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Growth-Accelerating Fiscal Devolution to the Third Tier*

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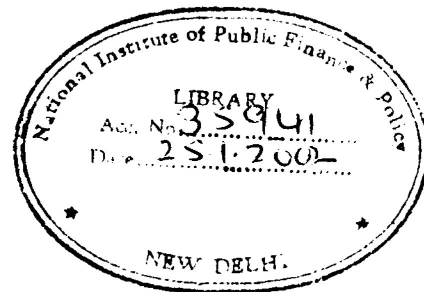

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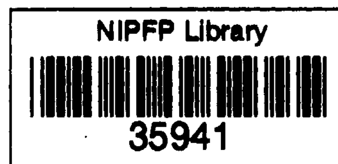

Executive Summary

This paper examines the design and outcomes of fiscal devolution to the third tier in respect of both State-local and Centre-local flows, and defines a desirable design from the viewpoint of growth acceleration with poverty reduction. The paper has an exclusive focus on panchayats, justified by the greater formal incrementality of the third tier in rural than in urban areas, and the formidable challenge posed by the larger numbers of local bodies in the rural sector (247033 as against 3682 urban) and their spatial scatter.

The States with higher pre-Amendment per capita panchayat revenue collections are those that show higher growth in panchayat revenues post-Amendment, upto 1997-98 (the latest data year). Thus, the formal introduction of the third tier has not led to any convergence in the cross-State variation in local resource generation. States with low initial own revenues have in general seen poor rates of growth of own revenues. The highest own revenue achieved in 1997-98 was Rs 40 per capita, in Kerala.

State Finance Commissions (SFCs) did not substantially expand upon pre-existing local fiscal domains, and in one case (UP) actually reduced it, based on a widely shared conviction of panchayat inability to enforce compliance. SFCs adopted instead the soft option of recommending revenue-sharing by State governments even for the performance of local "core" functions with a purely local spatial reach, not typically defined to include even functions such as primary education from within the larger functional domain as legislated in the conformity Acts. Thus, the SFC recommendations perpetuate fiscal dependence for the performance of even local functions; upward accountability instead of downward accountability to the local electorate; and the inevitable corruption attendant on fund flows unconnected to local tax effort. A few SFC Reports do recommend explicit incentives for local revenue effort, but only two, Maharashtra and Haryana specify physical or revenue targets in an operationally useful way.

The SFC funding provisions are based on externally-determined norms for local functions, and to that extent do not embody adverse incentives for reckless local

spending, but there is not enough stress on the need for physical monitoring of expenditure outcomes so as to contain misuse.

The total annual EFC provision of Rs 2000 crores for LBs is around 0.1 per cent of GDP in the initial year (2000-2001) and will fall thereafter. The EFC Report claims that this additional Central grant for local bodies is for the "purpose of inducing the States to speed up the process of decentralisation". The inclusion of a decentralisation index in determining State shares is claimed as providing that incentive, but the use of rural population even within the index of decentralisation and revenue effort components, over and above the separate weight of 40 per cent for the rural population in the overall formula, far from rewarding decentralisation, embodies an incentive structure that rewards States that have failed to control population growth.

The intergovernmental Central provision by the EFC is completely dwarfed by the direct fund flows to rural areas from the Centre. Exclusively rural schemes including budgetary and extra-budgetary provisions for FY 2001-02, sum up to Rs 21389 crore, more than 1 percent of GDP. Further adding on the rural component of numerous other schemes could double this to 2 percent of GDP. The reported mid-year utilisation rates suggest ineffective use in a context where the targeted objectives, ranging from rural infrastructure through employment schemes to rural sanitation, remain largely unmet.

Clearly, much the most important issue from the developmental perspective has to do not so much with the intergovernmental fiscal provisions for the third tier, but with getting local involvement in decisions relating to the large fund flow for building rural infrastructure – both the RIDF loan facility, as well as the rural employment grants. This issue gathers added importance in the light of the empirical finding (Fan et.al. 1999) that road connectivity is the single most productive avenue of public expenditure for poverty-reducing growth.

From the foregoing, the paper concludes that growth-promoting fiscal devolution requires the following:

1. The task of devolution to panchayats should move away from a narrow focus on inter-governmental transfers, and focus more broadly on panchayat involvement

in Central fund transfers to rural areas, whose magnitude dwarfs inter-governmental transfers to panchayats.

2. Panchayat involvement should not be simply a matter of fund transfer. Empirical evidence (Rajaraman and Vasishtha, 2000) shows that untied grants leads to a slackening of panchayat revenue effort, with such slackening likely to be selective, non-transparent, facilitative of corruption and hence regressive. Panchayat involvement has to go with effective external monitoring of physical outcomes.

3. There is clear scope for revenue additionality in the Indian fiscal system taken as a whole, through transfer to the local fiscal domain of the following State government levies which remain underexploited: land revenue; and the profession tax. The paper provides a suggested design for a further crop-specific levy supplementary to the land revenue.

4. There is a need for embodying incentives for fiscal autonomy and local resource generation in the design of fiscal grants from both Centre and State. SFC Reports leave this issue largely unaddressed. Only the SFC Reports for Maharashtra and Haryana specify incentives for local revenue effort in an operationally useful way.

5. Functional devolution has to be linked to fiscal devolution, in such a way as to move panchayats towards greater fiscal autonomy. Even where the local fiscal domain is inadequate for core local functions, exclusive assignment of a subset of functions to local revenues remains possible even in the poorest regions. Among the major advantages of so doing is that given the difficulties of levy and collection, local bodies will seek low cost options for the performance of the assigned function.

6. The absence of any incentivising Central funding for elections is a glaring omission in the approach to devolution in India, as is the failure to provide Central funds for initial establishment costs of constructing and equipping minimal office facilities for the third tier. The Constitutionally-prescribed (article 280(3)) sequencing of the expenditure additionality consequent upon the third tier, whereby the issue is first addressed by SFCs, and then accommodated to by national Finance Commissions, is fundamentally flawed.

7. In any Centrally funded intergovernmental maintenance flow, such as that provided by the EFC, State shares on the basis of rural capital assets would

carry incentives to increase rural capital formation over time, and serve the maintenance purpose of the fund flow. The underlying inequity in distribution of rural capital assets has to be redressed through altering the pattern and effectiveness of capital expenditures, not by a distribution formula that embodies adverse incentives to increase rural population.

8. More empirical work on panchayats is needed. The few findings available show that increased decentralisation/democratisation does increase school enrolment rates and lower child mortality rates. There is also some evidence that greater ethnic fragmentation may lead to more, rather than less, fiscal discipline, possibly because in the Indian context fragmentation may prevent the consensus needed among local elites in respect of directions of collusive corruption. This finding is important in the context of theoretical results (Bardhan and Mookherjee, 1998) where suceptibility to local capture is an important variable in determining whether or not decentralisation outperforms centralisation. More confirmatory evidence is clearly needed on these issues.

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GROWTH-ACCELERATING FISCAL DEVOLUTION TO THE THIRD TIER

1. INTRODUCTION

This paper will focus on the path that fiscal devolution to the third tier in India has taken in the eight years that have elapsed since the formal mandating of a third layer of government in India, and examine what this reveals in terms of the implicit model underpinning the fiscal operationalisation of decentralisation so far. It will then attempt to define the desirable design of fiscal devolution from the viewpoint of growth acceleration with poverty reduction.

Given the federal structure of India, the third tier had itself to be introduced in a decentralised manner, since the necessary legislation implementing the Constitutional amendments could only be enacted at State-level. Correspondingly, the fiscal provisions for the third tier vary across the States in accordance with the recommendations of their respective State Finance Commissions (SFCs, mandated by the new Constitutional provisions).

The recommendations of these SFCs are in turn required to be taken cognisance of by the national-level Finance Commissions, under article 280(3) of the amended Constitution, while making Centre-State allocations, although the Eleventh Finance Commission (EFC) was the first formally charged with this task for 2000-2005. The Tenth Finance Commission (TFC) made an ad hoc provision for 1995-2000 since it pre-dated the SFC reports.

The EFC report points out the difficulty of aligning Centre-State flows with SFC recommendations given their varying periods of coverage and heterogeneity of approach, and goes so far as to suggest (para 8.11d) that the Constitution be

amended so as to de-link national finance commissions from SFCs. The EFC had in any case to forge its own criteria for devolution to the third tier for States where SFC reports were not available at all.

In the absence of any other, the EFC report has to be taken as the only national-level examination of the expenditure and consequent revenue additionalities placed upon the national fiscal system by the introduction of a third tier. It therefore merits close examination.

This paper carries an exclusive focus on rural areas and panchayats for several reasons. First, the formal institutional incrementality of the new Constitutional provisions was almost negligible for urban centres, which had all along carried formal governance and a defined (if not well exploited) fiscal domain including property taxes. (Urban user charges for water and sanitation often fall in the domain of State government owned parastatals). The poor exploitation of the property tax in municipalities carried within it a clear revenue additionality possibility for better functional performance.[1] Panchayats on the other hand, did not pre-exist in any nationally uniform formal sense.[2]

Second the challenge of instituting formal governance in rural areas is far greater given the larger numbers of rural local bodies and their spatial scatter. Of the total of 250715 local bodies (LBs) reported by the EFC, a mere 3682 are urban. Thus, in terms of both numbers of new governance units, and area (98 percent) and population (75 percent) coverage, panchayats pose the core challenge in terms of achieving the principal purpose of decentralisation, which is to achieve poverty-reducing growth by improving the effectiveness and reach of developmental expenditure.

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[1] The greater availability of data on municipal finances has made possible estimates of the scope for higher revenue. See in particular Mathur, et.al. 2000 and Mathur 2000.

[2] Even though the institution of panchayats is sanctioned in the original Constitution of India, and there were Panchayat Acts in many States predating the conformity legislation following the Constitutional Amendments.

Finally, the absence of functioning elected panchayats has coexisted with sizeable fund flows from the Centre targeted at rural areas through scheme-specific district agencies. The coming into existence of panchayats calls for resolution of critical issues having to do with channeling, and improving the effectiveness of, these pre-existing fund flows.

In what follows, section 2 constructs from first principles the expenditure additionalities and corresponding revenue additionality requirement imposed upon the fiscal system by the introduction a third tier of government. Since in terms of the fiscal devolution sequence, the SFCs come first, with the national-level Finance Commission having to take up the implications of SFC recommendations for Centre-State transfers, that is the order in which this paper will examine the issues. Section 3 surveys SFC recommendations in twelve major States. The focus of the section is on the approach adopted by SFCs, and the implicit incentives contained within that approach for local autonomy and resource generation. Data are presented on the actual outcome on the ground in respect of growth of own revenues. Section 4 examines the EFC approach to quantifying an additional fund flow to support decentralisation for the incentives implicit in the design of the flow, although the quantum of the EFC provision is minuscule as compared to the large fund flow already in place from the Centre to rural areas through a variety of schemes for rural development, health, welfare, agriculture, and education. Section 5 examines these pre-existing developmental flows. Section 6 surveys the limited empirical literature on panchayats. Section 7 looks at the scope for expansion of the fiscal domain of panchayats, and the simultaneous revenue additionality possibility in the fiscal system taken as a whole, by empowering panchayats to levy productivity based taxes on agricultural land. The section presents a possible design for such a levy by panchayats. Finally, section 8 concludes the paper a design for growth-promoting fiscal devolution to the third tier, underpinned by the findings of the preceding sections.

