

# CHAPTER 10

## Local Bodies

### Introduction

10.1 The Commission is required to make recommendations on ‘the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of recommendations made by the Finance Commission of the State.’

10.2 There has been considerable progress in the empowerment of Panchayati Raj Institutions (PRIs) and municipalities since the Tenth Finance Commission (FC-X) first made a provision for explicitly supporting local bodies through grants, subsequent to the passage of the 73rd and 74th amendments to the Constitution in 1993. Approximately 30 lakh representatives are regularly elected to about 2.5 lakh local institutions all over the country. Providing basic services at the grassroots level makes them the primary interface of the citizens’ interaction with the government. The principle of subsidiarity implies that matters are best handled by the least centralised competent authority. Following this, these institutions need to be adequately empowered—both functionally and financially—to enable them to fulfil the role envisaged for them in the Constitution. The State Finance Commissions (SFCs), which buttress the functioning of local bodies, also need to be strengthened so as to make their functioning more predictable and the process of implementing their recommendations more transparent. A number of recommendations were made by FC-XI and FC-XII towards this end. Some of these recommendations, though important, have not been implemented so far. More needs to be done to promote effective

decentralisation. We also need to put in place a stronger incentive mechanism aimed at persuading State Governments to decentralise further.

### Previous Finance Commissions’ Flows to Local Bodies

#### Framework for Recommendations

10.3 There was no reference in the ToR of FC-X about making recommendations relating to local bodies. However, since the 73rd and 74th amendments to the Constitution had become effective before the Commission had finalised its report, it felt obliged to make recommendations regarding measures to augment the consolidated funds of the states for this purpose. It pointed out that it could recommend such measures only after ascertaining the need for them, and the primary basis for this would have to be the SFCs’ reports, which however, were unavailable. Therefore, it recommended *ad hoc* grants.

10.4 The ToR of FC-XI had two specific references to local bodies:

- i) A reference to the measures needed to augment the consolidated funds of states to supplement the resources of panchayats and municipalities on the basis of the recommendations made by the Finance Commissions of the concerned states.
- ii) Another reference reiterating the need to take into account the recommendations of the SFCs. Where such recommendations were not available, the Commission was directed to make its own assessment about

the manner and extent of augmentation of the consolidated fund required. This assessment was to take into account the provisions for emoluments and terminal benefits of employees (including teachers); the ability of local bodies to raise financial resources and the powers, authority and responsibilities transferred to them under articles 243(G) and 243(W) of the Constitution.

10.5 In its report FC-XI noted the following features of SFC reports:

- i) Lack of synchronicity in the periods covered by the reports of the SFCs and the Finance Commission.
- ii) Extreme diversity in the approach, the content, the period covered as well as quality of the reports of the different SFCs.
- iii) Delay on the part of the State Governments in finalising Action Taken Reports (ATRs) and placing them in the state legislatures.

10.6 FC-XI, therefore, underlined its inability to take into account the recommendations of the SFC's. It, therefore, recommended *ad hoc* grants.

10.7 The ToR of FC-XII had a single reference relating to the measures needed to augment the consolidated fund of a state to supplement the resources of the panchayats and municipalities on the basis of recommendations made by the Finance Commissions of the concerned states.

10.8 FC-XII noted that both the data furnished by the states as well as the SFC reports failed to provide a sound basis for estimation of the required augmentation of the consolidated funds of the states. It, therefore, recommended grants on an *ad hoc* basis.

### Quantum of Flows

10.9 FC-X recommended a grant of Rs. 100 per capita of rural population as per the 1971 Census to PRIs, which worked out to a total of Rs. 4380.93 crore. In the case of urban local bodies (ULBs), the Commission recommended an amount of Rs. 1000 crore. The aggregate grant of

Rs. 5380.93 crore represented 1.38 per cent of the divisible pool as estimated by them.

10.10 FC-XI recommended a grant of Rs. 8000 crore for PRIs and Rs. 2000 crore for ULBs for the five-year period starting 2000-01. The aggregate grant of Rs. 10,000 crore represented 0.78 per cent of the divisible pool as estimated by them.

10.11 FC-XII recommended a sum of Rs. 20,000 crore for the PRIs and Rs. 5,000 crore for municipalities for the five year period starting 2005-06. The aggregate grant of Rs. 25,000 crore represented 1.24 per cent of the divisible pool as estimated by them.

### Basis of Horizontal Distribution

10.12 FC-X distributed the PRI grant amongst the states on the basis of state-wise rural population as per the 1971 Census. The grant for urban local bodies was allocated to the states on the basis of the inter-state ratio of slum population derived from the urban population figures of the 1971 Census.

10.13 FC-XI distributed grants amongst the states as per the following parameters:

- i) Population: 40 per cent
- ii) Distance from highest per capita income: 20 per cent
- iii) Revenue effort: 10 per cent
- iv) Geographical area: 10 per cent
- v) Index of decentralisation: 20 per cent

10.14 FC-XII made allocations to states based on the following indicators:

- i) Population: 40 per cent
- ii) Distance from highest per capita income: 20 per cent
- iii) Revenue effort:
  - a) With respect to state's own revenue: 10 per cent
  - b) With respect to GSDP: 10 per cent
- iv) Geographical area: 10 per cent
- v) Index of deprivation: 10 per cent

**Table 10.1: Amounts Allocated by Previous FCs & Amounts Drawn**

(Rs. crore)

Commission	Amount Allocated		Amount Drawn		Amount not Drawn	
	PRIs	ULBs	PRIs	ULBs	PRIs	ULBs
FC-X (1995-2000)	4380.93*	1000	3576.35 (66.46 %)	833.88 (83.39 %)	804.58 ( 33.54%)	166.12 (16.61%)
FC-XI ( 2000-05)	8000	2000	6601.85 (82.52%)	1751.89 (87.59%)	1398.15 (17.48%)	248.11 (12.41%)
FC-XII** (2005- 09)	18000	4500	16664.77 (92.58%)	4024.54 (89.43%)	1335.23 (7.42%)	475.46 (10.57%)

Note: \* Rs. 100 per capita of rural population.

\*\* From 1 April 2005 to 6 November 2009.

Source: Ministry of Finance, Government of India

### Utilisation of Funds Allocated by the Previous Commissions

10.15 The funds allocated by previous Finance Commissions to PRIs and ULBs, along with amounts actually released are detailed in Table 10.1.

10.16 Under the FC-XII award 7.42 per cent of the eligible allocations for PRIs and 10.57 per cent of those for ULBs had not been drawn as on 6 November 2009. While some improvement can be noticed in the draw down between 1995 and 2000, the percentage of amounts not drawn remains significant. Such a situation is not desirable.

### Conditionalities Imposed

10.17 FC-X stipulated that its grant was not to be applied to establishment costs. It also expected local bodies to provide matching contributions for the schemes drawn up to utilise these grants. It mandated that the amount provided would be additional to the normal devolution by the State Governments.

10.18 It recommended that this grant be made available in four equal instalments from 1996-97, when it expected that the local bodies would be in place.

10.19 FC-XI listed the core civic services which it would support, including primary education, health, drinking water, street lighting and sanitation. It indicated that the funds released should be earmarked for operation and maintenance of these functions. The funds were

otherwise untied with the proviso that they should not be used for payment of salaries and wages.

10.20 Specific state-wise amounts were earmarked for maintenance of accounts (Rs. 98.60 crore) and creation of a data base of the finances of local bodies (Rs. 200 crore). FC-XI directed that these activities would have the first charge on the grants.

10.21 FC-XII recommended that the grant for PRIs be utilised to improve service delivery in respect of water supply and sanitation schemes subject to their recovering at least 50 per cent of the recurring cost in the form of user charges. It also stipulated that at least 50 per cent of the grants provided to each state for ULBs should be earmarked for solid waste management through public-private partnership.

10.22 FC-XII also noted the importance of building data bases and maintenance of accounts by local bodies and urged that part of their support be earmarked by the State Governments for this purpose.

10.23 FC-XII made a number of recommendations with regard to the constitution, composition, mode and methodology of working of SFCs aimed at improving their functioning.

10.24 FC-XII recognised that the conditionalities imposed for release of funds to local bodies ultimately handicapped the very local bodies for which they were meant. Amounts not drawn essentially reflected non-performance by State Governments. The Commission felt that conditionalities needed to be discouraged. It recommended that no additional conditionality be imposed over and above the conditions suggested by

them, viz. provision of Utilisation Certificates (UCs) for the previous instalment and the need for the release to be passed on by State Governments within 15 days, apart from the end use conditionalities described in Para 10.21 above. However, despite such a liberal approach, some states have not been able to draw down even the FC-XII grants. About 8 per cent of the grants for the period 2005-09 – the first four years covered by FC-XII recommendations—have not been drawn as on 6 November 2009. We understand that this is primarily due to non-submission of UCs by the State Governments. It appears that part of this handicap is attributable to lack of maintenance of accounts by the local bodies and their slack attitude towards getting accounts audited. This clearly reinforces the need for all local bodies to create and maintain a data base encompassing their resources, operations, and financial performance indicators. Using this as a basis, the accounts could be drawn up, which could then be regularly audited. Both FC-XI and FC-XII accorded priority to these areas. While a few states have set up an excellent set of accounts, the majority of states, regrettably, have not done so. It appears that earmarking of grants by FCs for such critical purposes has not yielded the desired results over the last 10 years. A stronger incentive system needs to be built in.

#### **Treatment of Schedule V and VI Areas**

10.25 FC-X stipulated that the grant would be distributed to even those states which are not required to have panchayats, to supplement the resources of similar local level representative bodies.

10.26 FC-XI identified shares for normal areas and excluded areas separately while making state-wise allocations. It also stipulated that the shares for the local bodies in the excluded areas should be made available only after the relevant legislative measures were put in place for extending the provisions of the 73rd and 74th amendments to them.

10.27 FC-XII did not make separate recommendations for excluded areas, leaving this to be done by the respective states in 'a fair and just manner'. They did so on the grounds that the

Ministry of Home Affairs was considering a proposal for amendment in Schedule VI to make autonomous district councils more effective and these proposals envisaged an enhancement of the powers of these councils.

#### **Other Recommendations Relating to Measures to Augment the Consolidated Funds of States**

10.28 FC-X made no specific recommendations on the other measures needed to augment the consolidated funds of State Governments.

10.29 FC-XI felt that the states could adopt the following measures to augment their consolidated funds to supplement the resources of the panchayats and municipalities:

- i) Imposition of taxes on land/farm income.
- ii) Surcharge/cess on state taxes.
- iii) Levy of profession taxes.

10.30 FC-XI suggested improvement in efficiency of collection of property/house tax as well as assignment of a suitable tax with buoyant revenues in lieu of octroi which was abolished. It also recommended levy and periodic revision of user charges.

10.31 FC-XI also recommended:

- i) Review of the accounting heads under which funds are transferred to local bodies to ensure clarity.
- ii) Prescription of the format for maintenance of accounts by the Comptroller and Auditor General (C&AG). State bodies would be responsible for preparing the accounts which would then be supervised by the C&AG.
- iii) Audit of accounts by the C&AG, whose report should be placed before a committee of the State Legislature constituted on the same lines as Public Accounts Committee.

10.32 FC-XI further recommended the following legislative changes:

- i) Transfer of functions and schemes to local bodies to be specifically mandated by

legislation and made operational at the earliest.

- ii) Enactment of legislation to clearly delineate the functions of all three tiers of the PRIs
- iii) Integration of the district rural development agencies and urban development agencies with the PRIs/ULBs.
- iv) Review of the Constitutional provision mandating states having a population of more than 20 lakh to have a three-tier Panchayati Raj system.
- v) Defining a strategy for extension of the 73rd and 74th amendments to uncovered areas in states like Meghalaya, Mizoram, Manipur and Nagaland, which have been excluded from the purview of these amendments.
- vi) Revitalisation of district planning committees.

10.33 FC-XII noted that the recommendations by FC-XI relating to maintenance of accounts and audit of local bodies had still to be implemented. It suggested that the SFCs should follow the procedure for data acquisition as well as report writing adopted by the Finance Commissions, by using a similar format and recommending transfer of resources in a like fashion.

10.34 FC-XII identified 14 best practices which PRIs could usefully adopt, including enhancing taxation powers, levy of user charges, setting up of SFCs in a timely manner and regular maintenance of accounts and audit.

10.35 High priority was to be given to creation of a data base and maintenance of accounts through the use of modern technology and management systems.

## Views Expressed During Consultations

### Ministry of Panchayati Raj

10.36 In its memorandum to the Commission the Ministry of Panchayati Raj has pointed out that the first generation of Panchayati Raj reforms—setting up of the State Election Commissions, conducting

regular elections, constituting the State Finance Commissions (SFCs) periodically, as well as devolving functions through legislation—has broadly been implemented by almost all the states. The ministry proposes to implement a five-pronged strategy to invigorate the functioning of the PRIs consistent with the spirit of the 73rd Amendment. These activities, which comprise the second generation of reforms, include:

- i) Implementing activity mapping such that each tier of Panchayati Raj is allotted clear-cut functions and responsibilities for those of the 29 activities listed in Schedule XI which have been devolved by the State Governments to the PRIs.
- ii) Providing budgetary support to the PRIs in consonance with the devolution of functions as well as ensuring transparency for such devolution through a Panchayati Raj window in the budget of both the Central Government and State Governments.
- iii) Encouraging preparation of participative plans for all the panchayats which are consolidated at the district level.
- iv) Capacity building of the PRIs and imparting training to their representatives in their core functions.
- v) Making PRIs more accountable and enhancing opportunities for citizens to review performance and approve plans in gram sabhas.

