Fiscal Decentralisation in Kerala: 5th State Finance Commission's Recommendations on Devolution and Status of Implementation

B.A.Prakash[1]

Introduction

Fiscal decentralisation is a pre-condition for effective functioning of Local Governments (LGs) and delivery of better public services. Fiscal decentralisation implies re-assigning expenditure functions and revenue sources to lower tiers of government, aiming decentralisation of fiscal policy and decision making. The components of a sound system of fiscal decentralisation are freedom to prepare budgets, power to fix and change rate of taxes, levy and collect taxes, power to allot and spend money for various purposes, unconditional and formula driven resource transfer from higher to lower governments, powers to borrow money, control over staff, etc. Transfer of funds to LGs based on the recommendations of state finance commission (SFC) is the cornerstone of fiscal decentralisation. Kerala had also a history of timely constitution of SFCs and implementation of its devolution recommendations. Regarding the transfer of powers and functions, decentralised governance, fiscal decentralisation and implementation of decentralised planning, Kerala achieved substantial progress compared to other States in India. But an unfortunate and disturbing development that happened recently is the delayed implementation of the 5th SFC report by two years and rejection of most of the devolution recommendations. In this context, this paper presents the approach, recommendations of devolution and status of implementation of the 5th SFC of Kerala. The sources of data used for the study are 5th SFC reports and its action taken report.

Category of LGs in Kerala

Kerala has two categories of LGs namely rural and urban. Rural LGs consist of three tier panchayats viz. grama, block and district. Urban LGs consist of municipality and municipal corporation (MC). Table 1 gives growth in number of rural and urban LGs between 1995 and 2015. A structural change that has been occurring in the State is the decline in number of

[1] B. A. Prakash was Chairman of 5th State Finance Commission, Kerala.

grama Panchayats (village Panchayats) and increase in number of urban LGs since 2010. The number of municipalities has increased from 53 in 2005 to 87 in 2015. This is largely due to the rapid urbanization that has been taking place in the State. The share of urban population according to Census had increased from 25.9 percent in 2001 to 47.7 percent in 2011. In November 2015, a new MC, namely Kannur, was formed. The other MCs are Thiruvananthapuram, Kollam, Kochi, Thrissur and Kozhikode.

Table 1

Number of Rural and Urban LGs in Kerala from 1995 to 2015

LG	1995	2000	2005	2010	2015
Rural					
GP	990	991	999	978	941
BP	152	152	152	152	152
DP	14	14	14	14	14
Urban					
Municipality	55	53	53	60	87
MC	3	5	5	5	6
Total	**1214**	**1215**	**1223**	**1209**	**1200**

Source: 5th SFC (2015). Report of the fifth state finance commission, Part 1. Thiruvananthapuram: Government of Kerala.

Table 2 presents the number of wards of rural and urban LGs. The number of wards of municipalities and MCs witnessed a substantial increase with the conversion of grama panchayats to municipalities in November 2015. The election to reconstituted LGs was conducted in November 2015.

The average area and population of rural and urban LGs is given in Table 3. According to 2011 Census, the average population of a district panchayat (DP) was 19.03 lakh, block panchayat (BP) 1.75 lakh and grama panchayat (GP) 26.6 thousand. The municipalities had an average population of 51.6 thousand and MCs 4.91 lakh. The average area per DP was 2651 sq. Km, BP 224 sq. Km and GP 37 sq. Km. The municipalities had an average area of 24 sq. Km and MCs 96 sq. Km.

Table 2

Number of Wards of LGs in Kerala

LG	**2010**			**2015 (as on November)**		
	Number of LGs	**Number of Wards**	**Average Number**	**Number of LGs**	**Number of Wards**	**Average Number**
Rural						
GP	978	16680	17	941	15962	17
BP	152	2095	14	152	2076	14
DP	14	332	24	14	331	24
Urban						
Municipalities	60	2216	37	87	3122	36
MCs	5	359	72	6	414	69
Total	**1209**	**21682**	**-**	**1200**	**21905**	**-**

Source: 5th SFC (2015). Report of the fifth state finance commission, Part 1. Thiruvananthapuram: Government of Kerala.