2. DECENTRALISATION ADDITIONALITIES

The legislative design of devolution to the third tier, although enacted at State-level, was subject to certain broad Centrally-imposed uniformities. There are clear expenditure additionalities flowing from these. But a critical deficiency in the design of decentralisation has been the failure to quantify, and provide for Central funding of, these expenditure additionalities. Features of decentralisation imposed by the Constitutional amendments on all State-level legislation, and carrying clear concomitant costs, are those arising out of either the new processes required (five-yearly elections,[3] finance commissions); additional institutional paraphernalia such as District Planning Committees (DPCs, which are the only Constitutionally mandated planning agency at any level of government); and establishment costs, both capital and recurring, of setting up the new tier of government (which in rural areas has three constituent tiers at village, taluk[4] and district level). Providing for these costs on the basis of uniform norms would have enabled decentralisation and incentivised States by providing Central financial backing for those parameters of decentralisation which were laid down Centrally, and over which States in any case had no discretion. To do so would not have robbed States of discretionary latitude, but would instead have defined the parameters within which they could have meaningfully exercised their discretion. The further advantage of meeting these establishment costs at Central level is that the pre-existing district-level agencies through which Central funds to rural areas are now routed can be merged with the newly mandated institutions, and would thus involve lower expenditure additionality for the Centre than for State governments.

In the absence of upfront Central support, State governments, already fiscally-stressed, became excessively focused on having to find additional funds

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[3] Under the provisions of Article 243 of the (amended) Constitution, the costs of elections are to be borne by State Election Commissions, which are funded entirely by State government.

[4] The middle rung is not mandatory in States with a population of 2 million or less.

for the third tier, and lost sight of the essential developmental purpose of the exercise.

Economic efficiency requires that taxes to cover the cost of public goods should be raised from within the beneficiary space of each, and that local public goods carrying a distinctly local spatial reach (sanitation, water, street lighting, law and order) should be paid for by taxes collected locally from property taxation or user charges.[5] Since it is these functions that were not effectively being performed previously, decentralisation clearly called for immediate attention to the local fiscal domain, and for identification of those taxes and charges that could feasibly be collected locally. Indeed, the case for decentralisation rests principally on the scope it offers for resolving the size-of-nation trade-off between economies of scale in provision of public goods with a national reach, and heterogeneity of preferences in respect of public goods with a sub-national reach (Alesina and Spolaore, 1997).

The Constitutional Amendments however prescribe a suggestive list of local functions extending far beyond that definable as purely local in terms of spatial reach.[6] To the extent that the local functional domain was visualised as functionally substitutive for State governments, there is clearly no implied expenditure additionality, since functional substitution calls merely for expenditure transfer from one level of government to another. This seems to have been the implicit basis for the conclusion of the TFC (para 10.7) that no transfer of funds from the Centre was necessary; the TFC chose to ignore the upfront establishment costs, mentioned by the States in their memoranda (para 10.4).

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5 It is possible of course that the better allocative (demand) efficiency achievable through decentralisation might be offset by lower production (supply) efficiency at lower levels of government (Prud'homme 1995), but this possibility has long been recognised, and is easily accommodated by unbundling provision and production of public goods (Oates 1972:45).

Thus, to summarise, there are two clear levels at which expenditure additionalities consequent upon decentralisation need to be met. One is from Central revenues, to meet the procedural and establishment costs of the new tier; and the other is from the local fiscal domain, to meet the costs of providing local services in accordance with the preferences, and willingness to pay, of local beneficiaries. The transfer of functions to local level from State-level calls not so much for additional fund flows as for substitutive fund flows with accompanying transfer of functional control. Education and health for example are presently delivered through departments of the State government. Transfer of monitoring of these functions to local authorities is necessary for achieving the developmental purposes of decentralisation, for the control of teacher absenteeism and other obstructions to effective rural delivery. But the point at issue here is that this carries no implied additionality in terms of a pure fund flow from States to LBs arising from transfer of functions. The paradox (see section 3) is that although, as argued here from first principles, there is no need for expenditure additionality at State-level following from decentralisation, that is in fact what State Finance Commissions have wound up recommending, instead of addressing the need to define feasible directions for augmenting the local fiscal domain.

It must be noted here that panchayats do not add to the consolidated government deficit because they are not authorised to borrow. The constraint varies in form across States, but is usually specified as a required percentage surplus of non-borrowed receipts over expenditures. Municipalities and Local Development Authorities on the other hand have been permitted to float bonds ever since the Local Authorities Act of 1914, usually capped at some percent of the annual rateable value of urban property falling in their jurisdictions. Municipal borrowing is subject to State government approval, which might explain the small number of actual bond flotations so far, by a few municipalities/local authorities in Gujarat, Maharashtra, Punjab, Karnataka and U.P. Borrowing from financial

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[6] The eleventh schedule to the amended Constitution includes a very large number of developmental functions, ranging from land improvement, social forestry and minor irrigation, all

institutions, and from the State government is also permissible (where the latter gets netted out, and does not add to the consolidated fiscal deficit across all levels of governments). Even inclusive of borrowings from State governments, the aggregate deficit estimate for all LBs in the country by Rao, 2000, at approximately 10 percent of NSDP,[7] seems implausibly large. The Rao estimate is based on the EFC Report expenditure figures for urban local bodies for 1997-98, which are prima facie, implausibly high.[8]

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the way through village and small scale industry, to education, literacy, and family planning.

[7] Net State Domestic Product; the corresponding percentage to GSDP would be of the order of 9 percent.

[8] The absolute figures display what appears to be a displacement by several orders of magnitude.

3. STATE FINANCE COMMISSION RECOMMENDATIONS

Setting up of SFCs in five-yearly cycles is one of the mandated requirements of the new Constitutional provisions, and has been largely complied with. Out of twenty-five States (before the recent creation of three new States) twenty appointed SFCs,[9] and 19 of these submitted their reports (all except Bihar; EFC, Annexure VIII.1).

Table 3.1 tabulates the SFC recommendations of twelve of these,[10] in respect of expansion of the local fiscal domain, through both new local taxes, and transfer of rights of levy of pre-existing taxes in the State fiscal domain. Table 3.2 tabulates recommendations on revenue-sharing by State governments. Table 3.3, which presents figures on panchayat revenues before and after the SFCs (for the most recent year for which official[11] data are available, 1997-98), shows the recorded outcome on the ground in terms of local fiscal self-sufficiency.

No attempt is made to track action taken by State governments upon the SFC reports.[12] The focus instead is on the recommendations themselves, so as to understand the parameters within which State-level fiscal devolution has typically been conceived across the country, and in particular, following from section 2, on whether the need for resource generation at the third tier has been recognised and incentivised.

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[9] Meghalaya, Mizoram and Nagaland have been excluded from the ambit of the 73rd Constitutional Amendment, and the two that did not were Jammu & Kashmir and Arunachal Pradesh.

[10] The period of coverage of most of these ends in March 2001, so that the second round of SFCs should have been constituted, and indeed ready with their reports. The seven excluded States from among those which did submit reports are Assam, Gujarat (submitted but not released), Manipur, Tripura, Sikkim, Goa and Himachal Pradesh.

[11] Other sources without official access and therefore smaller samples (PRIA, 1999) are likely to be less reliable.

[12] A State Finance Commissions Cell at the National Institute of Rural Development in Hyderabad tracks the "Action Taken Reports" (ATRs) of the States, where such a document has been issued in response to the SFC report. But "acceptance" in the ATR is not tantamount to notification.

The VP is traditionally the tier granted powers of revenue collection, since that is the tier which executes local functional responsibilities on account of its presence in every village. The other tiers typically have powers to piggyback on VP levies (Rajaraman et.al., 1996). It is harder to generalise about the tier to which external funds are given. Most usually, it is the VP again, with the DP given funds for larger schemes. But in Rajasthan, the middle tier has the responsibility for implementing rural development programmes, and therefore receives the largest fund flow. States are listed in all three tables in descending order by percent own in total revenue at VP level prior to the Constitutional Amendment (see table 3.3).

Expansion of the Local Fiscal Domain

The taxes already assigned to the local domain in the conformity legislation, prior to the SFCs, are fully listed in Rajaraman et.al., 1996. Land revenue, a specific levy normally confined to agricultural land,[13] was not in the local fiscal domain anywhere, although five States[14] allowed panchayats to levy a capped cess on the base land revenue. Most State governments however share revenues from the base land revenue and/or cesses with panchayats, most usually less than fully, and most usually not by origin but by formula. Panchayats however are assigned the right to levy an ad valorem (on capital or annual value) tax on non-agricultural land, with this "local rate" as it is called extending in three States[15] also to agricultural land, distinct from land revenue. The profession tax, the only Constitutionally sanctioned (Article 276) levy for local bodies, remains largely unexploited in rural areas even in States where the tax has already been assigned to the panchayat fiscal domain in the conformity legislation. Where the tax remains in the State domain, it is collected through withholding on urban salaried employees, and therefore is inoperative in the rural sector.

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[13] In Kerala, Maharashtra and West Bengal, land revenue extends to non-agricultural land as well.

[14] Gujarat, Madhya Pradesh, Rajasthan, Tamil Nadu and Uttar Pradesh.

[15] Kerala and Bihar at GP level, and Punjab at TP level.

Expansion by the SFCs of the local fiscal domain (table 3.1) was possible either by adding on taxes previously untapped at any level of government; or through a reassignment of powers of levy of pre-existing taxes levied at State level to panchayats, uniquely or concurrently.[16] The scope for new levies hitherto untapped at any level of government was in general limited. SFCs recommended the house tax where it was not already levied (or base-widening); levies on use of pumps or tractors, highway services, telephones or cable TV; and surcharges on land revenue or on sale of land.[17] In Rajasthan a DP surcharge was recommended on the fee on sale of agricultural produce in regulated markets.[18] The fee itself, a buoyant source of revenue in most States, was recommended for transfer to VPs in two States, West Bengal and Madhya Pradesh, the only revenue-significant suggestions for transfer of State taxes to the local fiscal domain.

None of the SFCs, with the exception of Punjab, pointed to the untapped rural revenue potential in the profession tax. Agriculturists are normally excluded from the ambit of the profession tax, but it offers a way by which to induct traders and other non-agricultural rural service providers into the local tax net.

No SFC recommended transfer of land revenue to panchayats. Transfer to panchayats of this levy could lead to revenue additionality in the fiscal system taken as a whole. The causes for its extreme revenue insignificance are explored in section 7, among them its shared status, which reduces the collection

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[16] The West Bengal report recommends a third option: voluntary contributions. In general a structured and defined levy is much preferable to unstructured and possibly capricious extractions termed voluntary, but there are dissenting voices on this (Marjit, 1999).

[17] Land sales were however already subject to stamp duty, so that this concurrent empowerment of panchayats to piggyback on stamp duty was liable to add to the pre-existing incentive to evade stamp duty by understating the value of the property transferred.

[18] The Andhra SFC Report suggests that a pre-existing local tax on some items of village produce be extended to "all the village produce whether sold or not" (para 13.3.3), but with an immediate admission that such a levy might not be feasible.

incentive for the levying government, and non-jurisdictional sharing, which gives local government no stake in improved collections.

