

**SPEECH OF
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ON THE OCCASION OF
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On behalf of the Twelfth Finance Commission, may I extend to all of you a hearty welcome to this Seminar on Panchayati Raj Finances. This seminar is being convened in the context of the tasks entrusted to the Finance Commission.

Like in many other federations, the Local Bodies in India are expected to perform many important functions on the strength of their own tax and non-tax revenues as well as the support they receive from their respective State Governments from time to time. These include such essential services as water supply, sanitation, street lighting and roads. That there is a considerable gap between the requirement and availability of resources for most local bodies for performing these functions is, perhaps, an unfortunate fact. The problem is more acute in the case of the Panchayati Raj Institutions (PRIs) than Urban Local Bodies as their resource base and taxable capacity are relatively small.

Evolution of Local Bodies

The roots of local bodies in India, particularly the rural local bodies go back to the ancient times. A reference to local governments is said to exist in the *Rig Veda* dating back to approximately 1200 B.C. Later, in the rise and fall of empires, the village panchayats continued to survive. The literal meaning of panchayat is an assembly of five elected by villagers. Sir Charles Metcalfe, the provisional Governor General of India in 1830 called Village Governments "little republics". The panchayats in India in ancient times were, however, different in character as compared to the concept that had evolved in the West. The ancient village communities constituted on a narrow basis of hereditary privilege or castes, restricted in the scope of their duties were not conscious instruments of the political process. Local self-government in India, in the sense of a representative organization, responsible to a body of

electors, enjoying powers of administration and taxation and as a vital link in the chain of organisms that make up the government of the country is, therefore, probably only a British creation. However, the efforts during the British rule were concentrated largely on the evolution of the urban local bodies. The need to set up and strengthen local governance in the rural areas appears to have received less emphasis.

In the immediate post Independence period, the debates preceding the adoption of the Indian Constitution threw up several contradictory views. A compromise was arrived at in 1948 following which it was agreed that the statement regarding the Panchayat Raj Institutions would go into the non justiciable part of the Constitution viz., the Directive Principles of State Policy which, inter alia, provides that the *State shall take steps to organize village Panchayats and endow them with such powers and authority as may be necessary to enable them to function as units of self-government.*

Since the adoption of the Constitution, several high level committees headed by outstanding leaders had gone into the structure, powers and functions to be assigned to the PRIs. Some of these committees are : Balwantraji Mehta Committee, in 1957, the Santhanam Committee in 1963, the Ashok Mehta Committee in 1978, the GVK Rao Committee in 1985, and the LM Singhvi Committee in 1986.

The Constitution Seventy-Third Amendment Act, 1992 was thus the culmination of a prolonged debate on the measures required to strengthen the third tier of the government so that it acquired the institutional capability to deal with the problems relating to rural development and administration. It was a recognition of the fact that though the Panchayati Raj Institutions had been in existence for a long time, they had not been able to acquire the status of viable and responsive people's bodies due to a number of reasons including absence of regular elections, prolonged supersessions, insufficient representation of weaker sections like Scheduled Castes, Scheduled Tribes and women, inadequate devolution of powers and lack of financial resources. The Act referred to the Directive Principles of State Policy and stated that in the light of the past experience and the short-comings observed, it

was imperative to enshrine in the Constitution certain basic and essential features in order to impart certainty, continuity and strength to the Panchayati Raj Institutions. Among other things, the Act provided for a Gram Sabha in a village or group of villages; constitution of Panchayats at village and other level or levels; direct elections to all seats in Panchayats at the village and intermediate level, if any, and to the offices of Chairpersons of Panchayats at such levels; reservation of seats for the Scheduled Castes and Scheduled Tribes in proportion to their population for membership of Panchayats and office of Chairpersons in Panchayats at each level; reservation of not less than one-third of the seats for women; fixed tenure of 5 years for Panchayats and holding elections within a period of 6 months in the event of supersession of any Panchayat; disqualifications for membership of Panchayats; devolution by the State Legislature of powers and responsibilities upon the Panchayats with respect to the preparation of plans for economic developments and social justice and for the implementation of development schemes; sound finance of the Panchayats by securing authorisation from State Legislatures for grants-in-aid to the Panchayats from the Consolidated Fund of the State, as also assignment to, or appropriation by, the Panchayats of the revenues of designated taxes, duties, tolls and fees; setting up of a Finance Commission within one year of the proposed amendment and thereafter every 5 years to review the financial position of Panchayats; auditing of accounts of the Panchayats; powers of State Legislatures to make provisions with respect to elections to Panchayats under the superintendence, direction and control of the chief electoral officer of the State and barring interference by courts in electoral matters relating to Panchayats. A new Eleventh Schedule was appended to the Constitution of India listing out 29 functions. However, the discretion allowed to the State Governments to transfer these functions to the PRIs is still very large with the result that there is considerable variation in the responsibilities assigned to them in different states.

