Panchayat Finances and the Need for Devolutions from the State Government

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One of the key tests to real empowerment of panchayats lies in the ability of local self-governing institutions to finance their own expenditures through internal generation of resources. Based on an analysis of three villages in Tamil Nadu, this paper argues that many gram panchayats are today in a position to substantially finance themselves and build a culture of self-sufficiency, independence and accountability to their citizens, reducing their dependence on devolutions from state governments. It concludes that by incentivising competition among panchayats and instituting a rural development fund to enable them to access debt capital, the perverse incentives they now face can be mitigated to a large extent, leading to several significant positive outcomes.

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1 Introduction

The 73rd Constitutional Amendment Act (73 CAA) of 1992 gave constitutional status to gram panchayats, which until then had been subject to the executive decisions of state governments. The objective of the 73 CAA was to enable panchayats to function as institutions of local self-government, planning and implementing schemes for economic development and social justice. With the Eleventh Schedule of the Constitution of India (Article 243 G) listing 29 subjects[1] appropriate for devolution to panchayats, the CAA directed all state governments to pass enabling panchayati raj legislation that devolved specific powers and responsibilities to these local bodies. According to the 2001 Census, there were close to 2,30,000 gram panchayats[2] in India and the rural population constituted 72% of the total population of 1,028 million.[3] Given the numbers involved and the potential impact of constitutionally mandated local self-governments, the 73 CAA was of immense importance.

All states followed up on the 73 CAA by passing enabling panchayati raj legislation. Tamil Nadu passed its Panchayati Raj Act in 1994, laying out the nature and scope of panchayati raj institutions (PRIs) in the state. The Act ensured the devolution of functions and finances to panchayats, thus laying the basis for local self-governance. While this has led to a marginal improvement in rural public service delivery, it is apparent that much more needs to be done to provide even a basic level of services to all the rural population. Addressing the fundamental issues surrounding panchayat finances is central to improving the ability of gram panchayats to fulfil their role as agents of economic development. This paper analyses the monetary resources of three panchayats – Pallavapuram, Pandiyapuram and Cholapuram[4] – to understand the institutional and financing arrangements underlying panchayat administration in the state.

It begins with a brief discussion of the Tamil Nadu Panchayati Raj Act, 1994, which is followed by an analysis of the demographic and income profiles of the three gram panchayats under study. The next section assesses the panchayats' current financial situation by looking into their own revenues as well as assigned and devolved revenues. We then examine expenditure, that is, what is spent on public infrastructure and services that gram panchayats are constitutionally required to provide. The following section assesses the actual revenue potential of these villages based on income levels and normative standards for own revenue collection in other developing countries. Finally, we compare the evidence generated from our analysis with second generation fiscal federalism theory to assess how revenue and governance outcomes can be improved.

2 Understanding the Tamil Nadu Panchayati Raj Act

The Tamil Nadu Panchayati Raj Act of 1994 lays down the law regarding panchayati raj administration in the state. Among other aspects of governance, it discusses the specifics of statutory functions, electoral processes, administrative structure, community participation mechanisms and financing levers. The Act clearly states that gram panchayats are statutorily responsible for the following functions: (i) constructing and maintaining village roads and bridges; (ii) lighting roads and public places; (iii) constructing and maintaining drains; (iv) cleaning streets and collecting garbage; (v) providing and maintaining public toilets; (vi) constructing and maintaining water works; and (vii) maintaining burial grounds. In addition to these, panchayats also have the power to undertake other duties such as opening and maintaining public markets, playgrounds and fairs.[5]

Own Revenues: To ensure the performance of statutory duties, the act empowers gram panchayats to collect a number of taxes and fees from villages. The taxes include house tax based on the type of house; water charges based on how much is used by those with individual connections; profession tax based on profession, trade, calling or employment; and advertisement tax, which is payable by those displaying advertisements in public. Gram panchayats are also permitted to collect a range of fees, including licence fees for trades and businesses situated in places determined by panchayats; lease rentals from annual auctions of tree rights, pond fishing rights, and so on; and market fees from businesses in panchayat-provided public markets. The Act gives gram panchayats the power to set these tax rates and fees, thereby allowing them to use these levers of financing to generate revenues for infrastructure development and service delivery.

Assigned and Devolved Revenues: In addition to these self-financing levers, the Panchayati Raj Act provides for assigned and devolved revenues. Assigned revenues are those that are directly due to gram panchayats but are collected by the state government to ensure greater ease and efficiency of collection. They include entertainment tax, stamp duty, local cess and local cess surcharge that are remitted to panchayats every six months. Devolved revenues are direct grants from the state government to panchayats based on recommendations of the state finance commission (SFC), which has a five-year term. The third SFC of Tamil Nadu (2006-11) recommended that a minimum of Rs 3 lakh per annum be devolved to each panchayat and any remaining amount be distributed to panchayats in proportion to their population. The SFC devolution is paid to gram panchayats in monthly instalments.