The reason for the absence of substantial expansion of the local fiscal domain seems to be a widespread perception that local bodies are unable to enforce compliance. All the SFC reports mention this without exception, and advance as proof the low revenues collected from the fiscal domain already assigned under the conformity legislation. Even obligatory taxes are reported as not collected, possibly because these do not carry an obligatory non-zero floor rate of levy (there is usually on the other hand a maximum rate of levy). UP however offers a rare instance where an obligatory GP surcharge with a non-zero minimum rate, on land revenue, was not collected. The UP SFC recommended transfer of the revenue collection function back to the State government, with the proceeds distributed not by origin of collection but by the formula applicable to grants, thus transferring the levy out of the local fiscal domain. It is clear from the U.P. example that a minimum rate of levy alone is not sufficient without some penalties for non-compliance, such as withholding of State funds from local bodies that collect no revenues. The difficulty with this kind of provision is that it will add to the delays already present in the flow of funds from State to panchayat.

The only effective enforcement of local revenue collection can be through the mapping of some local functions exclusively onto the local fiscal domain. Even where the local fiscal domain is inadequate for core local functions, exclusive assignment of a subset of functions to local revenues remains possible even in the poorest regions. This is possibly the greatest general failing of the SFC reports. There are exceptions. In West Bengal, the SFC report recommends handing over of irrigation rates to the DP specifically for supply and routine maintenance of local irrigation. Local bodies will have a positive incentive to levy local taxes only if a function or set of functions must be funded exclusively from local revenues. Among the major advantages of so doing is that given the

difficulties of levy and collection, local bodies will seek low cost options for the performance of the assigned function (see Bardhan, 1996 and Bardhan and Mookherjee, 1998).

State-Local Transfers: Incentives for Own Revenue Effort

Table 3.2 records the recommendations for State-level transfers. The table lists SFC suggestions for inclusion of additional State-level taxes in the set of shared taxes, but does not tabulate suggested changes in sharing formulae in respect of taxes already in the shared domain (for tax-sharing provisions enacted under the conformity Acts after the Constitutional Amendments, see Rajaraman et.al., 1996).

From tables 3.1 and 3.2, it is clear that SFCs in general adopted the soft option in not expanding the local fiscal domain, and merely recommended tax-specific transfers from the State government, and/or a certain percent of general revenues. The implicit incentives for local revenue generation embedded in the resource transfer mechanism therefore becomes a matter of importance more than the quantum of the provisions, which vary within a range of 1-2 percent of general revenue with the exceptions of West Bengal, Karnataka and Andhra (16-39 percent).[19]

The transfers recommended by the SFCs were in most though not all cases underpinned by prescribed norms for purely local "core" functions, not typically defined to include functions such as primary education from within the larger functional domain as legislated in the conformity Acts. Thus, the revealed judgement of SFCs seems to have been that even local functions required funding through transfers from State revenues.

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[19] However, see discussion on table 3.3.

In respect of these core functions, most reports specify minimum physical norms, and obtain the corresponding expenditure requirement, or specify minimum expenditure norms directly, and arrange for the requisite revenues by transfer from the State government, either entirely, or for the incremental distance from present performance to target performance.

Where the amount to be transferred is externally determined in this manner, there is no adverse incentive for reckless expenditure by local bodies. But it does mean local bodies are thereby reduced to essentially an agency status, and remain fiscally dependent and accountable upwards to higher-level governments in terms of externally determined norms of performance, rather than accountable downwards to their electorates.

In a few cases, SFCs recommend that local revenue collections be quantified and deducted, but only on a macro basis, in the sense that although the total revenue grant from the State deducts local revenue collections from the total requirement, the deduction is not done on a jurisdiction-specific basis. This ensures that there are no adverse incentives for local revenue effort, since any revenues that local bodies are able to collect on their own will not carry a penalty in terms of reduced transfers from the State.

The revenue transfer to each local body is obtained using a formula, most usually a simple per capita entitlement, which means revenue distribution by population. But some States like West Bengal and Tamil Nadu use complex formulae with adverse incentives for local literacy or infrastructure maintenance. More even than the adverse incentive, the complexity of the calculation, involving as it does knowledge about the maintenance of assets by each village panchayat, makes it likely that revenue flows to panchayats will be greatly disrupted by delays.[20]

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[20] Arrears in the revenue flow from State to panchayat are mentioned in the Orissa and M.P. reports, and are likely to be a severe problem in other States as well. The principal reason is

On balance, however, the formulae used by SFCs for revenue transfer from the State exchequer do not by and large carry adverse implicit incentives for local resource effort. But they do not carry positive implicit incentives either. A few SFCs recommend explicit incentives, normally involving either withholding of entitlements or additional grants contingent upon local resource efforts. Of these, the Maharashtra incentive with clearly defined targets, phased by year, and the Haryana incentive, based on physical performance outcomes, are well structured.[21]

Perhaps the greatest difficulty with fund transfer from the State exchequer for performance at externally-prescribed norms is that without a systematic provision for monitoring of physical outcomes, fund transfer will merely degenerate into a local battle for capture of public resources. One of the SFC reports points out that the grant from the Central government to the State governments by the Tenth (National) Finance Commission covering the period 1995-2000 were diverted from their sanctioned uses as stated in the guidelines from the Ministry of Finance (biogas; storage godowns; tubewells; link roads; school buildings) towards the building of marriage halls useful only for rural elite. Thus the need for effective physical monitoring is paramount. Even financial audit mechanisms are ineffective because of delays, and lack of feedback from negative findings into subsequent practice.

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that total revenue from any State tax (shared with panchayats) is not known until the conclusion of the financial year.

[21] Har. : Cash awards for performance on primary enrolments, small family norms, own resource effort and detection of power theft.
Mah. : Rs 25 lakh (TP: 50%; DP:50%) for phased increase upto 100% by 2000-01 of recovery of costs of drinking water supply and irrigation schemes.
MP; Pun.: Unspecified incentives
Raj : Cash awards for developmental work (not deducted from entitlements)
TN : 15 per cent of the transfer from general State revenues distributed as matching grants to house tax and local cess surcharge collections.
WB : 2 per cent of entitlement to a district goes to an (unspecified) incentive fund.

Own Shares in total Panchayat Revenue

Table 3.3 lists States in descending order by share of own in total revenue of village panchayats in 1990-91, prior to the 1993 Constitutional Amendments. The table also shows absolute figures of own revenue per capita in 1990-91, and subsequent growth rates of nominal own revenue over the period 1991-95, when most of the conformity legislation was enacted and presumably notified,[22] and 1995-98, when SFC Reports were submitted, and (again presumably) notified to the extent of their acceptance. The final column shows the percent share of own in total revenues in 1997-98, the latest year on which figures are given in the EFC Report,[23] although not possibly recent enough to record the full impact of the SFC Reports.

The following emerge from table 3.3:

1. The highest own rate of revenue collection per capita in 1990-91 was Rs 24 (in Haryana) and the median rate was of the order of Rs 4. Per capita figures are not given for 1997-98 because State-wise population figures are not available for inter-censal years. But it is clear from the figures of own revenue growth that Kerala would have reached the highest per capita levels by 1997-98 in terms of both own revenue (of the order of Rs 40) and total revenue (of the order of Rs 300).
2. In general, the States with higher pre-Amendment per capita panchayat revenue collection are those that show higher growth in panchayat revenues post-Amendment. Thus, the formal introduction of the third tier has not led to any convergence in the cross-State variation in local resource generation. States with low initial own revenues have in general

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22 For an example of notifiication failure see note 2 to table 3.1. There must be many others.

23 Notwithstanding the implausibility (noted in the previous section) of the urban figures. The SFC reports did not all report panchayat revenue collections,for reasons having to do with inability to collect the data, or simply because of negligible own revenues. The EFC carries the further advantage that it uniformly includes Central funding in panchayat finances (but see note 1 to table 3.3).

seen poor rates of growth of own revenues, notwithstanding SFC suggestions for expanding the fiscal domain (Rajasthan for example).

3. Kerala, which had the second highest per capita own revenue of Rs 14.6 in 1990-91 has seen a substantial fall in the percentage of own in total revenues to 13 percent in 1997-98, despite buoyant growth in own revenues, because of even higher growth rates in revenue receipts from the State government. State-local flows have also clearly outstripped (buoyant) own revenue growth in West Bengal, Karnataka and Tamil Nadu. In such States, the design of State-local flows becomes a matter of particular importance for the implicit incentives for own revenue generation. There are other States where own revenue shares have risen dramatically because of stagnation in State-local transfers (Andhra, Gujarat, Punjab). The stagnation in State-panchayat transfers in Andhra is surprising in the context of the very generous provisions recommended by the SFC (table 3.2). If notified, this fund flow has bypassed the panchayat structure by being channeled into parallel programmes like Janmabhoomi, directly administered by the State government.[24]

Summary

This section examines what devolution to the third tier has done for local fiscal autonomy, resulting from the recommendations of SFC reports for twelve major States.

SFCs did not substantially expand the local fiscal domain, and in one case (UP) actually reduced it, based on a widely shared conviction of panchayat reluctance, amounting to inability, to enforce compliance. SFCs adopted instead the soft option of recommending revenue-sharing by State governments even for the performance of local "core" functions with a purely local spatial reach, not

[24] The JB fund, into which panchayat funds are channelled, are operated by the District Collector (Government of A.P.Janmabhoomi Operational Guidelines).

typically defined to include even functions such as primary education from within the larger functional domain as legislated in the conformity Acts. Thus, the SFC recommendations perpetuate local fiscal dependence; upward accountability instead of downward accountability to the local electorate; and the inevitable corruption attendant on fund flows unconnected to local tax effort.

EFC figures of panchayat own revenues over the nineties upto 1997-98 display the highest growth rates in those States with a defined and exploited local fiscal domain prior to the Constitutional amendments. Some of these States show a dramatic fall in the share of own in total revenues resulting from the rise in State-local transfers consequent upon SFC recommendations.

The impact of the Constitutional Amendments on own revenue is least visible in those States where own revenue collections were poor to start with. This includes a wide swathe covering Rajasthan, Uttar Pradesh, Orissa, Assam, and of course Bihar, which is holding a first round of panchayat elections only in mid-2001.

These fiscal outcomes underline the need for embodying incentives for fiscal autonomy and local resource generation in the design of fiscal and functional devolution. The SFC funding provisions are based not on gap-filling of locally-determined expenditures, but on externally-determined norms for local functions, and to that extent do not embody adverse incentives for reckless local spending, but at the same time there is not enough stress on the need for physical monitoring of expenditure outcomes so as to contain misuse. A few SFC Reports recommend explicit incentives for local revenue effort, but only two, Maharashtra and Haryana specify physical or revenue targets in an explicit way.

The next section explores the incentives embodied in the EFC design of a fiscal flow from the Centre to the third tier.

Table 3.1

SFC Recommendations: Panchayat Fiscal Domain

State	Period	Taxes/user charges		
		New		Transfer from State domain
		VP[1]	DP[1]	
Kerala	1996-2001	Ent tax: cable TV	Property sale (surch)	-
Haryana		1. House tax: non-resid.	1. Tax on irrigd. land >2 ha[2] 2. Tax on pumpsets 3. Tax on tractors	
Andhra Pradesh	1997-2001	1. Tax on telephones[3] 2. Tax on all village produce 3. No exemption: house tax	-	-
Punjab	1996-2001	1. Tax on adverts; inds.	Land rev. cess[4]	-
Maharashtra	1997-2001	-	Tax on non-agricultural land	-
West Bengal	Unstated	-	-	1. Ent. Tax (VP) 2. Agri. produce sale (fee); irrigation rates (DP)

1. A fiscal domain for TPs was recommended only in Rajasthan, at 10 per cent of land rent.
2. This is "new" because the land revenue is not levied in Haryana.
3. The Andhra SFC report (para 6.4.1) recommends that the advertisement tax already assigned to the VP domain by the Panchayat Act of 1994 be notified so as to enable operationalisation of the legislative provision.
4. To be shared: (VP: 50%; TP: 30%; DP: 20%). However, the land revenue itself was repealed in Punjab in early 1997.
5. The land revenue surcharge was reverted back to the State government.

