

Performance Based Grants for Urban Local Bodies Suggestions for the Third State Finance Commission, Gujarat

Performance Assessment System
CEPT University

July 2013

Performance Based Grants for Urban Local Bodies
Suggestions for the
Third State Finance Commission, Gujarat

Prepared under PAS Project with inputs from Dr. Ravikant Joshi

CEPT University

July 2013

Table of Contents

1. Context/Background.....	1
2. Performance Based Grants for Urban Local Bodies	2
2.1. Performance Based Grants.....	2
2.2. Characteristics of the Performance Based Grant System.....	4
2.3. Benefits or Positive Aspects of Performance Based Grant System	4
2.4. PBGF – Challenges and Limitations.....	5
3. International Experience in Performance Based Grant System.....	6
4. Performance Based Grants for Urban Local Bodies in India	10
4.1. Performance Based Grants for ULBs in India at National Level.....	10
4.2. Performance Based Grants Recommended by Thirteenth Central Finance Commission	10
4.3. Performance Based Grants Recommended by State Finance Commissions	12
4.3.1. Karnataka -	12
4.3.2. Tamil Nadu	13
4.3.3. West Bengal.....	14
4.3.4. Punjab	14
4.3.5. Rajasthan	15
4.3.6. Uttar Pradesh.....	15
4.3.7. Uttarakhand.....	16
5. Suggestions by CEPT for a Performance Based Grant System (PBGS) for ULBs of Gujarat	17
5.1. Design Considerations and Characteristics for Proposed PBGS.....	17
5.1.1. Clarity about Objectives/Outcomes to be Achieved	17
5.1.2. Comprehensive but Simple to Administer.....	17
5.1.3. PBGS should be ‘Meaningful’ or ‘Sizeable’ Relative to Other Revenues of ULB..	17
5.2. Need for Facilitation by the State Government	18
5.3. The Recommended PBGS	18
5.3.1. Monitoring and Implementation	20
6. Summing Up.....	21

Abbreviations

GoI	-	Government of India
MCs	-	Minimum Conditions
PBG/PBGs	-	Performance Based Grant/Grants
PBGS	-	Performance Based Grant System
PMs	-	Performance Measures
SFC	-	State Finance Commission
ULB/ULBs	-	Urban Local Body/Urban Local Bodies

Acknowledgements

The Performance Assessment System (PAS) Project has over the past five years developed systems for measurement, monitoring and improvement of urban water supply and sanitation performance in Gujarat and Maharashtra. An important aspect in this endeavour has been to link this system for financing and investment planning at local level.

This report provides suggestions to introduce a performance based grants system for urban local bodies in Gujarat. It was prepared for consultation with and for consideration of the Gujarat State Third Finance commission (GSTFC).

After submission of this report, we have had a few meetings with the members of State Finance Commissions of Gujarat and other officials. We would like to thank them all for sharing the requisite data and information with our team. We have benefited greatly from the insights provided by members of GSTFC during our meetings. We would like to express our sincere thanks to Dr. Bharat Gariwala, Honourable Chairman, GSTFC for his support and encouragement. We also thank Shri Yamal Vyas, Member; Shri Dinesh Chokshi, Member and Shri D.N.Pandey (IAS), Member Secretary, GSTFC for providing us an opportunity to discuss this report.

We acknowledge support of the Urban Management Center and PAS Team for creating the database on water supply and sanitation for all urban local bodies of Gujarat. This database was used extensively in preparing this report.

This work on this report was carried out by a team led by Meera Mehta, Dinesh Mehta and Ravikant Joshi , who were ably supported by Dhruv Bhavsar and Paresh Chhajed.

Meera Mehta
*CEPT University,
Ahmedabad, India*

Dinesh Mehta
*CEPT University
Ahmedabad, India*

1. Context/Background

The Third State Finance Commission (SFC) for Gujarat was set up in 2011. Its main task is to review the financial position of Panchayati Raj Institutions (PRIs) and Urban Local Bodies (ULBs) and to make recommendations on grant-in-aid from consolidated funds of the State, assignment of taxes and distribution between the State Government and the local bodies of the taxes, duties, and fees levied by the State.

The Performance Assessment System (PAS) Project at CEPT University supports development of appropriate tools and methods to measure, monitor and improve delivery of urban water and sanitation services in the States of Gujarat and Maharashtra. The Project works on developing better information on water and sanitation performance at the local level, and help state and local governments to extend services to all, strive for financial viability and improve reliability and quality of services.

The team from PAS Project at CEPT University has held meetings with the Chairman, member secretary and other members of the SFC with a focus on ULBs and issues related to water supply, sanitation and financing. CEPT University also shared the information collected through the PAS Project on water and sanitation sector for all ULBs.

One of the suggestions made at SFC meeting at CEPT University was to develop a Performance Based Grant System (PBGs) which can help strengthen municipal capacity and provide incentives for improved service delivery. This paper is prepared for the consideration of SFC to initiate a performance based grant system in Gujarat. If implemented, Gujarat will be the first State in India, where a performance linked grant system would become operational.