Loans: The Tamil Nadu Panchayati Raj Act allows gram panchayats to raise loans from any financial institution as long as it is for works connected with the improvement or development of infrastructure; for carrying out relief work during calamities; and for carrying out other statutory functions. While the Act empowers panchayats to access loans for the purposes of infrastructure development and service delivery, no gram panchayat in the state (perhaps even the country) has borrowed from external financial institutions.

3 Demographic and Income Profiles of the Three Villages

The demographic profiles of Pallavapuram, Pandiyapuram and Cholapuram villages, as of 2001, are in Table 1.[6]

Table 1: Demographic Profiles

	Pallavapuram	Pandiyapuram	Cholapuram
Population	3,616	3,454	3,844
Households	802	814	897
Members per household	4.5	4.2	4.3
Sex ratio	972	1,018	1,018

Source: Census of India 2001.

To understand their income and occupational dynamics, we approached a local financial institution (LFI),[7] with a presence in all three villages, for specific but anonymous customer data on occupation, income and expenditure. We have analysed the data provided by the LFI to decipher the income and asset profiles, as well as income distributions, in these villages.[8] Table 2 shows the average and median household incomes in the three villages.

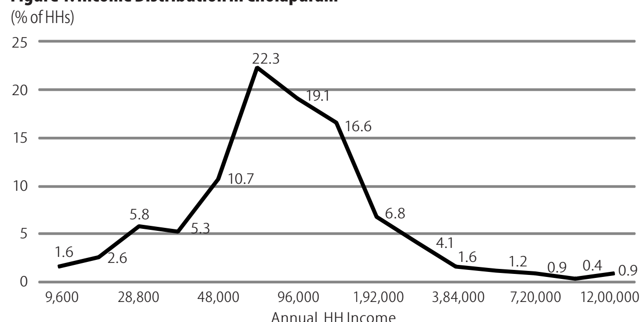
Table 2: Average and Median Household Incomes (in Rs)

	Pallavapuram	Pandiyapuram	Cholapuram
Mean annual household income	1,27,229	1,21,110	1,15,640
Median annual household income	86,928	85,200	76,800
Total Income (estimated)	10,20,38,016	9,85,83,288	10,37,28,695

Source: Based on data from LFI.

What Table 2 illustrates is that average annual household incomes in these villages are in the range of Rs 1.2 lakh per annum. The median household income, however, turns out to be about Rs 40,000 lower than the average income. This indicates that there is a high level of inequity in the distribution of income in all three villages. The inequity in incomes is borne out by the income distribution and inequality diagrams for Cholapuram (Figure 1 and Figure 2, p 75). Pallavapuram and Pandiyapuram villages exhibit a very similar pattern.

Figure 1: Income Distribution in Cholapuram

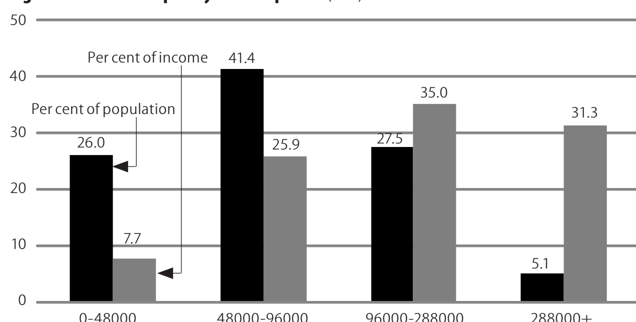


Source: Based on data from LFI.

The income distribution in Cholapuram follows a normal curve, with a majority of the households (58%) estimated to earn between Rs 72,000 and Rs 1,44,000 per annum. However, the inequality in the distribution of this income is quite staggering, as can be seen in Figure 2.

Figure 2 clearly brings out the income inequalities in the village. The bottom quartile of the village population generates less than 8% of the village income and the top 5% of the population has access to more than 30% of it. In between these extremes,

Figure 2: Income Inequality in Cholapuram (in %)



Source: Based on data from LFI.

the remaining 60% of the income is distributed among 69% of the population. Those in the bottom quartile of the population have incomes lower than Rs 48,000 a year.