Table 3.1 (contd.)

State	Period	Taxes/user charges		
		New		Transfer from State domain
		VP[1]	DP[1]	
Karnataka	1996-2001	-	-	-
Tamil Nadu	1997-2002	1. Water tax; 2. Social forestry (commons)		-
Rajasthan	1995-2000	1. House tax; 2. Tax on highway services	1. Land (barani) rev. 2. Land sale (surch) 3. Agri. produce sale (surch).	-
Orissa	1998-2003	House tax		-
Madhya Pradesh	1996-2001	-	-	1. Forest rev. 2. Agri. produce sale (fee)
Uttar Pradesh	1996-2001	1. Tax on pumpsets 2. Tax on tractors		To State[5] :land rev. (surch)

Source: SFC Reports.

Notes: The States are ranked in descending order by share of own in total revenues prior to the Constitutional Amendments (see table 3.3).

Table 3.2

SFC Recommendations: State-Panchayat Resource Transfers

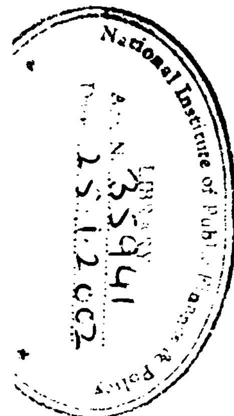
State	Tax-specific (additional to pre-existing)	From general revenue[1]		
		% of rev.[2]	R:U	Share by tier
Kerala	1. Building tax 2. Stamp duty	1%	Population	VP: 100%
Haryana	1. Land conversion charges 2. Stamp duty 3. Royalty on minor minerals	1. Maint; sanit. per block 2. Development per capita		
Andhra Pradesh	-	39.24%	Population	Unclear[3]
Punjab	1. 100% land rev. (prev. 40%)[4] 2. Liquor tax	20% (four taxes)	Origin principle	VP: 50% TP: 30% DP: 20%
Maharashtra	1. 10% profession tax	Per capita[5]	R entirely	VP: 100%
West Bengai	-	16%	Population	VP: 50% TP: 20% DP: 30%

1. Net of tax-specific sharing. There might in addition be pre-existing grants for establishment/other expenses.
2. Total tax plus non-tax revenue unless otherwise stated.
3. The (absolute) share by tier, obtained from norms applied to functional responsibility at each tier, allots only the additional devolution of Rs 819 crore (1.14 percent of State revenue). The distribution of the remainder is unclear, with a suggestion (para 9.11.2) of allotment on the basis of matching contributions from local bodies.
4. This recommendation was accepted, but the land revenue itself was repealed in early 1997.
5. Rs 8 in the first year, increased annually upto Rs. 11 in 2000-01 (amounting that year to 0.2 percent of State revenue).

Table 3.2 (contd.)

State	Tax-specific (additional to pre-existing)	From general revenue[1]		
		% of rev.[2]	R:U	Share by tier
Karnataka	-[6]	36% (own State rev)[7]	Pop; area; Backwardness 85:15	VP: 25% TP: 35% DP: 40%
Tamil Nadu	-	1997-98: 8% 2001-02: 12%	Population 60:40	VP: 43% TP: 43% DP: 14%
Rajasthan	-	2.18%	Population 3.4:1	-
Orissa	1. Stamp duty surcharge 2. Sairat tax 3. Forest revenue	No general transfer		-
Madhya Pradesh	-	4.24%	R entirely	VP: 100%
Uttar Pradesh	-	3%	R entirely	VP: 70% TP: 10% DP: 20%

Source: SFC Reports.



6. Earlier tax-specific sharing (of motor vehicles and entertainment taxes, stamp duty and octroi) was withdrawn.
7. Amounting to 25 percent of total State revenue.

Table 3.3

Own Revenues of Village Panchayats

States	Own/total revenue % 1990-91	Own revenue per capita (Rs)	Nominal annual Growth own revenue %		Own/total revenue % 1997-98
			1991-95	1995-98	
Kerala	32.41	14.63	15.44	21.23	13.31
Haryana[1]	30.67	23.70	9.80	7.42	..
Andhra Pradesh	22.71	10.74	10.19	14.83	38.70
Gujarat	22.47	7.53	5.05	8.39	33.82
Punjab	22.37	12.70	21.46	5.27	45.57
Maharashtra	18.42	6.55	15.97	22.54	20.63
West Bengal	17.07	1.74	-0.15	14.94	5.08
Karnataka	14.16	5.58	9.20	6.94	12.90
Tamil Nadu	11.21	2.80	15.64	11.76	9.22
Rajasthan	7.79	4.93	-6.01	0.99	1.68
Orissa	6.93	2.15	7.96	-4.46	4.80
Madhya Pradesh	5.29	2.31	18.92	5.07	3.98
Uttar Pradesh	0.83	0.30	9.88	-7.59	0.52
Himachal Pradesh	0.51	0.00	128.27	7.63	3.25
Assam[1]	..	1.03	2.00	2.00	..
Bihar	0.00	0.00	0.00	0.00	0.00

Source: EFC Report; Annexure VIII.2B and VIII.7.

Notes: 1. The figures suggest that JRY fund flows from the Centre were not included included in total revenue for Haryana and Assam. The Haryana percentage for 1990-91 was taken from the SFC Report, table 5.5.

4. ELEVENTH FINANCE COMMISSION PROVISIONS

FOR THE THIRD TIER: IMPLICIT INCENTIVES

The Eleventh Finance Commission (EFC) was the first national finance commission formally charged in its terms of reference with recommending measures to augment the finances of State governments so as "to supplement the resources of panchayats and municipalities on the basis of recommendations of the State Finance Commissions (SFCs)", in accordance with article 280(3) of the amended Constitution). Alignment with SFCs proved difficult since their award periods were not coterminous with the EFC. But even without this, the heterogeneity of State-level expenditure additionalities imposed by independent SFCs with varying approaches to the issue poses problems for a national FC. The EFC, in recognition of this difficulty makes suggestions for uniformity in presentation of SFC recommendations, but goes further to suggest that the constitution be amended so as to de-link national FCs from State-level FCs (para 8.11). The terms of reference required the EFC in any case to make its own assessment of LB needs where SFC reports were unavailable.

Thus, the EFC provides the first national-level examination of the issue of the Central intergovernmental burden in respect of the third tier. Both the EFC, and before it the Tenth Finance Commission (although not formally charged with the task) do make a provision for the third tier, despite having stated that the coming into existence of the third tier does not in and of itself require additional flows of funds from the Centre to States.[25]

The amounts provided by the TFC and EFC are shown below in Box 4.1. The TFC panchayat total was obtained from a per capita provision of Rs. 100 applied to the rural population as given in the 1971 census, but the municipality

[25] See EFC Report, para 8.17 and TFC Report, para 10.7.

aggregate was ad hoc.[26] The EFC aggregate also appears to be ad hoc although some components of it are built up from per unit assessments (Box 4.2).

Box 4.1: National Finance Commission Provisions for The Third Tier

Years		Panchayats	Municipalities	Total (Rs crore)
TFC: 1996-2000		4381	1000	5381
EFC: 2000-2005		8000	2000	10000
				(Rs lakh)
	Per LB	3.24	54.32	3.99
Number of LBs		*247033*	*3682*	*250715*
	VP	*240588*		
	TP	*5930*		
	DP	*515*		

The nominal EFC provision is roughly 1.5 times that of the TFC in annual terms. Assuming annual inflation of capital goods prices at 5%, the allocation in the final year of the EFC period (2004-2005) in real terms is 17.5 per cent higher than in the final year of the TFC (1999-2000).

Relative to GDP, the total annual EFC provision of Rs 2000 crores for LBs is around 0.1 per cent of GDP in the initial year (2000-2001) and will fall thereafter. Thus the total provision is not burdensomely large. Each municipality gets around Rs 11 lakh per year on average, and each panchayat receives around Rs 60,000 per year.

Purpose of Devolution to the Third Tier

The TFC grant was intended for "developmental expenditure" and explicitly excluded wages/salaries of LBs. As a stated purpose for a first-time

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[26] The inter-state distribution of the urban provision was based on the ratio of the population in urban slums as enumerated in the 1971 census. The TFC recommended actual distribution between local bodies on the basis of matching contributions (para 10.19).

grant provision targeted at LBs, it was a somewhat odd purpose in a context where channels of fund flow for developmental purposes from the Centre, either to the State governments or directly to scheme-specific district-level bodies, already existed (see next section). In the event, the TFC provision was treated as part of State Plan expenditures, so that there was in effect no additionality consequent upon the TFC provision.

Even in the absence of any additionality, the TFC earmarking for LBs can be argued to have led to re-allocation of State-level expenditure in favour of the qualifying list[27] (urban waste management schemes; rural roads, school buildings; biogas plants and storage), but funds are fungible, and this may not have happened either. One of the SFC reports reports that TFC grants were diverted towards construction of marriage halls, an inevitable consequence of the absence of any physical monitoring of expenditure outcomes. The enforcement mechanism specified in the guidelines involved submission of utilisation certificates, and was clearly capable of subversion.

If the intent was to ensure that the TFC grant was spent in accordance with democratically determined local priorities, a far better stance would have been, in the spirit of the Constitutional amendments, to ensure that the entire developmental fund flow from the Centre was in accordance with local priorities, and to enable this by providing funds for holding local elections.

The costs of holding elections are a clear expenditure additionality for State governments, and the absence of any incentivising funding for elections is a glaring omission in the approach to devolution in India, as is the failure to provide for initial establishment costs of constructing and equipping minimal office facilities. The Ministry of Finance guidelines for disbursement of the TFC grant mention that except for disbursements for the first year, 1996-97, States

[27] Mentioned in the TFC guidelines; the Report itself recommended that the grant be untied (para 10.15).

had to qualify for their share of the grant by having held local elections. This clause did ensure in principle a penalty for not holding elections but the funds so withheld were minuscule compared to the annual fund flow for developmental purposes (see next section).

The EFC provision is directed towards improving account-keeping in panchayats, and providing a database on LBs, with the residual (Rs 1309 crores annually for panchayats) meant for maintenance of existing assets created with Central funds[28] (see Box 4.2). Thus, there is a welcome shift in the EFC approach towards funding improvements in administrative capacity in panchayats. The construction of panchayat buildings is not explicitly provided for

Box 4.2: Constituents of EFC Third-tier Provision

Annual grant 2000-2005

Constituents		Panchayats	Municipalities	Total (Rs. Crore)
Total		1600.00	400.00	2000.00
Account-keeping				
	Rs 4000/VP	96.24		
	Rs 4000/TP	2.37		
		98.61		98.61
Data base	Rs 7977/LB	197.06	2.94	200.00
Maintenance of civic services[1]		1304.33	397.06	1701.39

Notes: 1. Primary education; primary health; drinking water; street lighting; Sanitation.

[28] This is well below the annual requirement of Rs 4500 crores calculated by the Ministry of Rural Development as the maintenance requirement, at 7 per cent of capital assets already in place in rural areas funded through Central and State Plans, and also falls well short of the annual requirement Rs. 28432 crores for maintenance of core services as estimated by an independent study commissioned by the EFC, although it is unclear if either of these estimates deducts maintenance fund flows already in place (see next section). The amounts awarded to municipalities, although less than for panchayats, is closer to the lower end of a range suggested by an independent study (Rs 6,907 crores to Rs 32,598 crores over five years).

by the EFC on the grounds that these should have been included in the routine State expenditure projections used as the basis for allocation of Central funds.