2. Performance Based Grants for Urban Local Bodies

2.1. Performance Based Grants

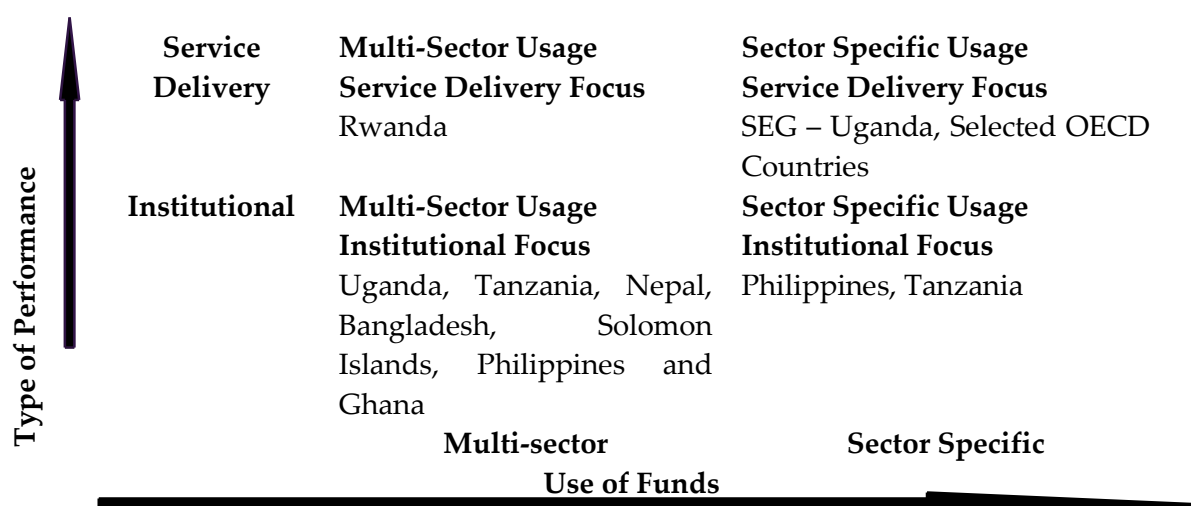
Performance Based Grants (PBGs) link performance in pre-determined areas with access to and size of funding, applying clear and transparent allocation formulas. The system is a move away from tight ex post control of local governments to strong performance-based incentives, coupled with ex ante monitoring and assessment.

PBGS can be distinguished from one another along two dimensions: i) the type of performance which they try to leverage – generic performance (*'multi-sectoral'*) such as overall financial management, governance and the like or sector output performance (*'sector-specific'*); and ii) the use of funds that is discretionary (*untied*) as opposed to earmarked or conditional (*tied*) grant funds.

Performance based grant systems may be *'multi-sectoral'* that is aimed at improving the overall generic institutional/organisational performance of the local governments, or *'sector-specific'* which seek to further sector specific improvements. Most experiences from developing countries have been within the first category, that is, PBGS aiming the generic institutional performance improvement of the urban local governments.

Performance grants require that this allocation is not an entitlement: the funds are only actually disbursed if the beneficiary ULB performs according to a number of pre-established criteria, typically called *'minimum conditions'* (MCs) which are also seen as *'minimum safeguards'* for handling of funds that is reducing fiduciary risks.

Figure 1 - Performance Based Grant System – Typology based on international experience



Source: Based on Steffenson (n.d.), ibid.

In most of the PBGS, ULBs need to show that they have complied with basic or minimum conditions in order to access their grants (or part of them). In this sense

minimum conditions are like *'on-off'* triggers. MCs are usually based on statutory provisions and are intended to reflect the basic capacity of a given ULB to perform its functions. Unless ULBs can demonstrate this performance, they will be unable to access all or part of their (most often, capital development) grants.

For the MCs to be effective, they should be very few in numbers – otherwise, they may deprive incentives and blur focus. Similarly, MCs should be realistic in scope and unambiguous; e.g. one of the MCs can be “ULB must submit final accounts within 90 days after end of the financial year”.

Many PBGSs, however, go one step further – by either increasing or decreasing the size of basic ULB grants in relation to the assessed performance of ULBs. This performance is usually based on assessing pre-determined and agreed *'Performance Measures' (PMs)*. The PMs are used to adjust the grants upwards and downwards (reward and 'punishment') to link the grant to ULB performance. Examples of these may be the extent to which ULBs have adopted double entry accounting system, or implemented tariff reforms. Most of the PBGS use generic institutional performance measures of financial management, fiscal capacity and tax effort.

Performance Measures based grant system is more nuanced and “qualitative” and is in sharp contrast to minimum conditions based grants. A ULB's performance when measured through performance indicators is *'relative'* whereas performance measured on basis of MCs is *'absolute'*. Each system has its advantage.

PBGS is often designed to include both MCs and PMs. In such a PBGS, PMs are assessed for all ULBs, and minimum conditions are used as eligibility criteria for receiving grants. The size of the grant, in such cases, depends on ULB performance across a range of measures.

It should be remembered that system of performance-based allocation is not suitable for all types of grants and expenditure areas. While it rewards the better performing ULBs, the 'laggards' may also require some special attention. It is therefore important to place PBGS in the overall architecture of inter-governmental fiscal relations and to show how the PBGS will be supplemented with other devolution of funds.

For a Performance Grant to be effective, the performance of the targeted units has to be regularly (e.g. annually) assessed. Obviously, this kind of grant requires more substantial administrative infrastructure than for example an unconditional block grant. Experience has shown that it is vital that the assessments of the local government performance has strong credibility and are accepted as valid by all parties involved. Fortunately, in Gujarat, the Service Level Benchmarking (SLB) Cell established by the Urban Development and Urban Housing Department does this assessment annually and it can form a basis for PBGS in Gujarat State.

2.2. Characteristics of the Performance Based Grant System

A performance based grant framework will have following characteristics –

- Performance based grant framework is essentially an interventionist strategy and is designed to improve specific performances and therefore, has to be always contextual. It must be rooted in local reality and must take into account specific goals that the State Government may have.
- Performance based grant framework should be stable and predictable over medium term (five to seven years) so that an urban local government can plan/execute performance improvement action plan.
- It should be flexible enough to accommodate changes in the light of improvement or deterioration in the performance over a period of time.
- It should be simple. For this, it should be based on few, simple and objective criteria or performance indicators. It should be transparent and clear to all
- It should be sizeable enough to incentivise participating ULBs.
- It should be free from political intervention or any other biases, and
- Finally, the performance areas which are going to be measured under PBGS for ULBs must be clearly defined and measurable. They should also be under full control of ULBs.