Based on the data available on local household incomes, we estimate that the total annual income generated by households in each village adds up to around Rs 10 crore, as can be seen in Table 2. While this figure may seem quite high, it does make sense when compared to data from the *Statistical Handbook of Tamil Nadu*.[9] According to this, state gross domestic product (GDP) at current prices for 2008-09 was Rs 3.39 lakh crore and per capita income Rs 51,097. Based on methodology used by the Central Statistical Office (CSO) to calculate rural GDP,[10] we estimate that Tamil Nadu's rural GDP was 29% of the state GDP in 2008-09. This means a rural GDP of Rs 98,310 crore and a per capita rural income of approximately Rs 28,170.[11] Assuming a village has a population of 3,500, the annual average village income would be Rs 9.86 crore. The levels of village income in the three villages under study are within a reasonable range of this theoretically calculated average village income. Since the village incomes of these three villages are clustered around the theoretical average, it can be argued that these numbers could be representative of income profiles in many villages in Tamil Nadu (and in other states in India). What is also apparent is that if the incomes generated in the three villages are at these levels, they should be able to generate taxes commensurate with them. Therefore, it is instructive to analyse the tax and fee bases of these panchayats.

4 Analysis of Own Revenues

The own revenues of the panchayats mainly comprise three components – house tax, water charges and professional tax. Analysing these revenues across time it becomes clear that there is no buoyancy in them. Delving into the details of each of them enables us to understand the reasons for the lack of buoyancy and the steps to be taken to address this.

House Tax: The house tax is an annual tax collected from all houses in each panchayat's jurisdiction. The power to set house tax rates rests with individual gram panchayats. The Tamil Nadu Panchayati Raj Act recommends a house tax based on plinth area and house type,[12] but all three panchayats have opted to adopt a flat annual rate for each house type. These rates are maintained at very low levels, as Table 3 indicates.

The low flat rates, combined with a reluctance to increase rates every few years, have conspired to keep house tax collections in these villages static over time. Another factor that militates against buoyancy in house tax is that the panchayats do not conduct periodic checks to ensure that all houses are in the tax net. The current tax base is based on outdated house counts. The collection efficiency of house tax is 100% in all three villages, presumably because a house tax receipt is needed to get water or electricity connections and benefits from some other government schemes. But a deeper analysis reveals some anomalies. A rough calculation of house tax based on the number of houses recorded in the panchayat registers yields a much higher figure than the collections reported in income statements. This holds true for all the three panchayats. So there is a difference between the house tax that should be collected and the actual amount collected by the panchayats that are certified to have 100% collection efficiency. This difference is because of substantial under-collection from some or many households (Table 4).

Table 3: Annual House Tax Rates (in Rs)

Annual House Tax Rates	Pallavapuram	Pandiyapuram	Cholapuram
Thatched	44	44	30
Tiled house	55	66	44
Government sanctioned house	110	77	77
Concrete	550	220	110

Table 4: Under-Collection of House Tax (in Rs)

	Pallavapuram	Pandiyapuram
Collected revenue	34,010	46,310
Calculated revenue	52,206	81,158
Under-collection (%)	35	43

It can be easily seen that these under-collections, in effect, subsidise the rich. For, the poor households fall in the lowest rate slab and no panchayat can issue house tax receipts for rates lower than the lowest slab. This means that the poor end up paying the house tax that is due from them, but those who are better off and live in better quality houses underpay by remitting amounts lower than what their house tax slab prescribes. As is clear from the numbers in Table 4, addressing the issue of underpayment alone can provide a substantial boost to revenue from house taxes. However, a thorough reform of the house tax system could have an even more significant impact. This would involve counts of all the houses in each village once every five years to ensure that all new houses are brought into the tax net and moving all houses that have been extended or rebuilt to their appropriate tax brackets.

A second aspect of house tax reform is the tax rate itself. As indicated earlier, most panchayats collect a flat rate for each type of house, irrespective of size. Further, these flat rates are not revised at regular intervals. Allowing panchayats to set very low rates has led to house tax collections remaining stagnant. This could be remedied by the SFC recommending minimum and maximum house tax rates for each house type. Gram panchayats should be obligated by the state government (through appropriate government orders) to set their rates within the SFC's prescribed range. This would preserve the autonomy of panchayats to set house tax rates, but at the same time prevent them from setting ridiculously low rates.

At the end of each financial year, each gram panchayat's accounts are audited at the panchayat union office. The auditing of the house tax income in the income statement is based on the number and sum of receipts generated. If the receipts generated match the total house tax collection in the financial statement, it

passes the audit test. This has resulted in audit statements recording 100% collection efficiencies. Instead, an audit should focus on calculating the house tax due on the basis of the number and types of houses in a village (available in the panchayat registers) and compare this to the house tax collection in the panchayat's income statement. This would give a true picture of collection efficiency in the village.

Water Charges: Gram panchayats provide individual water connections to houses in villages for a monthly charge. The rates can be set by each panchayat by passing a resolution. We find that the monthly water rates in the all three panchayats are set at very low levels, although there is some variation in rates among them (Table 5).

