and made an independent tax. It could be assessed as a percentage of the Property Tax linked to the recurring cost of performing the mandatory functions.

9.4.7 **(7) Surcharges.** As per Section 208 of the Kerala Panchayat Raj Act and as per Section 230 of the Kerala Municipality Act, Village Panchayats and ULBs are permitted to levy surcharges on Property Tax. Now the upper limit is statutorily fixed as 5% for Village Panchayats and 10 % for ULBs. Since the surcharge is to be specifically used for taking up new development projects, it is felt that the ceiling may be removed and the LSGIs be given the freedom to decide the percentage which can be varied every year as decided by them to meet the cost of the selected new projects.

9.5 NON-TAX REVENUE

9.5.1 The major items of non-tax revenue in the case of Village Panchayats and ULBs have been described in Chapter 3.

9.5.2 Non-tax Revenue constitutes 51 percentage of the total own collected revenue of Village Panchayats, 42.62 percentage, in the case of Municipalities 24.39 percentage, in the case of Corporations. (Own revenue here means, own revenue less assigned and shared taxes and grants-in-aid) It is an important source and it needs to be enhanced.

9.5.3 The main issues related to the collection of Non-tax Revenue are:

(1) In the case of ULBs, most of the Non-tax Revenue rates have to be determined by themselves. This is as per Section 492 of the Kerala Municipality Act. Due to inexperience, lack of awareness and weak political will, these rates do not often get fixed and even if they are fixed they are pegged at very low levels, for the Municipality Act or Rules do not fix a minimum or maximum. Another problem is that once fixed these items are rarely revised.

(2) The problem in the case of Village Panchayats is the reverse one. Here in most cases the rates are fixed in Rules either as minimum or maximum or by giving a range between the minimum and maximum. Since Rules are notified after receiving proposals from the Director of Panchayats, examining them in the Local Self Government Department and Law Department and sending them for the views of the Subject Committee and finally gazetting them, amendment to rules is a cumbersome process and

most of the rates do not get revised. This issue was pointed out by the First SFC, but solutions have not been fully found.

(3) As regards auctions, which fetch good amounts, particularly in the case of river sand, gate fees in public markets and usufructs from local government properties, the auctioning process is often not very transparent, resulting in poor competition. In most of the cases the same person bids during successive years and develops a permanent interest which is difficult to dislodge due to practical and humanitarian considerations like efficiency of operation, labour security, etc. Thus a kind of monopoly develops.

(4) As far as rent is concerned, in spite of Government instructions, the fixing of rent amount is not very rational and does not appear to have any relation to the market rent or the investment made. A Government circular capping annual increase of rent at 5 percentage has further compounded the problem. Similarly, fixing of rent for temporary occupation is also found to be unrealistically low.

(5) There is a general unwillingness on the part of LSGIs to collect user charges or service charges even to the extent of the amount required for routine operation and maintenance. This affects the sustainability of various services.

(6) Since LSGIs are very close to the people, there is a natural limitation in imposing penalties and fines. Even if, for the sake of deterrence, prosecution is to be resorted to, it is not done due to the cumbersome litigation process,

which would take away a lot of valuable time from senior officials of the LSGIs. This causes laxity in collection of dues.

9.5.4 Against this background the general recommendations of the Second SFC are spelt out as follows:

(i) In the case of ULBs, the Government should take up the responsibility of fixing the minimum fees for various kinds of licences. This could be done through notifications. Similarly, in the case of Village Panchayats, the Rules may be amended to ensure that only the minimum is fixed; but the minimum should be fixed in such a way that it is a reasonable one because it is noted that LSGIs tend to take the minimum as the general rate.

(ii) As far as possible the fees, rents etc., are to be indexed to take care of inflation. Necessary enabling provisions have to be made in the Kerala Panchayat Raj Act and the Kerala Municipality Act to allow for automatic two-yearly increases based on a general government notification.

(iii) In the case of Licences and Permits, which need to be renewed deterrent penal provisions have to be incorporated for delayed renewal. It is suggested that after a period of grace of ten days, 25 percentage of the Licence Fee may be collected as fine for delayed payment. This has to be increased by 25% for every further fortnight of delay.

(iv) Wherever auctions are held there should be transparent procedures. The Panchayats and the Municipalities should disclose the various items which are given by auction, the likely time of auction and the amount received during the previous years, during Grama Sabha, Ward Sabha and Ward Committee meetings. There must be a compulsory display by all LSGIs indicating the various items, which are auctioned, the name of the successful bidder and the amount. This should be permanently exhibited at the site like the sand mining place, market, slaughterhouse, shop building etc. This transparency provision should be enshrined in the Kerala Panchayat Raj Act and the Kerala Municipality Act and detailed rules issued.

(v) It is recommended that every year before the end of December all the Village Panchayats should inform the Deputy Director of Panchayats the auctions, which they have to conduct in the coming three months. This should be advertised in at least three newspapers having largest circulation in the district as a general advertisement. As far as ULBs are concerned this advertisement could be given for a group of ULBs in every district. The Joint Director of Municipalities could facilitate this.

9.5.5 In addition to these general recommendations, the Commission recommends enhancement and modifications in the following categories of non-tax revenue.

9.6 *LICENCE FEES*

9.6.1 **Trade Licences.** In the case of Village Panchayats licensing of trades is done as per the Kerala Panchayat Raj D & O Trades Rules. These rules as of now fix the maximum fees related to turnover. It is suggested that instead of this, minimum fees alone be fixed by Government. This may be converted into flat rates based on the size of the trade as in the case of ULBs, with separate rates for large, medium and small sizes.

9.6.1.1 In urban areas it is the local government, which set the rates under Section 492 (5) of the Kerala Municipality Act. The analysis made by the Commission shows that most of the ULBs have fixed relatively low rates and have been tardy in revising them. Since revision does not take place for very long periods of time it acts as an inhibitor when a Municipality wants a change, as these revisions after long intervals would invite protest due to the inevitable steep increases. The Commission would recommend that the minimum rates alone should be fixed by the Government through notification. In ULBs, since milk trade can be licensed under Section 447 there is no need to retain Section 456.

9.6.1.2 The rationale for shifting to trade-wise notification in the case of Village Panchayats is the difficulties encountered in assessing turnover of trades, which have resulted in gross under-assessment. A three-fold broad classification conforming to manufacturers, wholesalers and big retailers as Group A, medium-sized trades as Group B and small retailers as Group C is suggested. This classification has to be made by LSGIs themselves based on transparent criteria relating to nature of activity, size/ volume of activity, location, investment, etc.

9.6.1.3 Under Section 448 of the Kerala Municipality Act, rules were issued in 1966 viz. ‘Construction or Establishment of Factories and Installation of Plants or Machinery Rules’. But the rates have not been revised for nearly three and a half decades.

9.6.1.4 The existing rates and the suggested rates for each kind of trade including factories, plants and machinery are given separately for Village Panchayats and ULBs in Annexure 9.2.

9.6.1.5 In order to get a clear idea of the trade establishments functioning within a local government area, to keep track of renewal of licences, to serve as a guide for assessment of profession tax and to help in the discharge of other local government obligatory functions it is suggested that a separate numbering system should be adopted for trade establishments. This would be in addition to the building number assigned for Property Tax assessment. Every year the new establishments should be given supplementary numbers before the first of March.

9.6.2 **Theatre Licence.** Theatre construction and installation of machinery are governed by the Kerala Cinema Regulation Rules. It is recommended that the rates be brought on a par with those given in Kerala Building Rules 1996. The existing and revised rates are shown in Annexure 9.3.

9.6.3 **Private Market licence.** Licence fees for private markets may be revised as indicated in Annexure 9.4 Departing from past practice it is recommended that the minimum rates be set and for renewal of licence either the license fee or one-third the gate collection of the previous year whichever is higher could be fixed.

9.6.4 **Licences under Kerala Places of Public Resort Act.** The fees for these licences issued under Rule 28 may be revised and the minimum rates be fixed as indicated in Annexure9.5.

9.6.5 **Private Slaughterhouse.** These are regulated under Section 230 of the Kerala Panchayat Raj Act and Section 453 of the Kerala Municipality Act. The licence fees may be enhanced from the existing rate of Rs.300/- to Rs.1,000/- per year and for renewal it can be based on one-third the gate collection of the previous year or Rs.1,000/- whichever is higher.

9.6.6 **Licence fee for Brokers, Commission Agents, Weigh men, Measurers etc.** Licence fee is fixed as per the provisions of Rule 13 of the Kerala Panchayat Raj Public and Private Market Rules issued under Section 221 and Section 222 of the Kerala Panchayat Raj Act and Section 458 (2)(e) of the Kerala Municipality Act. It is suggested that the minimum licence fee should be fixed as Rs.100/- per year.

9.6.7 **Licensing of premises where animals are kept for commercial purposes.** These licences are issued as per Section 444 of the Kerala Municipality Act. The minimum suggested rates are given in Annexure 9.6. Similar provision for licensing may be made in the Kerala Panchayat Raj Act and the same rates may be made applicable.

9.6.8 **Licensing of Butchers, Fishmongers, Poulterers etc.** This is done under Section 469 of the Kerala Municipality Act. It is suggested that the minimum license fee for butchers may be fixed at Rs.100/- per year, Fishmongers at Rs.50/- per year and Poulterers at Rs.30/- per year. The same rates may be made applicable to Village Panchayats also by including them in the D & O Trade Rules.

9.7 *GATE FEES*

9.7.1 **Market Fee.** The various fees for using public markets may be increased as given in Annexure 9.7.

9.7.2 **Public Halting and Parking Places.** Fees for the use of public halting and parking places is levied as per Section 227 of the Kerala Panchayat Raj Act and Section 472(1) of the Kerala Municipality Act. Minimum rates may be fixed both for Municipalities and Panchayats as given in Annexure 9.8.

9.7.3 **Slaughterhouses.** Entry fees to slaughter houses are collected as per Section 229 of the Kerala Panchayat Raj Act and

Section 452 of the Kerala Municipality Act. The rates may be revised as suggested in Annexure 9.9.

9.8 *AUCTIONING OF MEAT STALLS / RIGHT TO FISH IN WATER BODIES etc.*

These may be auctioned every year by the concerned LSGIs after giving adequate publicity.

9.9 *SERVICE AND USER CHARGES*

LSGIs must broaden and deepen their collection of service/user charges. A list needs to be made of all services provided and utilities maintained by LSGIs with the cost of providing/running them. A policy decision may be taken by each Village Panchayat or ULB on the proportion of the cost to be realized from the users. Thereafter the users may be classified, and the rates for each class of users determined. As a rule of thumb full cost may be realized from commercial concerns and exemption need be given only to the families below the poverty line. It is suggested that service charges should be collected compulsorily from users of burial grounds, burning ghats and electric crematoria, which are maintained by the LSGIs. In the case of electric crematoria the fee should be fixed to meet the operation and maintenance cost of the machinery.