10.37 The Ministry of Panchayati Raj highlighted the growing agency functions of the PRIs relating to the implementation of Centrally Sponsored Schemes (CSS) including National Rural Employment Guarantee Scheme (NREGS), National Rural Health Mission (NRHM), Mid-day meals, Sarva Shiksha Abhiyan (SSA), Pradhan Mantri Gram Sadak Yojana (PMGSY), Accelerated Rural Water Supply Programme (ARWSP), Integrated Child Development Scheme (ICDS), Indira Awas Yojana (IAY), Rajiv Gandhi Gramin Viduyutikaran Yojana (RGGVY) and Backward Regions Grant Fund (BRGF). The total amount of funds to be released



directly to PRIs for 2009-10 is estimated to be Rs. 95,000 crore. The ministry also noted the relative incongruity of PRIs having substantial funds to implement these CSS on the one hand, and little by way of 'discretionary' funds for adequately meeting their administrative costs, performing their core functions, and leveraging the CSS releases to meet local needs on the other.

10.38 The ministry classified the requirements of PRIs into two categories. The first category is aimed at improving the operational infrastructure of the panchayats. They proposed that 4 per cent of the divisible pool be allotted to local bodies and earmarked for the following activities:

	(Rs. crore)
(i) Construction of Panchayat Ghars	23,587
(ii) Providing skeleton staff for each Panchayat as well as honoraria and sitting fees for elected representatives	87,730
(iii) Office expenses and e-governance	11,650
<b>Total</b>	<b>1,22,967</b>

10.39 Under the second category, the ministry proposed that 1 per cent of the divisible pool be given as a specific purpose grant-in-aid to panchayat for preparation of data bases; incentivisation of State Governments to empower panchayats; and provision of grants for area planning and capacity building.

10.40 Referring to funding of PRIs, the ministry highlighted the delays in disbursement and diversions of funds earmarked for local bodies and stressed the importance of panchayats receiving predictable financial support in a timely manner to enable them to plan their activities in a comprehensive and smooth manner. It proposed that all funds transferred to panchayats be undertaken through bank transfers and that this process be streamlined by electronically tagging and tracking all releases by both the Central and the State Governments using an independent agency on the lines of the work being done by National Securities Depository Limited (NSDL) for direct taxes.

10.41 It has also suggested that the State Governments should be discouraged from following the recently established trend of abolishing

panchayat level taxes like property tax and profession tax, and that towards this end, a significant component of the fiscal discipline criterion should be related to the State Governments' stance towards enlargement and maintenance of the panchayat tax base.

10.42 The ministry has also made a number of suggestions aimed at improving the quality of the SFC reports and aligning them with the reports of the National Finance Commissions. It also suggested that the amounts proposed for the PRIs be distributed even to those areas which are outside the purview of Part IX of the Constitution (which deals with panchayats) to achieve a commonality of purpose in the treatment of local bodies across the nation.

### Ministry of Urban Development

10.43 The ministry noted that the urban population, which was 28 per cent of the total population in 2001, was slated to rise to 38 per cent by 2026. Urban growth would account for two-thirds of the aggregate population increase during this period. This significant growth would pose a number of challenges to civic bodies in terms of meeting the basic needs of the existing as well as incremental population. Municipal bodies would need to ensure inclusive growth, while planning for optimal utilisation of urban space and creation and maintenance of assets for providing essential services.

10.44 Despite the increased scope and scale of their engagement, the fiscal space of municipalities is shrinking. According to the ministry's memorandum, the combined expenditure of urban local bodies shrank from 1.74 per cent of Gross Domestic Product (GDP) in 1998-99 to 1.56 per cent of GDP in 2002-03 and 1.54 per cent in 2007-08. Internal resources provide for less than half the total expenditure of local bodies. Octroi has been abolished in all but one state without a viable substitute being put in place. Local bodies have been unable to exploit property tax as a major source of revenue. SFCs have been recommending that a portion of the state revenues be transferred to local bodies. Grants from the Centre provide additional support. However, these transfers have not been adequate for local bodies to provide the

desired level of services. A significant part of resource transfer is tied and non-discretionary, limiting the abilities of the urban local bodies to match resources to locally felt needs.

10.45 The ministry stated that expenditure of local bodies has significantly increased in the recent past due to three reasons: first, the impact of the Sixth Pay Commission; second, additional operation and maintenance costs due to larger investments in civic infrastructure and third, additional investments necessary for improving the accounting system, computerisation of operations, tax administration, and project monitoring.

10.46 On the basis of data collected from 19 states, the ministry estimates the resource gap of the urban local bodies as under:

	(Rs. crore)
(i) Requirement for all 28 states based on a uniform per capita requirement of Rs. 1578 per annum for provision of core services	63,893
(ii) Requirement of O&M for new assets funded under central schemes	20,000
(ii) Requirement under state schemes	16,400
(iv) Impact of the Sixth Pay Commission	24,288
(v) Capacity building	1,290
<b>Total</b>	<b>1,25,871</b>

10.47 The ministry also pointed out that the aggregate resource requirement of ULBs for fulfilling all their functions is significantly larger. For the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) cities this is estimated at Rs. 2,76,822 crore for 2005-12. The requirement for all urban areas is projected at Rs. 7,91,080 crore.

10.48 The ministry stated that FC-X, FC-XI, and FC-XII had adopted an *ad hoc* approach to supporting local bodies. The quantum of funds released was also very low. They urged that FC-XIII should adopt a structured approach and provide for support to local bodies in the form of a percentage of the divisible pool over and above the share earmarked for the State Governments.

10.49 The ministry suggested that 3 per cent of the divisible tax pool of the Union be devolved to urban local bodies over and above the share of the State Governments. Such an approach will not

only further integrate ULBs into the constitutional framework but also provide them with a buoyant source of revenue. They pointed out that such an approach will not be violative of Constitutional provisions inasmuch as such a share of the divisible pool can be provided to the consolidated funds of the states with the express mandate that this be utilised to supplement the finances of the ULBs. They proposed that the horizontal distribution amongst the states be carried out on the basis of a few simple parameters which could include progress made in decentralisation of funds, functions and functionaries (FFF) as well as implementation of key reforms. The ministry proposed that the reform agenda set out under the JNNURM programme could be considered as a conditionality for assistance by FC-XIII to ULBs. They also urged that a permanent SFC cell be set up in each state to monitor local government finances, including transfer from line ministries.

10.50 The proposals made for devolution to PRIs and ULBs by the ministries of Panchayati Raj and Urban Development respectively aggregate to 8 per cent of the divisible pool.

#### Department of Drinking Water Supply, Ministry of Rural Development

10.51 The Department of Drinking Water Supply pointed to the significant efforts made to provide access to potable drinking water, with 97 per cent of the rural habitations having been covered in the past. However, due to lack of focus on the sustainability of the sources tapped and schemes implemented earlier, many of the fully covered habitations had slipped back to either 'partially covered' or 'not covered' status. Further, only 52 per cent of the rural population has access to basic sanitation. The department highlighted its priority for increasing coverage, ensuring sustainability, tackling water quality issues and institutionalising reforms. This can be best done by adopting a demand-driven approach and ensuring community participation in implementation as well as maintenance of the schemes through empowerment of the panchayats in this sector.

10.52 It further observed that supply of drinking water and sanitation are subjects under the State List which find mention in the Schedule XI. These subjects need to be transferred to the PRIs who should assume responsibility for their operation and maintenance. The department highlighted the steps being taken by them to empower PRIs and requested the Commission to provide resources to PRIs to manage, operate and maintain water supply systems as well as implementing sanitation programmes. They posed a requirement of Rs. 48,160 crore for the following purposes:

	(Rs. crore)
(i) Maintenance of functional rural drinking water supply assets such as hand pumps, rural piped water supply schemes, multi-village water supply schemes, public stand posts, etc.	12,124
(ii) Replacement and rejuvenation of non-functional rural drinking water assets	5,500
(iii) Augmentation of 10% of the functional schemes	2,121
(iv) Garbage/solid waste management services	9,300
(v) Sewage disposal	18,601
(vi) O&M in rural sanitation programmes	273
(vii) Capacity building of PRIs	240
<b>Total</b>	<b>48,160</b>

### State Governments' Views

10.53 In their memoranda to the Commission, 14 State Governments have made suggestions relating to the functioning of local bodies. Most of them wanted the Finance Commission to significantly increase its support to local bodies. Seven State Governments have suggested that local bodies be given a share of the divisible tax pool over and above the states' share to enable them to participate in the buoyancy of central tax revenues. Suggestions on the amount of such a share ranged from 4 per cent to 10 per cent.

10.54 It was urged that the increasing obligations of local bodies to provide basic services, infrastructure, as well as meeting other civic needs required a significant stepping-up of assistance. In view of the significant burden arising from the implementation of the recommendations of the Sixth Pay Commission, states requested that for FC support should be allowed to be used for payment

of wages and salaries. The need for such support to be untied as far as possible was emphasised by a number of State Governments.

10.55 These State Governments also suggested horizontal devolution parameters for *inter se* distribution of local body grants. Most of these states were of the view that population, area, income distance, revenue effort, and index of decentralisation could be considered as criteria, though their perception on the weights to be given for each parameter varied. A few states suggested that the deprivation index, tax effort, quality of expenditure, scheduled caste (SC)/scheduled tribe (ST) population ratio, revenue requirement, and proportion of own resources be also considered as parameters for horizontal devolution. Two states suggested a pure per capita devolution based upon the population in 2001—one suggested Rs. 150 per capita and the other Rs. 500 per capita.

10.56 A number of state-specific proposals also found place in the respective state memoranda. These included, variously, requests to discard the revenue effort as a criterion, discard population as a criterion, use 2001 population as a criterion, use 1971 population as a criterion, and use the extent of scheduled areas in the state as an additional criterion within the area criterion.

10.57 Three states suggested computing an index of decentralisation and using it as a parameter. The sub-indices they proposed to compute this index included: (i) untied investible funds devolved to Local Self Governments (LSGs) as a percentage of state expenditure; (ii) own revenue of LSGs as a percentage of the state's own revenue; (iii) the number of personnel directly employed by the local bodies vis-à-vis those in the employment of the State Government; (iv) the percentage of local bodies not having elected representatives and (v) delegation of financial and administrative authority and responsibilities to local bodies and the extent of fiscal decentralisation.

### Consultations with Local Body Representatives in State Capitals

10.58 We consulted with representatives of both urban and rural local bodies of each tier, as well as



the autonomous district councils during our visits to the states. These included 37 mayors, 65 zilla parishad presidents, 112 PRI representatives and 114 ULB representatives. They made many relevant and useful suggestions which have been listed in the three categories below:

#### *Decentralisation Issues*

- i) States should be incentivised to delegate funds, functions and functionaries to the local bodies. Expenditure of PRIs as a proportion of GDP is very low. This should be increased to at least 5 per cent.
- ii) All national rural schemes relating to health and education should be implemented through the panchayats only.
- iii) Centrally Sponsored Schemes such as NREGS should have sufficient flexibility to take into account local needs and provide for adequate material component in order to create proper assets.
- iv) Small towns which cannot access JNNURM are in a precarious financial position. They should be supported with regard to provision of core services.

#### *Operational Issues*

- i) The maximum limit of profession tax collectable should be raised from the present value of Rs. 2,500 per annum.
- ii) Local bodies should be permitted to levy tax on the properties of the Central Government.
- iii) Support should be provided to the Schedule VI areas where the 73rd and 74th amendments are not applicable.

#### *Issues Related to Support from the Finance Commission*

- i) Some representatives suggested that 10 per cent of the funds devolved to each state should be earmarked for the local bodies. Others suggested that 3 per cent of the divisible pool should be earmarked for ULBs.

- ii) Keeping in mind the rapid pace of urbanisation, funds should be distributed among urban and rural bodies in the ratio of 70:30 instead of 80:20 as was allocated by FC-XII.
- iii) Earmarking of funds should not be confined to water supply and solid waste management. Support should also be provided for roads, storm water drains, and sewerage.
- iv) The Finance Commission should support the establishment of a geographic information system (GIS)-based property tax system for all local bodies aimed at strengthening their revenues.
- v) Grants should be untied.
- vi) Each panchayat should be given a minimum grant of Rs. 10 lakh irrespective of population or any other criteria. Each zilla panchayat should be given a special grant of Rs. 5 crore to meet local needs.
- vii) The Finance Commission should directly devolve funds to autonomous district councils instead of routing it through State Governments.
- viii) Funds should be earmarked for creation of data bases at the level of local bodies while providing the flexibility to hire or outsource specialised manpower to undertake this.
- ix) FC support should be made available in a single annual grant, rather than in half-yearly instalments. At least 5 per cent of the grant should be allowed for administrative expenditure.
- x) Construction of assets should also be permitted, apart from maintenance of assets.

#### **Planning Commission**

10.59 The Planning Commission noted a significant increase in the agency role of the panchayats in the recent past. A number of Centrally Sponsored Schemes and plan schemes are being implemented

by the panchayats. Substantial tied funds are being transferred to them for fulfilling these functions. However, this has not been accompanied by a corresponding increase in devolution of untied funds to the panchayats. This has restricted their ability to respond to local needs and synergise the impact of various development programmes.

10.60 Despite this, however, the Planning Commission noted that this situation does not justify the consideration of any proposal to transfer a share of the divisible pool directly to the local bodies, as such an action does not have the sanction of the Constitution. Such a proposal would vitiate the Constitutional mandate that the Finance Commission recommend augmentation of the consolidated fund of the states on the basis of the recommendations of the SFCs.

### **Eleventh Plan Document**

10.61 The Eleventh Plan document recognises the criticality of involving PRIs in planning, implementing, and supervising the delivery of essential public services. It notes that this would be essential to ensure inclusiveness in the growth process and would require adequate incentives to be put in place for State Governments to empower PRIs through devolution of funds, functions, and functionaries to the PRIs. This could be done through a suitably designed devolution index.

10.62 It further proposes that local governments be given a pivotal place in centrally sponsored schemes in keeping with their constitutional mandate of economic development and social justice. Local governments being closer to the people, are in the best position to appreciate problems holistically, identify local priorities and forge a consensus amongst disparate socio-economic groups. They are also better placed to come out with cross-sectoral solutions based upon appropriate technologies. It notes that the devolution of functions to panchayats through legislative or executive order has not been matched by a concomitant transfer of funds. This is a major weakness. At the same time, panchayats themselves have also failed to effectively utilise their inherent taxation powers.