Table 5: Monthly Water Rates (in Rs)

Water Connection	Monthly Rate
Pallavapuram	30
Pandiyapuram	50
Cholapuram	30

An analysis of water charge collections from 2007-08 to 2009-10 shows that there is great variation in year-on-year collections, with the revenue yielded in most years nowhere close to the expected collections for the year (Table 6).

Table 6: Expected and Average Water Charge Collection (in Rs)

	Pallavapuram	Pandiyapuram	Cholapuram
Average collections (2007-08 to 2009-10)	63,187	84,877	57,450
Expected collections	68,760	1,63,800	84,600
Collection shortfall (%)	8	48	32

As with house tax, under-collection is the norm here. Based on our research, it emerged that the chief reasons for this were the lack of a real threat of disconnection and the requirement that the panchayat clerk collect water charges by going to each house. While panchayats are empowered to disconnect users in cases of non-payment or misuse of water, this is a power that is never used. Without a credible threat of disconnection, the incentive to pay water charges on time (or at all) disappears. Proof of this is that the only times when the panchayats were able to recover a substantial portion of water charges due to them (such as Pallavapuram in 2009-10) were when panchayat clerks went to individual households and threatened they would actually be disconnected if their water bills were not paid within a specified number of days.

The difficulty of collection is compounded by panchayat clerks having to collect house taxes and water charges by personally going to all households in a village. In villages with 900 households or more, this is a challenging proposition and, to make matters worse, people who do not have the money in hand to pay a fee, ask the clerk to come another day. The operational difficulty is such that it puts a brake on tax and fee collections. In addition, water charges are a monthly fee. But panchayat clerks find it difficult to visit 900 or more houses every month and this fee typically gets collected once a year. The current model of door-to-door collections is extremely inefficient and unsustainable. It is imperative that panchayats get households to pay water charges on a monthly basis at the panchayat office. To achieve this, there has to be a credible threat of disconnection in case of non-payment of water charges and panchayats must cut supplies to long-term defaulters to demonstrate they are serious. This could have the desired effect of all households paying their water bills in time. Finally, panchayats should raise water charges every five years to be able to cover a substantial portion of their annual operation and maintenance expenses on water infrastructure in villages.

Professional Tax: Professional taxes are collected from local businesses, government employees and employees in public institutions in a village. This is one item of revenue that shows an upward growth over time in all the three panchayats. Just as with house tax, a reform that can have far-reaching implications on the quantum of professional tax collected is a periodic revision of rates. The SFC can set upper and lower bounds for professional tax rate slabs and panchayats can be required to set their rates within this band. This will ensure that professional tax slabs are revised every five years and serve to augment panchayat income.

5 Analysis of Assigned and Devolved Revenues

The income statements of the three panchayats from 2006-07 to 2009-10 make it clear that devolved and assigned revenues constituted a much larger share of total income than the own revenues raised by them. On an average, the assigned and devolved revenues component was more than two-thirds of total income (Table 7).

Table 7: Average Assigned and Devolved Revenues as a Proportion of Total Revenues (2006-07 to 2009-10)

	Per Cent
Pallavapuram	71.2
Pandiyapuram	67.6
Cholapuram	78.9

As we have seen, the own revenue collections of the three panchayats are severely hampered by low tax rates and fees, under-collection and poor collection efficiencies. The high level of dependence on assigned and devolved revenues is a direct consequence of this. Panchayats do not have incentives to provide even basic public infrastructure and services of a minimum standard to their citizens because their funding is not contingent on performance. They receive their assigned and devolved revenues, irrespective of the quality of services they provide. The accountability of the local government to its citizens is compromised because panchayats are incentivised to look up to the state government for funds, rather than look out for its citizens. This was confirmed by our analysis of the quality of infrastructure in all three villages and the public services provided by the panchayats.

6 State of Village Infrastructure

To assess the spread and quality of infrastructure provided, we analysed the environmental infrastructure – water supply, sanitation, waste management and drainage – in the three villages.[13] It was obvious that there were glaring gaps in the provision of these basic public services in the villages and the following examples bring to light the dismal state of affairs.

- Water quality tests, based on a large number of samples from the drinking water network in each of the villages, revealed that more than 98% of the samples tested had coliform or faecal contamination. This could result in illnesses such as diarrhoea and gastroenteritis, among others.
- While there are no official statistics on the number of toilets in these villages, discussions with panchayat officials and interviews with villagers revealed that only between 20% and 30% of

the households had toilets. Public toilets built in these villages were in a state of disrepair.

- Garbage collection along the main roads in all the villages did not seem to be much of a priority. The trash, generated by shops, lay accumulated in spontaneous dumps and was not cleared on a regular basis.
- Barring Cholapuram, the two other villages lacked drainage systems. However, Cholapuram's open drainage system choked with garbage and sewage was widely regarded as the primary threat to public health in the village.