Table 3

Average area and population of LGs in 2011

LG	**Number**	**Average area (Sq.km.)**	**Average population (2011 Census)**
DPs	14	2651.7	1903357
BPs	152	244.24	175309
GPs	978	37.16	26674
MCs	5	95.6	491240
Municipalities	60	23.65	51664
Total	**1209**	-	-

Source: 5th SFC (2015). Report of the fifth state finance commission, Part 1. Thiruvananthapuram: Government of Kerala.

Terms of Reference

The 5th SFC was constituted by the Government of Kerala with Prof. B A Prakash as Chairman and Shri. James Varghese IAS and Shri. Rabindrakumar Agarwal IAS as members on 17th December 2014. The terms of reference (ToR) of the commission was as follows. The Finance Commission shall review the financial position of the Panchayats and the Municipalities and make recommendations as to – (a) The principles which should govern- (i) The distribution between the State, Panchayats and Municipalities of the net proceeds of the taxes, duties, tolls and fees leviable by the State, and the allocation between the Panchayats at all levels and the Municipalities of their respective shares of such proceeds; (ii) The determination of the taxes, duties, tolls and fees which may be assigned to or appropriated by the Panchayats and the Municipalities; (iii) The grants-in-aid to the Panchayats and the Municipalities from the Consolidated Fund of the State. (b) The measures needed to strengthen the financial position of Panchayats and Municipalities with special reference to the potential for LGs to raise funds from borrowing, Improving the quality of upkeep of own assets and assets of transferred institutions, rationalizing of taxes and revenues, achieving economy and efficiency in expenditure, providing incentives for higher own resource mobilization etc. (c) The measures needed for the proper institutionalisation of the decentralisation initiatives in the State and (d) To revisit the recommendations of first four SFCs, which were accepted but not operationalized and require changes.

Approach of the commission on fiscal devolution

The commission felt that the approach of devolution followed by the previous SFCs require radical change due to following reasons. First, the previous SFCs had used devolution of funds based on (t-2) or (t-3) method. Here t represents current year or year of devolution and t-2 indicates a year proceeding two years. This means that the devolution of resources for the year 2018-19 is done based on the proceeds of state own tax revenue (SOTR) received during the year 2016-17. Due to this practice, the LGs are denied their rightful share due to them based on SOTR of the year of devolution. Second, Union Finance Commission (UFC) is devolving resources from Centre to States based on the estimated tax receipts of the year of devolution (t) and subsequently adjusting the amount with the actual receipts.

Third, the 3rd SFC had projected the resource availability of the State and the expenditure requirements of the LGs and recommended an annual devolution of resources for a period of five years for all LGs as well as for each LGs in advance. This recommendation was implemented successfully. Fourth, majority of the LGs attended in the sittings of the commission demanded that the SFC should give a recommendation specifying the amount of money to be given to each LG for each year of the award period of five years as in the case of 3rd SFC. Fifth, in order to have a realistic projection of SOTR, the commission attempted projection using 'Baseline Scenario', 'Long Term Trend based method' and 'Minimum Buoyancy in SOTR' and compared them with the projection of the Finance Department of State government. And based on this exercise, the commission adopted 'Minimum Buoyancy in SOTR' method for projecting SOTR.

Sixth, the SFC has radically changed the norms of devolution to distribute development fund meant to finance annual plans. The approaches of the previous SFCs except the first and third SFC were to fix a share of annual plan size of Kerala as the share of the resources earmarked for development purposes of LGs. The commission is of the view that the approach has serious problems. (1) The Constitutional articles, provisions in the Kerala panchayat raj Act (KPRA), 1994 and the Kerala Municipality Act (KMA), 1994 and the ToR of the commission have not mandated the commission to devolve the State resources based on the annual plan outlay of the State. (2) The estimated resources for State plan are not usually realised. (3) SFC has no authority to fix the plan outlay of the State, which consists of a number of items or components. (4) The mandate given by the above Acts and ToR is to share the net proceeds of tax resources of the State. In this context, the commission recommended a share of the net proceeds of SOTR as calculated on (t) basis as the development fund.