### **Administrative Reforms Commission**

10.63 The Second Administrative Reforms Commission (SARC), in its second report on 'Local Governance – An Inspiring Journey into the Future', has made detailed recommendations covering a wide gamut of areas relating to rural and urban local bodies. The recommendations cover changes in the constitutional and functional structure of rural and urban local bodies, improvements in the working of their allied institutions – the State Finance Commissions (SFC) and the State Election Commissions (SEC), the scope for effectively implementing decentralised planning, improving functional devolution as well as enhancing the role of these institutions in improving the delivery of public services. While most of the recommendations relate to areas which are outside the scope of the ToR of the Commission, some of these are connected with the work of this Commission and it is to these that we now turn.

10.64 The SARC has recommended amendment of articles 243G and 243W to make it mandatory, for state governments to vest power and authority in local bodies, consistent with the XI and XII Schedules of the Constitution. The SARC has traced the progress of empowering local bodies to make plans and implement programmes aimed at economic development and social justice since the 73rd and 74th amendments were passed in 1993. It has pointed out that substantial progress still needs to be made. It has suggested a number of steps, including a clear delineation of functions for each tier through activity mapping and passing of a framework law to formalise the relations between the state and local governments. It also suggested that five additional subjects be included in Schedule XII as part of the responsibility of urban local bodies.

10.65 The SARC has supported the recommendations made by FC-XII directed at improving the working of the SFCs. It also reiterated the recommendation of FC-XI proposing amendment of Article 243 to ensure synchronicity between the recommendations of the SFCs and those of the National Finance Commission. It has supported

capacity building initiatives for the local bodies and encouraged outsourcing of specific functions. It proposes setting up of district councils to replace the present district planning committees, and the metropolitan planning committees envisaged in the Constitution. These councils would prepare comprehensive district plans for both the urban as well as the rural areas in their respective districts.

10.66 The SARC notes the importance of enhancing accountability of the panchayats parallel to the process of enhancing their powers and authority. It proposes setting up of audit committees in the local bodies as well as a separate standing committee for local bodies in the state legislature which would consider the reports of the C&AG, besides constituting a separate ombudsman for local bodies by amending the respective state Panchayati and Municipal Acts. The proposed ombudsman, with jurisdiction over a group of districts and large municipal corporations, would investigate cases and submit reports relating to corruption and maladministration in local bodies, including its elected representatives, to the Lok Ayukta, who would forward the report with his recommendations to the Governor. Simultaneously, the powers of the State Government to suspend panchayats and rescind the resolutions passed by them would be withdrawn.

10.67 In the matter of accounting and audit, the SARC endorses the National Municipal Accounts Manual (NMAM) for adoption by all State Governments. It emphasises the need to ensure the suzerainty of the C&AG over the audit of accounts of urban local bodies, even if they are to be initially undertaken by other agencies. It calls for institutionalising the existing arrangements under which the C&AG provides technical guidance and supervision over maintenance of accounts and audit of PRIs and ULBs, as well as for providing functional independence to the Director, Local Fund Audit at the State Government level. It proposes that FC grants be released to local bodies only after State Governments accept the technical guidance and supervision (TG&S) of the C&AG.

10.68 The SARC recognises the need for local governments to broaden and deepen their own

revenue receipts through widening of their tax base, improvement of collection efficiency and increase in tax rates subject to fiscal capacity constraints. To effectively monitor devolution and assignment of funds, it recommends that a separate panchayat line be created in every State Government budget and funds be electronically transferred to the local bodies.

10.69 It also exhorts State Governments to effectively implement the Panchayats (Extension to Scheduled Areas) Act (PESA) and calls for amendment of all legislation (both central and state) to make it consistent with PESA.

10.70 The SARC has recommended that State Governments should ensure that all local bodies switch over to the unit area method or capital value method of assessing property tax and limit exemptions. Tax details should be placed in the public domain and a computerised data base of all properties using GIS mapping should be prepared for all municipal areas. Land should be leveraged as a resource by local bodies. Sale proceeds of land collected by development authorities should be shared with the municipalities to the extent of at least 25 per cent. Legislation should be introduced to regulate the real estate sector.

10.71 This Commission endorses most of the recommendations which fall within our Terms of Reference. Such recommendations seek to empower local bodies and provide them with a statutory base for collecting revenue and providing core civic services, while at the same time, emphasising the need for accountability through a formal audit and accountability mechanism. The present constitutional structure envisages that the State Governments will drive the degree to which local bodies are empowered. Implementation of a number of SARC recommendations requires legislative (including Constitutional) changes which demand the consent and active support of State Governments. They can, at best, be implemented only in the medium term.

10.72 Other recommendations of the SARC, like those relating to accounting and audit, and improving the performance of SFCs, have not yet

been implemented despite having been on the agenda for a significant period of time. Other bodies including previous Finance Commissions have made similar recommendations earlier on, which do not require Constitutional changes, but which have not been implemented either. It is, therefore, necessary that State Governments be strongly incentivised to implement the recommendations in the latter group—a task which we propose to address.

### **National Commission for Review of the Constitution**

10.73 We discuss only those recommendations of the National Commission to Review the Working of the Constitution which are of direct relevance to our work. The Commission concluded that some State Governments were unwilling to share their fiscal powers with local bodies despite the 73rd and 74th amendments. Even in the case of those State Governments which had decentralised their functions, such an exercise had merely been limited to entrusting these bodies with the responsibility for implementation of State Government schemes. Local bodies had not been given an opportunity to prepare and implement plans on their own, thus reducing them to an implementing arm of the State Government. The Commission proposed that the Constitution be amended and the subjects listed in Schedules XI and XII be mandatorily assigned to rural and urban local bodies respectively, so that these subjects could statutorily form a distinct fiscal domain of the local bodies. This would enable them to fulfil their constitutionally assigned role as units of local self-government.

10.74 The Commission also found that the requirement in Article 280(bb) and (c) of the Constitution, that the Finance Commission make its recommendations about local bodies on the basis of the recommendations of the SFCs, was unduly restrictive. It felt that a requirement that the reports of the SFCs be considered by the National Finance Commission was adequate. It recognised the need to ensure synchronicity in the periods covered by the National FC and SFCs and suggested a suitable amendment in Article 243(I)

of the Constitution to provide for this. It suggested that the ceiling on profession tax imposed by Article 276 of the Constitution be removed and Parliament be vested with the power to determine this limit.

10.75 The Commission underlined the importance of prompt audit of accounts of local bodies and recommended that the C&AG be empowered to conduct the audit or lay down accounting standards for the panchayats. It should also be ensured that the audit cycle starting from conduct of audit through submission of report and ending with taking action on the audit findings be limited to one year after the close of the concerned financial year.

### **Studies/Seminars Sponsored by FC-XIII**

#### **Conference on ‘Empowering Panchayati Raj Institutions’**

10.76 The Commission sponsored a conference on ‘Issues before the Finance Commission: Empowering Panchayati Raj Institutions’ conducted by the Institute of Rural Management, Anand on 22-23 December 2008 wherein a number of important issues relating to devolution of funds, functions and functionaries, capacity building and constitutional provisions were discussed. The findings of the conference were presented to a select group of SFC Chairmen the next day and their views as well as suggestions incorporated into the conference recommendations.

10.77 The major recommendations of the conference have been listed in the three categories below:

#### *Decentralisation Issues*

- i) Some states have followed a ‘big bang’ approach to decentralisation. While this may be difficult to emulate, states should be incentivised to fully empower local bodies through linking the volume of both CSS and FC releases in proportion to the extent of decentralisation achieved.



- ii) Local bodies should be assisted both by the Central and State Governments for developing their administrative structure as well as meeting the costs of establishment.
- iii) It is desirable that all funds relating to local governments be routed through the local bodies and not through any statutory or non-statutory body whose activities overlap with theirs. All such parallel bodies may be abolished so that funds flow directly to the local bodies through the State Governments.
- vi) The C&AG should issue directions for classification of revenue receipts of the states providing details of duties, tolls and fees collected consistent with Article 243(I) of the Constitution so that the SFCs can make appropriate recommendations.
- vii) The work of the SFCs needs to be streamlined and strengthened in many ways. There needs to be some standardisation in the methods and approaches of the SFCs. SFCs could use templates which help in assessing needs as well as in preparing their reports more systematically and uniformly. SFCs are also hampered by lack of good quality data. FC-XIII also needs to address these issues.

#### *Operational Issues*

- i) PRIs, in turn, should be motivated to maximise their own tax and non-tax revenues through streamlining administration, enhancing tax assessment and collection efficiency and improving quality of services.
- ii) There should be an arrangement for advance sanction as well as automatic transfer of funds to local bodies to ensure predictability of devolutions, in terms of both volume as well as timing.
- iii) The recommendations of the FC-XI to enhance the ceiling on profession tax as well as taxing Central Government properties should be operationalised.
- iv) ULBs should be supported in implementing reforms to enable them to improve their credit rating and obtain market-based financing.
- v) PRIs should be provided support for meaningful compilation of accounts. This should include firming up of accounting formats and standards facilitating appropriate audit of their transactions as well as building an interactive electronic network linking accounting, auditing, performance review, financing, and monitoring functions. As submission of utilisation certificates has proved a major hurdle in the past, these steps will also ensure that State Governments are able to fully draw down the grants of the Finance Commission.
- viii) The National Finance Commission and the State Finance Commissions should be constituted simultaneously. Synchronising the periods of the FC and the SFCs may be required to avoid the problem of 'gap' years in the transfers.
- ix) There should be an SFC cell in each state to monitor efficient and effective data availability. This cell could also monitor and evaluate the performance of the PRIs at regular intervals. Setting up of an independent national agency to facilitate data and support exchanges among different SFCs could also be considered.

#### *Issues Related to Support from the Finance Commission*

- i) The previous Finance Commissions should not have assumed that decentralisation is fiscally neutral and does not entail any extra financial burden on the states. Decentralisation results in widening the ambit and improving the quality of services being provided by the local bodies. This requires substantially larger outlays. FC-XIII should attempt to enhance the local governments' share of public expenditure from the present 5-6 per cent to about 15-16 per cent in the short run.



- ii) The Commission should enable local bodies to improve their functioning by significantly increasing the volume of funds transferred to them. It should discard the *ad hoc* approach adopted by previous Commissions and provide for transfer of 5 per cent and 3 per cent of the divisible pool to the rural and urban local bodies, respectively.
- iii) Horizontal distribution of the transfers should be based upon a few simple fiscal parameters. These could include the share of untied funds devolved to total devolution and the share of own funds as a percentage of own resources of State Governments. Both these parameters should be verifiable through accounts.
- iv) The FC should be more proactive towards ULBs. Funding should be provided so as to be consistent with the norms for core service provision.
- v) In the areas where parts IX & IXA of the Constitution do not apply, there are no PRIs. Support is required for the agencies which provide local government functions in these areas.

### Study of Municipal Best Practices

10.78 A study on municipal best practices was also supported by the Commission. The report identified a number of best practices which could be usefully emulated by most municipalities. These included:

- i) Maintenance of municipal finance statistics.
- ii) Resource mobilisation.
- iii) Expenditure compression through outsourcing and Public Private Participation (PPP).
- iv) Adoption of accrual accounting.
- v) Delegation of funds, functions and functionaries (FFF).
- vi) Transfer of funds from GoI/State Governments.
- vii) Accountability of local bodies to the Citizens' Charter/NGO participation, etc.

- viii) Slum development.

10.79 This report has been published on our website ([www.fincomindia.nic.in](http://www.fincomindia.nic.in)). We would urge urban local bodies to consider such practices for implementation.

### Urban Property Tax Potential in India— Cities and Towns

10.80 This study had three objectives: first, to assess the present property tax collection in the country; second, to estimate the potential for property tax in all the municipalities in the country; and third, to suggest how this potential can be best exploited by municipalities. A detailed survey was conducted in 36 large municipal corporations, each with a population of more than 1 million. This formed the basis of the analysis. These cities account for 35 per cent of the urban population in the country. The main findings of the study are outlined below:

#### *Present Status of Property Tax Collections*

- i) Property tax revenues in the 36 largest cities in India are estimated at Rs. 4522 crore, yielding a per capita revenue of Rs. 486. In these cities, on an average, property tax revenues constitute 23 per cent of the total municipal revenues and 28.5 per cent of own source revenues. There are large inter-city variations in property tax revenues, with the Mumbai Municipal Corporation registering a per capita annual revenue of Rs. 1334 as against Rs. 25 for the Patna Municipal Corporation.
- ii) Property tax revenues depend upon: (a) enumeration of properties in the municipal tax register; (b) the collection rate; (c) the assessment and valuation system; (d) the extent of exemptions and (e) the level of tax rate.
- iii) On all these counts, there are serious shortcomings in municipalities today which hinder efficient collection. Absence of a formal count of properties in municipalities is one of the major handicaps in exploiting

the true potential of property tax in India. The percentage of assessed properties actually paying taxes in this 'large city sample' was found to be 63 per cent, and it is estimated that this would amount to 56 per cent of the universe of properties. Even for the house properties actually assessed, poor collection efficiency at 37 per cent of demand for the sample, along with non-indexation of property values exacerbated the problem.

- iv) The all-India collection of property tax yield blown up from the 36-city sample is estimated to be between a low of Rs. 6274 crore and a high of Rs. 9424 crore, or between 0.16 and 0.24 per cent of the country's GDP.

#### *Potential for Property Tax*

- i) It is clear from the low ratio, even within the 36 large city sample of assessed properties to the universe of all properties, and the low collection to demand ratio, that there is tremendous scope for improvement in revenue from property tax, even without increasing rates, and indeed, even without any structural alteration of the basis of levy. However, because the observed percentages of tax collection efficiency cannot be extended to all urban areas from the sample, it is not possible to quantify the revenue increase to be expected by improving tax collection efficiency. It is urgently required that the municipalities in India complete formal registration of all properties, whether assessable or not. This needs to be followed by the complete assessment of all registered

properties and collection of the demands raised on assessable properties at a minimum of 85 per cent efficiency.