Sanitation, quality of drinking water, and drainage and waste management were areas of critical concern in all the villages. These issues, in all likelihood, extend across a broad cross section of villages in the country. It goes without saying that larger investments in capital works as well as higher sustained expenditure on operations and maintenance will be required to tackle the range of infrastructure and service delivery issues that confront panchayats today.

7 Increasing Own Revenues

To raise the additional resources required for investment in public services, the panchayats cannot only depend on formula-based state government devolutions, but have to increase their own revenue base quite substantially. The impact of an increased generation of own revenues can be illustrated using the following exercise.

Table 8: Current Own Revenue Base and Target Revenue Base (in Rs)

	Pallavapuram	Pandiyapuram	Cholapuram
House tax	32,920	45,910	51,060
Water charge	78,946	79,815	52,470
Licence fee	2,923	1,363	1,490
Professional tax	77,162	77,003	54,160
Total	1,91,950	2,04,091	1,59,180
Total village income	10,20,38,016	9,85,83,288	10,37,28,695
Village tax revenue base (as % of village income)	0.19	0.21	0.15
Target tax base (as % of village income)	2.5	2.5	2.5
Target village revenue tax base	25,50,950	24,64,582	25,93,217
Multiplier	13.29	12.08	16.29
Average devolved and assigned revenues	7,55,296	7,85,307	7,41,669
Current village revenues/devolved revenues	0.25	0.26	0.21
Target village revenues/devolved revenues	3.38	3.14	3.50

When we separate the primary sources of own revenue generation for the three panchayats today, we find that the revenue collections are a paltry 0.15% to 0.2% of total village incomes. This is an extremely low figure and clearly indicates that the panchayats are severely undercharging for providing services. To determine a more optimal level for panchayat own revenues as a fraction of GDP, it is useful to look at the standards of own revenue collections of municipalities and see how they compare. We find that panchayat own revenue generation (at 0.15% to 0.2% of village GDP) in our sample of villages is less than, though not very different, from the overall contribution of municipal own revenues to the national GDP, which is 0.38%.[14] Therefore, both rural and urban local bodies in India appear to be operating at suboptimal levels of revenue generation. A more appropriate benchmark for India's rural and urban local bodies to aspire to can possibly be derived from local own revenue generation standards in similar developing countries such as Brazil and South Africa, which are recognised to have successfully reformed their local tax and fee structures. We find that these countries have much higher municipal own revenue ratios than India, with Brazil at 2.58%[15] and South Africa at 3.80%[16] of their GDPs. Based on these benchmarks, we propose a target own revenue tax base of 2.5% for panchayats in India.

As Table 8 further illustrates, if the three panchayats realise the target 2.5% of total village income as own revenue tax base, they would experience an increase in revenue of anywhere between 12 and 17 times compared to their own revenues today. This is a quantum jump in revenue generation and can, if these funds are put to productive use, have a tremendous impact on the quality of life in these villages. An additional comparison with the assigned and devolved revenues from the state government also helps to put into perspective the effect that an increased tax base can have on the financing mix of the panchayats. Own revenues are now around 25% of the assigned and devolved revenues, but if these villages can manage to increase their own revenues to 2.5% of village income, the ratio between own revenues and devolved revenues is turned on its head, to between 300% and 350%. This means that the panchayats can be largely self-financing and will no longer be dependent on grants from the state government. This will have a host of positive implications for the independence of the panchayats and their accountability to citizens.

It is also important to understand what the increase of tax base – from 0.2% to 2.5% of total village income – means to individual households in terms of increases in their annual tax and fee bills. An illustration using income data for households in Cholapuram shows that affordability is unlikely to be an issue as long as the tax and fee structures are designed in a progressive manner.[17]

Table 9: Income, Current and Target Annual Tax Spend in Cholapuram

Cholapuram	High Income	Medium Income	Low Income
Total households (est)		897	
% of households in each category	33	41	26
No of households in each category	292	371	233
Current average annual tax spend per HH (in Rs)	636	47	30
Current average annual income per category (in Rs)	2,16,884	71,085	31,759
Current annual tax spend (as % of annual income)	0.29	0.07	0.09
Target annual tax spend (as % of annual income)	3.00	2.00	1.50
Target annual tax spend per HH (in Rs)	6,507	1,422	476
Total target tax spend per category (in Rs)	19,02,647	5,27,962	1,11,103
Overall target tax due to gram panchayat (in Rs)			25,41,713

We find that low- and medium-income households spend less than 0.10% of their annual income on panchayat taxes and fees. High-income households spend comparatively more, 0.29%. It is clear that annual household expenditure on taxes and fees is almost negligible; this corresponds with our earlier finding on the share of Cholapuram's own revenues tax base as a portion of the village's income (0.15%). However, if we were to increase the expenditure of all households on taxes to more reasonable levels, with a progressive increase in expenditure (as a share of income) as shown in Table 9, we find that the total taxes and fees collected would be close to 2.5% of Cholapuram's income (which we earlier said would be a desirable level of tax collection).