2.3. Benefits or Positive Aspects of Performance Based Grant System

Generally, a performance based grant -

1. **Provides strong incentives** for ULBs (as corporate bodies) to improve in key performance areas and adhere to national standards (core objective);
2. **Ensures that spending takes place where there is a clear absorptive capacity** – it provides basic safeguards against misuse of funds and reduces fiduciary risks to an acceptable level, which then lead to a greater support to ULBs by State Governments. Given the safeguards provided by PBGS, greater discretion can be devolved over the use of grants – which, in turn, may imply that local priorities are more likely to be addressed;
3. **Supplements capacity-building needs assessments and monitoring and evaluation systems.** The PBGS assessment is a very useful tool for identifying the functional capacity gaps in any ULB and an effective tool for linking the needs assessment with actual support;
4. **Improves management and organisational learning**, as the initiatives will continuously be monitored and assessed. This is the case at the administrative as well as at the political levels;

5. **Strengthens capacity-development efforts (focus and incentives).** With the PBGS, ULBs have stronger incentives to use capacity building support efficiently, as their performance is linked to funding. Capacity building initiatives are thus more targeted toward addressing identified weaknesses and more likely to be “translated” into actual practice.

2.4. PBGF – Challenges and Limitations

Experience has shown that there are a number of challenges to performance-based funding systems for ULBs –

- implementation of PBGF can be affected by many external factors such as:
 - Severe conflict, very weak ‘horizontal’ controls over ULB staff, weak management capacities at the central level,
 - Poorly defined expenditure assignments (which blur ULB accountabilities),
 - Inappropriate/inadequate revenue assignments constraining resource mobilisation,
 - Significant levels of parallel funds which are not tied to performance (thus reducing the leverage exerted by PBGS-modulated grants),
 - Delays in disbursements and disjuncts with the annual budgeting cycle,
- The lack of political will to implement the consequences of poor ULB performance.
- Ensuring that the assessment process and its results are of high quality, credibility is a challenge common to all PBGS.

3. International Experience in Performance Based Grant System¹

The use of incentives in Inter-Governmental Fiscal Transfer (IGFT) frameworks is not new. It has been prevalent in many developed countries (see Table 1). The systematic inclusion of performance incentives as an integral part of the grant allocation process is relatively recent in developing and underdeveloped countries (see Box 1). Uganda was an early innovator, piloting its PBGS with United Nations Capital Development Fund (UNCDF) support and technical backstopping in the mid/late 1990s in four districts with a gradual expansion in the number of ULBs covered. By 2003, Uganda's PBGS had been scaled up to a nationwide basis, covering all of the ULBs

Box 1 – PBG initiatives in developing countries

Uganda – Pilot 1997 full scale from 2003

Kenya – 2001-02

Tanzania – Pilot 2004 full scale from 2005

Nepal – Pilot 2004 full scale from 2009

Bangladesh – Pilot 2003, roll-out 2007

Indonesia, Pakistan – 2005 area based

Sierra Leone - (2006/07)

Solomon Islands - (2008)

Ghana - 2009

Preparatory work in other countries e.g. India, China, Zambia and the Philippines

in the country. Other countries have since followed suit. At present (2013), more than 15 countries are using a PBGS approach, either on a pilot basis or nationwide, and several other countries (including Bangladesh) are planning similar approaches.

This increased motivation for PBGS is resulting from two factors – one, with increased decentralisation, sub-national governments are becoming increasingly pivotal and responsible for urban sector outcomes. Urban sectors outcomes are very important for economy, but with decentralisation, national governments do not have control over these outcomes. PBGS provides the means to influence outcomes. Secondly, higher level of government is required to provide a bulk of ULB finances and PBGS facilitates inter-governmental fiscal transfer linked to local results.

A number of countries implementing PBGS have initially applied only minimum conditions for eligibility. In subsequent phases, some countries have introduced more qualitative and complex performance measures. There is a clear tendency to develop and fine-tune the performance-based systems once they are in place, and to elaborate second and third 'generations' of the systems. On the other hand, performance-based grants, which are accessible to a limited number of ULBs, may operate with more and more

¹ This section is based largely on materials available in UNCDF (2010), "Performance-Based Grant Systems – Concept and International Experience", a report prepared by Jesper Steffensen, United Nations Capital Development Fund, New York.

complex indicators, while the effort of data assessment becomes more relevant after roll-out at national level.

Table 1 A – Summarised PBGS International Experience in Developed Countries

	Australia	Russia	Indonesia	EU structural fund	Italy	UK	UK England	US
Example	National Competition Policy (NCP) Payments	Regional Fiscal Reform Fund (RFRF)	Special Allocation Grants (DAKs)	Performance Reserve	National Performance Reserve	Local Public Service Agreements (LPSAs)	Regional Development Associations (RDAs)	Economic Development Association (EDA)
Objectives	Pro growth reforms	Reward Regions with strong fiscal reforms	Sectoral service delivery objectives	Promote effectiveness, management and financial criteria in implementation of EU structural Funds	Promote effectiveness, management and financial criteria in implementation of EU structural Funds with additional emphasis on objectives of region	Improve local public services	Development at intermediate level of government	Range of economic development and adjustment issues. Reward achievement of goal by project (e.g. employment increase)
Performance indicators	Analysis of Legislative Reform Progress	Negotiated Package	Evolving	Set / negotiated with national government focused on i) effectiveness ii) management criteria iii) financial criteria Poor absorption performance subject to decommitment	Initially, mainly intermediate process indicators growing focus on final outcome	Negotiated initially 12 outcome based stretch targets in multiple service areas. Now LA's select 35 indicators from list of 198	Government office assessment	Meeting established targets within EAD awards including to state and local governments building on balanced scorecard framework
Financial Resources	National-state transfer totalling AUD 8 billion between 1997/8 to 2005/6	15 regions received additional grant (of 24 applying typically 13 received USD 8 million and USD 4 million for partial	Less than 3% of general allocation	EURO 8.25 billion (4% of structural funds)	Supplementary 6% over EU 4% performance fund. EURO 3 billion (2007-11)	Up to 2.5% of total local authority budgets	GBP 50 million	Up to 10% of project awards