Status of PRI Finances

Post-73rd Amendment, Panchayats have been established at three levels, the district, block and cluster of villages. The village

panchayats number over 2,30,000, the intermediate panchayats over 5,900 and the district panchayats about 500. These numbers make the task of data collection in respect of the resources and expenditure of panchayats formidable. The EFC had earmarked funds for data building but no reliable information is available on the initiatives taken in this regard. The responsibilities assigned to the panchayats vary from state to state. Even among the functions devolved on the panchayats, very few could be said to be in their exclusive domain. This is particularly true of the developmental role assigned to them. Often, panchayats are asked to perform agency functions in respect of implementation of schemes in the formulation of which they are not even consulted. Nevertheless, certain essential services such as provision of safe drinking water, rural sanitation, lighting of public places, preventive health care and primary education have come to be accepted as the legitimate and core functions of the local government. The funding requirements of these services are staggering. In a study done for the Eleventh Finance Commission, the NIRD had estimated the operation and maintenance costs alone of these services at over Rs.1,40,000 crore over a five year period. The capital expenditure required to set up or upgrade the necessary infrastructure was assessed to be over Rs.83,500 crore. Given the paucity of resources, it is not difficult to imagine the quality of services that may be available from these bodies.

The need to empower the Panchayats to raise their own resources cannot, therefore, be over emphasized. The resources of the panchayats broadly comprise *internal revenue* mobilised by themselves through the exercise of their tax and non-tax powers, and resources received from the *State* in the form of devolution and grants from both the State and the Union Government. In most States, the Village level Panchayats alone are vested with revenue raising powers including the power to levy taxes and raise non-tax revenue. There are essentially three types of taxes which devolve on the Panchayats: **Own taxes** - the levy, collection and use of which vests in the Panchayat by statute; **Assigned taxes** - the levy and collection of which vests in State but its use vests in the Panchayat; and **Shared taxes**, - the levy and collection of which vests in the State Government but shared with local bodies. The Non Tax Sources for PRIs consists of revenues from license fees, fines and penalties, rents/leases from Governmental properties.

Different States have devolved different types of taxes on PRIs with the relative importance of these taxes varying across States. Amongst the more important taxes are the tax on houses/buildings or a tax on land and buildings, a tax on agriculture lands/crops, Profession tax, Entertainment tax/additional entertainment tax/show tax, additional stamp duty or an increase in surcharge on stamp duty, Tolls, User charges, octroi, advertisement tax, non-motor vehicle tax etc. The Entertainment Tax is an important source of revenue for Local Bodies in the Southern States. In about 13 States, House and Structures Tax/Property Tax has been devolved on Panchayats as an obligatory tax. However, this source remains an inelastic source of revenue because of collection inefficiency, with collection being constrained by factors such as the use of rental value for taxation and under declaration of rentals, lack of enumeration of constructed property - authorized and unauthorized etc. In many States the property tax is being rationalized by taxing buildings on the basis of plinth area, preparing tax maps etc. Non-tax revenues accrue mostly in the form of fees. In practice, however, internal revenue mobilisation (IRM) has been observed to play a very limited role in the finances of the panchayats. The data on Panchayat Finances supplied to the Eleventh Finance Commission showed that the IRM constituted only 4.17% of the total revenue of panchayats at all levels in 23 States during 1990-91 to 1997-98. In a few States like Bihar, Rajasthan, Manipur, and Sikkim, IRM by the panchayats during the period was totally absent. Some Research Studies have brought out that the tax mobilization effort by PRIs has weakened over the years and the levy of taxes by PRIs, has so far not been efficient, assessments are not done periodically, rates of fee when imposed are low and not revised for long. Minimum and maximum rates of tax are prescribed by the States restricting the freedom of panchayats to levy taxes. Amongst the reasons given for the general reluctance on the part of Panchayats to levy taxes are fear of erosion in the vote base; lack of necessary administrative machinery to collect taxes and limited capacity to pay tax in the villages, especially in drought hit and other disaster hit villages.

