Rejection of Kerala's Fifth State Finance Commission Recommendations

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The recent large-scale rejection of the devolution recommendations of the Fifth State Finance Commission by the Kerala government reflects a reversal of past progress, and a move towards fiscal centralisation.

This article is based on the "Report of the Fifth State Finance Commission" of Kerala (Parts I and II), and on the "Action Taken Report on the Part I and Part II of the Reports of Fifth State Finance Commission."

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Since the enactment of the Kerala Panchayat Raj Act (KPRA), 1994 and the Kerala Municipality Act (KMA), 1994, Kerala has transferred a number of powers and functions previously exercised by the state government; devolved more state resources to local governments (LGs); and promoted decentralised governance. Besides the traditional functions of the local bodies, they have also been assigned new functions, such as the transfer of local level government institutions like hospitals, schools, and krishi bhavans; maintenance of assets of transferred institutions; assignment of more development functions; formulation and implementation of annual plans; delivery of welfare and pension schemes; and implementation of centrally sponsored schemes like the Mahatma Gandhi National Rural Employment Guarantee Scheme.

Kerala has 1,200 LGs, comprising 941 gram panchayats, 152 block panchayats, 14 district panchayats, 87 municipalities and six municipal corporations. Kerala has evolved a sound and effective fiscal decentralisation system, and a share of state taxes and grants are transferred to the LGs to meet their expenditure based on the recommendations of successive State Finance Commissions (SFCs). In the past, Kerala also had a history of timely constitution of SFCs and implementation of their recommendations on devolution. 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 has occurred recently is the delay in the implementation of the Fifth State Finance Commission (Fifth SFC) report by two years, and rejection of most of the devolution recommendations.

Fifth State Finance Commission

The terms of reference of the Fifth SFC are: devolution of net proceeds of taxes, duties, tolls and fees leviable by the state to LGs; allocation of devolved funds and grants to all categories of panchayats and municipal bodies; to suggest measures needed to strengthen the financial position of LGs as well as measures needed for the proper institutionalisation of decentralisation initiatives in the state; and to revisit the recommendations of earlier SFCs, which were not implemented and require changes.

The Fifth SFC—comprising B A Prakash, a former professor of economics in the University of Kerala, as chairman; James Varghese, principal secretary, Local Self Government Department (LSGD); and V K Baby, Special Secretary Finance (Resources)—submitted the first part of the report containing recommendations on devolution in December 2015, and the second part on other subjects in March 2016 to the governor of Kerala. The award period of the commission was five years, from 2016–17 to 2020–21. But the report on action taken with respect to the recommendations of the commission was placed before the Kerala Legislative Assembly on 7 February 2018. Due to this, the state government has delayed the implementation of the recommendations of the commission by two years.

Let us begin with a discussion of the overall approach of the Fifth SFC. Although the local bodies with limited functions have been transformed into LGs—exercising a large number of administrative, civic, maintenance and development functions—corresponding changes have not been made with regard to the transfer of powers and resources. Regarding mobilisation of own resources, adequate powers were not given to LGs in order to levy and collect new taxes and non-tax items, effect periodical revision of taxes, and initiate revenue recovery proceedings for the collection of arrears, taxes, fees, etc.

The devolution method followed by previous SFCs is irrational, with devolution carried out based on the state's own tax revenue (SOTR) received two to three years ago. The commission wanted to move to a more effective method. The commission also wanted to change the method of distribution of the maintenance fund, which was based on inadequate and unreliable data regarding assets. It was of the view that the distribution of plan funds based on the state plan outlay is not within its mandate. Further, due to the extremely poor plan performance, the commission wanted to radically restructure the formulation and execution of annual plans of LGs, in order to improve their performance.

Regarding the devolution of the SOTR, transfer of funds, resource mobilisation and annual plans, the LGs had raised a number of issues and demands before the commission. These demands were taken into consideration while formulating the recommendations. In the devolution of the SOTR and other items, the commission strictly followed the provisions of the Constitution, the KPRA 1994, the KMA 1994 and the terms of reference (ToR) of the commission.

Recommendations on Devolution

The commission felt that the approach of devolution followed by the previous SFCs required radical overhaul due to the following reasons.

First, the previous SFCs had recommended devolution of funds based on either the *t-2* or *t-3* method. Here, *t* represents the current year, or the year of devolution. This means that the devolution of resources for 2018–19 is done based on the proceeds of the SOTR received during 2016–17. Due to this practice, LGs are denied their due share of funds, based on the SOTR of the year of devolution.

Second, the Union Finance Commission (UFC) is devolving resources from the centre to the states based on the estimated tax receipts of the year of devolution (t) and subsequently adjusting the amount with the actual receipts.

Third, the Third SFC had projected the resource availability of the state and the expenditure requirements of the LGs and had recommended an annual devolution of resources for a period of five years for all LGs, as well as to specify the amount for each LG in advance. This recommendation had been implemented successfully.