Costs of holding panchayat elections are not singled out by the EFC for mention at all.

Implicit Incentives

But perhaps the greatest difficulty is with the incentive pattern implicit in the inter-State distribution of the fund provision for LBs, based on the formula shown in Box 4.3, which assigns a weight of 20 percent for an index of decentralisation.

The inclusion of a decentralisation index is claimed as providing for the first-time an incentive to decentralise, but the unfortunate manner of its calculation robs it entirely of its incentivising property. States are assigned scores on ten indicators from five to zero (although the lowest possible score for at least one of the indicators is one, a matter of some significance). Each State's aggregate score is then used to form four groups in descending order, which are assigned values between a maximum of 4 to a minimum of 1 (see Box 4.3). These are then weighted by the rural population to obtain the share of each state by the (weighted) index of decentralisation.[29]

Assigning the decentralisation index a minimum value of one, and weighting the index by rural population, ensures that even a State with zero scores on the constituent indicators gets a weight of one applied to its share of rural population. Furthermore, since some of constituent indicators do not carry a zero score, no State can get an aggregate score of zero, so that the minimum unweighted index value for any State is in effect 2. Thus, even the best-

[29] The index values are incorrectly called "weights" applied to the rural population, when it is really the other way around.

performing State on decentralisation gets a weight applied to its rural population of 4, only twice that of the most delinquent State. Bihar for example, despite not

Box 4.3: Distribution of EFC Panchayat Provision Between States

Formula for State shares

		Per cent
i.	Rural population (1991 census)	40
ii.	Distance from highest per capita income	20
iii.	Index of decentralisation	20
iv.	Revenue effort of states	10
v.	Geographical area	10
	Total	100

Decentralisation (Unweighted) Index

State group	Decent. Score	Assigned Value
A	> Mean + 0.5 SD	4
B	Mean ±0.5 SD	3
C	0 < score < Mean – 0.5 SD	2
D	0	1

The assigned value is weighted by the rural population to obtain the share of each state by the index of decentralisation.

Source: EFC Report, Appendix VIII.1.
Notes:
States are scored for the index of decentralisation on ten indicators (score range in parentheses):

i. Enactment of State Panchayat Legislation in conformity with the 73rd Constitutional Amendment (0-5).
ii. Intervention/restriction in the functioning of the Panchayats (1-5).
iii. Assignment of functions to the Panchayats in the State Panchayat Legislation vis-à-vis the Eleventh Schedule (0-5).
iv. Transfer of functions to the Panchayats by way of Rules/Notifications/Orders of State Governments (0-5).
v. Assignment of taxation powers to the village panchayats as per State Panchayat Acts (0-5).
vi. Levy of taxes by the village panchayats (0-5).
vii. Constitution of State Finance Commissions and submission of Action Taken Reports (0-5).
viii. Action taken on the major recommendations of the SFC (0-5).
ix. Elections to the Panchayats (0-5).
x. Constitution of District Planning Committees (0-5).

having held a first round of panchayat elections by the time of the EFC Report, nevertheless gets a share by the EFC index of decentralisation of 7 percent (Box 4.4). The overall share of Bihar, at nearly 10 percent, is not much below the share of the State on the basis of rural population alone (12 percent).

Box 4.4: States' Share in Allocations for Panchayats

State	Allocation by: Rural pop. (%)	Allocation by: Index of decen. (%)	Allocation by: Own rev. (%)	Final allocation: Per cent share (%)	Final allocation: Absolute share (Rs crore)
Uttar Pradesh	17.785	15.817	15.629	16.489	263.83
Bihar	11.966	7.095	0.000	9.813	157.00
Andhra Pradesh	7.755	9.196	24.090	9.503	152.05
Madhya Pradesh	8.109	9.616	7.163	8.943	143.09
Maharashtra	7.719	9.153	7.950	8.209	118.84
Five-state aggregate	53.334	50.877	54.832	52.957	834.81

Source: EFC Report, Annexure VIII.4.

The only other element in the formula (weight of 10%) which rewards progress towards decentralisation is the revenue effort component, which rightly rewards own revenue collection by LBs. Even this is weighted by rural population, but because own revenue does carry a zero value for States where no local revenue is collected, this element does penalise non-compliance. The unfortunate obverse of this however is that the weighting by rural population gives a large State like Andhra Pradesh where local revenue is successfully collected around 22 per cent of share under this head.

The use of rural population even within the index of decentralisation, and revenue effort components, over and above the separate weight of 40 per cent for the rural population in the overall formula, clearly gives population size a far larger weight than what is apparent in the formula. Even the income distance proportion has been weighted by the rural population.

A more appropriate approach would have been to use an index of decentralisation based on the scores on the ten decentralisation indicators alone, unweighted by rural population, with another (say equal-weighted) element in the formula being the share of total rural capital assets in the State. Such an index of decentralisation would ensure that the fund flow preserves incentives to adhere to decentralisation markers, and the weightage given to rural capital assets would carry incentives to increase rural capital formation over time, and serve the maintenance purpose of the fund flow. The underlying inequity in distribution of rural capital assets has to be redressed through altering the pattern and effectiveness of capital expenditures, not by the present distribution formula that embodies adverse incentives to preserve rural poverty.

The first charge on the EFC provision is towards account-keeping and creating a database, with only the residual intended for asset maintenance. A peculiar feature of the EFC provision is that the inter-State distribution formula is applied to the entire provision of Rs 1600 crore, not just the maintenance component, even though the account-keeping and database provisions have a flat rate provision. Since there is enormous variation between States in the population coverage per panchayat, ranging all the way from 1,217 per VP in Punjab to 21,594 in Kerala (Rajaraman, 2000a: table 4.1), this in effect penalises those States with a smaller coverage of population per panchayat by giving them less funding for maintenance. It is unclear if this was an intended incentive to increase the population coverage per panchayat and reduce the number of LBs for a given population.

The EFC has rightly (para 8.19) pointed out the need for uniform accounting conventions at State-level, separating fund flows to panchayats and to municipalities. However, the recommendation that control over panchayat accounts should be entrusted to the office of CAG is to perpetuate delay and arrears in fund flows, already reported in the reports of many SFCs as a result of delay in audit of State-level accounts. It is time that, at least for the third tier, the

monitoring mechanism is moved decisively away to more decentralised control mechanism, with physical monitoring of outcomes replacing attention to account-keeping correctness. The further recommendation that the CAG undertake responsibility for co-ordinating creation of a financial database on a total of nearly 500,000 local bodies, aggregating across rural and urban, severely strains belief. These additional burdens could bring to a halt the present responsibilities of an already stretched agency.

The EFC report does address the issue of the fiscal domain of local bodies (paras 8.15-8.16) and makes a number of suggestions, which, given its sphere, can only be purely advisory. Some of these, such as augmentation of the land revenue, are entirely in line with theory and practice in respect of the fiscal domain of local bodies. Some, however, such as the recommendation that cesses or surcharges be imposed on mainstream State-level taxes such as sales tax and State excise, do not reflect any systematic exploration of whether revenue increases call for rate increases or base expansion. In particular, the recommendation that a cess be levied on the agricultural income tax is ill-advised. The State-level agricultural income tax has seen a marked shrinking of base over the years on account of administrative infeasibility, and is presently levied only in six States on plantation agriculture. The attempt to compensate for a narrow base with a steep rate structure has led to a serious misalignment with the rate structure on the Central corporate income tax on non-agricultural income (see section 7) and to pressures for Central taxation of agricultural income. A further cess would aggravate this misalignment.

The profession tax is the only Constitutionally provided (Article 276) revenue source for local bodies or States, capped at Rs 2500 per tax-payer per year. The EFC rightly suggests removal of the Constitutionally prescribed cap.

Finally, the EFC rightly endorses the call of many SFC reports for better exploitation of urban property taxes, and for recovery of user charges from supply of civic services. These however are necessarily revenue enhancement possibilities for municipalities rather than panchayats.

In summary, the EFC Report claims that the additional Central grant for local bodies is for the "purpose of inducing the States to speed up the process of decentralisation". The overwhelming weightage given to rural population share and poverty in determining State shares, far from rewarding decentralisation, embodies an incentive structure that rewards States that have failed to control population growth, and failed to raise per capita income.

5. CENTRAL FUND FLOWS FOR RURAL DEVELOPMENT

Table 5.1 lists fund flows to rural areas from the Centre. The annual provision from the Ministry of Rural Development is budgeted at Rs 12275 crore for FY 2001-02. This total alone is nearly eight times the annual EFC provision for panchayats and completely dwarfs it. Constituent schemes are listed and examined in table 5.2. The Ministry of Agriculture in principle is targeted entirely at rural areas, but many of its schemes are by way of institutional support for cooperatives, seed development or crop research. Only those of its schemes overlapping clearly with rural development schemes (for water or watershed management) or where the farmer is the targeted beneficiary are included. Table 5.1 adds on the larger of the schemes targeted exclusively at rural areas from three other Central Ministries: Human Resource Development, Health and Social Justice. There are other schemes of these Ministries with predominantly rural components (see notes to table 5.1) but a partitioning of these flows was not attempted. Summing across these yields a budgeted total flow for FY 2001-02 of Rs. 16389 crores, more than ten times the annual EFC provision of Rs 1600 crores. In addition, there is the extra budgetary loan facility under the Rural Infrastructure Development Fund (RIDF), budgeted at Rs 5000 crore for FY 2001-02. Adding this on yields a total of Rs 21389 crore, more than 1 percent of GDP. Further adding on the rural component of numerous other schemes could double this to 2 percent of GDP.

Clearly, much the most important issue from the developmental perspective has to do not so much with the intergovernmental fiscal provisions for the third tier, but with whether and how the deployment and use of the large Central fund flows to rural areas can be made subject to local democratic involvement. Local involvement is especially important in decisions relating to the large fund flow for building rural infrastructure – both the RIDF loan facility, as well as the rural employment grants. This issue gathers added importance in the

light of the empirical finding of Fan, Hazell and Thorat, 1999, establishing that rural road connectivity is the single most productive avenue of public expenditure for poverty-reducing growth. A study supporting this finding by Dreze and Kingdon, 1999, shows that expenditure on education is most effective in the presence of road connectivity.

Table 5.2 shows some mid-year utilisation figures for the rural employment and other major schemes of the Ministry of Rural Development for the year 2000-01. The utilisation figures are reported as a percent of available funds, including concurrent funding from the State government (see notes to the table). Mid-year utilisation rates, with a single exception, were under 50 percent of available funds (which in turn were around 50 percent of budgeted funds at mid-year). That this is so even for the two rural employment schemes is very surprising, since the first six months of the fiscal year from April encompass the agricultural slack season, when the demand for rural employment should be at its peak. Clearly there is an absence of effective relay of information on points at which employment is required, to the points at which funds are supplied. End-of-year utilisation levels (not reported in the table) are higher, suggesting hasty, wasteful utilisation in the second half of the fiscal year. The utilisation rates for administrative upgradation cover the entire period of ten or more years since the inception of these programmes, and even so are surprisingly low, for computerisation for example. The lowest utilisation rate of 11 percent is reported for a rural sanitation scheme.

Improving the appallingly ineffective utilisation of this massive annual budgetary flow to rural areas may not merely be a matter of routing funds through panchayats. The EAS scheme for example has been routed through DPs since 1997-98 (see notes to table 5.2). Clearly better information flows are needed between the three tiers of the panchayat structure, the Gram Sabha (the local democratic watchdog), and the District Planning Committee.