Taking into consideration the above aspects, the commission presented the following recommendations on the devolution of the SOTR to LGs: (i) The commission recommended following the UFC's approach, and that devolved funds are based on the estimate made for the year of devolution *t*. (ii) It was recommended that appropriate changes may be effected in projected gross and the net SOTR, based on actual tax realisation, and any excess or shortfall may be adjusted in devolution to LGs in subsequent years. (iii) It was recommended that the award be given specifying the amount of money to be devolved to each LG for each year of the award period based on the *t* method. (iv) Rejecting the practice of giving a share of annual plan size of Kerala as development fund, the commission recommended to give a share of net proceeds of SOTR as calculated on t basis. (v) The commission has decided to distribute the maintenance fund to each LG on the basis of the actual road and non-road assets based on commission's assessments.

Recommendation on Vertical Devolution

The commission recommended that 20 percent of the net proceeds of annual SOTR should be devolved to LGs as total devolution on (t) basis in the year 2016-17. For the subsequent years, an annual increase of 1 percent is recommended as shown in Table 4

Table 4

Total Devolution : Net SOTR on (t) basis (%)				
Year	Net SOTR on (t) basis (share) (%)	General Purpose Fund (%)	Maintenance Fund (%)	Development Fund (%)
2016-17	20	3.5	5.5	11.0
2017-18	21	3.5	6.0	11.5
2018-19	22	3.5	6.0	12.5
2019-20	23	3.5	6.0	13.5
2020-21	24	3.5	6.0	14.5

Source: Fifth SFC (2015), Report of the 5th SFC, Part I.

And the commission recommended an award of ₹ 8599.48 crore for the year 2016-17. The recommendation for the subsequent years of the period are ₹ 10105.94 crore for 2017-18, ₹ 11850.44 crore for 2018-19, ₹ 13868.59 crore for 2019-20 and ₹ 16201.19

crore for 2020-21. This devolution excludes the grants given by 14th UFC for civic services to LGs. The component wise recommendations are shown in Table 5

Table 5

Funds to be devolved during 5th SFC period *(₹ in crore)*					
	2016-17	**2017-18**	**2018-19**	**2019-20**	**2020-21**
General Purpose Fund	1504.91	1684.33	1885.30	2110.44	2362.68
Maintenance Fund	2364.86	2887.41	3231.94	3617.89	4050.30
Development Fund	4729.71	5534.20	6733.20	8140.26	9788.21
Total	***8599.48***	***10105.94***	***11850.44***	***13868.59***	***16201.19***
SOTR	44382.32	49709.34	55681.39	62377.26	69885.47
Net SOTR	42997.28	48123.47	53865.57	60298.15	67504.89

Source: Fifth SFC (2015), Report of the 5th SFC, Part I.

The commission recommended devolution of funds for three purposes viz. general purpose, maintenance of assets and development.

General Purpose Fund (GPF)

The commission recommended 3.5 percent of the net SOTR on t basis per year as GPF (Table 4) and the amount of funds (Table 5). GPF is primarily meant for meeting expenditure for the execution of the mandatory functions of GPs, municipalities and MCs as stipulated in the KPRA, 1994 and the KMA, 1994 and other basic functions. Most of the mandatory functions are the traditional civic functions. However, the fund shall be used for the following purposes also. (a) To cover the deficit in own funds (tax and non-tax sources) for meeting administrative, establishment, operating and other items of expenditure of LGs. (b) To meet the items of recurring expenditure of the transferred institutions which were met from the non-road maintenance fund up to the 4th SFC period. Items like electricity charges, water charges, fuel charges, purchase of furniture in Government schools/hospitals, purchase of consumables in school labs, renewal of AMC of computers and purchase of medicines including veterinary medicines in emergency situations.