#### *How Best to Exploit this Potential*

- i) States should focus on improving coverage and collection efficiency. Property tax revenues could increase to Rs. 22,000-32,000 crore, merely by bringing all cities to an 85 per cent coverage level and 85 per cent collection efficiency, without changing any other variables.
- ii) States should establish a Central Valuation Board on the lines of the West Bengal Central Valuation Board in order to standardise property assessment and valuation. Property values should be indexed and guidance values used.
- iii) States should institute a GIS system for mapping all properties in cities, which will result in increased coverage.
- iv) The Centre should introduce specific conditionality in JNNURM aimed at reducing the gap between the assessed and market value of properties.

10.81 The international experience on property tax collections as a percentage of GDP is summarised in Table 10.2 below. The present estimates for collection in India at 0.25 per cent are well below even the developing countries' average of 0.60 per cent and far lower than the developed countries' average of 2 per cent. The need for reform is evident.

10.82 While increasing the tax coverage and improving collection efficiency are immediate, compelling objectives, reform of the property tax system also requires improved valuation and

**Table 10.2: International Experience on Property Tax Collections**

	1970-1980	1980-1990	1990-2000	2000-2009
OECD Countries (number of countries)	1.24 (16)	1.31 (18)	1.44 (16)	2.12 (18)
Developing Countries (number of countries)	0.42 (20)	0.36 (27)	0.42 (23)	0.60 (29)
Transition Countries (number of countries)	0.34 (1)	0.59 (4)	0.54 (20)	0.67 (18)
All Countries (number of countries)	0.77 (37)	0.73 (49)	0.75 (59)	1.04 (65)

rationalisation of the structure of tax rates. The real potential of property taxes lies in correctly assessing the property values and in choosing an appropriate rate structure. An appropriate strategy will include the following elements:

- i) Broadening the tax base by instituting a geographic information system for mapping properties in all cities with a population of more than 1 lakh.
- ii) Establishing a Central Valuation Board in each state, on the lines of the West Bengal Central Valuation Board in order to standardise property valuation, which will also be charged with setting guidance values and subsequent updating.
- iii) Improving collection efficiency, identifying tax evasion and delinquency and enforcing penal clauses.

### **Institutions to Assist Municipalities in Assessing Property Tax**

#### **Municipal Property Assessment Corporation**

10.83 In Canada, the provincial governments determine municipal responsibilities and what taxes municipalities can levy, sets standards for service delivery, prohibits municipalities from running an operating deficit; restricts municipal borrowing for capital expenditures and provides conditional and unconditional transfers to them. While federal and provincial governments are funded by various taxes including income tax, gas tax and excise taxes, municipal governments are significantly dependent upon property tax. Property tax forms 54 per cent of municipal revenues followed by user fees (22 per cent) and provincial transfers (16 per cent).

10.84 Municipal Property Assessment Corporation (MPAC) is a not-for-profit corporation funded by Ontario's 445 municipalities. All Ontario municipalities are its members. Its board of directors is appointed by the Ontario Ministry of Finance. MPAC provides assistance to municipalities to assess properties on a comprehensive, consistent and

predictable basis. It prepares property tax assessment notices for all the municipalities in Ontario.

10.85 There are 4.7 million properties in the province of Ontario. Approximately 80,000 new properties are added to the inventory each year through subdivision of land; 90 per cent of these properties are residential in nature. MPAC uses a differentiated approach to value property. Depending upon the property to be valued, it uses either a direct comparison approach or an income approach or a cost approach. Wherever feasible, it uses a computer-assisted mass appraisal system. Under this, a number of models are built for each distinct category of property, which are then used as one of the inputs for assessing the property value of that category.

10.86 The work of the MPAC involves collection of property related data from all municipalities. Data on location, area, structural characteristics, ownership and utilisation are collected through field offices of the MPAC. The next steps include data analysis, fine-tuning of assessment value findings through field offices, production of assessment notices and mailing them to municipalities, conduct of open houses and considering requests for reconsideration of assessments. The actual levy and collection of property tax is done by the municipalities. Appeals against the assessment lie before an Assessment Review Board set up by the State Government. The Board's decision is final.

10.87 From 1 January 2009, MPAC has moved to a four-year assessment cycle. Property value as on 1 January 2008 will be built into the assessment, step-wise over the next four years, rising from the 1 January 2005 value such that tax on the full value as on 1 January 2008 will be applied for the 2012 tax year. Thus, property is taxed on value with a four-year lag.

10.88 Triggers for assessment include the issue of building permits, sale of property, appeal or request for reconsideration as well as vacancy applications. These are inherent mechanisms to increase coverage and update property values outside the assessment cycle.

10.89 MPAC provides a fine example of how municipalities can combine to avail of high value

services aimed at enhancing the efficiency of their mainstay—property tax collections.

### **West Bengal State Valuation Board**

10.90 A parallel effort in India is the West Bengal Valuation Board. This Board, set up on the basis of the West Bengal Valuation Board Act 1978, seeks to bring about a uniform and rational system of valuation of municipal properties throughout the state excluding the Kolkata Municipal Corporation limits. The primary function of the Board is to enumerate and assess the value of properties in all the municipalities in the state. It has adopted a transparent approach to its functioning and has made available publicly the procedure it adopts for valuation of property. It has undertaken survey work in 117 ULBs and published 217 valuation lists till 2007-08. The Board has faced a number of teething problems since its inception, including resource and capacity constraints, thus constraining its service delivery.

### **Data Collected by the Commission**

10.91 This Commission sought information from State Governments on the functioning of SFCs, the status of implementation of recommendations of FC-XI and FC-XII, as well as the physical and financial performance of local bodies. The specific issues on which particulars were sought are detailed in Annex 10.1.

10.92 The data provided varied in quality across State Governments. While some State Governments furnished good quality data, most of them provided data which was sparse, and frequently inconsistent with the data furnished to earlier Finance Commissions. Despite considerable follow-up as well as an attempt to give the State Governments an opportunity to confirm the data submitted by them, significant problems remain with the quality of data supplied to us by State Governments. Compounding this problem was the fact that the SFC reports submitted to the Commission were widely divergent in the quality of their analyses and the scope and scale of their recommendations. Non-synchronicity of the period of recommendations of the SFCs and this Commission was an additional handicap. Details of

the SFCs set up by the states are provided in Annex 10.2. Only three states have appointed SFCs whose recommendations cover the period 2010-15, the period covered by this Commission. For the above reasons, the data supplied by the State Governments as well as the reports of the SFCs did not provide a sound basis to quantify uniformly across all states the supplementation required to the resources of their respective rural and urban local bodies. Annex 10.3 lists the number of rural and urban local bodies in each state. As will be seen, the aggregate number of local bodies reported to this Commission by State Governments was 2,49,918 against a figure of 2,47,408 reported to the FC-XII. This increase is consequent to the bifurcation of existing panchayats during the interregnum.

10.93 There are significant discontinuities in data relating to revenue and expenditure of local bodies submitted by State Governments to FC-XI, FC-XII, and to this Commission. These discrepancies detract from the credibility of the data. Unfortunately, successive Finance Commissions, including our own, have been unable to independently verify the data provided on local bodies. The need to put in place a system where financial and performance data of local bodies can be audited and confirmed credibly cannot be overemphasised. The data on fiscal performance provided by State Governments is being verified by the FCs with reference to the respective State Finance Accounts. A similar system needs to be put in place for data relating to local bodies as well. While we have not utilised the information on revenue and expenditure of local bodies received from states, we are placing it on our website for information.

10.94 Ten years have elapsed since FC-XI underlined the need for maintaining a data base as well as up-to-date accounts and made a provision for supporting State Governments in addressing these shortcomings. Five years have elapsed since FC-XII highlighted similar inadequacies and made similar recommendations. Much has been said by the earlier Finance Commissions on this important subject. Despite this, little improvement has been noted in the situation. While we recognise, appreciate and support



the recommendations of the previous Commissions on the issue of data bases, accounts, and audit, clearly an alternative approach may need to be adopted to address these issues beyond funding support for these initiatives.

### Issues to be Addressed by the Commission

10.95 Based upon the consultations described above, the studies sponsored by the Commission, the recommendations of the previous Commissions, as well as the status of their implementation, the following issues have been identified by us as needing resolution. In our view these issues need to be effectively addressed to further empower local body institutions, improve their service delivery and ensure their financial sustainability.

### Devolution-Related Issues

#### *Use of a Devolution Index*

10.96 Some State Governments have proposed the use of a devolution index as a parameter for *inter se* distribution of local body grants. They have argued that it is necessary to incentivise states to devolve functions and funds to local bodies, although an index of this kind is basically a reward for past moves in this direction rather than an incentive for further effort.

10.97 The most significant initiative so far for creation of a devolution index has been the Panchayati Empowerment Accountability and Incentive Scheme (PEAIS) implemented by the Ministry of Rural Development through the National Council for Applied Economic Research (NCAER). Data on panchayati functions, finances and functionaries were directly collected from state governments by NCAER. Data collected on finances included delegation of powers to collect taxes; implementation of SFC reports; delegation of powers to prepare plans; presence of separate line items in state budgets; percentage of local bodies whose accounts are audited; own revenue as a percentage of expenditure and untied funds as percentage of total plan and non-plan grants. Data collected on functions included the number

of functions transferred based upon notifications; the number for which activity mapping has been completed; whether district planning committees are being involved in the preparation of the district plans; whether gram panchayats are implementing the flagship programmes of the government; and to what level these bodies have been empowered to sanction expenditure. Data collected on functionaries include the nature of their support to PRIs, accountability and training. A simple average of 5 sub-indices for functions, 15 sub-indices for finances and 14 sub-indices for functionaries then determined the devolution index, based upon which the states have been ranked.

10.98 This is an excellent ground-breaking initiative to measure the extent of devolution to PRIs across states. The questionnaire adopted is reflective of the areas where panchayats need to be empowered. We are, however, hesitant to adopt this index for the following reasons:

- i) Data provided by the State Governments have not been independently verified. For the reasons mentioned in Para 10.93, this is a critical requirement.
- ii) This index was not inclusive. All states were not covered. Seven states were eliminated in the framework component test which required states to establish SFCs, set up district planning committees and conduct regular elections to be eligible for ranking. Only the remaining 21 states were ranked.
- iii) Some states felt that the data collected were not comprehensive. They felt that implementation of e-governance by some states, and the degree of comprehensiveness of the delegation to local bodies made by other states had been ignored.
- iv) No parallel initiative has been taken for ranking devolution amongst urban local bodies.

10.99 Other suggestions made for computing a devolution index have been described in Para 10.57. Use of these parameters requires credible data, which regrettably, are presently unavailable.



*Providing a Share of the Divisible Pool to LBs*

10.100 A number of State Governments have proposed that local bodies should be provided assistance directly from the divisible pool over and above the share of State Governments. This was also a major recommendation in the Conference of PRIs sponsored by this Commission. While a separate study sponsored by us on this issue proposes that this can indeed be done taking a broader view of the Constitution, a legal opinion obtained by the Commission finds that such a proposal is not consistent with the Constitution.

10.101 The differential treatment presently accorded to transfer of proceeds of tax devolution to the states and transfer of grants provided to states in the Union Budget reflects the different status of these two modes of assistance. The share of central taxes devolved to the states does not enter the Consolidated Fund of India while the grants recommended by the FCs are voted. Providing local bodies with a percentage of the divisible pool as direct support would elevate this support to the level of tax devolution. This does not appear to be within the mandate of Article 280.

10.102 However, there is considerable justification for this proposal. The proposed introduction of the Goods and Services Tax (GST) will remove some tax instruments traditionally allocated to local bodies. These include entertainment tax, entry tax, as well as share in stamp duty. It is, therefore, important that local bodies be provided with a buoyant source of revenue as an alternative to fixed grants. This will also be in line with best international practice.

*Delay in Sending Funds to PRIs*

10.103 A number of states have delayed transmitting funds to local bodies despite the injunction of FC-XII that interest be paid by the State Governments to local bodies in case of any delay. We have come across a state which did not pay this interest, arguing that it had, on occasion, provided funds in advance to local bodies. We have also come across states which did pay this interest. While the states have generally passed on funds to

local bodies immediately, this process needs to be quickened and made predictable.

*Use of Conditionalities*

10.104 The conditionalities imposed by previous Commissions have been detailed in paras 10.17 to 10.24. These conditionalities have directed expenditure away from establishment costs and towards provision of core services, and have focussed on setting up of data bases and maintenance of accounts.

10.105 Such attempts have met with limited success. Maintenance of accounts still poses challenges. It has been argued that local bodies need to hire qualified staff to set up and maintain data bases and accounts. Further, during our field visits, local body representatives forcefully emphasised the need for providing untied support. The use of conditionalities linked to desired performance outcomes may, therefore, need to be reviewed.

**Accounts of Local Bodies**

10.106 As indicated in paras 10.92 to 10.94, data on financial and operational performance of all local bodies continues to be of poor quality. Notwithstanding substantial progress by local bodies in a few states on this account, the data remains cross-sectionally unreliable for the determination of local body grant amongst states. The exhortations of the previous Commissions have been seen as indicative rather than imperative and State Governments have been either unable or unwilling to implement them. It appears that an incentive-based approach may yield better results than an exhortation-based one, in matters relating to maintaining a comprehensive data base as well as an upto-date accounting system.

10.107 The assistance given to local bodies is presently required to be booked by the State Governments under the following minor heads below the respective functional major heads:

- i) Minor head 191-Assistance to Municipal Corporations.
- ii) Minor head 192-Assistance to Municipalities/ Municipal Councils.

- iii) Minor head 193-Assistance to Nagar Panchayats/Notified Area Committees or equivalent thereof.
- iv) Minor head 196-Assistance to zilla parishads/district level panchayats.
- v) Minor head 197-Assistance to block panchayats/intermediate level panchayats.
- vi) Minor head 198-Assistance to gram panchayats.