There are some Central flows (such as for rural family welfare services; see notes to table 5.1) which have a purely maintenance character. The need for the EFC maintenance provision to be meshed with Central maintenance flows has not been addressed at all. This is an issue independent of the relative quantum of the EFC and direct Central fund flows to rural areas.

To conclude, fiscal transfers to rural areas from the Central government compel our attention, not only because their magnitude dwarfs inter-governmental transfers to panchayats, but because their utilisation rates suggest ineffective use in a context where the targeted objectives, ranging from rural infrastructure through employment schemes to rural sanitation, remain largely unmet. Merely routing funds through panchayats, will not achieve results without physical monitoring of outcomes. The task of devolution to panchayats should move away from a narrow focus on inter-governmental transfers, and look more broadly at Central fund transfers to rural areas.

Table 5.1

Major Central Rural Schemes:[1] Fund Flows

Rs Crore (BE)

	2000-01		2001-02	
BUDGETARY				
Ministry of Rural Development[2]		**12270**		**12275**
Ministry of HRD		**969**		**1100**
a. Primary education (DPEP)	*969*		*1100*	
Ministry of Health		**1106**		**1360**
a. Rural family welfare services;[3] village health guide	*926*		*1110*	
b. Backward area projects	*180*		*250*	
Ministry of Social Justice & Empowerment		**491**		**482**
a. Special Plan for SCs in agri, village ind.	*423*		*408*	
b. Rehabilitation of scavengers	*68*		*74*	
Ministry of Agriculture		**937**		**1172**
a. National wasteland development	*156*		*0*	
b. Water mgt.[4]	*44*		*61*	
c. Crop insurance	*289*		*261*	
d. Supplement to State Work Plans[5]	*448*		*850*	
TOTAL		**15773**		**16389**
EXTRA-BUDGETARY				
Rural Infrastructure Development Fund VI		4500		5000
TOTAL		20273		21389

Source: Government of India, Ministry of Finance, Expenditure Budget 2001-02 and 2000-01, Vol. 2.

Notes:

1. This is merely a listing of the larger schemes with exclusively rural targeting. Other schemes with a predominantly rural component are Integrated Child Development (Rs 1198 crore in 2001-02), Operation Blackboard (Rs 520 crore) and Nutritional Support to Primary Education (Rs 930 crore) from the Ministry of HRD alone. There are similar examples from other Ministries, such as the Reproductive and Child Health Programme (Rs 1127 crore) of the Ministry of Health.
2. For constituents, see table 5.2.
3. There are 137027 "sub-centres", each serving a population of 5000 (3000 in hilly/tribal areas), of which 97,757 are centrally funded for maintenance. Higher tiers in the rural health structure (PHCs and CHCs) are funded by State governments under the Basic Minimum Services Programme.
4. With a regional focus on Eastern India.
5. This includes the relevant component from the provision for the Northeastern Region for 2001-02 but not for 2000-01.

Table 5.2

Major Rural Development Schemes: Fund Utilisation

		2001-02 (BE)		Fund Utilisation		
		Rs crore	% share	Period	% Released / Allocated	% Utilisation / Available
	Rural employment	2925	24			
1.	JGSY			Apr-Sep.2000	49	42
2.	EAS			Apr-Dec.2000	56	42
3.	**Rural roads**	2500	20		..	..
4.	**Rural water supply (Accelerated)**	1809	15	Apr-Sep.2000	63	47
5.	**Rural sanitation (Central)**	135	1	Apr-Sep.2000	32	11
6.	**Rural housing (IAY)**	1374	11		..	..
7.	**National social assistance**	1022	8			
	a. Old age pension(NOAPS)			Apr-Dec.2000	68	45
	b. Death compensation(NFBS)			Apr-Dec.2000	68	54
	c. Maternity(NMBS)			Apr-Dec.2000	59	49
	d. Food security(Annapurna)				..	..
8.	**NE & Sikkim**	977	8		..	..
9.	**Wasteland development**	744	6		..	..
	Rural self-employment					
10.	SGSY	450	4	Apr-Dec.2000	31	40
11.	**Admin.strengthening**	339	3			
	a. DRDA				..	..
	b. Computerisation			Apr 89-Dec2000	..	49
	c. Updating land records			Apr 87-Dec2000	..	78
	d. Panchayat training				..	..
	Total	**12275**	**100**		..	..

Source: Government of India, Expenditure Budget 2001-02 for 2001-02 BE; and Annual Report of Ministry of Rural Development 2000-2001 for utilisation figures.

Notes:

1. Utilisation is reported officially as a percent of available funds, obtained from the sum of released funds and balances carried forward from the previous year. Figures of availability and utilisation for all programmes other than (accelerated) rural water supply and rural sanitation include State funding.
2. The Jawahar Gram Sammridhi Yojana (JGSY) starting 1 April 1999 replaced the JRY, which was a 1989 merger of the NREP and RLEGP.
3. The Swarnjayanti Gram Swarozgar Yojana (SGSY) starting 1 April 1999 merged the IRDP, DWCRA, TRYSEM, SITRA, GKY and MWS.
4. The Employment Assurance Scheme (EAS) starting 2 October 1993, initially targeted at 257 districts situated in backward, drought prone and desert areas, was universalised in 1997-98, and is routed through Zila Parishads (DPs) who are the implementing authority. The District Rural Development Agency (DRDA) is the conduit through which many, though not all, Central fund flows for rural development are channeled.

6. EMPIRICAL FINDINGS ON PANCHAYATS

As already noted in section 3, the SFCs confronted an information vacuum on panchayat finances, and sparse local fiscal domains. Kerala was an exception, with a defined non-null fiscal domain prior even to the conformity Act of 1994. Data collected by the first Kerala SFC on panchayat finances were used by Rajaraman and Vasishtha, 2000, to assess the impact on own tax effort of State-local grants, using data for the year 1993-94 on 938 panchayats.

The only other empirical study on panchayats, by Mahal et.al., 2000, also pertains to 1994 and uses an independent sample survey[30] covering 33,230 households in 1750 villages selected from 15 major States. The paper concludes that increased decentralisation/democratisation increases school enrolment rates and lowers child mortality rates, after controlling for socioeconomic circumstances, civil society organisations, and capture of local bodies by elite groups. The interesting feature of the study is the use of indicators of democratization, such as frequency of elections, and parent-teacher associations, along with other more standard State-level indicator variables of decentralisation.

The Kerala study uses SFC data on panchayat finances to test the impact of lumpsum grants from the State governments on panchayat revenue effort. Own taxes from the legislated fiscal domain of panchayats consisted in 1993-94 (as today) principally of taxes on buildings, professions[31] and entertainment, with associated surcharges and/or additionalities,[32] along with an assortment of other

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[30] Conducted by the National Council of Applied Economic Research.

[31] Profession taxes in other States are levied by State governments. They consist in essence of a lump-sum tax on practitioners of "professions", defined usually to exclude agriculture. The tax may or may not vary across professions.

[32] There was an additional tax on entertainment; and a show tax which is levied per showing rather than per ticket and is therefore not passed on. The show tax and building tax both carried surcharges. At State and Central government levels, surcharges rather than alterations in the base rate of levy may be the preferred option in the case of taxes shared with lower-level

levies termed service taxes, for sanitation, water, street lighting and drainage services, more correctly classifiable as non-tax revenues. Thus own taxes so defined are the dominant component of own revenue collections of Kerala panchayats, with the only exclusions being relatively minor collections from registration and other licensing fees; and income from panchayat properties (rentals on buildings, bus-stands, and ferry services).

Shared taxes collected by the State government and fully given to panchayats, consist principally of a land tax (termed a "basic" tax), and a surcharge on stamp duty on transfer of property. A tax on motor vehicles is partially shared.

Shared taxes are termed "statutory" grants because shares are enshrined in the statutes under which State taxes are collected. All other grants are termed non-statutory even though they too have a legislative basis.[33] Non-statutory grants to panchayats from the State government in 1993-94 consisted of:

1. An "untied" block grant for developmental purposes, carrying no specific obligations in terms of heads of expenditure.
2. Other grants termed either "specific purpose" or "general purpose" grants.

Untied grants to panchayats in Kerala started only in 1990 (SFC Final Report: 99). Thus 1993-94, the data year, was the fourth (and final) year for which these types of grants were received. Untied grants constituted two-thirds, and thus the major share, of total grants, with an average of around Rs 2 lakh per panchayat that was remarkably uniform across districts. Total grants showed greater variation across districts around a mean a little over Rs 3 lakh. The uniformity in the per panchayat untied grant receipt across districts, and the

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governments, where surcharges do not carry the sharing obligation of the base levy (the reverse can also be true). The reason for additionalities in these forms at panchayat level, where there is no further sharing, is not immediately apparent.

[33] Aggregating across both types, there were 23 grant categories in all (SFC Final Report: 256).

higher coefficient of variation across districts in the untied grant receipt per capita, shows clearly that it was in conception a lumpsum grant.

Thus, untied grants in 1993-94 in Kerala offered a unique opportunity to test the impact of a lumpsum grant with what was then (1993-94) an expectation of annual regularity, on own tax effort.[34] The challenge posed by the data was that observed own tax revenue is an outcome of (unobserved) tax effort and (unobserved) tax capacity. The constituents of own taxes suggested total population as a possible proxy for (unobserved) taxable capacity at panchayat level. There was no statistical evidence of any inverse relationship between untied grants and taxable capacity as proxied by population (except in one district, Malapuram).

The results (table 6.1) show that an increase in the untied grant to panchayats by one rupee reduced own tax revenues by more than one rupee in twelve out of fourteen districts, after controlling for the taxable capacity of the panchayat as proxied by population. The interesting aspect of the results is the narrow range within which the coefficient of the grants term lies across districts. Reverse causality is ruled out with the single possible exception of Malapuram district, which showed the highest (negative) coefficient. Idukki and Wyanad were the two districts where grants did not impact negatively on own taxes.

There is in theory no efficiency problem with the substitution of State revenue transfers for local revenues, if that is in accordance with local preferences. Indeed, the whole fiscal illusion literature on the flypaper effect of transfers from outside, attempts to understand why transfers from above are found empirically to increase public expenditure to their full extent, unlike an

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[34] With the State government acceptance of the SFC recommendation that a lumpsum grant of this type be phased out in favour of more co-ordinated funding of programmes formulated by the District Planning Committee, which is one of the mandated bodies under the Constitutional amendment of 1993, there should now be in place an altered grant regime with greater year-to year variability in receipts by a particular panchayat. Indeed, this may explain the buoyant growth in own revenues after 1994 (see table 3.3).

equivalent increase in voter income, and why local tax refunds are not more commonly observed. The key assumption here though is that local revenues collected would be refunded to individuals in some proportionality to taxes paid, or equivalently by a rate reduction across the board.

An important institutional feature of local government (and indeed government at any level) in India is that unspent revenues are never distributable to local taxpayers as a refund. Given this, and given also the institutional and legislative rigidities standing in the way of a uniform rate reduction for all taxes, any negative impact on own taxes of transfers from above implies a selective, most likely non-transparent, slackening of own tax effort. What is important is that the direction of slackening of tax effort opens corruption opportunities, and is in general unlikely to preserve voter preferences. If the new pattern is driven by corruption, with some big players able to buy their way out of paying taxes, it will be more regressive, more distortionary and therefore less efficient.