Maintenance Fund

The commission recommended 5.5 percent of net SOTR as maintenance fund for the year 2016-17 (Table 4) and the amount of funds (Table 5). Maintenance fund is meant for meeting the maintenance expenditure of the assets of transferred institutions and LG's own institutions. Maintenance comprises of the repairs and replacements of spare items plus other requirements needed to retain an asset in working condition. The fund shall be used only for maintenance purposes. Two categories of maintenance funds are recommended viz. (i) for road and (ii) for non-road assets. Repair and maintenance of all types of roads of the LGs including roads constructed under MPLADs, MLA Fund, PMGSY, Flood Relief etc., maintenance of culverts, bridges etc., resurfacing/retaring of existing roads, construction of drainage system, filling up of potholes, strengthening of embankments. Maintenance fund (road) should not be used for creation/ construction of new roads and also for upgradation of existing roads. Repair and maintenance of all non-road assets including assets of transferred institutions, hospital buildings, furniture, machineries and equipment, toilets, computers and allied equipment including AMC, all other non-road assets including own assets.

Development Fund

The commission recommended 11 percent of net SOTR as development fund for 2016-17 (Table 4) and the amount of funds (Table 5). Development fund is meant to finance the decentralised plans of the LGs for local level development. The individual LGs will have freedom to prepare and execute annual plans consisting of a number of individual projects and schemes for local level development, subject to the overall plan guideline of the State Government.

Other Major Recommendations

The 14th UFC recommended grants to LGs for improving the delivery of basic services. The practice followed in Kerala is to transfer this as part of development fund. The commission disagreed the practice. The commission recommended that the grants given by the 14th UFC for civic services should be treated as a separate grant and it should be transferred in addition to the devolution of the commission.

The commission recommended that a gap fund shall be distributed to the financially weak GPs and set apart ₹ 50 crore from the share of GPF available to the GPs for the purpose. Gap is calculated as follows: Own fund plus GPF minus total of establishment, administrative, operations and other recurring expenses.

Recommendations on horizontal devolution

The commission recommended horizontal devolution of general purpose fund, maintenance fund and development fund to GPs, BPs, DPs, municipalities and MCs based on a number of norms like population, area, index of poverty, urban rural ratio of population etc. The horizontal devolution of development fund, maintenance fund and general purpose fund are shown in chart 1, 2 and 3.