9.10 *FINES AND PENALTIES*

The data available with the Commission show that realization by way of fines and penalties is extremely low. Of course at the local government level it would be rather difficult to exercise regulatory powers with an iron hand. However in certain cases of public nuisance like pollution, strewing of solid waste, occupation of public land etc., in the larger public interest, it is necessary to be as strict as possible through realization of fines and even prosecution.

9.10.1 It is seen that there is a discrepancy between the Compounding of Offences Rules applicable in Village Panchayats and those applicable in Municipal bodies. It is suggested that the same provisions applicable to the ULBs could be included in Village Panchayat Rules also. This will bring larger number of offences within the compounding powers of the Secretary enabling immediate punitive action to be taken.

9.11 *GROUND RENT FOR FAIRS AND FESTIVALS*

Now there is a practice in ULBs to auction right to set up temporary shops etc. in porambokes as per Section 376 of the Kerala Municipality Act. It is suggested that a similar practice be followed in Village Panchayats also.

CHAPTER 10

STATE FINANCES DURING THE DECADE 1990-2000

10.1 Our Commission has been guided by two major considerations while analysing the State Finances. Firstly, the issue that we have addressed is whether the state finances are in a position to accommodate the scale of transfers that we have suggested in our recommendations. Secondly, we have also examined whether there are significant pointers that we need to highlight on the evolving trends in the overall financial position. This becomes necessary because such movements accumulate to impinge on delivery of services to the people of the State and thus affect the LSGIs directly. In this process we would also like to capture broadly what the current trends reflected by the figures mean for the future development of the State, with reference particularly to the expenditure on maintenance services on assets, whose benefits directly accrue to the poor. A snapshot of expenditure and receipts figures, be it on the revenue or capital side, at the end of a particular year, will not serve the requirements of such an examination. To facilitate this discussion on the finances of the State Government, an analysis of the trends of a reasonably long period becomes necessary.

10.2 We feel that for three reasons, the decade of the nineties would afford a sufficiently long enough spectrum for the analysis. Firstly, data from this decade can be expected to capture the years when the world saw liberalisation and globalisation characterising international economies in general. Secondly, given the fact that trends in the nineties continue to firm up in various economies of the world as is reflected by subsequent developments, data from the nineties may broadly reflect the shape of things at least in the short term, and expectedly, for the starkly rising internal debt and interest payment liabilities on the borrowing State. The resource base of States is far too limited to meet growing expenditure commitments. State Governments account for a third of the combined receipts of the Union and the States, while they incur three quarters of the entire social service expenditure and half the economic service expenditure. Tax receipts in the States have exhibited a certain degree of rigidity during the nineties as compared to the eighties. States' tax base has remained narrow with greater dependence on sales tax in particular. States' own tax revenue receipts finance only 32-34 per cent of the total expenditure. Losses of the State Public Sector Undertakings (particularly the Electricity Boards and the Road Transport Corporations) have also contributed to the pressure on State Finances. Resource gaps are financed by vertical resource devolution from the Centre apart from direct borrowings by the State Government and its Public Sector Undertakings. The fiscal consolidation measures initiated by the Union Government since the early nineties have also had their effect on state finances. There has been a definite falling trend in the resource transfer from Central Governments particularly in the form of loans and advances to States. In the last two decades, debt-SDP ratio of States rose from an average level of 17.6 per cent in the eighties to 19.4 per cent in the nineties. Gross Fiscal Deficit and Revenue Deficit of States have recorded all time high levels of 4.3 per cent and 2.3 per cent of their State Domestic Product respectively. The additional expenditure arising out of implementation of the revised pay scales of the State Government Employees in 1996-97 continues to affect the deficit levels of most State Governments. The gross expenditure of the States in 1998-99 peaked at an annual growth rate of 22.4 per cent while the average decadal growth rates for the eighties and nineties have been of the order of 15 per cent only. Development expenditure accounted for 70.7 per cent of the total expenditure in the eighties. This fell to 65.4 per cent during the nineties. The high level of debt of all the State Governments put together raises questions about its sustainability, especially since its utilisation for capital investment is declining.

trend of (-) 14.00 per cent in total transfers. This is explained by the fact that the increase in 1997-98 was on account of the share of proceeds to the State from the earnings of Government of India under the Voluntary Disclosure Scheme (VDIS) – which was an isolated and one time revenue enhancing measure.

10.8 Overall, the own tax revenue of the State (OTR), reckoned as the sum of the tax and non-tax revenues of the State Government excluding all transfers from Government of India have grown annually at 15.78 per cent over the decade. The sharp dip in both tax revenue and non-tax revenue in 1998-99, mentioned earlier, is reflected in the low growth rate of 3.05 per cent in OTR for that year.

REVENUE EXPENDITURE

10.9 Revenue expenditure has been growing at a steep rate of 16.82 per cent per annum over the nineties. The Pay Revision granted by Government for its employees in 1997-98 led to a sharp spurt with expenditure registering a sudden jump of 21.4 per cent. Revenue expenditure in the year 1999-2000 increased by 24 per cent. Increase in the salary bill accounted for the major share of the increase in 1997-98. In 1999-2000, the increases in non-plan expenditure on account of interest payment (34.99 per cent), pension (56.65 per cent), police (38.35 per cent) and education (33.51 per cent) accounted for the high increase in revenue expenditure.

10.10 Table 10.1 below shows the salary, interest and pension components of the State for the period 1991-1999. An average of 60-65 per cent of the Revenue Expenditure of the State is devoted to meeting interest payments and paying the employees both serving and retired. Here, we would like to sound a note of caution. The State's bill on salary, interest and pension has assumed a level, which does not bode well for the future spending plans of Government. We have in detailing our approach observed that the State, as demanded by prudent fiscal

REVENUE DEFICIT

10.11 The excess of revenue expenditure over revenue receipts, which is the revenue deficit, is a good first measure of how well a Government is able to manage its finances. It is instructive to appreciate the behaviour of the revenue deficit of a State from year to year. For any given year, let the revenue expenditure, revenue receipts and revenue deficit be denoted by E_t, R_t and D_t respectively. Let the growth in revenue receipts and revenue expenditure for the next year be denoted by g^r_{t+1} and g^e_{t+1} respectively. The Revenue Deficit in the next year D_{t+1} will be given by

Revenue Deficit = Revenue Expenditure - Revenue Receipts

$$D_{t+1} = E_{t+1} - R_{t+1}$$

Hence

$$\begin{aligned} D_{t+1} &= (E_t)\,(1 + g^e_{t+1}) - R_t\,(1 + g^r_{t+1}) \\ &= (R_t + D_t)\,(1 + g^e_{t+1}) - R_t\,(1 + g^r_{t+1}) \\ &= R_t(g^e_{t+1} - g^r_{t+1}) + D_t\,(1 + g^e_{t+1}) \end{aligned}$$

10.12 The first component $R_t(g^e_{t+1} - g^r_{t+1})$ shows the effect of the revenue mobilisation *relative* to growth in expenditure. If the growth in revenue g^r_{t+1} equals the growth in expenditure g^e_{t+1} then this component would become zero and hence there is no contribution to the revenue deficit. If the growth in revenue g^r_{t+1} exceeds the growth in expenditure g^e_{t+1}, this would contribute towards decreasing the revenue deficit. Thus an improvement in this component can result from either a reduction in expenditure or a growth in revenue. Hence this may be referred to as the relative efficiency component.

10.13 Given the deficit D_t in any year, the second component $D_t(1 + g^e_{t+1})$ solely depends on the growth in expenditure. If the growth rate g^e_{t+1} can be controlled then this component of revenue deficit can be managed. Hence this component may be referred to as the expenditure component of revenue deficit. Reductions in expenditure growth g^e_{t+1}, directly result in reductions of this component. Table 10.2 shows these components for the ten years 1990-2000.

during this period. There seems to be an incongruity in this and we fail to understand how revenue mobilisation and economic growth could exhibit this kind of a divergence in their growth trends. But, suffice it for us to say, that if there has been any let up in the efficiency of tax and revenue administration in the State during the period, then unless such trends are guarded against in future, these would have very debilitating effects on the State finances.

10.16 **It is pertinent to remark here that the data reveal that high revenue deficit in Kerala in the recent years, is primarily a result of fall in efficiency of resource mobilisation, and only secondarily because of the growth in expenditure.** It is not the growth rate of expenditure that has shown a marked increase; it is the growth rate of revenue that has fallen noticeably. This interpretation of the State's deficit affords fair ground for optimism about the future of the State finances. Growth in revenue has historically been 18-20 per cent in the past. Many reasons are ascribed for the general fall in revenue collection in the second half of the nineties. Several analysts hold the view that revenue mobilisation has fallen partly on account of the general economic recession in the country and the slump in prices of agricultural commodities. The general prices of agricultural commodities grown in the State remain far from satisfactory and do not yield a reasonable margin to the farmer for sustaining production. Both Governments, at the State and the Centre, are seized of this crisis in the agricultural sector. If there is a recovery in the agricultural sector, then this fact, coupled with some improvements in the tax and non-tax administration, will push up revenue collections. There already are positive indications, which suggest a recovery in revenue collections. From figures available in the Finance Department, the half yearly tax collections show a growth rate near the 18 per cent mark in 2000-01. Of course, the absolute figures this year will not be impressive since there has been considerable erosion in revenue receipts in the years 1997-1999; but signs of a recovery are there. Even so, the task ahead for the Government in the next few years is quite formidable.

DEBT AND INTEREST BURDEN OF THE STATE

10.18 In this section we have attempted to present a summary of the debt situation of the State and the annual interest payments incurred by the State. Given the high gross fiscal deficit of the State, the entire extra devolution to the local bodies too would have to be financed by borrowing. It is in this connection that the picture of the State's debt and its growing interest payment has to be borne in mind.