Fourth, a majority of the LGs attending the sittings of the commission demanded that the SFC recommend that the amount of money to be given to each LG for each year of the award period of five years be specified, as it was in the case of the Third SFC.

Fifth, in order to have a realistic projection of the SOTR, the commission attempted a projection using a "baseline scenario," "long term trend based method" and "minimum buoyancy in SOTR," and compared them with the projection of the finance department of the state government. Based on this exercise, the commission adopted the minimum buoyancy in SOTR method for projecting the SOTR (FSFC 2015).

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 (FSFC 2015).

These three recommendations were rejected by the state government, and it was decided to continue with the existing formula of *t-2* as the base year for computation of the award amount (GoK 2018).

The commission recommended that 20% of the net proceeds of the annual SOTR should be devolved to LGs as total devolution on *t* basis in 2016–17. For the subsequent years, an annual increase of 1% is recommended as shown in Table 1 (FSFC 2015).

Table 1: 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

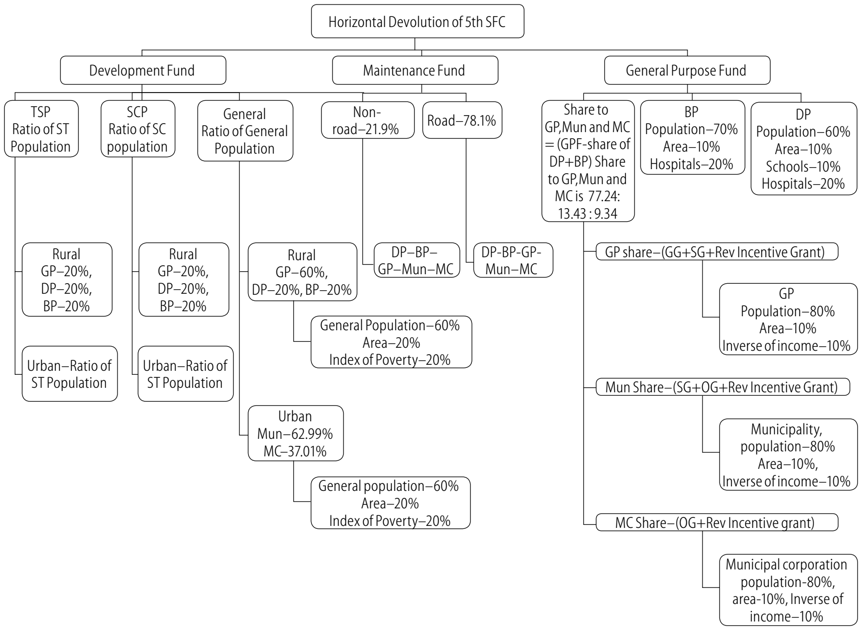
Source: FSFC (2015).

Table 2: Funds to be Devolved during Fifth SFC Period (₹ crore)

	2016–17	2017–18	2018–19	2019–20	2020–21
General Purpose Fund	1,504.91	1,684.33	1,885.30	2,110.44	2,362.68
Maintenance Fund	2,364.86	2,887.41	3,231.94	3,617.89	4,050.30
Development Fund	4,729.71	5,534.20	6,733.20	8,140.26	9,788.21
Total	8,599.48	10,105.94	11,850.44	13,868.59	16,201.19
SOTR	44,382.32	49,709.34	55,681.39	62,377.26	69,885.47
Net SOTR	42,997.28	48,123.47	53,865.57	60,298.15	67,504.89

Source: FSFC (2015).

Figure 1: Horizontal Devolution of Fifth State Finance Commission



The commission recommended an award of ₹8,599.48 crore for 2016–17. The recommendation for the subsequent years of the period are ₹10,105.94 crore for 2017–18, ₹11,850.44 crore for 2018–19, ₹13,868.59 crore for 2019–20, and ₹16,201.19 crore for 2020–21. The component-wise recommendations are shown in Table 2 (p 22). This devolution excludes the grant given by the 14th UFC to LGs for civic services. This recommendation has been rejected.

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

General Purpose Fund

The General Purpose Fund is a fund to meet expenditures relating to mandatory or civic functions of gram panchayats, municipalities and municipal corporations. The functions are collection and disposal of solid waste, disposal of liquid waste, street lighting, establishment of burial and burning grounds, provision of parking spaces for vehicles, construction of waiting sheds, provision of public toilet facilities, control of stray dogs, provision of facilities in slum areas, regulation of slaughtering of animals, etc. However, the fund shall also be used for covering the deficit in the LGs' own funds and to meet the recurring expenditure of the transferred institutions (FSFC 2015). The commission recommended that 3.5% of the net proceeds of the annual SOTR be devolved as GPF on *t* basis for five years (Table 1). This recommendation has been rejected and it has been decided to continue allocation on the *t*-2 basis, as well as continue the existing expenditure pattern of the GPF (GoK 2018).