10.108 Any assistance given by the State Governments to PRIs is presently booked as a lump sum under the minor heads 196, 197 & 198 which appear in the budget documents as well as in the finance accounts of the State Governments. However, neither the budget documents nor the finance accounts of most State Governments depict the details relating to the expenditure incurred by the PRIs by detailed heads and object heads. Further, it is not possible to determine the corresponding expenditure incurred by the PRIs as they do not maintain similar accounts that could capture these details.

10.109 Accurate data on the financial performance of local bodies are best obtained from accounts of the local bodies themselves, apart from the budget documents of the State Governments and the respective finance accounts. This requires that all State Governments make distinct budget provisions for local bodies, the expenditures relating to which are reported in the finance accounts. Such an approach has been recommended by previous Commissions as well as the SARC. A number of states do maintain distinct budgetary provisions for amounts transferred by them to each tier of PRIs and each category of ULBs. They provide 'object head-wise' details in the budget documents. Object heads like salary, wages and office expenses are captured under the relevant detailed heads.

10.110 It is desirable that this best practice be emulated by all states. We recommend that a supplement to the budget documents be prepared by the State Governments. This supplement should show the details of plan- and non-plan-wise

classification of transfers separately for all categories of ULBs and all tiers of PRIs, from major head to object head, which have been depicted in the main budget under the minor heads 191, 192 and 193; and 196, 197 and 198 respectively. This supplement could also incorporate details of funds transferred directly to the local bodies outside the State Government's budget. The supplement should aim to provide details of spatial distribution of transfers—at least upto district level. Parallel to this, the finance accounts should also reflect such a distinction. A separate statement needs to be included in the finance accounts showing the detailed plan- and non-plan-wise classification of transfers separately for all categories of ULBs and all tiers of PRIs, from major head to object head, which have been depicted in the finance accounts under the minor heads 191, 192 and 193; and 196, 197 and 198 respectively.

#### *Panchayati Raj Institutions*

10.111 In its recommendation relating to formats for the budget and accounts of local bodies, FC-XI had recommended that the C&AG prescribe the format in which local bodies should prepare their budgets and maintain their accounts. C&AG and the Ministry of Panchayati Raj have finalised a Model Panchayat Accounting System which is proposed to be introduced from 1 April 2010. The accounting system uses a simplified cash-based system (with provision to shift to accrual accounting) along with the list of codes for functions, programmes and activities capturing receipts and expenditure in respect of all 29 subjects mentioned in Schedule XI of the Constitution. It is desirable that all states adopt an accounting framework and codification pattern consistent with the Model Panchayat Accounting System.

10.112 In addition, for proper monitoring of the budget allocation and consolidation of accounts of PRIs at the state level, the states will have to allot specific codes to each zilla parishad, block panchayat and gram panchayat. Similarly, arrangements need to be put in place for consolidation of accounts of PRIs at the national level. Further, the eight data base formats prescribed by the C&AG for local bodies have not been compiled by any state. This also requires to be done.

*Urban Local Bodies*

10.113 The C&AG had set up a task force in February 2002 to recommend appropriate accounting and budget formats for ULBs. Based on the report of the task force, the National Municipal Accounts Manual was prepared by the Ministry of Urban Development and circulated to all the State Governments in December 2004. The National Municipal Accounts Manual provides for a codified structure that facilitates the capture of all financial information within an urban local body. This framework, based upon accrual accounting, has been agreed to by almost all the states. They are in the process of customising and adapting the NMAM to meet their individual requirements.

10.114 The codification and classification system for ULBs has been suggested in Chapter 4 of the National Municipal Accounts Manual which covers all 18 functions of the ULBs as given in Schedule XII of the Constitution.

10.115 As per instructions issued by the C&AG in the year 2002, assistance given by the State Governments to the municipal corporations, municipalities, and nagar panchayats is to be shown separately under the minor heads 191, 192 and 193 respectively in the budget and finance accounts. None of the State Governments comply fully with these instructions. A few State Governments operate the minor heads 191 and 192 for the first two classes of ULBs. Other State Governments club assistance to all three categories of ULBs in one minor head, i.e., 191, which makes it very difficult to ascertain the end-use of the assistance given by them. For the purposes of enhanced transparency, it is desirable that:

- i) All states comply with the instructions of Controller General of Accounts (CGA) and show assistance to all categories of ULBs separately under the minor heads 191, 192 and 193 below the respective major heads of accounts in the budget documents as well as in the finance accounts.
- ii) As mentioned in Para 10.110, a supplement to the budget documents needs to be prepared

by State Governments. This supplement should show the details of plan and non-plan classification of transfers to all categories of ULBs and all tiers of PRIs from major head to object head which have been depicted in the main budget under the minor heads 191, 192 and 193. The supplement should aim to provide details of the spatial distribution of the allocations, at least upto district level.

10.116 The states should implement in all urban local bodies an accounting framework consistent with the accounting format and codification pattern suggested in the National Municipal Accounts Manual.

**Audit and Accountability of Local Bodies**

10.117 The state-wise position of audit arrangements of local body accounts is placed in Annex 10.4 below. As per the FC-XI report, the Technical Guidance and Supervision (TG&S) of maintenance of accounts and audit was to be entrusted to the C&AG. The components of TG&S include: (i) setting audit standards & audit planning; (ii) adoption of improved audit methodologies; (iii) training in audit and accounts and (iv) annual transactions audit by random selection and supplementary audit of institutions audited by the State Director of Local Fund Audit.

10.118 As will be seen, there are three groups of states:

- i) The first group comprises 18 states which have entrusted all tiers/categories of both Panchayati Raj and urban local body audit to the technical guidance and supervision of the C&AG. The C&AG issues an Annual Technical and Inspection Report which is laid before the legislature.
- ii) The second group comprises four states which have partially entrusted this responsibility to the C&AG, excluding variously, different parts of PRIs, ULBs or both.
- iii) The third group comprises three states which have not entrusted any audit to the C&AG at all.

Another three states are exempt from the purview of the 73rd and 74th amendments.

10.119 As per the office of the C&AG, audit by the State Accountants General has been completed for the year 2007-08 and audit of the year 2008-09 is in progress in those states where entrustment has taken place. C&AG is not undertaking certification of accounts, except in Karnataka. Only transaction audit is being taken up for all the states where audit has been entrusted.

10.120 In six states, viz. Andhra Pradesh, Karnataka, Kerala, Maharashtra, Rajasthan, and Tamil Nadu, the C&AG's Audit Report on Local Bodies is prepared under Section 14/19 (3) of the C&AG's Duties, Powers, and Conditions of Service (DPC) Act and laid in the respective assemblies. Karnataka's Panchayati Raj Act and Kerala's Municipality Act also provide for laying of reports of local bodies in the state legislature. In West Bengal, the Examiner of Local Accounts' Report on PRIs is laid in the state legislature as per the West Bengal Panchayati Raj Act. There is no provision for laying of reports in the state legislature as per the TG&S arrangement. A separate legislature committee has been formed in Kerala and West Bengal for considering the C&AG's reports.

10.121 As mentioned in paras 10.92-10.94, the Commission has been unable to obtain credible data on the financial performance of local bodies. We have noted during our state visits that while a number of Panchayati Raj and urban local bodies maintain up to-date and audited accounts, the majority are unable to do so. Such a situation inhibits the study of the sector as a whole as well as each category of local body. This handicap can be overcome if accounts of local bodies are prepared and audited on a regular basis in a uniform manner across all states. For this reason, it is necessary that the C&AG be entrusted with TG&S for all local bodies for all states. This will also be a necessary consequence of the standardisation of accounting formats for all local bodies across states. Further, the Annual Technical Inspection Report of the C&AG as well as the Annual Report of the Director of Local Fund Audit should be placed before the

state legislature. If necessary, this may need to be institutionalised by introducing relevant legislation.

10.122 While such an arrangement will provide a credible assurance of the audit of accounts, an independent authority for investigating complaints of malfeasance and administrative laxity by local body representatives is still not in place in most states. The recommendations of the SARC referred to in Para 10.66 are, therefore, extremely relevant.

### State Finance Commissions

Major issues relating to the functioning of Finance Commissions include:

#### *Synchronicity with Central Finance Commissions*

10.123 Article 243-I of the Constitution requires that SFCs be appointed at the 'expiration of every fifth year'. The intention of this clause appears to be that all State Government transfers to local bodies should be governed by the mandate of a current SFC. The mandate given to an SFC should thus be applicable only for a period of five years and should not be extended. In practice, this has not happened. In one state the SFC report for the period 2005-06 to 2009-10 was submitted to the State Government as late as 31 January 2009. The State Government has yet to finalise its action taken report. In the interregnum, the recommendations of the previous State Finance Commissions are being implemented.

10.124 Clearly, an urgent need exists to ensure that SFCs are appointed on time, the period covered by the SFCs is synchronous with the period covered by the National Finance Commission, and action taken reports are placed by State Governments in the state legislature in a timely manner.

10.125 Since the timing of the National Finance Commission's constitution as well as the period for which it makes recommendations is known, State Governments should be empowered to constitute and direct their respective SFCs to give their report well before the National Finance Commission finalises its recommendations. We, therefore, endorse the recommendation of the SARC that Article 243-I (1) of the Constitution should be



amended to include the phrase 'or earlier' after the words 'every fifth year'.

#### *Quality of SFC Reports*

10.126 The quality of SFC reports continues to be patchy. Though FC-XII had recommended that SFCs collect data in the formats suggested by it, this advice has not been uniformly followed. The basis for determination of support is not uniform across SFCs. Further, the recommendations of the SFCs do not follow a uniform pattern, thus detracting from their usability.

10.127 This problem was also recognised by the Conference on Empowering PRIs referred to in Para 10.76 which was attended by a number of chairmen of prior SFCs. This Commission had earlier constituted a task force to prepare a template for SFC reports. This template was discussed during the conference and finalised on the basis of the inputs received. It was then uploaded on the Commission's website and further amendments made on the basis of the suggestions received. The template finalised after this comprehensive consultation process is placed in Annex 10.5. We recommend that SFCs consider this for adoption.

10.128 The recommendations of FC-XII on membership of the SFCs continue to be valid and merit attention. Important issues—legal, economic, financial and administrative, as well as those relating to decentralisation—need to be examined and SFC members should be well equipped to meet these challenges. Article 243-I (2) of the Constitution enables State Governments to legislate on the requisite qualifications of SFC members. It is desirable that all states legislate in this matter.

#### *Implementation of SFC Reports*

10.129 The experience of SFCs has not been found to be successful for a number of reasons. SFCs themselves are hampered by lack of data. Limited capacity and poor ownership by State Governments compounds this problem. There is little incentive for them to produce a comprehensive report. Further, or because of these reasons, states are not

overly keen either to accept their recommendations or to place the Action Taken Report before the state legislature in a timely manner. This situation provides a further disincentive for SFCs to produce good quality reports. There is, thus, a need for State Governments to ensure that the recommendations of SFCs are implemented without delay and that the Action Taken Report is placed promptly before the legislature.

#### *Article 280(3)(bb) and (c)*

10.130 The SARC as well as previous Commissions have recommended amendments to Article 280(3) (bb) and (c) such that the words 'on the basis of the recommendations made by the Finance Commission of the State' are changed to 'after taking into consideration the recommendations ....' We endorse this recommendation.

#### **Role of Other Development Authorities**

10.131 During our consultations, it was pointed out that there are a number of parastatal bodies which operate in areas earmarked for local bodies by XI and XII Schedules, thus emasculating them both financially and operationally. It was proposed that all funds relating to the subjects listed in the XI and XII Schedules, devolved either by the Central or the State Government, be given to the local bodies instead of to agencies whose activities intersect with theirs. It was suggested that all such parallel bodies be abolished and that funds should flow directly to the local bodies through the State Government.

10.132 One major argument for such a proposal is the potential for the use of land as a financing option by municipalities. A study sponsored by this Commission, which examined the position in this regard in four major cities, found that revenue from land lease/sale by Urban Development Authorities (UDAs) in these cities accounted for between 6 and 390 per cent of the aggregate own revenue sources of the four municipal bodies, between 5 and 120 per cent of their total revenues, and between 35 and 4412 per cent of property tax revenues. We recognise the difficulty in making generalisations based upon a study of only four cities. However, we



feel that two valuable lessons of general applicability across local bodies can be drawn from the study. First, the scope for exploiting land sales as a source of revenue can be very considerable, from the upper end of the range observed. This is especially necessary in the light of the number of infrastructure building programmes taken up, like the Pradhan Mantri Gram Sadak Yojana (PMGSY), Accelerated Power Development and Reforms Programme (APDRP), Rajiv Gandhi Gramin Vidyutikaran Yojana (RGGVY) and National Rural Employment Guarantee Scheme (NREGS), which indirectly tend to raise the price of land. These revenues can accrue to local bodies if development authorities are either merged with them or are made to share revenues with them. Second, the study points to the need for a common approach to fund sharing between local bodies and development authorities across all states in the country. Presently there are a variety of fund-sharing arrangements in place. In some states development authorities do not share revenue with municipalities at all. Other states mandate statutory transfer of funds from these authorities to municipalities. Still others have administrative arrangements aimed at this. We note that one of the reform measures mandated under JNNURM is 'Assigning or associating elected ULBs with city planning functions and transferring over a period of seven years, all special agencies that deliver civic services in urban areas to ULBs'. We would urge speedy implementation of this reform measure.

### Nagar Panchayats

10.133 Article 243Q(1) provides for constitution of nagar panchayats in areas that are in the process of transition from rural to urban areas. There are no uniform guidelines to define this transition and in some states nagar panchayats have been created even if the population does not exceed 10,000. In such cases, the nagar panchayat is deprived of the benefit of rural development programmes such as PMGSY and NREGS. Further, these institutions may incur higher establishment costs than gram panchayats. State Governments should lay down guidelines consistent with Article 243Q(2) of the Constitution, or else, review existing ones with regard to creation of nagar panchayats and municipalities.