10.19 Tables 10.4 to 10.10 show the growth of various components in the overall debt of the State in the years 1990-1999. Debt of the State arises from borrowings on account of Internal Debt, Savings and Loans from Government of India. Internal debt of the state consists of Market Loans borrowed by Government and Ways and Means Advances received from the Reserve Bank of India. Debt liabilities on Savings arise from the deposits received in the Savings Accounts in the Treasuries, the remittances retained in the State Provident Fund, Money in Insurance and Pension Funds and in trusts and endowments. Loans received from Government of India include those received under Central Plan, Non Plan Loans, State Plan Loans and Centrally Sponsored Schemes. Each of these three streams of the State's debt (viz. Internal debt, Savings and Loans from Government of India) was subjected to a detailed analysis. The interest payment on accumulated liabilities in each of these streams was also examined. We looked at gross retention (defined as the excess of receipts over disbursements) and net retention (defined as gross retention less interest payments for that stream of borrowing). This approach has its limitations: interest payments in a particular year used for reckoning net retention, would relate wholly or largely to accumulated balances on that stream of borrowing in the past. Likewise the disbursements in any year would correspond to the repayment on the principal borrowed in the past. A rigorous analysis would therefore include an analysis of the lag in the receipts, disbursements and interest payments over a longer time horizon.

TABLE 10.5

Small Savings and Deposits (in Rs. Cr.)

Year	Receipts	Disbursements	Interest	Gross Retention	Growth Rate	Net Retemtion	Growth Rate
1990-91	786.85	709.16	23.14	77.69		54.55	
1991-92	996.95	905.35	27.37	91.60	17.90%	64.23	17.75%
1992-93	1268.78	1142.05	40.19	126.73	38.35%	86.54	34.73%
1993-94	1629.29	1504.39	45.79	124.90	-1.44%	79.11	-8.59%
1994-95	1880.90	1581.54	103.26	299.36	139.68%	196.10	147.88%
1995-96	1887.17	1824.76	64.62	62.41	-79.15%	-2.21	-101.13%
1996-97	1988.28	1809.58	62.46	178.70	186.33%	116.24	-5359.73%
1997-98	2396.71	2168.57	76.70	228.14	27.67%	151.44	30.28%
1998-99	3875.61	2935.66	78.92	939.95	312.01%	861.03	468.56%

10.22 Net accretions from the State Provident Fund have steadily tapered off, and in some years show negative balances (Table 10.6). Insurance and Pension funds account only for a very small amount of the total borrowing and hence separate data for this stream of borrowings are not presented here.

TABLE 10.7

Internal Debt (in Rs. Cr.)

Year	Receipts	Disbursements	Interest	Gross Retention	Growth Rate	Net Retention	Growth Rate
1990-91	*1355.50*	*1143.87*	*97.56*	*211.63*		*114.07*	
1991-92	*1859.13*	*1635.48*	*124.61*	*223.65*	*5.68%*	*99.04*	*-13.18%*
1992-93	*2162.62*	*1831.94*	*154.98*	*330.68*	*47.86%*	*175.70*	*77.40%*
1993-94	*1143.35*	*1102.81*	*180.90*	*40.54*	*-87.74%*	*-140.36*	*-179.89%*
1994-95	*509.32*	*164.68*	*216.41*	*344.64*	*750.12%*	*128.23*	*-191.36%*
1995-96	*427.64*	*20.68*	*253.63*	*406.96*	*18.08%*	*153.33*	*19.57%*
1996-97	*623.01*	*138.44*	*318.08*	*484.57*	*19.07%*	*166.49*	*8.58%*
1997-98	*947.81*	*333.54*	*388.50*	*614.27*	*26.77%*	*225.77*	*35.61%*
1998-99	*3101.91*	*2262.67*	*465.38*	*839.24*	*36.62%*	*373.86*	*65.59%*

10.24 For the limited purpose of this analysis, a discussion on each line of debt financing in detail may not be called for. But, the stark reality that confronts us is that with respect to many of the sources of debt financing, outflows exceed the inflows. The overall picture that emerges is given in Table 10.8.

TABLE 10.9

GR = Gross Retention, NR = Total Retention, INT = Interest. All figures in %.

Year	Internal Debt			L&A from GOI			Small Savings etc.			State Provident Fund		
	GR/ Total GR	NR/ Total NR	INT/ Total INT	GR/ Total GR	NR/ Total NR	INT/ Total INT	GR/ Total GR	NR/ Total NR	INT Total INT	GR/ Total GR	NR/ Total NR	INT Total INT
9-91	27.36	26.26	28.64	34.82	30.28	40.61	10.03	12.56	6.79	26.02	28.53	22.82
91-92	29.83	37.17	25.78	35.89	14.25	47.82	12.22	24.11	5.66	19.05	19.84	18.61
92-93	39.81	60.98	28.57	34.47	16.88	43.80	15.26	30.04	7.41	8.08	-12.09	18.79
93-94	4.50	-65.45	26.33	43.61	53.63	40.48	13.85	36.89	6.66	35.86	69.56	25.34
94-95	21.25	15.98	26.40	37.72	35.03	40.35	18.45	24.43	12.60	21.26	23.13	19.44
95-96	31.48	41.60	27.45	39.62	25.54	45.24	4.83	-0.60	6.99	22.24	30.25	19.05
96-97	37.06	81.59	28.83	28.63	-58.74	44.79	13.67	56.96	5.66	18.65	14.27	19.46
97-98	42.44	140.01	30.21	26.12	-107.13	42.82	15.76	93.92	5.96	13.28	-38.12	19.73
98-99	29.63	26.97	32.18	23.22	3.69	41.94	33.19	62.12	5.46	12.64	5.90	19.11

10.26 Table 10.10 shows the growth of the Debt of the State along with the interest payments over the period 31.3.1990 to 31.3.2000.

10.27 The picture of the year-to-year borrowing of the State that emerges is not encouraging. The data in Tables 10.4 to 10.10 above warrant a critical look at the advisability of the State's taking increasing recourse to debt. We feel that drawing up a comprehensive debt strategy for a reasonably long period ahead, with the assistance of experts would be eminently desirable for the State at this juncture. We leave this suggestion for the consideration of Government.

MAINTENANCE EXPENDITURE OVER THE PERIOD 1990-2000

10.28 In the preceding chapters, it was argued that the maintenance of assets created should be a focal point for action for LSGIs. Given the scale of transfer of resources to the LSGIs, through Plan devolution from 1995-96, the State is witnessing an unprecedented surge of activity, which has led to creation of wealth at the community level, in the form of buildings, roads and irrigation structures. Besides, institutions that were hitherto managed by Departments of the State have been transferred on a large scale to LSGIs. These aspects have been discussed elsewhere in this report.

10.29 It has been a general experience that the first casualty of a shortage of funds is the outlay earmarked for maintenance expenditure. This is not confined to LSGIs or State Governments alone, but seems to be a universal phenomenon. Successive Finance Commissions have been seized of this problem and have in their assessment made provisions for maintenance requirements of the States. The Eleventh Central Finance Commission in its report (Chapter V, Para 5.38) observed as follows: "*It is a matter of concern that our capital assets are languishing because of poor maintenance*". Despite affirmations about the importance of earmarking adequate provisions for maintenance, expenditure for this has not been commensurate with the requirements. The Report of the Eleventh Central Finance Commission further notes: "*This has happened in spite of the fact that successive Finance*

GROSS FISCAL DEFICIT OVER THE DECADE 1990-2000

10.31 Data on the growth of the gross fiscal deficit (GFD) of the State and its components are shown in the Table below. The growth in revenue deficit accounts for a growing share of the gross fiscal deficit. There has been a decline in net capital expenditure on the State account, particularly from 1997-98. This watershed line coincides with the 35-40 per cent devolution of the total plan to the local bodies in the wake of decentralised planning. The revenue deficit has grown inordinately in the second half of the decade, particularly since 1997-98, the first year in which decentralised planning was introduced. Revenue deficit accounted for 74 per cent, 82 per cent and 73 per cent of the gross fiscal deficit in the years 1997-98, 1998-99 and 1999-2000. A partial explanation for this disproportionate growth in revenue deficit, is that the entire devolution under Plan to local bodies, is, for accounting reasons prescribed by the Comptroller and Auditor General, classified as revenue expenditure. However, the stiff rise in revenue expenditure on account of the pay revision has also contributed significantly to the problem.

10.32 There are two ways of assessing the high revenue expenditure. Government has held the view that as much as 60-70 per cent of the transfer to local bodies is on capital works, and that there is not much cause for alarm in the figures of revenue deficit. While it is not possible to confirm the actual percentage of capital expenditure out of the plan devolution to local bodies, in the absence of data, it should be conceded there is a great deal of merit in this argument. Even when final figures are available, classifying micro-level infrastructure works into two neat categories of 'revenue' and 'capital' expenditure would pose problems. By Government's argument thus, the percentage of revenue deficit in the gross fiscal deficit for the three years would reduce to 25 per cent, 45 per cent and 65 per cent respectively.

FORECAST OF STATE FINANCES 2001-2005

10.35 In this section, we attempt a fairly simple forecast of State Finances over the period covered by the award of our Finance Commission. This forecast is aimed at presenting a picture of how the finances are affected by the aggregate transfer of nine per cent of the Own Tax Revenue that we have recommended as general and maintenance grants. We have, while keeping the number of assumptions as few as possible, looked at the major components of revenue receipts. But we do not propose to analyse individual components of revenue expenditure. We have adopted this ground rule, which stems from the observation that revenue expenditure, as stated earlier, has been far more stable than revenue receipts in the State. Of course this approach also uses a major premise, that Government may find it difficult in the medium term, in the absence of an explicit strategy, to make reductions in expenditure, beyond the range of 1-2 per cent. At the same time we note that it can ill-afford to step up expenditure beyond what is being incurred now. Hence we believe that fine-tuning our efforts to forecast individual components of the revenue expenditure will not yield commensurate improvements in the quality of our forecast. The only disaggregation we use is to look at the interest burden and the rest of the revenue expenditure separately. For the year 2000-01 we have used the revised estimates used by Finance Department for its annual projections. This is justified as these projections are generally fairly close to those presented in the budget. For the year 2001-02, we employ the estimates of revenue receipts used for the assessment of the resources for the annual plan 2001-02. For revenue expenditure, we use the revised estimate for the year 2000-01 and the forecast for the year 2001-02; we do the same for interest payments.

10.36 The allocations to local bodies are a part of the revenue expenditure of the State. As stated earlier, since it is not our intention to prescribe remedies or measures to improve the State's finances, we have not attempted to project the capital side of the state finances or the gross fiscal deficit.

(5) However where there has been a decrease or negative growth in either of the two previous years (i.e. 1998-2000), we take the minimum of the half yearly buoyancy for 2000-01 and the positive growth rates registered in 1993-1999.

NON TAX REVENUE

(1) The major components of this non-tax revenue in the State are Forests, Miscellaneous Departments and Interest receipts. Collection from Forests is largely dependent on the revenues that come out of felling of trees and disposal of timber. With felling of trees having been brought under more rigorous guidelines in the recent years, the growth of this line of revenue has not been as significant as it used to be in the past. For Forests, we use the half yearly growth rate.