Maintenance Fund

The Maintenance Fund is used for meeting the expenditure relating to repairs and replacements of spare items plus other requirements needed to retain an asset in a working condition. The fund is used for maintenance of "own assets" of LGs as well as the assets of transferred institutions. The SFCs used to give two categories of the Maintenance Fund, for road and non-road assets.

Previous SFCs distributed the Maintenance Fund to LGs without assessing the actual road and non-road assets of LGs, resulting in numerous complaints from LGs about this method of distribution. In this context, the commission has decided to distribute the maintenance fund to each LG on the basis of the actual road and non-road assets (FSFC 2015). The commission recommended that 5.5% of the net proceeds of the annual SOTR calculated on *t* basis be devolved to LGs as Maintenance Fund for 2016–17 (Table 1). For the subsequent four years, the rate shall be increased to 6% per annum (FSFC 2015: 205). This recommendation has been rejected, with the government deciding to continue the existing formula of the SOTR in *t*-2 for the allocation of maintenance fund.

Development Fund

The Development Fund is meant to finance annual plans prepared and executed by LGs for local-level development. The approach of the previous SFCs—apart from the First and Third SFCs—was to fix a share of the annual plan size of Kerala as the share of the resources earmarked for development purposes of LGs.

The Fifth SFC stated that this approach has serious problems. First, the articles in the Constitution, provisions in the KPRA 1994 and the KMA 1994, as well as the ToR of the commission have not mandated the SFCs to devolve state resources based on the annual plan outlay of the state. Second, the estimated resources for state plans are not usually realised. Third, the SFC has no authority to fix the plan outlay of the state, which consists of a number of items or components. Fourth, the mandate given by the above acts and the ToR is to share the net proceeds of tax resources of the state (FSFC 2015).

In this context, the commission recommended a share of the net proceeds of the SOTR—as calculated on *t* basis—as the Development Fund (FSFC 2015). The rate of devolution shall be 11% in 2016–17, 11.5% in 2017–18, 12.5% in 2018–19, 13.5% in 2019–20, and 14.5% in 2020–21 (Table 1). This recommendation has been rejected.

Other Major Recommendations

The 14th UFC recommended grants to LGs for improving the delivery of basic services (FSFC 2015: 200). The practice in Kerala had been to transfer these grants as a component of the development fund. The present commission deviated from this practice, recommending instead that the grants given by the 14th UFC for civic services be treated as a separate grant, and transferred in addition to the devolution of the commission. This recommendation has been rejected.

The commission also recommended that a gap fund be distributed to the financially weak gram panchayats, and set apart ₹50 crore from the share of the GPF available to the gram panchayats for this purpose. The gap is calculated as follows: own fund of LGs plus GPF minus total of establishment, administrative, operations and other recurring expenses (FSFC 2015: 205). This recommendation has been accepted with modifications.

The commission recommended horizontal devolution of the GPF, Maintenance Fund and Development Fund to gram panchayats (GP), block panchayats (BP), district panchayats (DP), municipalities (Mun) and municipal corporations (MC), based on a number of norms such as population, area, index of poverty, urban–rural ratio of population, etc. The details of these are presented in Figure 1 (p 23). Among the recommendations on horizontal devolution, a majority have been either accepted, or accepted with modifications.

Regarding the recommendations on other items such as mobilisation of resources of LGs, other fiscal issues, restructuring plan formulation and execution, and changes in laws, rules and procedures, a majority of the recommendations of the Fifth SFC have been accepted by the government. Here, the question is whether the government will implement them or not.

Conclusions

The delayed implementation of the Fifth SFC and the rejection of most of the devolution recommendations raise many serious issues. The recommendations of the Fifth SFC, a constitutional body, have not been implemented for two years. The 1,200 LGs in Kerala have been denied their legitimate right to receive their due share of state taxes recommended by the Fifth SFC for three years. Further, the government allotted a lower amount than recommended by the Fifth SFC for three consecutive years. The amount allocated to LGs was 10% less in 2016–17, 14% less in 2017–18, and 19% less in 2018–19. Most of the core devolution recommendations of the Fifth SFC, which were formulated on the basis of clear norms for general purpose, maintenance of assets and development, have been rejected. As a result, the fiscal decentralisation system in Kerala has been subverted. There is an arbitrary allocation of resources, a reversal of fiscal decentralisation and a move towards fiscal centralisation. Due to this, Kerala, once considered one of the leading states with respect to decentralised governance and fiscal decentralisation, has lost its position.

The subversion of the Fifth SFC's recommendations may be considered a most serious lapse on the part of a state government which claims the strengthening of decentralisation to be an important aspect of its development agenda.

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