State Finance Commission

The provisions regarding the constitution of the State Finance Commission (SFC) for recommending transfer of resources from the State to the local bodies as well as the requirement that the Finance Commission at the national level should also recommend measures for augmenting the Consolidated Fund of the States to supplement the resources of the Panchayats would need to be seen in this context. Under the new fiscal arrangement, every state government is required to constitute, once in five years, a Finance Commission and entrust it with the task of reviewing the financial position of LSGs and making recommendations as to the principles that should govern: the distribution between the state and the Panchayats and Municipalities of the net proceeds of the taxes, duties, tolls and fees leviable by the state; the determination of the taxes, duties, tolls and fees that may be assigned to, or appropriated by, the Panchayats and Municipalities; and the grants-in-aid to Panchayats and Municipalities from the Consolidated Fund of the State. Besides, the Finance Commission of the State is also expected to recommend measures needed to improve the financial position of the Panchayats and the Municipalities. Barring one or two exceptions, all States have now set up the State Finance Commission (SFC) as required under the Constitution. Many of the SFCs have submitted their reports and in many States their recommendations are already under implementation. The importance of the SFCs in the scheme of fiscal decentralization is that besides arbitrating on the claims to resources by the State Government and the local bodies, their recommendations would impart greater stability and predictability to the transfer mechanism. However, the convention established at the national level of accepting the principal recommendations of the Finance Commission without modification is not being followed in the States. Even the accepted recommendations are not always fully implemented citing resource constraints and this defeats the very purpose of constituting the SFCs. On the other hand, the funds transferred for the implementation of development schemes remain unspent either due to institutional/procedural constraints or diversion to meet other committed expenditure.

Central Finance Commission

The Constitution requires the Finance Commission to recommend measures to augment the Consolidated Fund of the States to supplement the resources of the Local Body on the basis of the recommendations of the SFCs. For both historical and economic reasons, the extent of devolution of functions to the local bodies, their fiscal capacity and expenditure needs vary widely not only across states but even within the states. The lack of uniformity in the approach of the SFCs in terms of the principles laid down for devolution of resources from the state government to the local bodies and the absence of a rational determination of the gap between normative costs of service delivery and the normative capacity to raise resources from all sources including appropriate user charges in different states makes the task of recommending measures on the basis of the recommendations of the SFC hugely complex. The Eleventh Finance Commission had, in fact, gone to the extent of recommending the deletion of the reference to the SFCs in the relevant clause of the Constitution so that future Commissions did not face similar handicaps. However, our terms of reference clearly require us to consider the issue exactly in accordance with the present constitutional provision.

Before attempting to suggest measures to supplement the resources of the Local Bodies, it is necessary to understand the precise role of the Finance Commission in this regard. The Tenth Finance Commission had expressed the view that such measures to augment the Consolidated Fund of the State need not necessarily involve transfer of resources from the Centre to the States. It had observed that once the SFCs completed their task, the Finance Commission was duty bound to assess and build into the expenditure stream of the States, the funding requirements for supplementing the resources of the Panchayats and Municipalities. The transfer of duties and functions listed in the Eleventh & Twelfth Schedule of the Constitution would also involve concomitant transfers of staff and resources and, therefore, not entail any extra financial burden. The Commission, however, felt that the corpus of untied funds in the hands of the panchayats would require to be supplemented and recommended an amount of Rs.4,381 crore based on Rs.100 per capita for a period of four years.