(2) Non Tax Revenues from other departments come largely through collection of fees and user charges. The Non Tax Revenue Wing of the Finance Department has submitted proposals for approval of Government. Decisions are yet to be taken in many of these. Hence for the years 2001-02 and 2002-03, we assume that there will be a quicker growth in such revenue and assume this to be 17 per cent per annum. Subsequently we have assumed this to stabilise at the same rate as the non-interest component of revenue expenditure viz., at 13 per cent.

(3) Interest receipts are assumed to grow at the average historical rate observed for the period 1993-1999.

GRANTS IN AID

Grants in aid received from Government of India are for Non Plan, State Plan, Central Plan, Centrally Sponsored Schemes and Special Plan schemes. The major share is accounted for by Grants in aid for

STATE NON TAX REVENUE

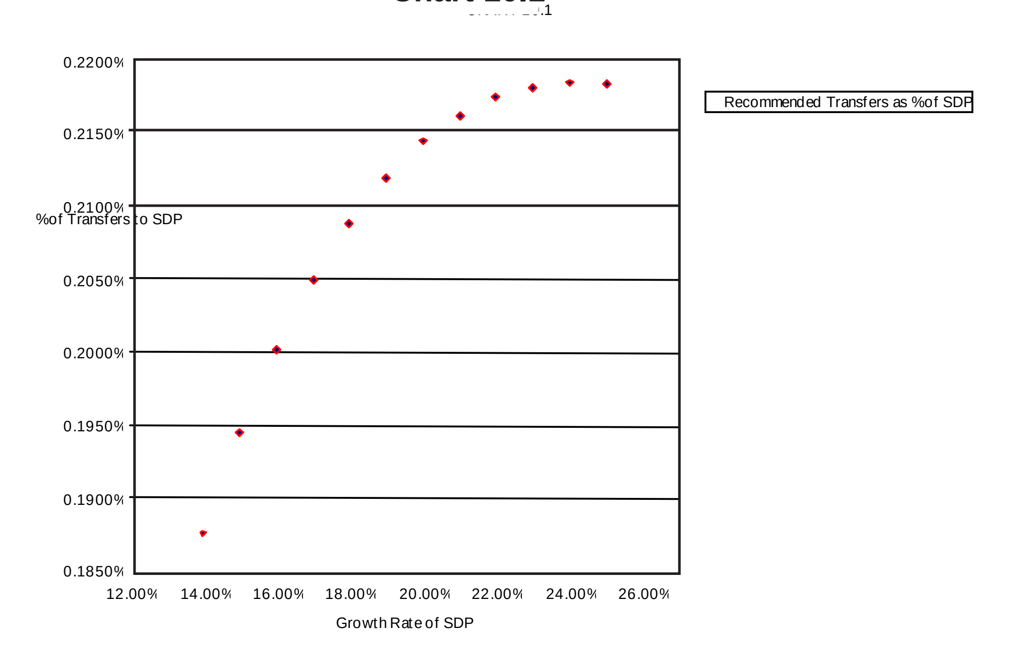
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	Maximum Growth Rates for selected items in 1990-2000
Forest	*10.00%*	*10.00%*	*10.00%*	*10.00%*	*10.00%*	*10.00%*	*10.00%*	*32.94%*
Others	*17.00%*	*15.00%*	*14.00%*	*13.00%*	*13.00%*	*13.00%*	*13.00%*	*62.16%*
GOVERNMENT OF INDIA								
Grant in aid	*8.98%*	*8.98%*	*8.98%*	*8.98%*	*8.98%*	*8.98%*	*8.98%*	
Fin. Commission Transfers		*PROJECTIONS OF THE CFC*						
REVENUE EXPENDITURE								
Interest Payments	*18.00%*	*18.00%*	*18.00%*	*18.00%*	*18.00%*	*18.00%*	*18.00%*	
Revenue Exp. minus Interest	*13.00%*	*13.00%*	*13.00%*	*13.00%*	*13.00%*	*13.00%*	*13.00%*	
Maintenance Expenditure	*12.00%*	*12.00%*	*12.00%*	*12.00%*	*12.00%*	*12.00%*	*12.00%*	
STATE DOMESTIC PRODUCT								
SDP	*15.94%*	*15.94%*	*15.94%*	*15.94%*	*15.94%*	*15.94%*	*15.94%*	

10.40 The figures for own revenue, revenue receipts, revenue expenditure and revenue deficit for the years 2001-02 to 2005-06 arrived in the forecast exercise are shown in Table 10.14. We have analysed the figures for three years beyond the period 2005-06. However the general results for the award period hold also for this extra period. We see a decline in the percentage of revenue deficit as a share of State Domestic Product from the current level of 3.5 per cent to under 2 per cent, even assuming a comparatively low nominal growth rate of SDP at 15.94 per cent (the average historical value).

10.41 The State has seen a comparatively steep decline in tax collection over the last few years. However, if the cycles of economic growth, as reflected in the eighties and nineties repeat over the next five years, the State is poised for a faster financial recovery than what we have given in Table 10.14. We have taken care to recommend a scale of transfers, which therefore would not impose an unduly difficult target for the financial managers of the State.

10.43 In our exercise, we have also looked at the behaviour of this difference under various growth rates of the State Domestic Product for the forecast period. With our recommended scale of transfers, the average value of transfers as a percentage of State Domestic Product stabilises with improved economic growth at around a peak value of 0.2184, as is shown in Chart 10.1. As mentioned elsewhere earlier, we have assumed that the State Domestic Product will grow at the average historical value. For alternative growth rates, Own Tax Revenue has to be correspondingly adjusted for the forecast period. This has been done by using a simple proportionality factor. It is clear that with faster growth the transfers that have been recommended by this Commission will be accommodated better in the fiscal balance of the State: this is so because revenue deficit as a percentage of SDP declines for increasing growth rates of SDP (Table 10.15)

Chart 10.1



10.44 Table 10.15 shows the behaviour of Revenue Deficit, post transfers, over the forecast period for a few alternative rates of economic growth. The transfers that have been recommended will not upset fiscal management, since they do not, by themselves, introduce any spurts in Revenue Deficit as a percentage of the State Domestic Product.

10.46 We have taken the non plan revenue surplus projected by the Eleventh Central Finance Commission in Table 10.2. We have also assumed that the Annual Plan will grow at a rate of 13 per cent per annum over the award period (at the rate of growth of non-interest component of revenue expenditure). Given that the revenue component in the Plan continues to be 70 per cent of the total plan outlay then the revenue deficit computed is shown in Table 10.16.

10.47 The figures arrived at in our forecast lie between those given in the report of the CFC and those presented in the State's Memorandum to the CFC. Generally, memoranda presented by State Governments tend to overestimate the Expenditure figures. This is largely to prevent the possibility of the State losing out on non plan assistance in the Award. The Memorandum's estimate of revenue deficit for the year 1999-2000 for example is Rs.5680 cr. while the audited figures show a revenue deficit of Rs.3625 cr. Likewise, the Finance Commissions use normative measures of 'prescriptive' rates for various items particularly on the expenditure side. As a result the final audited figures at the end of the award period of the various Finance Commission and the projections that these commissions have made in their awards differ by a very large margin. This detracts considerably from the reliability of the projections, particularly of revenue expenditure by the Finance Commission.

10.48 In our own forecast, we have adopted figures, which are suggested by the trends in the past, specifically the period 1993-94 to 1999-2000. At the same time we neither anticipate any runaway expenditure nor any unusual momentum in the growth of any revenue stream. At the end, it is relevant to mention that we have avoided taking into account the implications of a further pay revision for the employees of the State Government through the next Pay Commission. We have done this for two reasons. Firstly there is a recommendation of the last Pay Commission that pay revisions should be made once in ten years as against the existing practice of once in five years. As of now, the State

CHAPTER 11

SOME ISSUES RAISED BY THE ELEVENTH CENTRAL FINANCE COMMISSION

11.1 Our report is being prepared at a time when the Eleventh Central Finance Commission has just submitted its report to the President. The Eleventh Central Finance Commission's report has given rise to a lively controversy on the appropriate criteria for the *inter se* distribution of resources between the different states. These issues are outside the sphere of our concern; but the CFC has made a number of important suggestions regarding the setting up and functioning of State Finance Commissions, and has expressed its views on a number of questions relating to decentralisation, on which we feel we must give our opinion.

11.2 The CFC has pointed to an anomaly which has been exercising us as well. This consists in the following. Article 280(3)(bb) and (c) of the Constitution states that the CFC must make recommendations as to the measures needed to augment the Consolidated Fund of a State to supplement the resources of Panchayats and Municipalities in the State "*on the basis of the recommendations made by the Finance Commission of the State*" (emphasis added). But the timing of the setting up of the crop of First State Finance Commissions happened to be such that their reports could not be made available to the Tenth Central Finance Commission and appeared almost immediately afterwards. The only SFC reports available to the Eleventh CFC therefore are almost five years old and hence at the end of their time-frame of reference, they cannot conceivably be of any use to the CFC in formulating its recommendations. Besides, since both CFCs and SFCs are constituted once every five years, this problem will recur with every CFC. In the case of Kerala for instance the first SFC's report was submitted in February 1996 and was supposed to cover the period 1996-7 to 2000-1. This can hardly form the basis of the recommendation of the Eleventh CFC whose report is supposed to cover the period 2000-1 to 2004-5. Thus the only SFC report available to the CFC is one whose time-frame of reference has nearly ended; it can not possibly form the basis of the CFC's recommendations.

11.3 The first SFC of Kerala had drawn attention to this problem. It had suggested that the SFCs should be constituted on a date early enough, such that their reports could be made available six to nine months before the CFC submits its report. It had also drawn attention to the discrepancy that while Article 280 of the Constitution empowered the President to appoint a CFC after five years or "*at such earlier times as the President considers necessary*" there was no such leeway provided in Article 243 (I) dealing with the appointment of the SFCs; clearly a removal of this discrepancy allowing for the appointment of SFCs earlier than at the "expiration of the fifth year" can resolve the problem.

11.4 The Eleventh CFC has suggested precisely this, namely a Constitutional Amendment which merely adds "or earlier" to "the expiration of the fifth year" in Article 243(I), making it exactly analogous to the provision regarding the appointment of CFCs. While we agree with the spirit of this suggestion, there is a practical problem here, namely that such an amendment would open up the possibility of a state government appointing a Finance Commission whenever it fancies. This danger already exists in the wording of the provision governing the appointment of the CFC; it would now get generalised to the case of the SFCs as well. A more suitable amendment therefore would be to say that SFCs have to be appointed "two years before the expiry of the term of award of the preceding CFC". Since it would take about one year for any SFC to submit its report, this would mean that SFC reports would appear in the midst of the CFC's deliberations.If this Constitutional amendment is enacted then in the case of Kerala the next State Finance Commission would have to be appointed around March 2003, i.e. three-and-a-half years after the date of appointment of our Commission. Of course once the SFC and CFC dates are synchronised, the "expiration of the fifth year" rule can be applied in each case without any further anomalies.