Idukki and Wyanad, the two exceptions to the general result, are atypical districts, with the lowest population density in Kerala State, along with a high share of agricultural among total workers, reinforcing the low taxable capacity correlate of low population. The two districts also have the highest scores on the ethnofractionalisation index, which is a matter of considerable significance in the context of recent results (Alesina et.al. 1999) showing that more ethnically diverse jurisdictions in the United States spend more in aggregate, but less on productive public goods, in line with political economy theories showing that greater ethnic fragmentation leads to low valuation of public goods, *higher* valuation of patronage, and absence of fiscal discipline. The results here showing an absence of tax effort slackening in the presence of ethnic fragmentation suggest that fragmentation may prevent the consensus needed among local elites in respect of directions of tax effort slackening. Thus greater ethnic fragmentation in the local context in India may lead to more, rather than less, fiscal discipline.

Table 6.1

Impact of Untied Grants on Own Tax Effort: Kerala Panchayats (1993-94)

Dep. Var: Observed Own Tax Revenue (Rs.)

S. No.	District	Panch-ayats	Obs.	Intercept	Popula-tion	Untied grants	Adj. R^2
1.	Trivandrum	82	77	195279.04 (1.15)	15.98 (5.26)	-1.34 (-2.11)	0.29
2.	Kollam	71	70	527024.09 (1.65)	14.87 (4.22)	-2.56 (-1.65)	0.20
3.	Pathanamthitta	53	53	633215.47 (4.76)	8.92 (2.72)	-2.36 (-3.59)	0.22
4.	Alapuzha	70	66	500179.17 (2.44)	14.86 (5.62)	-2.30 (-2.46)	0.34
5.	Kottayam	73	70	84598.62 (0.73)	23.19 (9.45)	-1.15 (-2.05)	0.56
6.	Idukki	51	51	-13409.65 (-1.39)	23.02 (12.80)	-0.11 (-0.25)	0.77
7.	Ernakulam	86	78	416441.41 (2.17)	22.42 (6.66)	-2.54 (-2.63)	0.36
8.	Thrissur	98	90	359743.75 (1.78)	27.41 (7.79)	-2.45 (-2.91)	0.44
9.	Palakkad	89	89	291458.33 (1.15)	26.43 (5.06)	-2.28 (-2.46)	0.26
10.	Malapuram	94	88	885872.80 (2.36)	19.41 (3.82)	-4.44 (-3.23)	0.27
11.	Kozhikode	76	71	374329.08 (1.80)	24.64 (6.74)	-2.42 (-3.46)	0.48
12.	Wyanad	24	22	-105696.72 (-0.07)	23.26 (1.98)	0.07 (0.01)	0.10
13.	Kannur	81	77	279471.18 (2.47)	16.44 (6.70)	-1.53 (-2.91)	0.38
14.	Kasargod	37	36	149142.17 (1.03)	24.81 (8.13)	-1.42 (-2.99)	0.68

Source: Rajaraman & Vasishtha, 2000; table 2.

7. SCOPE FOR AGRICULTURAL TAXATION BY PANCHAYATS

Agriculture is not effectively taxed in India. Thus, there is a clear opportunity here for revenue additionality, with the further advantage that it can effectively be tapped at panchayat, and only at panchayat level. The historical view of agricultural taxation, as a means of transferring resources out of agriculture, has to be replaced by a new emphasis on the need for retention of resources raised from agriculture for within-sector productivity and growth enhancement, critically necessary in the one sector where the links between growth and poverty reduction have been empirically established (Ravallion and Datt, 1996). Improved agricultural productivity is crucially necessary for pro-poor growth (Ravallion, 2000).

The power to tax agricultural income is Constitutionally vested with State governments, separately from the power to tax non-agricultural income, vested with the Central government. Two types of direct taxes on agriculture are found at State level. There is a land-based tax, called the land revenue. There is also a schedular agricultural income tax which is less universal, levied in only six States (Assam, Karnataka, Kerala, Tamil Nadu, Tripura and West Bengal), and confined essentially to plantation crops. Of the combined yield from land revenue and the agricultural income tax levied by State governments, which together account for a mere 1.6 per cent of tax revenues collected by the States,[35] land revenue accounts for over 90 per cent.[36] The coefficient of agricultural taxation, which normalises the tax revenue share with respect to the share of agriculture in GDP, works out to 0.03 for India, including land revenue on non-agricultural land.

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[35] And 0.6 per cent of total national tax revenue aggregating across Centre and States.

[36] Collections from land revenue as reported include levies on non-agricultural land. The breakdown of land revenue by sub-heads of account is available for only 1996-97. For that year, when the West Bengal cess on coal mines is excluded, the yield from agricultural taxes drops from Rs 1177 crores to Rs 725 crores, 0.4 per cent of national tax revenue.

Quite independently of the constitutional separation of powers of levy, there is an intrinsic difficulty in taxing agriculture through a conventional income tax in developing countries stemming from the following:

a. Books of accounts are not maintained by farmers in general, except in large-scale organised operations like plantations.
b. Payments and receipts are not routed through the banking system except in the plantation sector. The large numbers of petty cash transactions in agriculture makes self-declared incomes difficult to verify or monitor.
c. The spatial spread of agriculture necessarily calls for a more decentralised tax collection network. Centralised revenue collection is possible only where agriculture is concentrated in large holdings.
d. In agriculture, vast differences in net income between crops can coexist in equilibrium because factor-specificity restrictions do not equate the risk-adjusted return across crops, even within any given agro-climatic zone.
e. Except with orchards and plantations, where perennial standing trees and shrubs yield a harvest which carry year to year variation only in respect of yield, annually sown field crops carry variability in both yield and area sown to each crop in each season. The information requirements of assessment are what make comprehensive taxation of agriculture all but impossible.

Given the above, it is no surprise that the State-level agricultural income tax has dwindled to a tax on plantations in the few states that still levy the tax, excluding even orchard crops, which differ from plantation crops only in terms of size of holding. This identifies the source of the essential difficulty of taxing agriculture - the problems posed by spatially dispersed enterprises functioning on a small scale.

Where the taxed plantation crop is tea, as in West Bengal, Assam and Tripura, the taxable base of the agricultural income tax is a defined fraction of net income of tea producing companies as assessed for the Central income tax.

Thus, only the three southern states levy an agricultural income tax independently of the Central income tax.

Because the base of the state agricultural tax is so narrow, the rate structure is very steep, and the rates of levy on corporate plantations in particular are much higher than the present-day (uniform) 35 per cent rate of levy under the Central corporate income tax.[37] The lowest slab rates lie in the 40-50 per cent range (with the single exception of Karnataka at 30 per cent). In the highest income slab, tax rates on total income are 65 per cent in Tamil Nadu and 60 per cent in Kerala;[38] the corresponding marginal rates are capped at 80 per cent in both states. Only Karnataka has slabbed marginal rates with 50 per cent on the highest slab. In the three eastern states, the highest rate goes up to 60 per cent in Tripura.[39]

The lack of parity between Central and State rates has driven a call for transfer of taxation rights to the Centre. But it is clear that such a transfer would achieve little, given the intrinsic difficulty of income-based assessment.

All three southern states offer an option (compounding/composition schemes) in the form of a specific levy per acre/hectare, progressively slabbed by size class of holding, and varying also by crop in the case of Kerala, for holdings below a specified size. The percentages of assessees opting for this simplified alternative varies between 72 per cent in Kerala to close to 100 per cent in Tamil Nadu among those eligible.[40] The eligibility ceiling is to be essentially lifted altogether in Kerala with effect from 1 April 2000.

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[37] Another clear area of lack of parity, the exemption for export income under the Central corporate income tax which is not granted under the state-level tax, is no longer an issue with the five-year phase-out of the Central export income exemption introduced in April 2000.

[38] Reduced in 1998 from 65 per cent.

[39] Reduced in 1999 from 70 per cent.

[40] However, the revenue yield from assessees opting for compounding, by virtue of the size limitation, accounts for a small share of total collections (4 out of 40 crores in Karnataka). The major share comes from regular assessment.

Even in respect of regular assessees, it has proved necessary for the agricultural income tax that crop-specific norms in respect of yield, cost of cultivation and net income per hectare be developed so as to serve as benchmarks and keep the task of assessment within manageable limits (see Rajaraman, 2000b for details).

The revealed evidence shows very clearly that what works in the agriculture context is norm-based crop-specific taxation of agricultural land, building on the land revenue which already exists in the State fiscal domain in most States,[41] and is fundamentally structured in relation to the productivity of land. The land revenue has reduced to revenue insignificance over the years, principally on account of long legally-prescribed intervals between, and caps on, permissible rate revisions.[42] However, what can be and is done during the intervals between rate revisions, is the loading of surcharges and cesses on to the base levy. Some States also have additional levies on commercial crops

The pre-existing land revenue provides a template on which to build more effective taxation of agriculture.[43] The present, exceedingly complicated rate structure based on productivity differentials several decades old, with exemptions varying widely across States, can be replaced with a single uniform rate of levy on all land, with a supplementary crop-specific levy.

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[41] Only six states levy neither land revenue nor any substitute with equivalent coverage; this list surprisingly includes the agriculturally prosperous states of Punjab and Haryana, along with Orissa, Goa, Nagaland and Arunachal Pradesh (although Orissa records a fairly substantial receipt under a miscellaneous category of the land revenue head of account).

[42] Even when rates are revised, there are legal provisions either explicitly forbidding any improvements such as irrigation introduced by the cultivator during the preceding thirty years from being incorporated in the rate revision (as in Karnataka) or placing a ceiling on the upward revision permissible (as in Rajasthan).

[43] Land revenue enhancements have proved to be the only feasible route so far in Pakistan to more effective agricultural taxation, introduced in December 1996 with a rate structure differentiated by crop in two provinces (Sindh and Baluchistan) and by land use in the other two (Punjab and NWFP). This is despite the fact that the much greater inequality of land holding in Pakistan, and the greater share of commercial crops in land operated, lends a conventional income tax far greater prima facie feasibility in Pakistan than in India.

The present national average rate of levy is Rs 15 per arable acre, aggregating across all sub-heads of account, excluding only the West Bengal levy on coal mines. If a uniform exemption in all States from land revenue were granted for all holdings below 4 hectares (10 acres) a levy of Rs 33 per acre on holdings of 10 acres or more in size would preserve present collections from land revenue. These are averages across non-levying states and states like Assam and Kerala where there are special levies on plantation lands. In terms of reference rates for states without plantation agriculture, Gujarat, Maharashtra and Andhra Pradesh levy rates falling in the range Rs 19-34 per acre, which are surely attainable in agriculturally prosperous states like Punjab and Haryana, at present among the non-levying states.

The base land revenue can then be supplemented by a crop-specific levy. Maharashtra already has in place seven-rate sixteen-crop levy on commercial crops, which is however a set of specific rates not indexed to inflation. The other possible model is that followed in Andhra, where the land revenue has been abolished and replaced with a water tax on land irrigated from government sources (in addition to Irrigation Department levies). The Andhra replacement is a tax on the enhanced productivity of land made possible by irrigation, as distinct from a user payment for the water itself, in sharp contrast to land revenue legislation in force in many states, which explicitly forbids enhancement of rates on land irrigated from government sources.