These illustrations show that if panchayats have the will to increase taxes and fees to reasonable levels and design their tax regimes in a progressive manner, they can generate substantially greater revenue than they do now and, at the same time, ensure that citizens are charged in a manner that the tax and fee liability does not become onerous to them. It cannot be stressed enough that increases in tax rates and fees should be concomitant with improved public infrastructure and better service delivery outcomes. Ultimately, increased fees and taxes will make citizens demand more from panchayats and this can drive a virtuous cycle where increased internal revenue drives increased citizen demand, which leads to improved infrastructure, which, in turn, enables the panchayat to build credibility and charge reasonable rates for achieving better service delivery outcomes. Additionally, it helps to create a culture of payment for services among citizens, which is essential if we are to have sustainable and meaningful local self-government. As rural areas urbanise,[18] a culture of payment among citizens will be invaluable because these growing regions can then count on their citizens to be active participants in financing sustainable development.

8 Evidence in the Light of Second Generation Fiscal Federalism Theory

A review of the literature on second generation fiscal federalism theory yields constructs that attempt to explain why local governments are reluctant to try to bolster their own revenue bases. The central problem indentified is the perverse incentives that local governments have when confronted with the "soft" budget constraints of higher-level governments. If there are no clear guidelines on the "hardness" of fiscal budget constraints as they pertain to the flow of funds from higher-level governments to local ones, local governments will have the tendency to spend beyond their means in the expectation that they will be bailed out in times of need. What such "soft" budget constraints also imply is that local governments will slacken their efforts to levy and collect taxes and fees because, in addition to such moves being politically unpopular, they expect that their funding needs will be largely met by flows from higher-level governments.

Therefore, in a fiscally decentralised structure where the revenues of local government are composed of both own revenues and revenues devolved from higher-level governments, the efficacy and efficiency of own revenue sources is very closely linked to the hardness of budget constraints. If hard budget constraints are legislatively mandated, the question around them becomes one of enforceability. Local government behaviour, in this scenario, is not simply dictated by existing legislative norms but by the actual enforcement of such laws in situations of real distress. Unless local governments believe that hard budget constraints are credible, they will continue to be incentivised to treat them as soft budget constraints.

In the case of the three villages under consideration, it is very clear that the panchayats have neglected own revenues collection, which is reflected in their infrequent rate increases and poor collection efficiencies. Though income levels in these villages would permit a substantially higher own revenues base (as our analysis shows), own revenues continue to languish at abysmally low levels. The panchayat balance sheets are dominated by grants from the state government and they are the source of funds for the bulk of expenditure on public works in these villages. This appears to corroborate the theory that local governments expect to spend the funds that are devolved to them by higher-level governments, but are not incentivised to augment their own revenue collections.

This, however, is only part of the story. The balance sheet of these panchayats reveals only the "untied" fund devolutions to panchayats from the state government. Untied funds are those that can be utilised by the panchayats in any way they deem fit, as long as it is for activities within their constitutional mandate. These untied funds, however, form only one component of the transfers from the state government to panchayats. The other important component is "tied" funds, which are devolved for use in specific schemes of the central and state governments. For instance, in the case of the three villages, we found that tied funds were devolved from the central and state governments under a number of schemes such as the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS), Indira Awas Yojana (IAY) and Kalaignar Veedu Vazhangum Thittam (KVVT).[19] When there are a plethora of schemes, political economy considerations dictate that local panchayat officials are better served by attempting to spend these funds in a timely manner in their constituencies rather than trying to raise own revenues through taxes and fees. As local officials are likely to be rewarded by the political leadership on the basis of their execution of devolved schemes, their incentive is to ensure scheme implementation rather than augmentation of own revenues. This also implies that a local official is best served by trying to bring inasmuch scheme-based funding as possible from the state government and spending it in his or her jurisdiction because the local population would prefer this to paying more as taxes and fees.

However, in terms of local government accountability, this situation yields decidedly suboptimal outcomes. When public infrastructure is almost exclusively financed by devolutions and local populations pay very minimally for services, there is likely to be little demand for accountability on the quality of services provided by panchayats. The evidence on the ground corroborates this. As our study revealed, public services delivery in the three villages suffered from a number of shortcomings. Yet, our field interviews with the local populations did not reveal there was any demand among the people for accountability on the part of the panchayats.

Overall, the evidence from our analysis appears to strongly corroborate the second generation fiscal federalism literature on fiscal decentralisation and soft budget constraints. However, as the previous section showed, these villages have the potential to generate much higher internal revenues. If tapped, this can lead to much improved governance and accountability outcomes. It is imperative to explore how this can be achieved.