	Australia	Russia	Indonesia	EU structural fund	Italy	UK	UK England	US
		success)						
Concerns	National congressional councils recommends to treasury challenges of backlogging	Packages negotiated on individual/discretionary basis with regions	Special funds seek to substitute for perceived lack of equalisation in general allocation	High share of projects received bonus complexities with significant variations across EU	Complexity and limited visibility/prominence of priority objectives	Negotiations on targets time consuming/complex risk of gaming	One time nature/limited size of awards	Challenge of attribution of projects to regional development outcomes bringing short to longer term complex outcome emphasis
Period	1997-98	2002	2001	2002-06	2002-06	Initiated 2000	2004-05	2007
Status	On-going	First Phase completed	Under further development	Compulsory requirement suspended at EU wide level	New Performance based system for 2007-13	Second generation launched 2003 further consolidation in 2007	Broader transition to outcome based framework	EDA shifting from project funding agency

Source: Based on Dumas and Kaiser (2009) as used in presentation by the World Bank (2010) "Governance and Public Sector Management".

Table 1 B – Summarised recent PBGS International Experience in Developing Countries

Features	Uganda 2008	Ghana 2009	Nepal 2009	Indonesia 2006	Bangladesh 2008	SoI 2009
Minimum Conditions	8	9	13	6 + 30 for various stages	Pilot 9	8
Performance Measures	121	60	57	NA	Pilot 42	64
Assessment	Combined Ministry + QA	Contracted out	Contracted out	Submission of documents to project office	External Audit Contracted	Contracted out/Audit
Scoring	Fixed Scoring	Relative Performance	Fixed Scoring	Phasing of reforms levels	Fixed Scoring	Relative Performance
Formulae	Population, Poverty, Land + Performance	Population, Land, Equal share + Performance	Population, HDI, Equal Share, Cost Index and Performance	Selection based on reform mindedness and poverty	Population + Performance adjustments	Population, Equal share + Performance
Coverage	Nationwide	Nationwide	Nationwide	Piloting	Rollout	Nationwide
Funding	GoU + DP	GoG + DP	GoN + DP	GoI + DP	GoB + DP	GoV + DP

Source: Based on presentation by Jesper Steffensen, "PBGS – Concept and International Experience", at the World Urban Forum, 2010.

The observations about the introduction and implementation of PBGM/PBGS in various developing countries are summarised as follows -

- The majority of countries have applied PBGS principles to
 - multi-purpose capital (or 'developmental') discretionary grants, rather than specific sector earmarked grants,
 - The majority of countries relied upon generic indicators (e.g. planning, financial management, fiscal effort, transparency, etc.), rather than output-based indicators of service delivery, to assess local government performance;
- The use of Minimum Conditions has been near universal;
- All the countries have included capacity building component in PBGS;
- Most of the countries measured ULB performance through a 'balanced' scoring system (which encourages better performance across the board, rather than just in specific areas);
- PBGS is progressively refined in some countries with modifications to budgetary 'consequences' to ensure that ULBs access minimum levels of funding regardless of their performance;
- Most countries use fairly robust and relatively intensive performance assessment processes (detailed assessment manuals, outsourced assessment teams, training of assessors, etc.), but some have sought to 'internalise' the process by making assessments into 'in-house' functions (with the risk of forgoing impartiality).

4. Performance Based Grants for Urban Local Bodies in India

A concept of performance based grants to ULBs to improve their performance is not new in India. It existed even in 1980s but it was basically confined to resource mobilisation. Also, this concept has been in the form of incentive grant rather than performance based grant. While performance based grant is based on the actual performance, an incentive grant is a soft budgetary support provided to ULBs to meet certain conditions. For example, Andhra Pradesh Second SFC had recommended an incentive grant of Rs. 1 crore for a municipal corporation if they come forward to set up a Solid Waste Management Plant.

4.1. Performance Based Grants for ULBs in India at National Level

Till 2002, Government of India (GoI) did not provide significant grants to ULBs. In 2002-03, GoI announced two schemes – Urban Reforms Incentive Fund (URIF) and City Challenge Fund (CCF). Under URIF, GoI provided funds to State Governments to pass them off to those ULBs which were carrying out certain specific reforms. Thus, for the first time reform linked performance grant system was introduced at central government level. CCF was also a performance based grant but it was of a onetime/project development grant. In this, a ULB was required to submit a proposal for service improvement or other reforms and GoI would fund the proposal.

Both these schemes, especially CCF failed to take off as the incentive offered under this scheme was very small. In 2005, GoI announced the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) which essentially merged the two schemes with huge outlay. JNNURM can also be seen as a performance based grant since it stipulates release of grant funds for urban infrastructure projects contingent upon completion of 23 reforms by the State and ULBs.

4.2. Performance Based Grants Recommended by Thirteenth Central Finance Commission

Thirteenth Central Finance Commission did two historical things - first, it recommended grant to ULBs on the basis of percentage share of divisible pool of GoI's resources (general basic grant at 1.5 percent of the previous year's divisible pool) to provide benefits from the buoyancy of central taxes and second, introduced concept of PBG in form of General Performance Grant – at the rate of 0.50 to 1 percent of the previous year's divisible pool to only those states which meet performance stipulations. (The performance grant-effective from 2011-12-will be 0.50 percent for the year 2011-12 and 1 percent thereafter, up to 2014-15).