A design for a crop-specific supplementary levy indexation to inflation and with a systematic exemption provision for idiosyncratic yield failure, which requires producer-specific information unlike non-idiosyncratic yield failure covering an entire region, is provided in Rajaraman, 2000b, and reproduced

below. The need for catastrophe exemption is particularly important, in the absence of perfect risk markets.[44]

The design of the levy needs a clearly identified exemption threshold, obtainable from the yield defining the lower limit of the stable cost-revenue domain. The operational advantage of a taxable threshold so defined is that it is independent of yield averages and therefore does not need redefinition over time. Thus each crop requires the following parameters which can be retained as constants for all years:

Y : Threshold yield, specified in physical units per acre (or other land unit).

f_y : [TR-TC]/TR at Y

Using the above parameters, a simple single-rate absolute levy can be worked out for any current year, c, as follows:

i. $TR^c{}_y = Y \times p^c$

where for current year, c

$TR^c{}_y$ = total revenue at threshold yield.
p^c = price of crop.

ii. $L^c = r \times f_y \times TR^c{}_y$

where for current year, c

L^c = absolute levy payable per acre (or other land unit)
r = rate of levy, as a % of [TR-TC].

Jurisdictional retention holds the key to success in inducing voluntary compliance with such a tax. It is essential that the uses to which the revenues are put are visible and enable downward accountability to the taxpayer, as a

44 Recent literature on crop insurance (see for example Ramaswami and Roe, 2001) looks at the risk reduction possible with area yield insurance schemes, which do not pose informational

substitute for the upward accountability ensured by present systems of auditing and control. The purpose of such a tax should be to enable provision of public goods in accordance with local priorities, so that failure to implement the tax carries implications that, in the first instance, will be local rather than national.

Even limited information of the type called for in the simplest-possible design for a crop-based levy, a list of cultivators growing taxable crops, and elimination of those cultivators from this list whose yields fall below the stipulated threshold yield for any given crop cycle, is obtainable only at village level. Such levies are leviable therefore only at the panchayat-level of government. This is in accordance with practice world-wide whereby local government is granted taxation rights over immoveable real property.

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problems of moral hazard and adverse selection for insurers.

8. A DESIGN FOR GROWTH PROMOTING FISCAL DEVOLUTION

This paper argues that fiscal devolution to the third (rural) tier needs to be restructured along the following lines:

1. Fiscal devolution as a term has been narrowly confined to inter-governmental flows, excluding what is most staringly obvious, the massive annual developmental expenditure flows from the Central government targeted at rural areas. These are mentioned in both the TFC and EFC Reports in passing, but need to be according centrality of focus for three reasons:

a. The massive quantum of these flows dwarfs any intergovernmental provision by the TFC or EFC. Section 5 sums major schemes with an exclusively rural focus to obtain a budgetary total for 2001-02 (BE) of Rs 16 thousand crore, ten times the EFC annual provision of Rs 1600 crore. Adding on the extra-budgetary RIDF loan provision brings this up to 1 per cent of GDP. Further adding on the rural component of numerous other schemes could easily double this to 2 percent of GDP.

b. Empirical evidence on the most promising avenues of public investment for poverty-reducing growth point to the agriculture sector (Ravallion and Dutt, 1996); rural roads (Fan, Hazell, Thorat, 1999); and the importance of road connectivity for better utilisation of education expenditure (Dreze and Kingdon, 1999). It is only the direct Central fund flows towards rural areas that are large enough to meet this massive need for public expenditure.

c. The low mid-year utilisation figures of these funds suggest very clearly poor information flows between village-level points of need, and the points of fund supply from a plethora of district-level scheme-specific agencies. To the extent end-of-year utilisation figures are higher than mid-year levels, there is clearly wasteful utilisation in the second half of the year. This is especially true for the massively funded rural bemployment schemes, which should show higher utilisation in the first half of the fiscal year

corresponding to the agricultural slack season. This expenditure will be less wastefully directed if it is aligned with local democratically-determined priorities.

Thus, to conclude, fiscal devolution should first and foremost be about involvement of panchayats in decision-making so that local priorities determine the deployment of Central government expenditure on rural development, since orchestration from afar has from the evidence of the figures led to incomplete and wasteful utilisation.

2. This involvement should not be simply a matter of fund transfer. Empirical evidence (Rajaraman and Vasishtha, 2000) shows that untied grants lead to a slackening of panchayat revenue effort, with such slackening likely to be selective, non-transparent, facilitative of corruption and hence regressive. Panchayat involvement has to go with effective external monitoring of physical outcomes. Without that, fund transfers whether from the Centre or State degenerate into a local battle for capture of public resources. Financial audit mechanisms are capable of subversion, and lead to procedural delays with little feed back from negative findings into corrective action. The need for effective information flows between the three tiers of the panchayat structure, the Gram Sabha (the local democratic watchdog), and the District Planning Committee, has quite simply not been addressed at all and lies at the heart of growth-promoting fiscal devolution. Monitoring systems such as the Gram Sampark Abhiyan (GSA) introduced in Madhya Pradesh in 1998, provide for random visits by senior officials, including the Chief Minister, to check on implementation of rural schemes, and on whether these schemes are in accordance with local preferences; but there have to be in place provisions for more systematised and routine monitoring.

3. There is clear scope for revenue additionality in the Indian fiscal system taken as a whole, through transfer to the local fiscal domain of the following State government levies which remain underexploited.

a. Agriculture, is not effectively taxed by State governments (for details see section 7). Transfer to panchayats of the right to levy land revenue, a productivity-based specific levy usually confined to agricultural land,[45] would be in accordance with practice world-wide whereby local government is granted taxation rights over immoveable real property. The present national average rate of levy is Rs 15 per arable acre,[46] excluding only the West Bengal levy on coal mines. If a uniform exemption in all States from land revenue were granted for holdings below 4 hectares (10 acres), a levy of Rs 33 per acre on holdings of 10 acres or more in size would preserve present collections from land revenue. These are averages across non-levying States and those with special levies on plantation lands (Assam and Kerala). For states without plantation agriculture, Gujarat, Maharashtra and Andhra Pradesh provide a reference range of Rs 19-34 per acre, which is surely attainable in agriculturally prosperous states like Punjab and Haryana, at present among the non-levying states. The design for a further crop-specific supplementary leviable (only at) at panchayat level is detailed in Section 7 of this paper, satisfying the two criteria for a feasible levy on agriculture: parsimonious information requirements consistent with equity, and a systematic exemption provision for idiosyncratic yield failure.

b. The profession tax is the only Constitutionally sanctioned (article 276) revenue source for local bodies. Where it is a State levy, there is no systematised provision for collection independently of withholding on salaried employees, so that it is essentially inoperative in the rural context. Agriculturists are normally excluded from the ambit of the profession tax,

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45 For exceptions see footnote 13.

46 Aggregating across all sub-heads of account; see Rajaraman, 2000b for details.

but it offers a way by which to induct traders and other non-agricultural service professionals into the local tax net.

The highest own revenue raised per capita in 1997-98, in Kerala, was of the order of Rs 40, out of a total revenue of Rs. 300. These proportions can be altered in favour of own revenue in a manner that raises total revenue in the system, and at the tier where additional revenues are most urgently needed from a growth perspective.

4. State Finance Commissions (SFCs) did little to expand the local fiscal domain because local bodies were judged incapable of enforcing tax compliance. Thus, the formal introduction of the third tier has not led to any convergence in the cross-State variation in local resource generation. States with higher pre-Amendment per capita panchayat revenue collection are those that show higher growth in panchayat revenues post-Amendment. The impact of the Constitutional Amendments on own revenue is least visible in those States where own revenue collections were poor to start with. This includes a wide swathe covering Rajasthan, Uttar Pradesh, Orissa, Assam, and of course Bihar, which is holding a first round of panchayat elections only in mid-2001. These fiscal outcomes underline the need for embodying incentives for fiscal autonomy and local resource generation in the design of fiscal devolution.

5. SFC recommendations were in general confined to transfers from State governments of a certain percent of revenues underpinned by prescribed norms for purely local "core" functions, not typically defined to include even primary education let alone the larger functional domain legislated in the conformity Acts. Thus, the revealed judgement of SFCs seems to have been that even local functions required funding through transfers from State revenues. This reduces local bodies to an agency status, accountable upwards rather than downwards to a taxpaying electorate even for performance of functions with a local spatial reach, and the inevitable corruption attendant on fund flows unconnected to local

tax effort. SFCs left largely unaddressed the issue of how local revenue efforts could be incentivised (section 3). A few SFC Reports however do recommend explicit incentives for local revenue effort, but only two, Maharashtra and Haryana, specify physical or revenue targets in an explicit and operationally useful way. Local bodies will have a positive incentive to levy local taxes only if a function or set of functions must be funded exclusively from local revenues. Even where the local fiscal domain is inadequate for core local functions, exclusive assignment of a subset of functions to local revenues remains possible even in the poorest regions. Among the major advantages of so doing is that given the difficulties of levy and collection, local bodies will seek low cost options for the performance of the assigned function. Functional devolution has to be linked to fiscal devolution, in such a way as to move panchayats towards greater fiscal autonomy.

6. The Constitutionally-prescribed (article 280(3)) sequencing of the expenditure additionality consequent upon the third tier, whereby the issue is first addressed by SFCs, and then accommodated to by national Finance Commissions, is fundamentally flawed. Instead, there is need for an upfront undertaking by the Centre of the procedural and institutional expenditure additionalities of the third tier, which are amenable to uniform national-level norms. The absence of any incentivising funding for local elections is a glaring omission in the approach to devolution in India, as is the failure to provide Central funds for initial establishment costs of constructing and equipping minimal office facilities. The advantage of so doing is that the establishment costs of the Central agencies at district level through whom rural fund flows are presently channelled can be directed to the third tier, thus imposing less of an expenditure additionality than by throwing the burden on the States in the first instance. SFCs were left to find a way of funding these expenditure additionalities, without any empowerment to consider merger with, and transfer of funding from, pre-existing Central agencies.

7. The EFC provision of Rs 1600 per year for maintenance of rural assets created with Central funds and for upgradation of administrative capacity was independent of SFC recommendations. Indeed the EFC suggested delinking altogether of national from State Finance Commissions. The EFC claims that inclusion of a decentralisation index for determining State shares provides a first-time incentive to decentralise. But the overwhelming weightage given to rural population, far from rewarding decentralisation, embodies an incentive structure that merely rewards States that have failed to control population growth. In any Centrally funded intergovernmental maintenance flow, State shares on the basis of rural capital assets would carry incentives to increase rural capital formation over time, and serve the maintenance purpose of the fund flow. The underlying inequity in distribution of rural capital assets has to be redressed through altering the pattern and effectiveness of capital expenditures, not by a distribution formula that embodies adverse incentives to increase rural population.

8. Empirical work on panchayats is limited is on account of a general absence of data. The few findings as are available show that increased decentralisation/ democratisation does increase school enrolment rates and lower child mortality rates, after controlling for socioeconomic circumstances, civil society organisations, and capture of local bodies by elite groups (Mahal et.al., 2000). There is also some evidence (Rajaraman & Vasishtha, 2000) that greater ethnic fragmentation in the local context in India may lead to more, rather than less, fiscal discipline, contrary to political economy theories showing that greater ethnic fragmentation leads to low valuation of public goods, higher valuation of patronage, and absence of fiscal discipline. It is possible that fragmentation prevents the consensus needed among local elites in respect of directions of collusive corruption. This finding is important in the context of theoretical results (Bardhan and Mookherjee, 1998) where susceptibility to capture is an important variable determining whether or not decentralisation outperforms centralisation. More confirmatory evidence is clearly needed on these issues.

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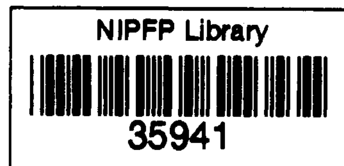
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