Chart 1

Horizontal Devolution of 5th SFC : Development Fund

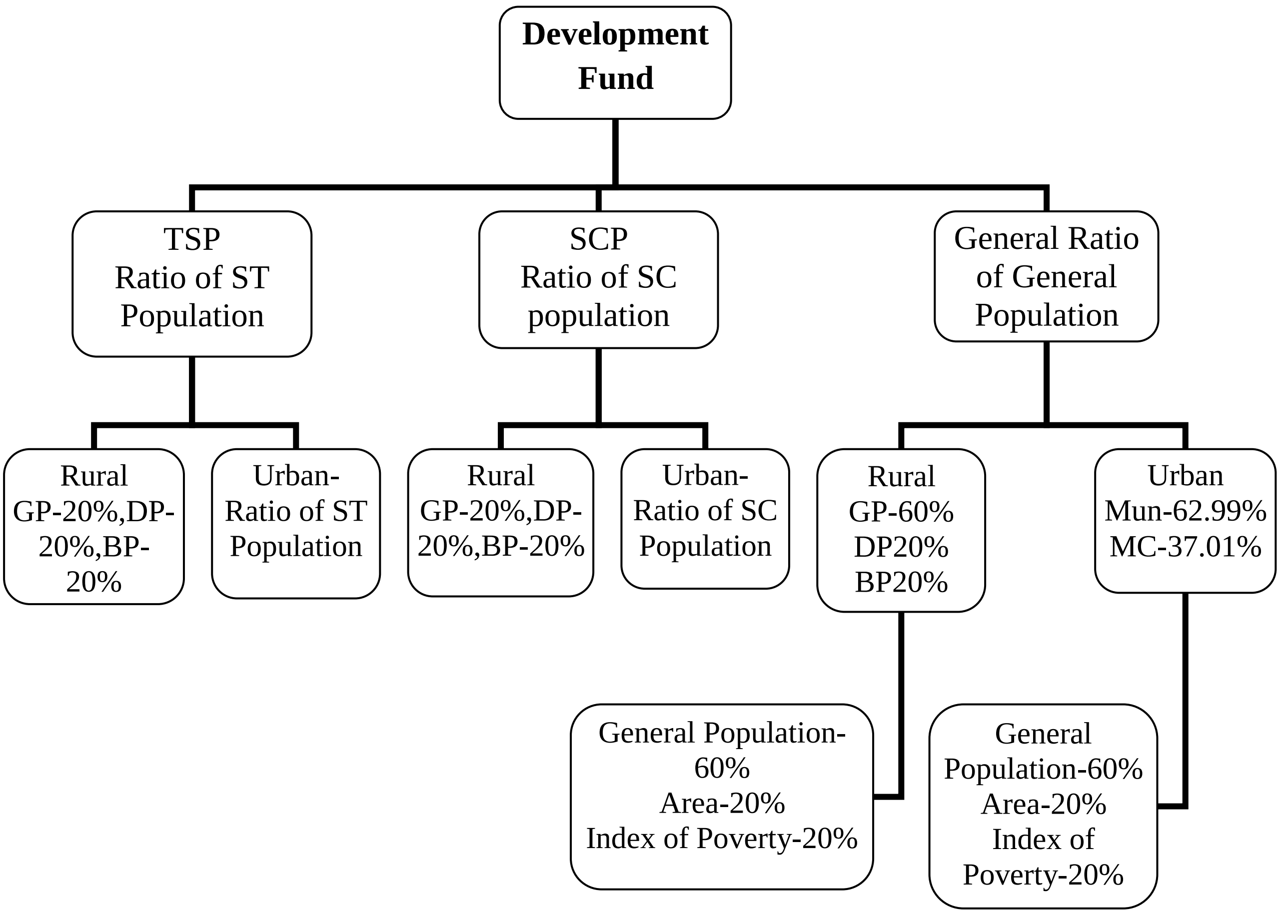

Chart 2

Horizontal Devolution of 5th SFC : Maintenance Fund

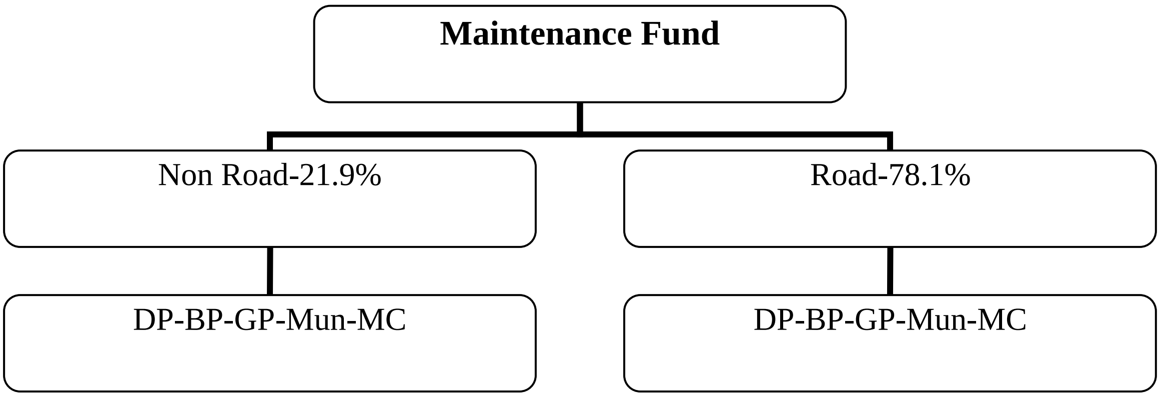