It further stated that the states which will not meet performance stipulations, their grant for the year will be forfeited and 50 percent of such forfeited grant will be distributed to performing and non-performing state as per sharing formulae for General Basic Grant and

rest of 50 percent forfeited grant will be distributed to only amongst the performing states which have complied with the performance stipulations.

The performance conditionality or stipulations that states are required to meet are as follows:

1. State Government to add special supplement to its budget and 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.
 - Incorporating details of funds transferred directly to the local bodies outside the State Government's budget.
 - Providing details of spatial distribution of transfers—at least up to district level.
2. The Comptroller and Auditor General (C&AG) must be given Technical Guidance and Support (TG&S) over the audit of all the local bodies in a state at every tier/category and C&AG's Annual Technical Inspection Report as well as the Annual Report of the Director of Local Fund Audit must be placed before the state legislature.
3. 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.
4. 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.
5. Prescribe through an Act, the qualifications of persons eligible for appointment as members of the SFC consistent with Article 243I (2) of the Constitution.
6. 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.
7. 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.
8. State Governments must gradually put in place standards for delivery of all essential services provided by local bodies.
9. All municipal corporations with a population of more than 10 lakhs (2001 Census) must put in place a fire hazard response and mitigation plan for their respective jurisdictions.

It can be observed from the above that the PBS recommended by the Thirteenth Finance Commission is of MCs. Though this PBGS was recommended for improving urban local governance, it is not linked directly with the performance of the ULBs but it is linked with the performance of the states.

4.3. Performance Based Grants Recommended by State Finance Commissions

After the passage of 74th Constitutional Amendment, SFCs were set up in all states. However, as observed by the Thirteenth Finance Commission, the SFCs have not been set up regularly as required by the Constitution. The reports of SFCs have not been given due attention by State Governments. There are a few SFCs that have recommended performance linked grants for local bodies.

Table 2 – A Summary of SFC recommendations about PBGS

State	First SFC		Second SFC		Third SFC		Fourth SFC	
	Incentive Scheme resource mobilisation (RM) related	Incentive Scheme other reforms	Incentive Scheme RM related	Incentive Scheme other reforms	Incentive Scheme RM related	Incentive Scheme other reforms	Incentive Scheme RM related	Incentive Scheme other reforms
Bihar							-	-
Kerala							-	-
Karnataka	-	-	Yes	-	Yes	Yes ²		
Punjab			Yes	Yes ³				
Rajasthan	-	-	Yes	-				
Uttar Pradesh	-	-	Yes	-				
Uttarakhand	Yes	Yes						
Tamil Nadu	Yes	-	Yes	-	Yes	Yes ⁴		
West Bengal	Yes	-	Yes	-	Yes	-		

4.3.1. Karnataka -

The Second SFC of Karnataka recommended setting up of an incentive fund to encourage Gram Panchayats to maximise their revenue mobilisation. An amount of Rs.10 crore was recommended to be earmarked every year as incentive fund and not to be diverted for any other purpose. All Gram Panchayats whose internal resource mobilisation (recovery against the demand-current and past) was 60 percent and above in each year for three consecutive preceding financial years were eligible to be considered for awarding cash incentive under

² Incentive grant included implementation of Double Entry Accrual Based Accounting System and E-governance.

³ Reducing ratio of salary expenditure to total expenditure.

⁴ Separate Incentive Grant was recommended on the basis of public report card.

this fund. It recommended that the State Government formulate an incentive scheme on similar terms for municipal bodies after two years of implementation of the capital value based property tax system.

The Third SFC of Karnataka earmarked an amount of Rs. 50.00 crores for each year from 2006-07 as Incentive Fund, which is to be given to ULBs for the following revenue and reform performance;

- Adoption of Self Assessment Scheme for property tax,
- Actual increase in revenue receipts,
- Adoption of Double Entry Accounting System,
- Per capita performance of Tax and Water Charges collection,
- Adoption of e-governance initiatives.

4.3.2. Tamil Nadu

In Tamil Nadu, prior to the First SFC, the Panchayats were provided matching grant on the basis of House Tax collection. The First SFC of Tamil Nadu recommended extension of this grant to ULBs to improve their own source of income. The Incentive Fund allocated by the Tamil Nadu Government based on the recommendations of First SFC were utilised for incentivising property tax collection, repayment of loans to financial institutions and for repayment of non-debt dues in ULBs.

The Second SFC of Tamil Nadu (2002-03 to 2006-07) recommended setting aside 5 percent of total SFC devolution as incentive grant to rural and ULBs to improve their own source of income. It also formulated and recommended self-reliance index and fiscal accountability norms. In ULBs, the Incentive/matching grant was recommended for Town Panchayats for a minimum collection of 90 percent of property tax demand.

Incentive award was also recommended based on Report Card scores, to the best ULBs. Under this concept, the Second SFC derived various performance indicators for monitoring the performance of ULBs, the assignment of scores and weightages and based on these, the following Incentive Funds were recommended to the local bodies for distribution:

Tiers of local bodies	Incentive based on Report Card (Rs. in lakh)
Municipal	Rs. 50 lakh each
Municipalities	Rs. 10 lakh each for 3 best Special Grant
Town Panchayats	Rs. 30 lakh
Panchayat Unions	Rs. 10 lakh
Village Panchayats	Rs. 5 lakh

The Government accepted the recommendations of TFC with modifications. In respect of incentive grants, it modified some conditions. But the incentive award for performance was not accepted.

The third SFC of Tamil Nadu, recommended adoption of the existing incentive grants and awards but these suggestions were not accepted by the Government.