### Areas Where Parts IX and IX A do not Apply

10.134 Provisions contained in parts IX and IX-A of the Constitution providing for panchayats and municipalities, respectively, exempt certain areas from the applicability of these parts. These provisions are contained in articles 243(M), 243(ZC) in parts IX and IXA of the Constitution respectively, read with Article 244. The main areas to which either of the provisions of parts IX and IX-A of the Constitution do not apply are described in Table 10.3.

10.135 With the passage of the Panchayats (Extension to the Scheduled Areas) Act of 1996, the provisions of Part IX of the Constitution relating to

**Table 10.3: Areas Where Provisions of Parts IX and IX-A do not Apply**

State/Area within a State	Provisions Under Which Exempt
Meghalaya	Exempt under Article 243M and covered by Schedule VI except selected wards of Shillong Municipal Area
Mizoram	Exempt under Article 243M, with two administrative districts Lawngtai and Saiha covered by Schedule VI
Assam: Bodoland, North Cachar, and Karbi Anglong districts	Covered by the Schedule VI
Tripura	Only the Tripura Tribal District is covered by Schedule VI
Nagaland	Exempt under Article 243M and not covered by Schedule VI
Manipur: Hill areas for which District Councils exist	Exempt under Article 243M and not covered by Schedule VI
West Bengal: The hill areas of the district of Darjeeling, covered by the Darjeeling Gorkha Hill Council	Exempt under Articles 243M/243ZC of the Constitution and not covered by Schedule VI

the panchayats have been extended to Schedule V areas. The tribal areas included in Schedule VI still remain outside its purview.

10.136 Concern has been expressed about the perception that Schedule VI areas of the Constitution have been getting less favourable treatment as compared to other areas of the states. The Seventh SARC Report entitled 'Capacity Building for Conflict Resolution' indicates that an emerging area of conflict is the rising disparity between the autonomous councils and the local bodies established in pursuance of the 73rd Amendment as the latter are being more liberally funded by SFCs. It goes on to recommend that State Governments initiate a system of meeting at least the establishment costs of the councils from sources outside the tribal sub-plan and incorporate the resultant financing needs in their projections to the next Finance Commission. We understand that consensus needs to be built for extension of the 73rd and 74th amendments to the Schedule VI area. We urge that this be done speedily.

10.137 While the general power of sanctioning grants for rendering financial assistance is left to Parliament by Clause 1 of Article 275 of the Constitution, specific grants are enabled through the two provisos to the clause:

- i) The first proviso concerns payment from the Consolidated Fund of India (without vote in Parliament) of sums necessary for schemes of development, for the welfare of scheduled tribes and for raising the level of administration of Scheduled Areas, as may have been undertaken by a state with the approval of the Government of India.
- ii) The second proviso concerns similar payments to the state of Assam, for the development of the tribal areas in that state only.

10.138 It has been observed that the powers conferred by Article 275(1) are not limited or restricted, but would cover all grants, whether of capital or revenue nature, whether for general or special purpose, whether unconditional or conditional, and whether on plan or non-plan account.

10.139 FC-X, FC-XI, and FC-XII have preferred to provide grants to the scheduled areas through the local bodies route. The view in taking such a course of action appears to be premised on the fact that the provision regarding measures to augment the consolidated funds of the states is included in Article 280 and not in parts IX and IX-A of the Constitution. This course of action followed by the previous Finance Commissions may have been dictated by the fact that their Terms of Reference excluded consideration of grants-in-aid under the provisos to Clause(1) of Article 275.

10.140 Another point of view goes thus: The Finance Commission is required to recommend measures to augment the consolidated fund of a state to supplement the resources of panchayats and municipalities on the basis of the recommendations made by the Finance Commission of the state. Thus, grants-in-aid meant for panchayats given to the states' consolidated funds cannot be expected to be apportioned to the 'excluded areas', and the Schedule VI areas as these areas are excluded from the ambit of the recommendations of the SFCs. The argument then would be to earmark grants for such 'excluded areas' under Article 275, notwithstanding the specific exclusion in the Terms of Reference.

## Recommendations

### Grants to Local Bodies

10.141 A feature observed uniformly across states is that all local bodies indicated their inability to meet the basic needs of their constituents and urged this Commission to increase the volume of grants to them. They particularly cited the need to provide core services—drinking water, sewerage, solid waste management, and street lights at acceptable levels of service. They also requested support for enhancing their operational infrastructure including office buildings and skeleton staffing for maintaining accounts and data bases.

10.142 The Ministry of Panchayati Raj has urged this Commission to substantially support PRIs to enable them to effectively provide basic services to their

constituents. Only 52 per cent of the rural population has access to basic sanitation. The Department of Drinking Water has underlined the large investments required to be made in rehabilitation and maintenance as well as for new schemes to ensure full coverage of drinking water and sanitation to the entire rural population. The Ministry of Urban Development highlighted the major challenges currently being faced by the urban sector. On the one hand, the urban population of the country is projected to increase from 28 per cent of the total population to about 38 per cent by 2026. Urban growth will account for two-thirds of the projected population increase. On the other hand, the current state of supply of core services in the urban areas is below norms. Only 70 per cent of urban households have access to piped water, only 74 per cent of urban households have access to latrines, only 23 per cent of sewage is treated, only 30 per cent of solid waste generated is treated prior to disposal. In addition to core services, other responsibilities like roads and citizen facilities also require investment.

10.143 There is, thus, an undisputed need to bolster the finances of the rural as well as urban local bodies. All local bodies need to be supported through a predictable and buoyant source of revenue, substantially higher than the present levels, in addition to their own tax revenues and other flows from State and Central Governments.

Simultaneously, local bodies should also be made more accountable in the discharge of their functions. Their accounts and audit must be up-to-date.

10.144 We have examined the Constitutional imperatives on transfers to local bodies earlier in paras 10.100 to 10.102. Taking into account the demand of local bodies that they be allowed to benefit from the buoyancy of central taxes and the Constitutional design of supplementing the resources of panchayats and municipalities through grants-in-aid, we recommend that local bodies be transferred a percentage of the divisible pool of taxes (over and above the share of the states), as stipulated by us, after converting this share to grant-in-aid under Article 275. The value of the grant must be commensurable at the start of the year, since the grant would have to be included in the Union Budget. We, therefore, recommend that the volume of the divisible pool for the previous year (t-1) be used as a basis for computing the grant eligibility of local bodies for a particular year (t). For example, the grants-in-aid for local bodies in 2010-11 would be based on a percentage of the divisible pool of 2009-10 (Revised Estimates). After the 'actuals' of that year are determined, adjustments may be made in the second tranche of the two-tranche system that we recommend.

10.145 Keeping these factors in mind, we recommend that grants be given to local bodies as detailed in the Table 10.4.

**Table 10.4: Recommended Grants for Local Bodies**

(Rs. crore)

Year	BE 2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2010-15
<b>Percentage of the previous years' divisible pool to be given to all states as grant under Article 275 of the Constitution-General Basic Grant and Total Special Areas Grant</b>							
General Performance Grants		1.50%	1.50%	1.50%	1.50%	1.50%	1.50%
<b>Aggregate Grants to Local Bodies</b>		<b>1.50%</b>	<b>2.00%</b>	<b>2.50%</b>	<b>2.50%</b>	<b>2.50%</b>	<b>2.28%</b>
<b>Projected (Rs crore) Divisible Pool: 2009-14</b>							
General Basic Grant and Total Special Areas Grant	545463	636183	746179	880156	1038188	1224595	3846169*
General Basic Grant		8182	9543	11193	13202	15573	57693
General Performance Grant		8022	9303	10873	12883	15253	56335
<b>General Basic Grant &amp; General Performance Grant</b>		<b>8022</b>	<b>12484</b>	<b>18335</b>	<b>21685</b>	<b>25635</b>	<b>86161</b>
<b>Total Special Areas Grant</b>		<b>160</b>	<b>239</b>	<b>319</b>	<b>319</b>	<b>319</b>	<b>1357</b>
Special Areas Basic Grant		160	160	160	160	160	798
Special Areas Performance Grant		0	80	160	160	160	559
<b>Aggregate Grants to Local Bodies</b>		<b>8182</b>	<b>12724</b>	<b>18654</b>	<b>22004</b>	<b>25955</b>	<b>87519</b>

\* Period 2009-10 to 2013-14. Totals may not tally due to rounding off.

10.146 As shown, the proposal is to award 2.28 per cent of the relevant divisible pool (2009-14) as a grant to local bodies. This is equivalent to 1.93 per cent of the 2010-15 divisible pool—the relevant period for this Commission.

10.147 The grant will have two components—a basic component and a performance-based component. The basic grant will be equivalent to 1.50 per cent of the previous year's divisible pool. All states will have access to this grant for all the five years as per the criteria and weights mentioned in Para 10.158. The performance grant—effective from 2011-12—will be 0.50 per cent for the year 2011-12 and 1 per cent thereafter, upto 2014-15. Only those states which meet the stipulations outlined in Para 10.161 will have access to the performance grant.

10.148 We recognise the need to specially support areas covered by the V and VI Schedules and the areas exempted from the purview of Part IX and IX A of the Constitution, for a number of reasons including those mentioned by SARC (Para 10.136). We therefore propose to carve out a small portion of the basic grant and allocate it exclusively for the development of these areas which we term 'special areas'. Eligibility for the special areas grants has been computed on the basis of population in these areas. An amount of Rs. 20 per capita per year has been allocated as the 'special area basic grant'. This special area basic grant will be accessible by all the eligible states for all five years. A special areas performance grant of Rs. 10 per capita for 2011-12 and Rs. 20 per capita for the subsequent three years will be made available to those states which meet the stipulations in Para 10.162. The state-wise allocation of the aggregate special areas grant is provided in Annex 10.6.

10.149 The general basic grant and the total special areas grant has been estimated as aggregating to Rs. 57,693 crore for the five year period 2010-15. As indicated above, Rs. 1357 crore has been allocated to the special areas grant. This amount represents 2.35 per cent of the basic grant for the local bodies. This leaves Rs. 56,335 crore as the general basic grant to be divided amongst states in the manner specified in paras 10.150 to 10.158.

10.150 The general basic grant and the general performance grant will initially be segmented into rural and urban shares on the basis of their respective populations as per the 2001 Census, with 26.82 per cent as the urban share and 73.18 per cent as the rural share. By thus splitting the total grant provision, we are, in effect, providing a uniform per capita entitlement in both sectors of the economy. The grant for rural and urban local bodies will then be separately allocated amongst states as discussed below. However, the special areas grants, both general and performance, will be distributed as per Annex 10.6 without distinguishing between urban and rural areas.

10.151 We are conscious of the need to ensure a certain degree of predictability in the devolution criteria adopted, both in terms of generally accepted criteria as well as in the need to nurture incentives which have been set up by previous Commissions. A number of states have suggested that population, area, income distance, revenue effort and index of decentralisation be considered as criteria, though their perceptions on the weights to be assigned to each parameter have varied. We have decided to retain the population, area and income distance criteria. Though we are strongly inclined to use the revenue effort criteria, the available data do not appear credible. The reasons for not doing so are mentioned in Para 10.93. We appreciate the reasons for FC-XII devising and using an index of deprivation as a criteria for devolution. However, we consider that using the 2001 Census figures in November 2009 to compute this index would not truly reflect the relative deprivation of the population in different states with respect to minimum needs like water and sanitation. The Accelerated Rural Water Supply Programme, the Total Sanitation Campaign and the Nirmal Gram Panchayat Scheme have made a significant difference to the position as determined by the 2001 Census. A number of villages may also have slipped from the 'fully covered' category for water supply to 'uncovered' due to failure of the source or breakdown of the system. We have, therefore, discarded the use of this index in our calculations. In its place we propose to use the aggregate percentage of scheduled castes and



scheduled tribes in a state as a criterion, as a proxy for deprivation. However, we recognise that this criterion is more relevant in the rural areas than in the urban areas. In the urban areas, in our view the income distance criterion dominates the caste criterion. We, therefore, propose to allot differential weights for rural and urban areas in relation to the criteria of percentage of SC/STs. The percentage of SC/STs is available separately for the rural sector in the 2001 Census data. This criterion has been given a weight of 10 per cent. No weight has been assigned to this parameter for ULBs.

10.152 We recognise the need to incentivise states to empower panchayats and are inclined, in principle, to use an index of decentralisation as a parameter for devolution. However, for the reasons mentioned in paras 10.98 and 10.99, we are unable to do so. In its place, we propose to use an index of devolution derived from the finance accounts for the years 2005-06, 2006-07, and 2007-08. The amounts devolved to local bodies in the finance accounts have been aggregated across the following heads:

- i) For rural local bodies under sub heads 196, 197, and 198 under applicable major heads in the non-plan category.
- ii) For urban local bodies under the sub heads 191, 192, and 193 under applicable major heads in the non-plan category.
- iii) For other assistance to all local bodies under the head 3604 in the non-plan category.

10.153 From the above aggregated amount FC-XII grants released to local bodies for the same period were deducted. Since there is a possibility that FC-XII grants might have been received in a year subsequent to the year of recording of the respective devolutions, we used figures summed up over a three-year period. The figure so obtained was the amount devolved to local bodies from the State Governments' own resources. Even so, this figure was negative for nine states. One reason could be that the state may not have devolved all FC-XII grants to the local bodies. Alternatively, it could have devolved them under the plan head. Also, it may not have recorded this expenditure under the sub-heads mentioned above. Having carefully considered the

existing modalities for booking such expenditure and weighing all alternatives, we decided that the best approach would be to assign the negative entries under the non plan head a minimum value of zero. Where a state had recovered unspent balances available with local bodies at the end of the year, a suitable correction was made. The modulated transfer so determined was divided by the states' non-plan revenue expenditure for the three years (after deducting FC-XII grants for this period) and state-wise percentages obtained. These percentages were then weighted by their respective 2001 populations to obtain the state-wise devolution index. The calculations are shown in Annex 10.7. We allot this index a weight of 15 per cent.