11.5 The CFC however makes a second suggestion for a Constitutional amendment to Article 280, with which we cannot agree. This is for deleting the words "on the basis of the recommendations made by the Finance Commission of the State" from Article 280(3)(bb) and (c). The reasons given by the CFC are that in several states the SFCs had not been constituted or submitted their reports, and that even where they had submitted their reports, there was extreme heterogeneity in "approach, contents, and period covered". This suggestion of the CFC appears to us to amount to an abandonment of a Constitutional principle for reasons that are purely technical, and to an extent trivial. Issues relating to the non-constitution of SFCs, non-submission of reports in time, heterogeneity of the period covered, and heterogeneity of contents (which can be overcome by having similar terms of reference) can be separately addressed, at the Inter-State Council for instance, where both the Central and State governments are represented. Heterogeneity of approach on the other hand has to be taken as a fact of life in a democracy and cannot *possibly* be a reason for abandoning a Constitutional principle. Thus none of the reasons cited by the CFC appears to us to be compelling enough to justify a change in the Constitutional provision in this regard. The principle underlying this provision is clear: in deciding upon financial devolution from the Centre to the states, the CFC must be fully informed of the total picture regarding state finances, including what the states themselves are being called upon to devolve to LSGIs. (Since the latter is governed by the recommendations of the SFCs, the Constitution talks of the CFC making its own recommendations "on the basis of the recommendations made by the Finance Commission of the State"). This is an eminently reasonable provision. What is more, it constitutes an anti-thesis of the "top-down" approach and an expression of commitment to the primacy of LSGIs: instead of SFCs taking the devolution from the Centre as a datum in their decision-making it is the CFC that is supposed to take the devolution to LSGIs as the datum in its decision-making. The needs of LSGIs, as reflected in the SFC recommendations, have a primacy and constitute a constraint within which the CFC must operate, rather than having to adjust to what the CFC decides to devolve. An amendment deleting this provision therefore is not just unwarranted; it amounts to an *overturning* of a basic principle.

11.6 Indeed it seems to us that the two Constitutional amendments suggested by the CFC would undermine each other's rationale, i.e. the second Constitutional amendment suggested by the CFC would undermine the rationale of its first Constitutional amendment, and vice versa. If CFC recommendations are no longer to be linked constitutionally to those of the SFCs then the need for synchronising the two, so that the latter comes before the former, disappears. On the other hand if the Constitution is to be amended to ensure synchronisation, then the exercise of doing so would be futile if at the end of it the CFC is no longer required to take SFC recommendations as the basis on which it makes its own awards. To be sure, it may be argued that SFC recommendations, if available to the CFC, would be *useful* for it, even though the latter may not recommend on the *basis* of them. But the case for synchronisation would lose much of its compelling power if convenience alone is invoked in support of it. And in any case the argument that the second proposed amendment would remove some of the Constitutional shackles on the CFC would still remain. There may be a case for adding "and other relevant factors" to "on the basis of the recommendations made by the Finance Commission of the State", but none in our view for deleting the latter.

11.7 There is however an implication of Article 280(3)(bb) and (c) which has gone generally unnoticed. In stating that the CFC should make recommendations regarding augmenting the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities on the basis of the SFC recommendations, the Constitution implicitly suggests that the recommendations of the SFC would be more or less binding on the state government. There would be no point in the CFC taking the SFC recommendations as the basis of its own award, if the latter recommendations amounted to no more than mere pious wishes which the state government could accept or reject at will, or, in the case of those it accepts, could give effect to at a time of its own choice. In short, in enjoining on the CFC the need to heed the SFC recommendations, the Constitution accords the latter a degree of sanctity. Unfortunately, state governments have been quite cavalier in their treatment of SFC recommendations. The CFC itself quotes instances of Action Taken Reports on SFC recommendations not being presented to state legislatures even two to three years after the submission of the SFC report. In Kerala too some of the recommendations of the First SFC were rejected by the government (e.g. the provision regarding 1 percent of State revenue, appropriately defined, going towards the Rural and Urban Pools); and, even with regard to the others, the necessary legislation has taken an inordinately long time. Of course the total devolution from the state government to the LSGIs in Kerala has been impressive and unprecedented, and has in fact gone beyond the prevailing conception at the time of the first Finance Commission report. This fact however was never advanced as the reason for the partial acceptance of the SFC report. We welcome the CFC's suggestion that the Action Taken Report on the SFC's recommendations should be placed before the state legislatures within six months of the submission of the SFC report, and urge greater regard on the part of the state government for the spirit of the Constitutional provision in dealing with the recommendations of the SFC.

11.8 The CFC's suggestions for augmenting the Consolidated Funds of the States are welcome, and in particular the suggestion that Parliament should be empowered to raise the ceiling on the Profession tax without going in for a Constitutional Amendment each time. This is a matter that has also exercised us, especially since in Kerala LSGIs have been empowered to levy Profession tax, and it constitutes an important source of their revenue. The scope for raising revenue from Profession tax is very large, given the weight of the service sector in Kerala's economy, provided its rate as well as coverage could be increased. Specific suggestions regarding ways of extending its coverage (as well as garnering revenue through other means) have been made in Chapter 9, which also highlight the constraint placed by the Constitutional ceiling. We welcome the addition of the CFC's voice to ours for overcoming this constraint.

11.9 Of the annual amounts of Rs.1600 crores for Panchayats and Rs.400 crores for Municipalities which the CFC would be transferring for an improvement in civic services, Kerala's share would be Rs.65.92 crores for distribution among Panchayats, and Rs.15.05 crores for distribution among Municipalities. The criteria for *inter se* distribution within each of these categories have been left to the SFCs. We recommend that these sums be distributed entirely on the basis of the population criterion among the Panchayats and among the Municipalities. Since this sum according to the CFC "should be over and above the normal flow of funds to the local bodies from the States, and the amounts that would flow from the implementation of SFC recommendations", its availability makes no difference to the rest of our report. These funds, it must be emphasised too, should not be included in the Plan funds which have a completely distinct existence. It is suggested that these grants should be devolved in one instalment.

11.10 A perusal of the CFC report however makes it clear that the process of decentralisation in Kerala has gone way beyond what the CFC, looking perhaps at the average picture among states, visualises. The CFC had commissioned a study by the NIRD on rural local bodies and by NIPFP on urban local bodies. According to the CFC, "The Study done by the NIRD reveals that the 73rd amendment has not significantly altered the functional domain of the panchayats at various tiers. Few states have been serious in vesting the panchayats with the necessary powers, funds and staff to enable them to perform the functions assigned to them under the statutes. The Centre as well as the States have sponsored schemes for rural people without associating panchayats in planning and implementation." The picture in Kerala is vastly different: not only were a whole array of assets transferred to the LSGIs in 1995 together with staff and funds to meet operating costs, but, under the stimulus of the Peoples' Plan Campaign, over 35 percent of plan outlay has been given to LSGIs to spend on projects of their choice. Precisely because of this unique status of Kerala, the index of decentralisation prepared by the CFC (which has to do with criteria such as when the SFCs were set up and the extent of action on their report, matters that have become secondary in a context where over Rs.1000 crores are handed over every year as plan grants to LSGIs) does not do justice to Kerala.

11.11 The use of such criteria in the preparation of an index of decentralisation is in any case questionable, since it elevates *form* over *substance*. Any such index has to be based on substantive criteria such as the proportion of *actual* devolution from the state government to LSGIs, or the magnitude of assets *actually* transferred to LSGIs, since this is the essence of the process of decentralisation, as envisaged in the Constitutional Amendments. Looking only at the SFC recommended devolution, which has in most states, for no convincing reason (and certainly not for any Constitutionally-specified reason), excluded plan funds from its purview, is inadequate to start with. But not taking into account the actual devolution even with regard to the non-plan part, but concentrating only on the state government's *formal* response to the SFC recommendations, increases further the inadequacy of the index. It is in fact a symptom of the inadequacy of the index that a state like Kerala, with its unique record of decentralisation, performs so poorly according to it.

11.12 There is however a more basic sense in which Kerala's remarkable essay in democratic decentralisation which is qualitatively different, conceptually, from the average picture among the States in India, has not elicited the response it deserved from the CFC. The CFC does "not find adequate justification in the demand that a certain percentage of the funds transferred by the States to the panchayats and municipalities be provided by the Finance Commission". The reason is the following. On the one hand, the mere transfer of plan schemes to LSGIs should not lead to any additional expenditure liability on the States; on the other hand the additional financial burden falling on the State for implementing the SFC recommendations has to be built into the expenditure stream of the State which the CFC is already cognisant of. (And any transfer to LSGIs over and above SFC recommendations is outside its purview anyway). It follows then that the CFC has to take no special note of the devolution to LSGIs by the State government. This argument might have some cogency in the "normal" situation, *but not in the context of the democratic decentralisation experiment in Kerala.* The reasons are obvious, and are as follows.

11.13 With the devolution of plan funds to LSGIs, there has been a significant change in the composition of plan investment. In particular there has been a massive increase in road length. This change in composition is nothing to frown upon; on the contrary, if decentralised planning is really meaningful, then it must be reflected in some change in the composition of plan investment, for otherwise the need to shift away from paternalistic planning would appear correspondingly weaker. Roads in particular, and similar investments in local infrastructure in general, require, as discussed in an earlier chapter, high levels of maintenance expenditure. If plan funds are not to be frittered away on maintenance expenditure (and the whole effort in Kerala at the present juncture must be to educate the people *not* to fritter away plan outlays for current uses, for which the temptation would be almost irresistibly high), then adequate provision must be made for maintenance. The argument can be advanced, and our Commission in fact has advanced it and accepted it in an earlier chapter, that the State government which has transferred the plan outlay should also meet the maintenance expenditure, since if the same outlay had been spent through departments, it would have provided for the maintenance of the assets anyway. Now, the CFC's argument amounts to saying that if the state government transfers plan schemes to LSGIs and meets their maintenance requirements, then its overall expenditure obligations do not increase. But this presumption is incorrect since *the change in the composition of plan investment also raises the maintenance expenditure, and hence the overall expenditure obligation of the state government.* It is certainly true that in so far as this additional obligation gets reflected in the SFC report, it would be taken cognisance of by the CFC. But that would be almost five years from now. Meanwhile, maintenance expenditure needs have to be met immediately, since the roads constructed in 1997-8, the first year of enhanced plan devolution, would be already due for re-topping (a very expensive operation) in the coming fiscal year itself; and subsequent fiscal years would only see an escalation in such expenditure. By the time the Twelfth CFC makes some arrangement to help the state, it would already have carried a big fiscal burden. The Eleventh CFC regrettably, in concentrating on the average picture, has provided little succour to a state like Kerala (the amount coming to the state from the CFC's provision for civic services is too meagre relative to the state's requirement, which, to repeat, is highly specific). Our Commission nonetheless has enjoined upon the state government the task of meeting the maintenance expenditure in full. This is an obligation which cannot be shirked merely because the Eleventh Central Finance Commission chose not to recognise its existence.