4.3.3. West Bengal

The First SFC of West Bengal recommended an Incentive Scheme to encourage Panchayats and Municipalities to raise their income. An amount of 2 percent of the entitlement due to a district was recommended to be set aside to act as an incentive fund. The Second SFC recommended continuation of incentive grant but suggested that this may be retained for incentives at the state level instead of the district level. The Third SFC of West Bengal continued with the idea of an 'Incentive Fund' of 2 percent of the total 'untied' fund kitty of the State for each year.

These funds should be used for encouraging the ULBs in their efforts to improve their own resource mobilisation and participatory governance.

4.3.4. Punjab

The Second SFC recommended of Punjab incentive grant for ULBs as follows –

- The State Government should provide Rs. 10 crore p.a. to the Incentive Fund for ULBs.
- These funds should be non-lapsable and any amount remaining undisbursed during a year should become available for disbursement. The Incentive Fund for ULBs will be as follows -
 - 40 percent of the amount available in the Incentive Fund may be earmarked for being awarded to the ULBs, which increases their total tax income in the previous year at a rate higher than that achieved by them in the year 2000-01.
 - Another 40 percent of the amount available in the Incentive Fund during the year may be distributed amongst the ULBs, which increase the percentage recovery of operation and maintenance (O&M) expenditure on water supply and sewerage schemes during the previous year over what was achieved in 2000-01.
 - Remaining 20 percent out of the amount available in the Incentive Fund may be awarded to the ULBs which bring about reduction in the ratio of their expenditure on salary of establishment, to their total expenditure (revenue and capital) during the SFC award period below the ratio of such expenditure in the year 2000-01.

4.3.5. Rajasthan

The First SFC of Rajasthan recommended that every year ULBs should be selected on the basis of their performance and service and an incentive grant should be given to such selected ULBs, but it did not specify performance criteria or mechanism of measuring performance. The Second SFC of Rajasthan recommended earmarking of 0.05 percent share in the net proceeds of State taxes as incentive amount for local bodies. SSFC estimated that this would make Rs. 16.41 crore available for giving incentive to local bodies (Rs. 12.57 crore for PRIs and Rs. 3.84 crore for ULBs).

- Payment of incentive amount equal to the revenue raised by a Gram Panchayat from taxes and fees, which have not been tapped so far. This incentive grant would be admissible on raising revenue from levy of new tax/recovery of fee from persons or organisation that have not paid the fee in the past or a tax not recovered so far.
- In case of ULBs, release of incentive grant was linked to recovery of discretionary taxes stipulated under section 105 of Rajasthan Municipalities Act. Second SFC recommended payment of incentive amount equal to the recovery of discretionary taxes not levied and collected so far by the councils and municipalities.
- SSFC excluded Municipal Corporations from the operation of incentive scheme due to paucity of funds.

Third SFC of Rajasthan recommended payment of incentive amount equal to the recovery of discretionary taxes not levied and collected so far by the ULBs from the incentive amount of Rs. 74.65 crores which Third SFC earmarked for incentive grant over a period of five years.

4.3.6. Uttar Pradesh

The Second SFC of Uttar Pradesh recommended incentive mechanism for ULBs and PRIs stating that 'a specified amount of annual entitlement of devolution may be retained by the State Government in an Incentive Fund and released only to those LBs, which raise their own revenue, by more than the suggested norm during the preceding year. This fund should be non-lapsable and un-distributed amounts due to below normal performance of LBs must be added to the total divisible pool of the succeeding year'. For ULBs, it suggested following mechanism –

- 15 percent of the devolution entitlement of each ULB may be withheld in an Incentive Fund. Two thirds of the Incentive Fund should be paid to Municipal Corporations showing an increase of more than 15 percent and to municipalities showing an increase of more than 12.50 percent in their income from own sources over the preceding year. For calculation of own income, the amount raised through sale of assets, loans and receipts from similar other items of non-recurring nature shall be excluded.

- The balance one third should be paid to such ULBs that have effected minimum 75 percent recovery of the assessed demand of taxes and non-taxes including arrears up to the preceding year.

4.3.7. Uttarakhand

The First SFC linked devolution to ULBs to their performance and recommended that initially in a year only 70 percent of the entitlement should be released and the release of remaining 30 percent be linked to their financial and institutional performance for which the Commission recommended the following criteria:

- The fulfilment of revenue increases as per norms recommended by the Commission (15 percent). A State Level Monitoring Committee chaired by the Finance Secretary should determine this entitlement.
- The progress towards more democratic good governance (15 percent) as judged by:
 - a) The grievance removal mechanisms and community mobilisation.
 - b) Regularity and quality of proceedings of their councils and committees.
 - c) Grading achieved in audit for budgeting, account keeping, and timely placement of audit reports before the Parishad. A committee chaired by the Divisional Commissioner and convened by the Director, Local Bodies or his nominee should determine the entitlements in this regard. In case of Badrinath, Kedarnath and Gangotri, which do not have elected bodies in place, this component of 15 percent would be held in abeyance till they are constituted as per the law.

5. Suggestions by CEPT for a Performance Based Grant System (PBGS) for ULBs of Gujarat

5.1. Design Considerations and Characteristics for Proposed PBGS

While designing a PBGS, following considerations and characteristics should be considered:

5.1.1. Clarity about Objectives/Outcomes to be Achieved

A PBGS cannot be a standalone exercise or should not exist for sake of existence but PBGS must be firmly rooted in the vision-mission-goals-objectives-outcomes to be achieved. For this purpose, there must be full clarity about objectives/outcomes to be achieved. Clarity about the outcomes to be achieved is must as PBGS can be devised in several ways.

The performance of Gujarat ULBs against various service level indicators indicates that ULBs of Gujarat need to improve their performance in terms of:

- Service delivery to achieve 100 percent coverage of basic services.
- Operational efficiency to achieve cost efficiency.
- Financial viability by raising adequate resources.
- Reduce water losses and improve cost recovery of services.
- Need to sustain and strengthen the online monitoring system.