10.154 As mentioned earlier, we used the 2001 Census to determine state-wise shares in grants for the rural and urban populations. As far as local bodies are concerned, population continues to be the best indicator of need. We therefore depart from FC-XI and FC-XII, and allocate to the population criterion an enhanced weight of 50 per cent. Rural and urban areas have also been determined on the basis of the 2001 Census. We allot a weight of 10 per cent to area and follow the FC-XII in computing the income distance criterion. For the rural sector, we have used the average per capita comparable Gross State Domestic Product (GSDP) from the primary sector, derived on the basis of comparable GSDP figures supplied by the Central Statistical Organization (CSO) for the years 2004-05, 2005-06 and 2006-07. The corresponding mid year state-wise population figures for these years were obtained from the report of the Technical Group on Population Projections, chaired by the Registrar General of India and published by the National Commission on Population in May 2006. While measuring the per capita income distance of each state from the maximum, outliers were eliminated as their use tended to suppress the relative income distance of the weaker states. Thus, income distance was measured from the state with the second highest sectoral per capita income in case of the rural sector (Punjab). To ensure inclusion, one quarter of a standard deviation from the average per capita sectoral income of all states was added to the per capita sectoral income of the benchmark state. This determined the target per capita sectoral income.

States with per capita sectoral income equal to or higher than the benchmark state were awarded the same distance as the benchmark state, i.e., one quarter of the standard deviation indicated above. For all other states, the income distance was determined as the difference between the target per capita sectoral income and the states' own per capita sectoral income. These income distances were then weighted by the rural populations (2001) of the respective states to arrive at the share of the panchayats. A similar approach was followed in case of urban local bodies as well. We have used the average per capita GSDP excluding the primary sector on the basis of the GSDP data supplied by the CSO. The population projections made by the technical group mentioned above were used. The distance of each state was measured from the state with the third highest average per capita GSDP in the non primary sector (Goa) plus one quarter standard deviation from the average per capita sectoral income. The distances were then weighted by the urban population (2001) of the concerned state to arrive at its share. The data used, along with these computations, are placed in annexes 10.8 to 10.10. Income distance is a more significant criterion in the urban sector when compared to the rural sector. We therefore allot this criterion a weight of 10 per cent for the rural sector and 20 per cent for the urban sector.

10.155 As pointed out in Para 10.17, of the eligible allocations under the FC-XII award; 7.42 per cent of the allocation in the case of for PRIs and 10.57 per cent in the case of ULBs had not been drawn as on 6 November 2009. The percentage of undrawn amounts was significant during earlier periods as well. This has led to an anomalous situation where grants recommended by the FC-XI are being drawn-down during the period of FC-XII. Rs. 319.56 crore of grants approved by the FC-XI were released in February 2007. Such a situation is not desirable and we propose using the level of draw down of FC-XII funds in the past as a criterion for inter-state distribution of grants. We include this to signal the importance of timely releases to local bodies. We, however, propose to allot to it a weight of only 5 per cent. For computing this index, we confine ourselves to an examination of the grants awarded by FC-XII and the releases made to State Governments thereafter.

10.156 Local body grants are released in two instalments every year—in January and in July.

State Governments were required by FC-XII to submit the following details prior to the release of every instalment:

- i) Details of allocation of funds to local bodies for the forthcoming instalment.
- ii) Details of release of funds to local bodies at all levels at all tiers for the previous instalment.
- iii) Percentage of grants spent on solid waste management by ULBs and on water supply and sanitation by PRIs.
- iv) Details of recurring costs recoverable by PRIs on water supply schemes.

10.157 FC-XII had stipulated that all local body grants drawn by State Governments should be immediately transferred to local bodies and interest would be payable if the delay in doing so exceeded 15 days. Since transfer of releases by State Governments to local bodies was effectively a criterion for release of the subsequent instalment, the releases of the FC-XII grants would reflect the commitment of State Governments to promptly providing the documentation to GoI necessary for such releases, and thus, display their commitment to the local bodies. FC-XII releases to State Governments from 2005-06 onwards for local body grants are placed in Annex 10.11a&b. A total of nine tranches of FC-XII grants were eligible for release as on November 2009. The percentage eligibility of each state has been worked out on the basis of the actual number of tranches released. These computations are also shown in Annex 10.11 a&b. We are confident that the states will make all possible efforts to draw down all the grants made by this Commission in a timely fashion.

10.158 The summary of criteria and weights allotted is as shown in Table 10.5.

**Table 10.5: Weights Allotted to Criteria for Grants to Local Bodies**

Criterion	Weights Allotted (%)	
	PRIs	ULBs
Population	50	50
Area	10	10
Distance from highest per capita sectoral income	10	20
Index of devolution	15	15
SC/STs proportion in the population	10	
FC local body grants utilisation index	5	5
<b>Total</b>	<b>100</b>	<b>100</b>

10.159 Based upon the above criteria and the weights allotted, the state-wise percentage share of the basic grant to be transferred to PRIs is given in Annex 10.12. The state-wise percentage share of transfers to urban local bodies is given in Annex 10.13. The state-wise composite percentage has been worked out in Annex 10.14. The same shares apply to the performance grant although access to that grant is subject to the conditionalities listed in Para 10.161. The projected share of each state has been worked out in Annex 10.15 as under:

- i) The state-wise general basic grant is detailed in Annex 10.15a.
- ii) The state-wise general performance grant is detailed in Annex 10.15b.
- iii) The state-wise special areas basic grant is detailed in Annex 10.15c.
- iv) The state-wise special areas performance grant is detailed in Annex 10.15d.

The computations in Annex 10.15b and 10.15d assume that all states will become eligible to draw down their general performance grant and special areas performance grant respectively at the earliest. These annexes assume fulfilment of all conditionalities by all states and to that extent they are tentative and contingent upon the performance of the states. If any state is unable to draw down the performance component of the grants allocated to it, its share will be distributed in the manner specified in paras 10.163 and 10.164 and Annex 10.15b&d will stand amended to that extent.

### **Incentive Framework for General Performance Grant**

10.160 This distribution arrangement outlined above will be subject to the following conditions. For all five years between 2010-11 and 2014-15, all states will be eligible to draw down their share of the general basic grant shown in Annex 10.15a. This will be done in two instalments, latest by 1 July and 1 January of each year, subject to submission of a utilisation certificate (UC) for the previous instalment drawn. No other documentation need be stipulated. This utilisation certificate will provide

details of the distribution of the concerned instalment to urban and rural local bodies and is not required for the first instalment in 2010-11.

10.161 For the years 2011-2012, 2012-13, 2013-14 and 2014-15, a State Government will be eligible to draw down its share of the general performance grant shown in Annex 10.15b only if it complies with the following nine conditions. These conditions must be met by the end of a fiscal year (31 March) for the state to be eligible to draw down its performance grant for the succeeding fiscal year.

- i) The State Government must put in place a supplement to the budget documents for local bodies (separately for PRIs and ULBs) furnishing the details (other than those relating to Finance Accounts) indicated in Para 10.110. They should require the PRIs to maintain accounts as specified in paras 10.111 and 10.112. They should also require urban local bodies to maintain accounts as provided in Para 10.116. To demonstrate compliance with this condition, a State Government should: (a) submit the relevant supplement to the budget documents and (b) certify that the accounting systems as recommended have been introduced in all rural and urban local bodies.
- ii) The State Government must put in place an audit system for all local bodies (all categories of ULBs and all tiers of PRIs) as indicated in Para 10.121 above. The C&AG must be given TG&S over the audit of all the local bodies in a state at every tier/category and his Annual Technical Inspection Report as well as the Annual Report of the Director of Local Fund Audit must be placed before the state legislature. Certification from the C&AG will demonstrate compliance with this condition.
- iii) The State Government must put in place a system of independent local body ombudsmen who will look into complaints of corruption and maladministration against the functionaries of local bodies, both elected members and officials, and recommend

suitable action. This system should be made applicable to all elected functionaries and officials in all municipal corporations, municipalities and zilla parishads at least. The passage of relevant legislation and its notification will demonstrate compliance with this condition. In the event that all or a class of the functionaries mentioned above fall under the jurisdiction of the Lok Ayukta of the state, we leave it to the state to decide whether to continue with these arrangements or to shift the functionaries to the jurisdiction of the ombudsman. Self-certification by State Governments will demonstrate compliance with this condition.

- iv) The State Governments must put in place a system to electronically transfer local body grants provided by this Commission to the respective local bodies within five days of their receipt from the Central Government. Wherever this is not possible due to lack of easily accessible banking infrastructure, the State Governments must put in place alternative channels of transmission such that funds are transferred within ten days of their receipt. Self-certification by the State Governments with a description of the arrangements in place will demonstrate compliance with this condition.
- v) The State Governments must prescribe through an Act the qualifications of persons eligible for appointment as members of the SFC consistent with Article 243I (2) of the Constitution. The passage of relevant legislation and its notification will demonstrate compliance with this condition.
- vi) All local bodies should be fully enabled to levy property tax (including tax for all types of residential and commercial properties) and any hindrances in this regard must be removed. Self-certification by the State Government will demonstrate compliance with this condition.
- vii) State Governments must put in place a state level Property Tax Board, which will assist

all municipalities and municipal corporations in the state to put in place an independent and transparent procedure for assessing property tax. The Board (a) shall, or cause to, enumerate all properties within the jurisdiction of the municipalities and corporations; (b) shall review the present property tax system and make suggestions for a suitable basis for assessment and valuation of properties; and (c) shall make recommendations on modalities for periodic revisions. The findings, suggestions and recommendations of the board will be communicated to the respective urban local bodies for necessary action. The exact model to be adopted is left to the respective state. The board should be staffed and equipped in such a manner as to be able to make recommendations relating to at least 25 per cent of the aggregate number of estimated properties across all municipal corporations and municipalities in the state by 31 March 2015. The board should prepare a work plan indicating how it proposes to achieve this coverage target and the human and financial resources it proposes to deploy. Passage of the relevant legislation or issue of the necessary executive instructions by the State Government for creation of the Property Tax Board as well as publication of the work plan by the Board in the State Government gazette will demonstrate compliance with this condition.

- viii) Lack of resources often results in local bodies diluting the quality of services provided by them. State Governments must gradually put in place standards for delivery of all essential services provided by local bodies. For a start, State Governments must notify or cause all the municipal corporations and municipalities to notify by the end of a fiscal year (31 March) the service standards for four service sectors-water supply, sewerage, storm water drainage, and solid waste management proposed to be achieved by them by the end of the succeeding fiscal year.



This could be in the form of a declaration of a minimum level of service for the indicators mentioned against each of these four service sectors in the *Handbook on Service Level Benchmarks* published by the Ministry of Urban Development. For example a State Government may notify before 31 March 2011 that by 31 March 2012, all municipalities and municipal corporations in the state will provide a specified minimum level of service for each of the indicators for the four service sectors of water supply, sewerage, storm water drainage and solid waste management. These levels may be different for different municipalities. We envisage such a commitment to be achieved through a consultative process with the local bodies. Such a notification will be published in the State Government gazette and the fact of publication will demonstrate compliance with this condition.

- ix) All municipal corporations with a population of more than 1 million (2001 census) must put in place a fire hazard response and mitigation plan for their respective jurisdictions. Publication of these plans in the respective State Government gazettes will demonstrate compliance with this condition.

### **Incentive Framework for Special Area Performance Grant**

10.162 A state will be able to draw down its special area performance grant only if it satisfies the following conditions:

- i) It indicates in a supplement to its budget documents the details indicated in Para 10.110 while specifying the agencies which will receive the special area basic and performance grant and the conditions under which it is given including the procedure for auditing these expenditures. If these agencies are panchayats, then the conditions mentioned in Para 10.161 (i), (ii), (iii) and (vi) must be satisfied. Compliance will be

demonstrated as described in the respective paragraphs.

- ii) If these agencies are not panchayats, they must maintain accounts consistent with the instructions in force. These accounts should be up-to-date, the audit of these accounts should be completed by the C&AG, and the audit reports tabled, wherever so mandated. Compliance will be demonstrated by a certificate from the C&AG to this effect.
- iii) At least, the district level elected functionaries and officials of these agencies must be brought under the ombudsman mentioned in Para 10.161 (iii). The passage of relevant legislation and its notification will demonstrate compliance with this condition.
- iv) The stipulation in Para 10.161 (iv) regarding transfer of funds within the stipulated time is also required to be satisfied. Self-certification by the State Government with a description of the arrangements in place will demonstrate compliance with this condition.

### **Processes for Release of Funds**

10.163 As explained in Para 10.147, each state is entitled to a share of the basic grant from 2010-11 and a share of the general performance grant from the year 2011-12 onwards, respectively. In addition, the states listed in Annex 10.6 are also entitled to a share of the special area basic grant from 2010-11 and to a share of the special area performance grant from the year 2011-12 onwards. The aggregate entitlements for all grants for all states will be computed every year and budgeted in accordance with the Table 10.4. From the year 2011-12 onwards, where a state meets the conditionalities specified in paras 10.160 and 10.161, it will be eligible to receive both the basic grant and the general performance grant as shown in annexes 10.15a and 10.15b respectively. However, where a state is unable to meet these conditionalities by 31 March of a particular fiscal year, it will only be entitled to the basic grant for the succeeding fiscal year, provisional upon submitting UCs as specified

in Para 10.160. Its share of the performance grant as indicated in Annex 10.15b will be forfeited. The forfeited performance grant for the state will be divided into PRI & ULB components in the proportions indicated against that state in Annex 10.15b. It is possible that more than one state may not become eligible to draw down their performance grants. In such a case, the PRI & ULB components of the general performance grant forfeited will be aggregated separately across all such non-performing states. The total amount of PRI & ULB performance grants forfeited by the non-performing states for that particular year will then be distributed as under:

- i) Fifty per cent of the PRI amount so forfeited will be divided amongst all the states (both performing and non-performing) by the shares indicated in Annex 10.12 and 50 per cent of the ULB amount forfeited will be distributed by the share indicated in Annex 10.13.
- ii) The remaining 50 per cent of the forfeited PRI & ULB performance grants will be distributed only amongst the performing states which have complied with the stipulations in Para 10.161, in the ratio of their entitlements specified in annexes 10.12 and 10.13 respectively. If no state is eligible, this amount shall not be disbursed.