CHAPTER 12

PROCEDURAL SAFEGUARDS

12.1 In the context of the considerable devolution of funds both Plan and non-Plan suggested by this Commission, it is felt that strong procedural safeguards are necessary both ways to ensure that the Government and the LSGIs perform their fiscal responsibilities fair and straight. The Government has to accept the financial entitlements of LSGIs and honour their due claim promptly. The LSGIs have to show utmost diligence and care in utilizing public money. The Commission would be dwelling at length on issues related to fiscal responsibility and financial management of LSGIs in the second part of the Report. However the Commission feels that certain procedural safeguards be adopted immediately and would recommend the following.

12.2 *LEGISLATIVE PROVISIONS*

12.2.1 There should be new sections introduced in the Kerala Panchayat Raj Act, 1994 and the Kerala Municipality Act, 1994, to the effect that LSGIs are entitled to nine percent of State's own tax revenue defined as the sum of the amounts received by way of Sales Tax, Excise, Motor Vehicles Tax, Stamp Duty, Basic Tax, Building Tax and other taxes and surcharge imposed by the State and reckoned on the basis of the latest accounts certified by the Accountant General.

12.2.2 Once this principle of general sharing of taxes is accepted and implemented, simultaneously the existing assigned taxes of Basic Tax, and Surcharge on Stamp Duty and the shared Motor

Vehicles Tax would move out of the financial domain of LSGIs and become state taxes. For this, appropriate amendments to the Kerala Panchayat Raj Act, Kerala Municipality Act and Kerala Motor Vehicles Taxation Act and the relevant rules are needed.

12.2.3 This nine percent has to be split up into two groups viz., the General Purpose Grant and Maintenance Grant, getting 3.5 percent and 5.5 percent shares respectively. LSGIs should be free to spend the General Purpose Grant for establishment expenses as well as for performing the obligatory and other functions; the Maintenance Grant should be used exclusively for maintenance and well-defined related requirements only. It should be made non-divertible. Similarly the Plan funds should be used exclusively for development purposes and again should be totally non-divertible. While General Purpose Grant would be released fully as per entitlement and would be allowed to be transferred to PD Accounts permitting unlimited carry over; for the other two grants, unspent funds would lapse.

12.3 *SAFEGUARDS AT GOVERNMENT LEVEL*

12.3.1(1) Flow of Funds. Now Plan Funds flow to LSGIs in four quarterly instalments. For claiming each instalment the concerned LSGI has to make an application, to the Deputy Director in the case of Village Panchayats, to the Heads of Department in the case of Block Panchayats and Municipalities and to the Government in the case of District Panchayats and Corporations. Every time an instalment is to be released prior general approval of the Finance Department is required. This system has been found to be cumbersome and slow since there is considerable time lag between the preferring of a claim and the actual crediting of funds to the LSGI account. It often happens that funds cannot be accessed when most needed.

12.3.1.1 In respect of sponsored schemes, both Plan and Non-plan, the funds flow to LSGI from the Heads of Department either directly or through district level officers. Normally it is given in one instalment; but sometimes the release is made rather late in the financial year. Also, there is some communication gap between the department and the LSGI on how exactly some of the funds can be spent, with the result that there are substantial unspent funds lying with LSGIs from sponsored schemes.

12.3.1.2 As per the existing system, LSGIs are permitted to carry over 25 percent of their allotted Plan funds to the next financial year. This is justified on two counts:- Firstly due to delayed releases the last quarter get credited only towards the end of the financial year with the result that it is not possible to spend it and carryover becomes inevitable; secondly, the first instalment of the succeeding year also gets delayed as various procedures are to be followed and this necessitates LSGIs to have carry over funds so that their expenses during the early months of the financial year could be met. This system of carryover has not been very efficient.

12.3.1.3 The Finance Department has a letter of credit system in vogue for regulating expenditure by cheque drawing departments like the Public Works, Irrigation and Forest Departments. Also there is a practice of issuing monthly and quarterly ceilings for regulating the expenditure of major departments. These were put in place for regulating outflows from the treasury. Drawing elements from these systems, in order to get over the problems outlined above, the Commission recommends an entitlement approach in the case of Plan Grants, Maintenance Grants and General Purpose Grants by the LSGIs. This would mean that the instalments would be automatically credited to the LSGIs. For the release of Plan Grants and Maintenance Grants, giving due consideration to the need of the Government to manage the ways and means position and to the right of LSGIs to get a free flow of funds, the following procedure is recommended.

(1) The Director of Panchayats (in the case of Village Panchayats), the Commissioner of Rural Development (in the case of Block Panchayats and District Panchayats) and the Director of Municipalities in the case of Municipalities and Corporations) would be declared as the Controlling Officers of these grants for the LSGIs serviced by them.

(2) These Controlling Officers would, as soon as the Budget is passed, issue annual allotment letters giving LSGI-wise allocation to the District Collectors. (Normally in the state only the Vote on Account is passed. However, since the withdrawals would be allowed only on a quarterly basis, the question of exceeding the Vote on Account does not arise.)

(3) At the district level, the District Collector would issue allotment letters to individual LSGIs. This is to be done in four quarterly instalments. This would mean that on the first day of April, July, October and January, the LSGIs would get as their entitlement in the treasuries one-fourth of the annual allotment. This system would negate the need for claims, allotments and transfer crediting. Based on the allotment order of the District Collector funds would automatically move into the account of the LSGIs. For discharging this function, District Collector would be supported by the Deputy Director of Panchayats, Assistant Development Commissioner (General) and the Joint Director of Municipal Administration.

(4) In the interest of free flow of funds, even while facilitating liquidity management and avoiding the possibility of excessive lumping of expenditure, LSGIs would be authorized to carry over a fixed percentage of funds from the quarterly allotment as follows:

From the first quarter	*50 percent*
From the second quarter	*40 percent of the quarterly allotment plus the carried over amount*
From the third quarter	*30 percent of the quarterly allotment and the carried over amount*
From the fourth quarter	*Nil*

Even if the LSGIs were to use this flexibility to the maximum the quarterly percentage of expenditure would not exceed the following:

First quarter	*25 percent*
Second quarter	*37.5 percent*
Third quarter	*40.0 percent*
Fourth quarter	*37.0 percent*

This arrangement would restrict runaway expenditure towards the end of the financial year.

(5) In this system since the Plan Grants and Maintenance Grants would be drawn against bills presented in the treasuries the question of carrying over any amount at the end of the financial year does not arise. In other words, unspent funds would lapse on the 31st of March.

(6) The District Collector would issue two sets of allotments to each LSGI. The first set can be called "regular allotment" to be issued just before the beginning of the year immediately after the Budget is approved. Against

this 'regular allotment' expenditure can be permitted subject only to the condition that the maximum permissible amount should not exceed one-third of the quarterly allotment in the first month and two-third of the quarterly allotment in the first two months together. This is to regulate too much of outflow from the treasury in any given month.

(7) The second allotment can be called "authorization to use carryover funds". This is also to be done quarterly. However this would not be automatic and a system of certification by the LSGI Secretary and elected head with counter signature from the Treasury Officer would be insisted on. This authorization could be given within a fortnight of LSGI submitting their utilization certificates.

In order to curb the possibility of false claims, invariably, false certification should be treated as a crime resulting in prosecution and loss of job for the persons certifying.

(8) For the Treasury to monitor drawal of funds against allotments a kind of appropriation account needs to be maintained.

12.3.1.4 For devolution of the General Purpose Grant, a monthly allotment is suggested; i.e. 12 equal monthly instalments would be automatically credited on the first of each month. The above procedure may be followed *mutatis mutandis*, with the only difference being that there will be no requirement to spend a prescribed minimum of funds and there would be no lapsing of funds. Also the LSGI would be able to transfer credit its allotment to its Personal Deposit account in the treasuries as soon as it is received.

The Eleventh Finance Commission grant could be given in one instalment in the first quarter of the year in the same manner as above. LSGIs can transfer-credit the amount. Releases in subsequent years could be linked to expenditure.

The elaborate procedures explained above would ensure that the objective of liquidity management of government is fully met even while simplifying the mechanism of flow of funds.

12.3.2 (2) **Calculation of entitlements**: For the purpose of calculating the share of taxes due to the local governments, the accounts of the year previous to the last one should be taken so that the accounts certified by the Accountant General can be used.

12.3.3 3) **Assessment of maintenance requirement**: Government should carry out a proper survey of assets transferred to LSGIs as well as assets owned by them. And using this data it should calculate Standard Spending Assessment for maintenance purposes for each LSGI as per existing norms. Thereafter allotments of maintenance grants can be made in proportion to the assessed amount, according to the availability of funds.

12.3.4 4) **Separate Budget Document**. Through an appropriate entry in the Kerala Panchayat Raj Act and the Kerala Municipality Act, it should be ensured that Grants-in-Aid to LSGIs are shown in a separate budget document. It should show LSGI-wise distribution of funds in respect of three streams of Grants-in-Aid – Plan, Maintenance and General Purposes. In the case of other kinds of Grants-in-Aid, for pensions, as well as noon feeding in schools, the allocations may be shown indicating the entitlements of different types of LSGIs and formulae for devolving funds to individual LSGIs.

12.4 RESTRICTIONS ON CREATION OF NEW STAFF

12.4.1 In the context of transfer of responsibilities it is only natural that LSGIs would be demanding creation of more posts both for institutions/offices transferred to them as well as for expanding their traditional staff strength. The Government may also want to create new staff for the institutions/offices transferred to LSGIs either on normative considerations or in response to pressures from employees or LSGIs. The Commission would like to reiterate the principle enunciated by the Committee on Decentralisation of Powers that there should not be any net addition to the staff due to decentralisation of functions and powers.

12.4.2 An analysis of the State finances shows that there is need for utmost care and caution in expanding the staff strength in view of the severe financial crunch. For practical reasons, salaries and pensions end up as the first charge on government revenues and when the revenues are not enough, borrowing is resorted to meet these commitments. This has dangerous implications; for, it fully eats away the allocations for maintenance, which is so essential for the optimum use of the good social infrastructure, which Kerala has built up over the years. Therefore there is every reason to economize on creation of staff and allot more resources for the upgradation and upkeep of the assets created.