9 Agenda for Reform

All these villages find themselves in a low-level equilibrium with poor public infrastructure on the one hand and the potential to generate much higher own revenues that can be deployed to

improve this situation on the other. While second generation fiscal federalism theory help explain the reluctance of local government to levy taxes and fees, it is essential that villages in India are able to move towards a higher-level equilibrium with increased local revenue generation and improved infrastructure outcomes.

Incentivising Inter-panchayat Competition and Citizen Participation: One way to improve public service outcomes and increase own revenues in panchayats would be to incentivise competition among panchayats in each state. This could be accomplished by publishing an annual or biannual ranking of panchayats, comparing them on the basis of their public infrastructure. The ranking methodology could be developed by the Union Ministry of Rural Development and regularly carried out by non-governmental organisations (NGOs), universities or research institutes in conjunction with the department of rural development in each state. Such rankings would be the first step to ensure inter-panchayat competition, but the process would be incomplete if the findings are not widely publicised through the local print and electronic media.

Wide dissemination of such information would inform rural citizens about the level of services provided in their villages compared to other, better-performing villages. This information could lead to greater demands from citizens for improved public services. Panchayats, under citizen pressure, would have to improve infrastructure and raise additional revenues for it. In such a scenario, they could make a fair case for citizens paying reasonable taxes and fees for public services, which would ensure that their performance in service delivery will be closely monitored by paying citizens. Increased own revenue generation would decrease dependence on state government grants and, more importantly, increase the accountability of panchayats.

Pooled Financing for Rural Development through a Rural Development Fund: The villages under study (and many others like them) can generate a much higher level of revenues than they now do and if they are able to realise these revenues, it can form the basis for their accessing debt from capital markets. The ability to take on debt allows local governments to plan their developmental activities in a more systematic manner and thus lead to long-term improvements in providing public services. The second generation fiscal federalism literature points out that one of the ways of combating the perverse incentive of soft budget constraints is financing local governments with debt from efficient credit markets. Since attracting credit from capital markets will mean greater scrutiny of local governments' internal systems and processes, it incentivises them to improve their finances and capacities. The better the revenue generation prospects of a panchayat and the more robust its processes, the better the terms on which it can attract debt. In view of these benefits of the credit market, it is important to see how panchayats can access debt in a way that does not pose a risk to the overall sub-national debt situation.

One way for attracting debt in a calibrated manner to panchayats is through pooled finance. The pooled finance design could be based on the Tamil Nadu Urban Development Fund (TNUDF), which was set up with the objective of helping smaller urban local bodies (ULBs) in the state gain access to debt capital markets and also build their capacity to finance and manage public infrastructure projects. These ULBs would otherwise find it difficult to access debt markets because of the size of their requirements, the costs of accessing such markets and the lack of a track record in assuming debt. A pooled financing mechanism allows such entities to pool their projects together and access the market with a single bond issue, backed by cash flows from the underlying projects as well as their balance sheets. The size of the pooled issue would be large enough to attract institutional investors and the presence of multiple ULBs in the issue would mean costs can be shared, thus making it economical for each ULB to participate. The technical expertise for structuring such a transaction could be provided by the TNUDF. The TNUDF would also work with ULBs to improve the quality of their systems and processes, thus incentivising them to develop their capabilities to be able to tap the markets again and access further debt when required. Improving their capacities over time also ensures that when these ULBs approach the debt market again, they can access credit at better terms than before.

Based on the TNUDF, a rural development fund (RDF) could be set up as a public-private partnership (PPP) between the state government and private financial institutions. The one concern that needs to be mitigated is the perverse incentive local governments have to default on debt in the expectation that the state government will bail them out (the soft budget constraint). With the state government as a partner in the fund, this perverse incentive will be fully eliminated because it can intercept SFC devolutions to panchayats that default on debt repayments. This serves as a hard budget constraint and it should spur panchayats to improve their own revenue generation efforts so that they are able to access the RDF to tap capital markets and thus finance their public services. The state government as a PPP partner would also help ensure that panchayats remain leveraged within limits and do not overstretch themselves. The RDF can be critical in not merely enabling the financing of many important rural public services, but also to ensure that panchayats have the incentive to reform their own revenue generation efforts, their internal systems and processes, and build their internal capacities over time. In the long term, this would have a transformational impact on the quality of rural public finance and governance.

SFCs Recommending Tax Bands: One of the short-term responses to poor internal revenue generation by panchayats is requiring SFCs to recommend maximum and minimum tax slabs (bands) for house taxes and professional taxes. Each panchayat should enjoy the discretion to set its rates anywhere within the band. This will ensure that panchayats keep their tax rates at viable levels and not continue at the depressed levels they are now. Each new SFC would come up with fresh recommendations on appropriate tax bands, thus ensuring that panchayats will have to calibrate their tax rates every five years. This arrangement ensures that while tax rates are set within SFC-defined bounds, panchayats have the autonomy to choose the rates in the band that best suit their situation.