Chart 3

Horizontal Devolution of 5th SFC : General Purpose Fund

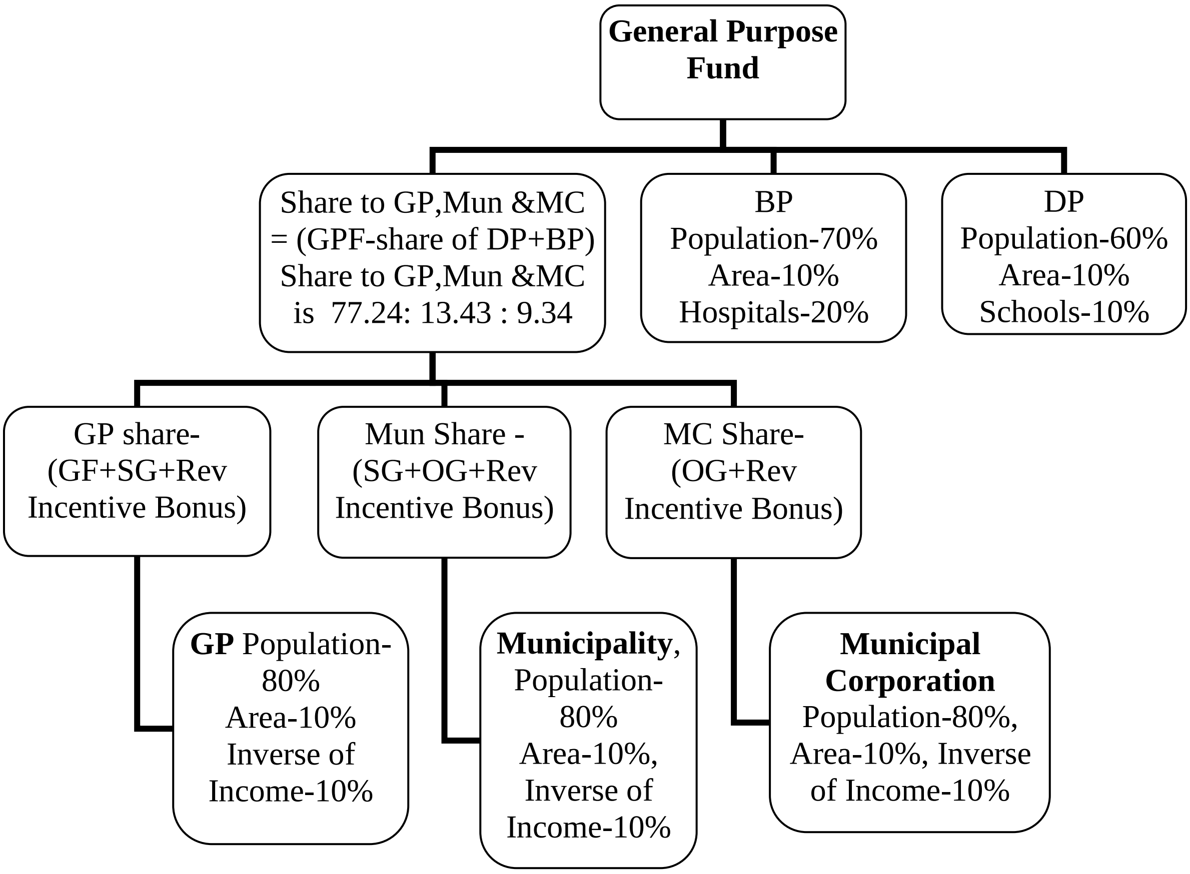

Table 6

Total transfer of funds during the 5th SFC period : LG Category wise (₹ in crore)