12.4.3 Of course the transferred staff are paid for by the Government; but if the staff costs increase the first squeeze will be on funds recommended to be earmarked to LSGIs for maintenance and probably even for Plan purposes. Also, in the not too distant future, LSGIs would have to take on the full responsibility of meeting the establishment costs. So too much of staff can later prove to be a burden for the LSGIs themselves. In this context the Commission would put forward certain basic suggestions to contain the salary and related commitments.

12.4.4 Firstly any proposal by Government to create staff in institutions/offices transferred to LSGIs should be formulated in consultation with the concerned LSGIs. Secondly it would be advisable to let the LSGI bear the additional cost due to the staff creation. Thirdly it is necessary to have an independent institutional mechanism to thoroughly analyse proposals for staff creation either from LSGIs or Government, relating to both own staff as well as transferred staff. What is required is a kind of Expenditure Ombudsman. Since Kerala already has an excellent organisation in the form of a multi-member Ombudsman created with the primary responsibility of controlling maladministration in LSGIs, it is felt that this body could take on the responsibility of vetting all proposals for staff creation. Since unnecessary expenditure on staff is a kind of maladministration there is logical justification for the Ombudsman to handle this task. Therefore the Commission would recommend that Ombudsman for LSGIs be authorised to approve every proposal for creation of staff either from LSGIs or from Government, in institutions/offices transferred to LSGIs or in the original offices/institutions of LSGIs. The approval could be based on the reasonableness of the request with reference to need and existing norms, sustained affordability of the proposal on the part of the State Government as well as LSGIs, implications for future, possibility for redeployment from other local governments or from Government, possibility of out-sourcing, potential for streamlining existing work etc. The Council of Ministers could then take an informed decision based on the recommendations of the Ombudsman. This institutional mechanism would ensure that while absolutely unavoidable posts get created, there would be an effective check on uncontrolled, ad-hoc expansion of bureaucracy. It could bring reliability in staff creation and over a period of time give push to efficiency and economy in the administration of LSGI responsibilities.

12.4.5 Alongside, Government may set up a one-time Local Government Staff Commission, which could go into the question of scientific reallocation of staff among LSGIs and redeployment from government to LSGIs subject to the condition that no creation of staff would be recommended. In the latter report it could take off from where the Committee on Decentralisation of Powers has stopped and fully operationalise the principle of "work and worker going together". It could also suggest measures for improving office management through the use of modern techniques and technologies as well as through retraining the existing staff. It could explore the possibility of outsourcing certain kinds of work as also pooling of human resources for access by a group of LSGIs. This Staff Commission could give its recommendations in about a year.

12.5 *SAFEGUARDS AT LSGI LEVEL*

1. All LSGIs should have a maintenance plan, which will spell out both the maintenance needs and the intended expenditure for each item.

2. In order to prevent inflating of expenditure by writing out cheques which are cashed after the end of the financial year it is suggested that all cheques issued by local government after 31st December should carry a stamped statement to the effect that the cheques would be valid only up to 31st of March of that financial year.

3. Unpermitted diversion of funds should invite automatic penalty by way of interest at 2 percent per month for the fund diverted and should be recovered from the persons responsible.

4. All LSGIs should have a single account for crediting all their

entire collected income other than grants-in-aid from State or Central Government or other agencies.

5. In respect of Maintenance Grants and Plan Grants, the existing PD Account system where funds are drawn by cheques may be replaced by a system where Bills are prepared and presented with appropriate certification regarding the bonafides and admissibility of the Bill. For the sake of convenience, to help easy distinguishing of Bills presented by various LSGIs it is suggested that separate colours could be used for Village Panchayats, Block Panchayats, District Panchayats, Municipalities and Corporations.

12.6 *COMMITTEE TO FOLLOW-UP ACCEPTED RECOMMENDATIONS*

12.6.1 Once the recommendation of the Commission are accepted by Government, there has to be a system of quickly operationalising them, at any rate within three months. There would be need for amending Acts and Rules and issue of orders by Local Self Government Department, Finance Department and other Departments. This process takes a lot of time. As has been pointed out, many of the accepted recommendations of the First State Finance Commission are yet to be operationalised.

12.6.2 Therefore the Commission would recommend the setting up of an Empowered Committee under the Chief Secretary consisting of the following members:

1. Secretary (Finance)
2. Secretary (Law)
3. Director of Panchayats

4. Director of Municipal Administration

5. Secretaries of Departments which have to carry out the recommendations

6. Secretary (LSGD)_ - Convener.

12.6.3 This Committee would have the task of preparing amendments to Acts and Rules and monitoring the issue of notifications and general orders. It should prepare the Action Taken Report to be submitted to the Legislature. This Committee could be serviced by the SFC Cell of the Finance Department.

12.7 *SFC CELL*

12.7.1 The first SFC had recommended setting up of a Special Cell and accordingly as per G.O.(MS)564/97/Fin dated 4-6-1997 a Cell has been set up in the Finance Department. Unfortunately this Cell has not been able to discharge its functions very effectively with the result that there have been delays in operationalising the recommendations of the first SFC. The fact that the second SFC had really to struggle and spend a lot of time to get the data and details, which could have been gathered and analysed regularly by the SFC Cell without much difficulty, further reinforces the need to have a small but efficient regular set up.

12.7.2 Accordingly the Commission recommends the setting up of a cell under the joint control of Secretary (Finance) and Secretary (LSGD) consisting essentially of an officer from the Finance Department and an officer from the Panchayat and Municipal Wings of LSG Department, an officer from the Statistical Department competent in use of Computers and analysis of data. This could be supported by a small team consisting of two ministerial staff, two Data Entry Operators, one Stenographer and the required class IV staff, driver etc. The Commission would like to underline the fact that it is not suggesting any level for the posts. It is felt that the accent should be on the quality of the person rather than his rank in the official hierarchy.

12.7.3 The mandate of this Cell would be –

(i) Follow up the accepted recommendations of the First Finance Commission and co-ordinate them to their logical conclusions.

(ii) Process the recommendations of the Second Finance Commission for decision at appropriate levels and operationalise them fully.

(iii) Design formats for monitoring resource mobilization at the local level and resource flow from Government to the LSGIs, obtain periodical reports in the formats, collate them, analyse them and prepare monthly statements and annual reports. This monitoring system could be used by LSGD for taking necessary remedial action wherever required.

(iv) Play the nodal role in organizing training programmes for LSGIs in respect of recommendations of this Commission relating to new systems of Budgeting, Accounting, Auditing etc.

(v) Serve as a resource center on local government finances.

(vi) Search, collect and store information on local government finances from both within the State and outside the State.

(vii) Create a data bank for the use of future State and Central Finance Commissions.

SUMMARY OF RECOMMENDATIONS

1 The important recommendations of the Second SFC are summarised below:

2 DEVOLUTION OF FUNDS

(1) Government may devolve to the LSGIs, Plan funds (excluding state sponsored schemes) not less than one-third the annual size of the State Plan as fixed by the Planning Commission. This Fund is to be used by LSGIs for planning and implementing locally relevant projects. The sectoral ceilings if any within this grant may be fixed by Government from time to time. (Para 6.3)

(2) Five and a half percent of the annual own tax revenue of the State Government may be devolved to the LSGIs as Grant-in-aid for maintenance of assets under the control of the LSGIs including the transferred assets. This percentage may be determined on the figures certified by the Accountant General, which normally relates to the financial year two years before the Budget year. All expenses related to running of institutions except wages, supply of medicines to health institutions, educational concessions / scholarships to students, supply of books, equipments and consumables to schools and conducting noon-feeding in schools, shall be borne by the LSGIs. This should include payment of rents, repair of equipment including vehicles, and meeting of telephone charges and vehicle operating expenses. (Para 7.5.2)

(3) Three and a half percent of the own tax revenue of the State Government based on the figures certified by the Accountant General could be devolved to LSGIs as General Purpose Grant in lieu of assigned taxes, shared taxes and various statutory and non-statutory grants-in-aid, both specific purpose and general purpose. This grant-in-aid would subsume under it Basic Tax Grant, Surcharge on Stamp Duty, Vehicle Tax Compensation, Rural Pool Grants, the specific purpose and general purpose grants to Urban Local Bodies and all other non-plan grants-in-aid devolved to LSGIs from the Local Self Government Department. (Para 8.11)

3 The Eleventh Finance Commission grants to LSGIs should be passed down as such, over and above the grants suggested above. (Para 11.9)

4 For the above three streams of grants-in-aid the devolution formula and the distribution formula are as suggested below:

(a) **Plan Grant-in-Aid**. The existing devolution formula as well as the distribution formula may continue. However up to ten percent of the non-SCP/TSP Funds may be distributed as an incentive for increased own revenue mobilization by the Village Panchayats and the Urban Local Bodies. The actual percentage to be distributed as incentive grant-in-aid should be the same as the percentage of Village Panchayats and Urban Local Bodies showing an increase in own revenue. And this amount could be shared as per the formula given below: (Para 6.11)

$$\theta i = r_{i\,.} P_i \;/\; \Sigma r_{i\,.} P_i$$

θi – share for LSG1 i

r_i – percentage increase in its revenue

Pi – Population of the LSGI i

The date of effect of the incentive system may be indicated to LSGIs well in advance.

(b) **Maintenance Grant**. The maintenance grants should be based on the current cost of replacement and the initial norms (which has to be updated periodically) may be as follows: (Para 7.5.11)

i. Maintenance of buildings constructed before 1-4-1967.	*3% of capital cost*
ii. Maintenance of buildings constructed after 1-4-1967	*2% of capital cost*
iii. Current construction cost.	*Rs.400/- per Sq.ft.*
iv. Frequency of resurfacing of black-top/WBM Roads	*Once in five years*
v. Annual repair expenditure of Blacktop roads.	*Rs.25,000/- per K.M.*
vi. Annual repair expenditure of WBM roads.	*Rs.23,000/- per K.M.*
vii. Annual repair expenditure of unsurfaced roads.	*Rs.2,000/- per K.M.*
viii. Cost of re-surfacing black-top roads (3.8 Metre width)	*Rs.1.65 lakhs per K.M.*
ix. Cost of resurfacing WBM roads (3.8 Metre width)	*Rs.1.84 lakhs per K.M.*

6 The distribution of the maintenance grant could be as follows: (Para 7.5.12)

(1) On the basis of a price index work out what Rs.140 crores at 2000-2001 prices would amount to for the year for which the provision is being made. The deflator for the construction sector can be utilized for this purpose.