10 Conclusions

Our findings on the finances of Pallavapuram, Pandiyapuram and Cholapuram panchayats as well as incomes and tax bases in these villages lead us to conclude that with judicious increases in their tax and fee regimes, all three will be in a position to self-finance a substantial portion of their infrastructure and service needs. Their current dependence on state government devolutions could end, bringing in important improvements in governance, especially those related to independence and accountability to citizens. These fundamental changes in governance will signal a transition towards the true spirit of the 73 CAA. Therefore, focused action on internal revenue generation by incentivising competition among panchayats, creating RDFs and requiring SFCs to recommend tax bands could have a transformative effect on local governance and, more fundamentally, the quality of life of citizens in rural India.

NOTES

1 This list included agriculture, land improvement, minor irrigation, animal husbandry, fisheries, social forestry, minor forest produce, small-scale industries, village and cottage industries, rural housing, drinking water, fuel and fodder, roads, electrification, non-conventional energy, poverty alleviation, education, technical training, adult education, libraries, cultural activities, markets and fairs, health and sanitation, family welfare, women and child development, social welfare, welfare of the weaker sections, public distribution system, and community assets.

2 According to the State of the Panchayats Report for 2008-09, there are 2,32,855 gram panchayats in India.

3 For the Census of India 2001 figures; look up http://www.censusindia.gov.in/Census_Data_2001/India_at_glance/rural.aspx.

4 These are not the real names of the villages studied; they have been changed to prevent identification.

5 This expansive list includes planting trees on roadsides, opening public slaughter houses, reading rooms, public resting places, public cattle sheds, cart stands, parks, sports clubs, literary centres and social education centres.

6 Data from Census of India 2001.

7 This is not the real name of the financial institution; it has been changed to preserve anonymity.

8 Since the LFI collects income information based largely on the input of clients, it is reasonable to assume that clients have an incentive to overstate income. To negate this effect, we assume actual income to be 80% of that stated by a client and recorded in the LFI database.

9 Available at http://www.tn.gov.in/deptst/Tnataglance.htm#STATE INCOME.

10 Available at http://mospi.nic.in/rept%20_%20pubn/sources_methods_2007/Chapter%2032.pdf. The CSO's approach estimates the number of workers in each sector and uses this as the basis for apportioning rural and urban incomes. We use this approach to calculate the rural GDP for Tamil Nadu for 2008-09, assuming that the fraction of rural and urban workers in India from 1999-2000 to 2008-09 changed in proportion to the change in their ratios in overall national population; and adjusting for the higher level of urbanisation in Tamil Nadu (44% against an all-India average of 27% in 2001).

11 This is based on a rural population of 3.49 crore, as per the census data of 2001 for Tamil Nadu.

12 The Tamil Nadu Panchayati Raj Act recommends per square foot rates for different house types: concrete 0.5 to 1; tiled 0.30 to 0.60; thatched (> 20 square metres) 0.20 to 0.40; and (iv) thatched (< 20 square m) 0.40 to 1.

13 A detailed discussion on the state of infrastructure in these three villages can be seen in "Improving the State of Rural Environmental Infrastructure: A Case Study in Three Villages of Tamil Nadu" by Anand Sahasranaman, forthcoming in the *International Journal of Rural Management*.

14 As per the Twelfth Finance Commission report.

15 From Govinda Rao and Richard Bird (2010), "Urban Governance and Finance in India", Working Paper 10/68, National Institute of Public Finance and Policy, New Delhi.

16 Based on estimates from the South African Treasury's "Local Government Budgets and Expenditure Review, 2008".

17 For the purpose of the illustration we assume that households with an annual income lower than Rs 48,000 fall in the low-income category, households with an annual income between Rs 48,000 and Rs 96,000 fall in the medium-income category and households with incomes higher than Rs 96,000 fall in the high-income category. The average tax spend per household in the high-income category includes house tax, water charges and professional tax. For medium- and low-income households, the total tax burden comprises only house tax. Since the number of individual household water connections and professional tax assessees is less than the number of high-income households, we assume that these taxes are paid only by high-income households.

18 McKinsey Global Institute's 2010 report "India's Urban Awakening: Building Inclusive Cities, Sustaining Economic Growth" predicts an urban population of 590 million by 2030, compared to 340 million in 2008.

19 In Pallavapuram, for 2009-10, there were scheme-based devolutions of Rs 7.28 lakh for the MGNREGS and Rs 2.01 lakh for the IAY. The KVVT came into being only in the 2010-11.

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