Name	2016-17	2017-18	2018-19	2019-20	2020-21
Grama Panchayat	**5562.56**	**6523.62**	**7590.48**	**8976.80**	**9164.23**
Development Fund	2304.83	2696.87	3281.15	3966.82	4769.89
General Purpose Fund	1094.84	1225.31	1371.46	1535.19	1718.63
Maintenance Fund	1562.27	1907.49	2135.09	2390.06	2675.71
UFC Grant	600.62	693.96	802.78	1084.73	
Municipality	**1446.45**	**1697.50**	**1977.40**	**2382.75**	**2108.01**
Development Fund	559.00	654.08	795.79	962.08	1156.85
General Purpose Fund	190.57	213.29	238.73	267.23	299.16
Maintenance Fund	380.69	464.81	520.27	582.40	652.00
UFC Grant	316.19	365.33	422.62	571.05	
District Panchayat	**1015.77**	**1197.52**	**1427.93**	**1696.43**	**2008.86**
Development Fund	768.28	898.96	1093.72	1322.27	1589.96
General Purpose Fund	35.91	40.22	45.04	50.45	56.50
Maintenance Fund	211.59	258.35	289.17	323.71	362.39
Municipal Corporation	**799.25**	**934.42**	**1090.81**	**1315.95**	**1175.00**
Development Fund	329.33	385.34	468.83	566.80	681.55
General Purpose Fund	132.52	148.31	166.00	185.82	208.02
Maintenance Fund	166.66	203.49	227.77	254.96	285.44
UFC Grant	170.75	197.28	228.22	308.37	
Block Panchayat	**862.99**	**1009.44**	**1217.42**	**1460.79**	**1745.07**
Development Fund	768.28	898.96	1093.72	1322.27	1589.96
General Purpose Fund	51.07	57.20	64.06	71.75	80.36
Maintenance Fund	43.64	53.28	59.64	66.76	74.74
Grand Total	**9687.02**	**11362.50**	**13304.04**	**15832.72**	**16201.17**

Source: Fifth SFC (2015), Report of the 5th SFC, Part I.

Transfer of Funds Recommended by 5th SFC

The transfer of funds recommended by the 5th SFC was for a period of five years (2016-17 to 2020-21). The funds consist of two items: a share of the SOTR devolved to LGs and UFC grant given by the Central government as per the recommendations of the 14th UFC. Though the SFC can use its own formula to distribute UFC grants, the 5th SFC used the 14th UFCs formula to distribute the grants. The 5th SFC treated UFC grant as separate grant and recommended to transfer it in addition to the share of SOTR transferred to LGs.

The total amount recommended for different categories of LG from the share of SOTR (development, general purpose and maintenance fund) and UFC grant are given in Table 6. All the categories of LGs are entitled to get development, general purpose and maintenance fund. In the case of UFC grants, only three categories of LGs – GPs, municipalities and MCs are eligible for the grant. The total funds recommended by the 5th SFC increased from ₹ 9687.02 crore in 2016-17 to ₹ 16201.17 crore in 2020-21. An LG wise growth and composition of transfer of funds recommended by the 5th SFC is given in Table 7

Table 7
LG Category wise transfer of funds : Growth & Composition

Sl. No	**Category of LGs**	Growth (%)				
		2016-17	2017-18	2018-19	2019-20	2020-21
1	GP	-	14.73	14.06	18.26	2.05
2	Municipality	-	14.79	14.15	20.50	-13.03
3	DP	-	15.18	16.14	15.83	15.55
4	MC	-	14.47	16.74	17.11	-12.00
5	BP	-	14.51	17.08	16.66	16.29
Total		-	14.75	14.59	15.97	2.27
		Composition (%)				
1	GP	57.42	57.41	57.05	56.70	56.57
2	Municipality	14.93	14.94	14.86	15.05	13.01
3	DP	10.49	10.54	10.73	10.71	12.40
4	MC	8.25	8.23	8.20	8.31	7.25
5	BP	8.91	8.88	9.16	9.23	10.77
Total		100	100	100	100	100

Source: Based on Table 6

Status of Implementation

The 5^{th} SFC had submitted their first part of the report containing the recommendations on devolution on December, 2015 and second part on other subjects on March, 2016 to Governor of Kerala. The award period of commission was five years from 2016-17 to 2020-21. But the action taken report on the recommendations of the commission was placed in Kerala Legislative Assembly on February 7, 2018. Due to this, State Government delayed the presentation of the Action Taken Report to Kerala legislature by two years. State government also failed to devolve funds to 1200 LGs in Kerala based on 5^{th} SFC recommendations in three budgets for the years 2016-17, 2017-18 and 2018-19. The Government allotted a lower amount than the amount recommended by 5^{th} SFC for, three consecutive years. The amount allotted to LGs was 10 percent less in 2016-17, 14 percent less in 2017-18 and 19 percent less in 2018-19. And the 1200 LGs in Kerala were denied their legitimate right to receive their due share of State taxes recommended by the 5^{th} SFC for three years.