(2) One-seventh of this amount may be kept aside for the District and Block Panchayats and divided between them in the ratio 19 : 1. The share of the Block Panchayat should be divided equally among them. As regards District Panchayats, half the share should be divided according to the ratio of distribution of the transferred village roads and other district roads and the other half based on norms for repair of non-road assets in their control (other than those created after 1995).

(3) Seven-eighth of the share of the Village Panchayats and Municipalities is to be distributed among the Village Panchayats, Municipalities and Corporations in the same ratio as VTC is currently divided; one-eighth of the share of the Village Panchayats and Municipalities should be distributed according to the maintenance needs of non-road assets, own and transferred, (other than those created after 1995) - as determined by norms.

(4) The division formula mentioned above needs to be corrected by a series of iterations.

(5) The remaining portion of the maintenance grant i.e. the excess over Rs.140 crores at 2000-01 prices may be distributed exactly in the same manner as Plan Grant-in-aid.

c) **General Purpose Grant**. The Government may determine as a one-time exercise, the share of District Panchayats and Block Panchayats in the General Purpose Grant, based on normative assessment of their establishment cost and office expense requirements. The remaining amount may be distributed as follows: (Para 8.13)

Village Panchayats	78.5 percentage
Municipalities	8.5 percentage
Corporations	13.0 percentage

7 The *inter se* distribution among the Municipalities and Corporations should be entirely on the basis of population. As regards Village Panchayats, a corpus of Rs.10 crore may be set apart and be used as per a gap filling formula – to fill the gap between obligatory expenditure (reckoned as establishment expenses, street light and water supply charges) and the revenue usable for these purposes (calculated as the sum of own collected revenue and the share of the Village Panchayat from the General Purpose Grant). The entire gap could be filled in the case of Second and Third Grade Village Panchayats, 50 percent of the gap in the case of First Grade Village Panchayats and 25 percent of the gap in the case of Special Grade Panchayats. The remaining portion may be distributed according to the population criterion. (Para 8.14)

8 In order to avoid hardships during transition period, it is recommended that no Village Panchayat or ULB should experience a real shortfall in its receipts on account of these transfers compared to the previous year. (Para 8.16)

d) **EFC Grants:** Eleventh Finance Commission grants may be devolved on the basis of the population criterion in one instalment. (Para 11.9 & 12.3.1.4)

9 *OWN RESOURCE MOBILISATION BY LSGIs*

(1) For Property Tax the recommendations of the First SFC may be operationalised and the following scheme is suggested for classifying buildings and fixing the tax. (Para 9.4.1.1)

(i) Location Zone – Four Zones.

(ii) Type of building –

(a) Ordinary building.

(b) Medium type building.

(c) Luxury building.

(iii) Type of use: - (a) Commercial use.

(b) Non-commercial use.

(iv) The relative weights for the Zones could be

1 : 1.5 : 2 : 2.5

(v) The relative weights for the type of building could be – 1 : 1.5 : 2

(vi) The relative weights between non-commercial and commercial use could be – 1 : 3

(vii) Deduction for age and owner occupation may be as provided for in the Kerala Municipality Act.

(2) On no account should there be a cap on increase or a limit to decrease when the new system is introduced. (Para 9.4.1.2)

(3) A dual system of numbering is suggested so that incomplete buildings can get a provisional number and their completion tracked properly. (Para 9.4.1.3)

(4) Presumptive Profession Tax may be introduced to bring certain self employed occupational groups into the tax net. (Para 9.4.2)

(5) Entertainment Tax may be introduced for Cable and Internet. (Para 9.4.3.1)

(6) In the case of Advertisement Tax the Government may fix the minimum rates for taxation for different kinds of advertisement for different types of locations by issuing Advertisement Tax Rules, which could set out the guidelines for LSGIs to assess the tax. (Paras 9.4.4(4) (i)&(ii))

(7) There should be a system of authenticating advertisements to avoid unauthorized advertisements. Penal provisions for unauthorized advertisement should be at least five times the normal tax. (Para 9.4.4 (4) (iii))

(8) Conversion Tax may be realized at the rate of five per cent of the capital value in the case of conversion of paddy lands. Half this rate may be made applicable for other kinds of conversions. In the case of conversions without prior

permission a severe penalty of ten times the Conversion Tax should be realized in the case of conversion of paddy land and an amount equivalent to the Conversion Tax could be realized in other cases. (Paras 9.4.5.1 & 9.4.5.2)

(9) The Service Tax should be made compulsory and be linked to the cost of performing obligatory functions and calculated as a percentage of Property Tax. (Para 9.4.6 (6))

(10) The ceiling on Surcharges may be removed. (Para 9.4.7 (7))

(11) In the case of Non-tax Revenue the Government should fix the minimum fees for various kinds of licences in the case of Municipalities and Corporations through notification. In the case of Village Panchayats only the minimum amount may be fixed in the rules. (Para 9.5.4 (i))

(12) In the case of licences and permits, which are renewed periodically, 25% of the licence fee may be collected as fine for delay beyond a grace period of ten days; this penalty may be increased by 25% for every additional fortnight of delay. (Para 9.5.4 (iii))

(13) There must be compulsory display by LSGIs at the point of realisation of revenue like markets, sand mining area etc. and in the case of auctions a district level public notice should be given in December about all the forthcoming auctions. (Para 9.5.4 (iv) & (v))

(14) For trade licences the present practice in Village Panchayats of calculation based on turnover may be done away with and for both Village Panchayats and Urban Local

Bodies, Government could notify the minimum rates for each trade with separate rates in each category for small, medium and large establishments. (Para 9.6.1)

(15) A separate numbering system should be adopted for trade establishments. (Para 9.6.1.5)

(16) The following fees may be enhanced.

(i) Building fee for Theatres. (Para 9.6.2)

(ii) Licence fee under the Kerala Places of Public Resort Act. (Para 9.6.4)

(iii) Licence fee for Private Markets. (Para 9.6.3)

(iv) Licence fee for Private Slaughterhouses. (Para 9.6.5)

(v) Licence fee for Brokers, Commission Agents, Weighmen and Measurers. (Para 9.6.6)

(vi) Licence fee for Butchers, Fishmongers, Poulterers. (Para 9.6.8)

(vii) Licence fee for premises where animals are kept for commercial purposes. (Para 9.6.7)

(viii) Market fee. (Para 9.7.1)

(ix) Gate fee for public halting and parking places. (Para 9.7.2)

(x) Gate fee for slaughterhouses. (Para 9.7.3)

(xi) User charges for burial grounds, burning ghats and electric crematoria. (Para 9.9)

(17) The meat stalls and the right to fish in water bodies may be auctioned every year by the concerned LSGIs after giving due publicity. (Para 9.8)

(18) Village Panchayats may auction the right to set up temporary shops in public land just as Urban Local Governments are doing so under Section 376 of the Kerala Municipality Act. (Para 9.11)

10 *FOLLOW UP OF FIRST SFC RECOMMENDATIONS*

(1) Rules for levy of Advertisement Tax in Village Panchayats and ULBs may be issued immediately. (Para 5.6 (5))

(2) Steps to finalise minimum land value for use in registering sales may be completed at the earliest. (Para 5.6 (7))

(3) Tax mapping may be done immediately and unique premises numbering system introduced. (Para 5.6 (10))

(4) A single financing agency for LSGIs may be set up by merging KUDFC and the Rural Development Board. (Para 5.6 (11))

(5) 50% of building exemption fees and regularization fees may be given to the concerned Village Panchayats and ULBs. (Para 5.6 (12))

(6) The question of Village Panchayats and ULBs levying daily fee for use of poramboke may be examined and decided by Government without further delay. (Para 5.6 (13))

(7) Rationalisation of revenue village and Village Panchayat/ULB boundaries may be done in such a way that no revenue village would lie within more than one Village Panchayat or ULB. (Para 5.6 (14))

(8) Shortfall in devolution of assigned and shared taxes vis-à-vis the accepted level may be made good by Government. (Para 5.6 (16))

11 PROCEDURAL SAFEGUARDS

(1) Necessary amendments to the Kerala Panchayat Raj Act and the Kerala Municipality Act may be made to specify the minimum shares of LSGIs, of the Plan Grant, Maintenance Grant and General Purpose Grant. (Paras 12.2.1 & 12.2.2)

(2) LSGIs should get automatic allocations at the beginning of every month. (Paras 12.3.1.3 & 12.3.1.4)

(3) A survey of assets transferred to LSGIs as well as assets owned by them may be carried out to calculate the standard spending assessment for maintenance purposes and the result of the study should be utilized for devolution of maintenance funds. (Para 12.3.3 (3))

(4) A separate Budget document indicating LSGI-wise distribution of the three streams of grants-in-aid and grants-in-aid for pensions and noon feeding may be prepared. For other grants-in-aid, district-wise figures may be indicated along with formula for devolving them to individual LSGIs. (Para 12.3.4 (4))

(5) A legislative provision may be introduced for indexing non-tax revenue items, and taxes like Property Tax, Advertisement Tax and Service Tax. Two-yearly revisions are recommended for non-tax licence items and Advertisement Tax based on Consumer Price Index for non-manual workers for Thiruvananthapuram in the case of Urban Local Bodies and Consumer Price Index for agricultural labourers for the state in the case of Village Panchayats; four-yearly revision may be

done for Profession Tax and Service Tax. (Paras 9.4.2 & 9.5.4)

(6) All proposals for staff creation should be cleared by the Ombudsman. (Para 12.4.4)

(7) A Local Government Staff Commission may be set up to suggest redistribution of staff among LSGIs as well as from Government to LSGIs. (Para 12.4.5)

(8) All LSGIs should prepare annual maintenance Plans. (Para 12.5 (1))

(9) Unpermitted diversion of funds should be penalized by charging a penalty of two percent per month from the persons responsible. (Para 12.5 (3))

(10) Village Panchayats, Municipalities and Corporations should have a single account for crediting all their own collected revenues. (Para 12.5 (4))

(11) In the case of Plan Grant-in-aid and Maintenance Grant-in-aid, bill system of drawing from treasuries should be introduced in the place of PD Accounts. (Para 12.5 (5))

(12) An Empowered Committee under the Chief Secretary may be set up to follow-up the accepted recommendations and implement them fully. (Paras 12.6.2 & 12.6.3)

12 A Cell under the joint control of Finance and Local Self Government Departments may be created for concurrent monitoring of all financial matters of LSGIs. (Paras 12.7.2 & 12.7.3)

PRABHAT PATNAIK
Chairman

K.M. ABRAHAM
Member

S.M. VIJAYANAND
Member

Thiruvananthapuram
8th January, 2001