The Eleventh Finance Commission more or less agreed with these views and stated that while assessing the revenue and expenditure of the States, the additional burden falling on the financial resources of the States had already been taken into account and, therefore, no additional provisions were required to be made on this account. The EFC did, however, recommend a largely untied grant of Rs.8,000 crore for the Panchayats during its award period with a view to reemphasizing the need for maintenance of essential civic services including primary education, primary health, safe drinking water, street lighting, sanitation, public conveniences etc. The EFC had evolved a formula for *inter se* distribution of the grants among the States which included a weightage for the steps taken by the States towards decentralization. This was considered necessary, as many states were slow to follow up on the legislative and the executive measures required to be taken in the wake of the Constitutional Amendment. The EFC also recommended certain measures which if taken by State Government/Local Bodies would enable them to supplement the resources of the Local Bodies.

Conclusion

It is well recognized that local bodies have an important role to play in the democratic process and in meeting the basic requirements of people. The old adage “for every citizen, most government is local government” still holds good. It is also recognized that the financial resources available to the PRIs fall far short of what is needed by these institutions to fulfill their responsibilities. The role of the Central Finance Commission in this context is one step removed. The primary responsibility rests with the local bodies and the State Governments. The local bodies need to do their best to raise as much resources as possible through the various avenues available to them. At present there is no strong evidence that the panchayats are exercising in full the powers given to them to raise revenues. That benefit taxes where there is a direct quid-pro-quo between the taxpayer and the tax authority can be levied more easily has not happened. The States have come to the help of the local bodies in a number of ways. Apart from tax assignments, there has also been revenue sharing as well as untied grants. However, the mode of support from the State Government to the local bodies has varied from one state to another.

The Terms of Reference to the Twelfth Finance Commission as already mentioned require the Commission to suggest measures needed to augment the Consolidated Fund of the State to supplement the resources of the panchayats and municipalities. "Measures" could be interpreted to include not only financial but also legislative and administrative. In relation to allocation of financial resources by Central Finance Commission to the Panchayats, several approaches are possible. One is a radical departure under which a proportion of tax devolution from the central pool is set aside for local bodies. The other is to follow the route of the Tenth and Eleventh Finance Commission and provide for an ad hoc grant which will go in some way to augment the resources of the local bodies. A third approach can be to supplement the ad hoc grants with additional resources to fulfill some basic services such as, say, supply of drinking water in rural areas. This would be an application of the equalization principle that a citizen should be entitled to certain minimum standard of civic services irrespective of where he or she resides. Each local government must be able to provide a comparable level of services at comparable charges and if there are gaps due to the factors beyond the control of the local bodies, the higher levels of government should come to its aid. Even here one must recognize that the role of the Central Finance Commission must be treated as supplementary rather than primary. Nevertheless, an application of the equalization principle to one or two select services based on normative projections of revenue and expenditure is worth considering. However, the financial implications will have to be carefully studied, given the constraints at the State and the Central levels. A reference must also be made here to the principles which would underline the distribution among states of resources earmarked by the Central Finance Commission. The Eleventh Finance Commission, as indicated earlier, used a formula which included variables such as population with a weight of 40 per cent, index of de-centralisation with a weight of 20 per cent, distance from the highest per capita income with a weight of 20 per cent and revenue effort and geographical area, each with a weight of 10 per cent. The variable, Index of Decentralisation has come in for some criticism. While recognizing that the states which have actively taken forward the process of decentralization must be rewarded, a critical question is: How to measure it? Mere assignment of functions or even financial or taxation powers may not necessarily reflect the

extent of decentralization at the ground level. A search for an appropriate measure becomes necessary, if the incentive through additional funds allocation is to achieve its purpose. The transfer mechanism must be such that it encourages both the state and local bodies to do their maximum in terms of raising resources.

The Finance Commission is keen to play its role to improve the standards of services of the Panchayats. We look forward to your ideas and suggestions in this regard. I thank you for sparing your time to participate in the Seminar and hope that, by the time of its conclusion this evening, there would be a greater clarity regarding the approach that we should take to strengthen the local bodies in the true spirit of the Constitution 73rd Amendment Act.