Rejection of Devolution Recommendation

It is disturbing to note that all core devolution recommendations of the commission were rejected by the State Government. They include devolution of funds based on the year of devolution t followed by UFC, recommendations of devolved funds to each LG for the award period, distribution of maintenance fund based on actual assets of LG, unhealthy diversion of maintenance fund for non-maintenance purpose, distribution of a share of SOTR as development fund, treating 14^{th} UFC grants as separate grant etc. Table 8 gives the list of core devolution recommendations of 5^{th} SFC rejected by the State Government.

Instead of opting for a progressive criterion suggested by the 5^{th} SFC, the State government decided to continue with existing practice of devolving SOTR based on the tax receipts of two years back. The government is not prepared to change norms of distribution of maintenance fund to LGs based on reliable data of assets. This results in distorted distribution of maintenance fund for LGs with small assets getting large amount and LGs with large assets getting small amount.

Table 8

Major Devolution Recommendations rejected by State Government

1	Devolution of funds based on the estimate made for the year of devolution t following UFC approach.
2	Any excess or shortfall may be adjusted in devolution to LGs in subsequent years based on tax realisation.
3	Award recommending the amount of money to be devolved to each LG for each year of the award period based on the t method.
4	3.5 percent of the net proceeds of the annual SOTR be devolved as GPF on t basis for five years.
5	Distribute the maintenance fund to each LG on the basis of the actual road and non-road assets based on commission's assessment.
6	5.5 to 6 percent of the net SOTR on t basis as maintenance fund.
7	Maintenance fund should be used only for the purpose of maintenance of road and non-road assets.
8	A share of the net proceeds of the SOTR – as calculated on t basis – as the development fund. The rate of devolution recommended ranged between 11 and 14.5 percent.
9	The grants given by the 14th UFC for civic services to LGs be treated as a separate grant and transferred in addition to the devolution of the commission.
10	Transfer the devolved funds to public accounts of LGs in 12 instalments in a year.

Conclusions

The delayed implementation of 5th SFC and rejection of most of the devolution recommendations raise many serious issues. The recommendations of 5th SFC, a constitutional body was not implemented for two years. The 1200 LGs in Kerala were denied their legitimate right to receive their due share of State taxes recommended by the 5th SFC for three years. The Government allotted a lower amount than the amount recommended by 5th SFC for, three consecutive years. Most of the core devolution recommendations of 5th SFC which are formulated on clear norms for general purpose, maintenance of assets and development were rejected. The fiscal decentralisation system in Kerala is subverted. There is arbitrary allocation of resources, reversal of fiscal decentralisation and move towards fiscal centralisation. Due to this, Kerala which stood in top position in decentralised governance and fiscal decentralisation in the country lost its position. The subversion of the 5th SFC's recommendations may be considered as the most serious lapse on the part of State government which says that strengthening decentralisation is their important agenda of development.

References

Fifth State Finance Commission (2015), Report of the Fifth State Finance Commission, Part I, Thiruvananthapuram, Government of Kerala.

Fifth State Finance Commission (2016), Report of the Fifth State Finance Commission, Part II, Thiruvananthapuram, Government of Kerala.

Government of Kerala (2018), Action Taken Report on the Part I and II of the Reports of Fifth State Finance Commission, Thiruvananthapuram, Government of Kerala.

(The above three reports are available in the website **www.finance.kerala.gov.in)**

B A Prakash (2018) : "Rejection of Kerala's Fifth State Finance Commission Recommendations", *Economic & Political Weekly*, Vol 53, No 13, March 31, pp 21-24.