The minimum conditions and performance measures suggested below for a PBGS in Gujarat have taken these into consideration.

5.1.2. Comprehensive but Simple to Administer

A single criterion or performance indicator fails to capture various dimensions of performance and equity. It is necessary to use multiple indicators to measure different dimensions of the performance to make PBGS comprehensive but at the same time performance indicators should be limited in number to keep it simple to understand and to administer. There is no fixed value for this but a PBGS having minimum five indicators to maximum ten indicators has been suggested to satisfy conditionality of simplicity and comprehensiveness.

5.1.3. PBGS should be 'Meaningful' or 'Sizeable' Relative to Other Revenues of ULB

Performance based grant is essentially to incentivise performance and therefore, must be sizeable or meaningful relative to the size of revenue of ULBs. It should be different for different size or Class of ULBs. CCF and URIF failed to create impact as incentive offered by these schemes were very small. Learning from this experience, GoI increased size of funds available to ULBs enormously under JNNURM. In the light of this design parameter, Table 3 provides a preliminary recommendation for size of performance

based grant per annum for different class of ULBs. This would amount to about 30 percent of the total divisible pool of non-tied transfers made in 2012-13.

Table 3 – Suggested amount of Performance Based Grant by ULB categories

Category of ULB/ population	Number of ULBs	PBG per ULB	Total PBS Amount
Municipal Corporations			
MCs above 10 lakhs	4	Rs. 3.0 crore	Rs. 12 crore
MCs less than 10 lakhs	4	Rs. 2.0 crore	Rs. 08 crore
Municipalities			
Class A – above 1 lakhs	18	Rs. 1.0 crore	Rs. 18 crore
Class B – 50,000 to 1 lakhs	33	Rs. 0.7 crore	Rs. 23 crore
Class C – 25,000 to 50,000	44	Rs. 0.5 crore	Rs. 22 crore
Class D – less than 25,000	64	Rs. 0.3 crore	Rs. 19 crore
Total	166		Rs. 102 crore

5.2. Need for Facilitation by the State Government

Any PBGS to be successful needs active guiding, handholding, capacity building and impartial monitoring role by the higher level government (in this case by Government of Gujarat). Proposed PBGS will require strong commitment, leadership and capacity on the part of government of Gujarat. In order to introduce and to sustain PBGS, Government of Gujarat will have to undertake following measures:

- Make it mandatory for all ULBs to regularly use the online reporting and monitoring systems set up for service level benchmarks and for municipal finance.
- Prepare model guidelines (for tariff setting, consumers’ charters, preliminary water audits, SLB indicators, etc).
- Provide capacity building support to ULBs through funds and training, especially to meet the minimum conditions.

5.3. The Recommended PBGS

Keeping in mind above described design considerations, desirable characteristics of PBGS and existing service delivery and other performance of Gujarat ULBs, following PBGS is recommended.

- The recommended PBGS has blend of MCs and PMs. The ULBs which attain the MCs will only be eligible to performance based grant based on their performance with respect to five performance measures.
- Following five Minimum Conditions and five Performance linked measures are suggested for the PBGS –

Minimum Conditions to be met to receive lump-sum grant (as suggested in Table 3)

1. Set up an SLB measurement system at the city level for all SLB indicators specified by the State Government for urban water supply, sanitation, solid waste, and regularly submit it online as per the State Government guidelines.
2. Reach the benchmark for efficiency in collection of property tax which is 90 percent of total tax demand or achieve at least 10 percent increase in previous year's collection efficiency levels till the benchmark of 90 percent collection against total tax demand is reached.
3. Introduce a system of measuring level of cost recovery achieved for water supply, wastewater and sanitation, and solid waste and achieve either the benchmark of 100 percent O&M cost recovery or at least 10 percent increase in previous year's cost recovery levels for each service till the benchmark of 100 percent O&M cost recovery is achieved.
4. Adopt a Citizens' Charter for all main ULB services and set up a computerised consumer grievance system with regular reporting for receipt and addressing of all complaints received.
5. Carry out a preliminary water audit as per the State Government guidelines to assess the extent of non-revenue water, and set up a monitoring system for assessing water losses.

Performance Measures: The following five performance measures are suggested. For measuring performance, each performance measure will carry maximum 20 marks and a ULB will be assigned marks as per the performance measurement scale provided in annexure tables. ULBs differ in their size, empowerment and capacity to perform therefore three different performance measurement matrixes have been suggested taking in to account size, level of evolution and likely capacity to achieve performance of the ULBs.

1. Coverage of water supply at Household level.
2. Toilet Coverage.
3. Household level coverage of solid waste management services.
4. Cost recovery in water supply.
5. Level of property tax collection (Rs./property).

Table 4 below shows illustrative allocation of performance grant of Rs. 1000 to eight cities depending upon their performance.

- The grant funds to be released on the basis of actual performance of a ULB after due verification. A ULB will have to submit its financial and service delivery data using the online system set up by Urban Development and Urban Housing Department for SLB and municipal finance to the State Government within 90 days from the completion of financial year i.e. that is by 30th June of the year.

- A PBGS requires quality and adequate data base. At present, there are issues with regard to availability and quality of data and keeping this weakness in mind, five minimum conditions have been recommended. If these minimum conditions are not fulfilled by a ULB, then performance data submitted by it cannot be taken as credible and therefore, it is stipulated that the ULBs failing to comply five conditions should not be entitled for performance based grant.

Table 4 – Illustrative working of performance grant of each ULB

Particulars	City - A	City - B	City - C	City - D	City - E	City - F	City - G	City - H	Total
Performance of ULBs (in %)	90%	85%	80%	70%	60%	50%	40%	25%	500%
Relative Performance of ULBs (in %)	18 %	17%	16%	14%	12%	10%	8%	5%	100%
Allocation based on performance of each ULB (in Rs.)	180.0	170.0	160.0	140.0	120.0	100.0	80.0	50.0	1000.0 (Rs)

5.3.1. Monitoring and Implementation

The State SLB Cell under the Urban Development and Urban Housing Department will monitor performance of ULBs throughout the year, collect the data, evaluate the data independently, assign score and workout the performance based grant amount to be allocated to ULBs.