10.164 Similarly, from the year 2011-12 every state listed in Annex 10.6 will be eligible to draw the share of the basic special areas grant and its share of the special areas performance grant if it meets the conditionalities stipulated in paras 10.160 and 10.162. In case, a state does not meet these conditionalities, its entitlement will be restricted to only the basic special area grant as indicated in Annex 10.15c subject to its submitting UCs as specified in Para 10.160. Its share of the special area performance grant will be forfeited. It is possible that more than one state of those listed in Annex 10.6 may not be eligible to draw down the special areas performance grant. The special areas performance grant so forfeited will be aggregated across all non-performing states. The total amount forfeited by these non-

performing states for that particular year will then be distributed as under:

- i) Fifty per cent of the amount will be distributed amongst all the eligible states (both performing and non-performing states) as listed in Annex 10.6.
- ii) The balance 50 per cent of the amount will be distributed only amongst the performing states from those listed in Annex 10.6 which have complied with the stipulations in Para 10.162 in the ratio of their entitlements specified in the same annex. If no state is eligible, this amount shall not be disbursed.

10.165 If a state is unable to meet the stipulations in Para 10.161 or Para 10.162, as the case may be, by 31 March 2011, but meets the above stipulations by 31 March of any succeeding fiscal year, it will be entitled to its share of performance grant only prospectively from the fiscal year after the fiscal year during which it demonstrates compliance with the conditions.

10.166 We recognise the criticality of supporting all local bodies through adequate levels of devolution. They are increasingly being called upon to meet the challenges of environmental degradation, population pressure, exhaustion of resources and revenue constraints. We have, therefore, provided for a broad level of unconditional support for both urban and rural local bodies for the entire five-year period governed by our recommendations. However, all these flows need to be consistently accounted for and audited within a uniform framework across the country. Local bodies also need to be adequately empowered through appropriate transfers in a timely manner. It is for addressing these issues that we have put in place a regime of conditionality which acts as a gateway to performance grants. The conditions imposed are prudential rather than output-based; they are concerned with processes rather than being expenditure-directed and they are aimed at putting in place a credible framework for analyzing the performance of all local bodies as well as making them responsible for their service levels. These

conditions have been derived from our consultation process. We have attempted to put in place conditionalities which will increase responsibility, enhance transparency and augment accountability of local bodies to the public. These steps, which are consistent with the subsidiarity principle, will, in our view, improve the quality of expenditures of local bodies and result in better outputs and outcomes.

10.167 The substantial increase in the volume of transfers to local bodies envisaged by this Commission requires that State Governments strengthen their audit framework. While the C&AG will provide technical guidance and supervision, the major portion of the work will have to be undertaken by the local fund audit department. We recommend that all State Governments strengthen their local fund audit departments appropriately through both capacity building as well as augmentation of personnel.

#### **Role of Other Development Authorities**

10.168 Ideally, development authorities should be dissolved and their functions taken over by the local bodies in whose jurisdiction they operate. As pointed out in Para 10.132, one of the reform measures mandated under JNNURM is 'assigning or associating elected ULBs with city planning functions and transferring all special delivery civic services in urban areas to ULBs over a period of seven years'. We urge speedy implementation of this reform measure. In the interim, we recommend that these bodies share a percentage of their income (including income from land sales) with local bodies.

10.169 A number of the 62 cantonments in the country are now located within city boundaries. It is necessary that the development plans made for the city incorporate the civilian portions of the cantonment areas as well. We recommend that the development plans for the civilian areas within the cantonment areas (excluding the areas under the active control of the forces) be brought before the district planning committees. This would also enable integration of services like water supply and

schemes like JNNURM from the other areas into the cantonment areas.

#### **Areas where Parts IX and IX-A do not Apply**

10.170 The terms of reference of this Commission do not include the provisos to Article 275(1) relating to grants to the Schedule VI areas. This Commission finds no reason to depart from the course of action followed by the previous Commissions and recommends that the states may appropriately allocate a portion of their share of the general basic grant and general performance grant, to the specials areas described in para 10.148, in proportion to the population of these areas. This will also promote uniformity of approach across all states in the country in the matter of devolution to local bodies. This allocation will be in addition to the special area basic grant and special area performance grant recommended by us in Para 10.148. We are confident that these steps will lead to national policies like gender representation being integrated into the working of the agencies functioning in these areas. We understand that proposals for improving the functioning of the ADCs based upon the report of an Expert Committee are under consideration of Government of India. We recommend that this issue be addressed promptly.

#### **Revamping Fire and Emergency Services**

10.171 The National Disaster Management Authority (NDMA) has drawn the Commission's attention to the dismal state of fire services in the country. NDMA has estimated the deficiency of the services in the country as under:

i) Fire Stations	- 97.54%
ii) Fire Fighting & Rescue Vehicles	- 80.04%
iii) Fire Personnel	- 96.28%

10.172 NDMA argued for allocation of grants worth Rs. 7,000 crore to the states to meet these shortages. We accept the need to restructure fire and emergency services across the urban and rural areas of the country and recognise that the stipulation in Para 10.161(ix) is merely a first step. Though this is

an important area, we are not imposing an expenditure conditionality on local bodies in view of our approach to conditionality outlined in Para 10.166. We recommend that a portion of the grants provided by us to the urban local bodies be spent on revamping of the fire services within their respective jurisdictions. These bodies could provide financial support to the State Fire Services Department towards this objective. In this process, they could draw upon the expertise of state agencies and the National Disaster Management Agency, as required.

### **Strengthening the Local Body Framework**

10.173 Though our recommendations provide enhanced support to local bodies, we recognise that there is no substitute for local bodies raising their own tax and non-tax revenues and for State Governments augmenting their tax assignment and transfers to them. Local bodies must be encouraged to fully exploit those taxation powers which have been assigned to them by their respective State Governments. They should be in a position, not only to fully exploit sources like property tax and profession tax, but also to recover at least maintenance costs for services like water supply, solid waste management and sewerage. Where construction of a road has led to tangible commercial benefits being provided, a suitable user charge could be considered. The issue of collection of user charges from roads is elaborated in a subsequent chapter. We recognise that local bodies should be incentivised for such efforts. This, in our view, can best be done if own revenue of local bodies is used as one parameter for devolution. Unfortunately, due to data frailties mentioned earlier, we were unable to do so. We have, however, through the use of conditionalities, attempted to ensure that all stakeholders including the Finance Commissions in future will have access to comparable and audited data of local body revenues across all the states in the country. The State Governments, in turn, can incentivise own revenue collection by local bodies through a variety of methods, such as mandating some or all local taxes as obligatory at non-zero rates of levy; by deducting

deemed own revenue collection from transfer entitlements of local bodies, or through a system of matching grants. We have not imposed any stipulation that State Governments maintain their present level of transfers such that FC transfers become an additionality. We believe that funds, functions and functionaries are interdependent. This virtuous circle will get enlarged with increased financial support to local bodies and enhanced devolution of functions and more functionaries will follow. We trust that these issues will be examined carefully by the respective State Finance Commissions and that they will make appropriate recommendations.

10.174 Given the rapid growth in urban population and the need to improve urban infrastructure, ULBs need to look for market-based financing to provide additional funds for infrastructure investments. Ahmedabad Municipal Corporation was the first ULB to access the capital markets in January 1998. Since then, ULBs have raised funds through both taxable and tax-free municipal bonds to the tune of Rs. 1200 crore. Several of these municipal bonds have been issued without State Government guarantees. In recent years, the Tamil Nadu Urban Development Fund and the Greater Bengaluru Water Supply and Sewerage Project have raised funds through the pooled financing arrangements, which allows local bodies to pool their resources and jointly access the capital market. Although the municipal bond market has been limited so far, we expect that more and more ULBs will, in future, be able to access market-based financing or urban infrastructure, using the pooled finance model. However, proper accounting and audit mechanisms and adequate transparency would be critical for the success of the municipal bond issues. Hence our emphasis on the quality of accounting and auditing processes as well as data on all aspects of the functioning of ULBs.

10.175 We recommend that the system of notification of minimum levels of service described in Para 10.161(viii) and stipulated only for municipal corporations and municipalities would be gradually extended in future to all local bodies, both urban and rural.



10.176 We would urge State Governments to consider gradually putting in place the ombudsman system to cover all local body functionaries including gram panchayats, block panchayats and nagar panchayats at the earliest.

### **Changes to the Finance Accounts**

10.177 To buttress the accounting system stipulated in Para 162(i) and (ii), we recommend that the finance accounts should include a separate statement indicating head-wise details of actual expenditures for both PRIs and ULBs. under the same heads as used in the budget. Details are provided in Para 10.110. We recommend that these changes be brought into finance accounts with effect from 31 March 2012.

### **Other Measures to Strengthen Local Bodies**

#### **Payment of Service Charges**

10.178 Article 285 (1) of the Constitution exempts all properties of the Central Government from tax imposed by local bodies in the states. However, the Central Government, as early as May 1954, recognised the need to make payment for the unallocable civic services provided by the local bodies. It was noted that while metered services like electricity and water could be paid for, based upon consumption, there was need to reimburse local bodies for unallocable services like street lighting and roads which are normally funded through the property tax route. The Central Government reiterated these instructions in 1967, 1976, and 1986. FC-XI had recommended that all government properties of the Centre as well as the states should be subject to levy of user charges which should be regulated by suitable legislations. There has been little progress in this area over the last ten years. A common refrain during our state visits has been the need for municipalities to be compensated for the unallocable civic services provided by them. We endorse the recommendation of the FC-XI that payment of service charges by Central and State Governments should be regulated by suitable legislation. This may take time. We urge both the Government of India and the State Governments to

issue executive instructions that all their respective departments pay appropriate service charges to the local bodies. We are of the view that user charges levied on Central Government properties should not exceed the charges levied on similarly placed State Government properties, and where no charges are collected by the local bodies in respect of State Government properties, Central Government properties should be equally exempt.

### **Sharing of Mining Royalties**

10.179 In our discussions with representatives of local bodies they asked that mining royalties received by the states should either be assigned to the local bodies or shared with them. During field visits in the states we witnessed significant environmental degradation affecting the lives of people in the mining regions. There is a feeling that while natural resources are extracted from resource-rich areas, the local population does not benefit from the exploitation of these resources. They, however, have to bear the negative externalities. We recommend that State Governments share a portion of their income from royalties with those local bodies from whose jurisdiction such income originates.

### **Setting up SFC-like Bodies in Areas not Covered by Part IX**

10.180 We endorse the recommendation of the Expert Committee on 'Planning for the Sixth Schedule Areas' set up by the Ministry of Panchayati Raj relating to setting up of bodies similar to the SFC in states which are not covered by Part IX of the Constitution, and are thus, not required to set up SFCs. As recommended by them, the terms of reference of these SFC-like bodies may be patterned on the provisions of Article 243I of the Constitution. The Union Government has to take the necessary steps in this regard.

### **Summary of Recommendations**

10.181 Article 280 (3) (bb) & (c) of the Constitution should be amended such that the words 'on the basis of the recommendations of the Finance Commission of the State' are changed to 'after taking into consideration the

recommendations of the Finance Commission of the State' (Para 10.130).

10.182 Article 243-I of the Constitution should be amended to include the phrase 'or earlier' after the words 'every fifth year' (Para 10.125).

10.183 The quantum of local body grants may be provided as per Table 10.4. The general basic grant as well as the special areas basic grant be allocated amongst states as specified. The state-wise eligibility for these grants is placed in annexes 10.15a and 10.15c. (Para 10.159)

10.184 State Governments will be eligible for the general performance grant and the special areas performance grant only if they comply with the stipulations in paras 10.161 and 10.162 respectively. These grants will be disbursed in the manner specified in paras 10.163 and 10.164. The state wise eligibility for these grants is placed in annexes 10.15b and 10.15d.

10.185 States may appropriately allocate a portion of their share of the general basic grant and general performance grant, to the 'excluded areas' in proportion to the population of these areas. This allocation will be in addition to the special area basic grant and special area performance grant recommended by us (Para 10.170).

10.186 State Governments should appropriately strengthen their local fund audit departments through capacity building as well as personnel augmentation (Para 10.167).

10.187 The State Governments should incentivise revenue collection by local bodies through methods such as mandating some or all local taxes as obligatory at non-zero rates of levy; by deducting deemed own revenue collection from transfer entitlements of local bodies or through a system of matching grants (Para 10.173).

10.188 To buttress the accounting system, the finance accounts should include a separate statement indicating head-wise details of actual

expenditures under the same heads as used in the budget for both PRIs and ULBs. We recommend that these changes be brought into effect from 31 March 2012 (Para 10.177).

10.189 The Government of India and the State Governments should issue executive instructions that all their respective departments pay appropriate service charges to local bodies (Para 10.178).

10.190 Given the increasing income of State Governments from royalties, they should share a portion of this income with those local bodies in whose jurisdiction such income arises (Para 10.179).

10.191 State Governments should ensure that the recommendations of SFCs are implemented without delay and that the Action Taken Report is promptly placed before the legislature (Para 10.129).

10.192 SFCs could consider adopting the template suggested at Annex 10.5 as the basis for their reports (Para 10.127).

10.193 We recommend setting up of bodies similar to the SFC in states which are not covered by Part IX of the Constitution (Para 10.180).

10.194 Local bodies should consider implementing the best identified practices (Para 10.79).

10.195 A portion of the grants provided by us to urban local bodies may be used to revamp the fire services within their jurisdiction (Para 10.172).

10.196 Local bodies should be associated with city planning functions wherever other development authorities are mandated this function. These authorities should also share their revenues with local bodies (Para 10.168).

10.197 The development plans for civilian areas within the cantonment areas (excluding areas under the active control of the forces) may be brought before the district planning committees (Para 10.169).

10.198 State Governments should lay down guidelines for the constitution of nagar panchayats (Para 10.133).