Though it is recommended to work out share of each ULB on the basis of annual statements and actual performance, the current SLB and municipal finance monitoring system could be enhanced by collecting selected data on monthly/quarterly basis. The State SLB Cell will need to be given adequate support staff to manage the online system and to analyse progress information. The State SLB Cell can also send observations and instructions to correct or improve performance should be communicated to ULBs on a quarterly basis.

6. Summing Up

In recent years, more and more developing countries are adopting performance based grant system to improve performance of sub-national governments. In India, the concept of performance base grant existed since 1980s but in a simpler, softer and primary form which offered a very small incentive (amount) against revenue mobilisation efforts.

After 74th Constitutional Amendment, institution of State Finance Commission has come in to existence. SFCs of some states recommended performance based grants but most of them linked it to revenue improvement performance and could offer very small size of incentive.

In the year 2005, GoI introduced performance based grant concept through JNNURM. Through this scheme, GoI tried to incentivise implementation of 23 basic reforms by the State and ULBs. The Thirteenth Central Finance Commission in its award for inter-governmental fiscal transfers during 2011-15 periods has linked release of grants to State for ULBs to implementation of nine reforms/performance conditions.

In spite of various examples of performance based grants for ULBs over the years, none of the example of PBGS is linked to improving service delivery performance of ULBs, offering really sizeable incentive and based on performance measurement in an objective and transparent way.

It is the most propitious time for Third SFC of Gujarat to become a pioneer in introducing a performance linked grant system and demonstrate to the rest of country that Gujarat believes in fair and transparent system of resource transfer to local government that takes into account vertical and horizontal equity as well as efficiency of service delivery.

Annexures

Annex Table A – Performance Measurement Matrix for Municipal Corporations

Performance Indicator	Zero level performance / marks assigned	1 level performance / marks assigned	2 level performance / marks assigned	3 level performance / marks assigned	4 level performance / marks assigned	5 level performance / marks assigned	Maximum Marks
1. Coverage of Water Supply at household level	Less than 70%	70 to 75%	75 to 80%	80 to 90%	90 to 99%	100%	
	0 marks	4 marks	8 marks	12 marks	16 marks	20 marks	20 Marks
No. of cities	1	0	2	4	1	0	8
2. Coverage of toilets	Less than 70%	70 to 75%	75 to 80%	80 to 90%	90 to 99%	100%	
	0 marks	4 marks	8 marks	12 marks	16 marks	20 marks	20 Marks
No. of cities	1	1	0	4	2	0	8
3. Household level Coverage of SWM services	Less than 70%	70 to 75%	75 to 80%	80 to 90%	91 to 99%	100%	
	0 marks	4 marks	8 marks	12 marks	16 marks	20 marks	20 Marks
No. of cities	2	0	1	2	2	1	8
4. Extent of cost recovery (O&M) in Water supply service	Less than 30%	31 to 50%	50 to 70%	70 to 80%	80 to 90%	>90%	
	0 marks	4 marks	8 marks	12 marks	16 marks	20 marks	20 Marks
No. of cities	3	2	1	1	0	1	8
5. Efficiency in collection of Property Tax	Less than 30%	31 to 50%	50 to 70%	70 to 80%	80 to 90%	>90%	
	0 marks	4 marks	8 marks	12 marks	16 marks	20 marks	20 Marks
No. of cities	No Data						0
Total							100 Marks

Annex Table B – Performance Measurement Matrix for Class A and B Municipalities

Performance Indicator	Zero level performance/ marks assigned	1 level performance/ marks assigned	2 level performance/ marks assigned	3 level performance/ marks assigned	4 level performance/ marks assigned	5 level performance/ marks assigned	Maximum Marks
1 Coverage of Water Supply at household level	Less than 60%	60 to 70%	70 to 80%	80 to 90%	90 to 95%	> 95%	
	0 marks	4 marks	8 marks	12 marks	16 marks	20 marks	20 Marks
No. of cities	11	10	18	8	2	2	51
2. Coverage of toilets	Less than 60%	60 to 70%	70 to 80%	80 to 90%	90 to 95%	> 95%	
	0 marks	4 marks	8 marks	12 marks	16 marks	20 marks	20 Marks
No. of cities	5	12	16	9	6	3	51
3. Household level Coverage of SWM services	Less than 60%	60 to 70%	70 to 80%	80 to 90%	90 to 95%	> 95%	
	0 marks	4 marks	8 marks	12 marks	16 marks	20 marks	20 Marks
No. of cities	7	7	4	14	5	14	51
4. Extent of cost recovery (O&M) in Water supply service	Less than 30%	31 to 50%	50 to 70%	70 to 80%	80 to 90%	>90%	
	0 marks	4 marks	8 marks	12 marks	16 marks	20 marks	20 Marks
No. of cities	4	12	13	4	8	10	51
5. Efficiency in collection of Property Tax	Less than 30%	31 to 50%	50 to 70%	70 to 80%	80 to 90%	>90%	
	0 marks	4 marks	8 marks	12 marks	16 marks	20 marks	20 Marks
No. of cities	4	9	23	8	4	3	51
Total							100 Marks

Annex Table C – Performance Measurement Matrix for Class C and D Municipalities

Performance Indicator	Zero level performance/ marks assigned	1 level performance/ marks assigned	2 level performance/ marks assigned	3 level performance/ marks assigned	4 level performance/ marks assigned	5 level performance/ marks assigned	Maximum Marks
1. Coverage of Water Supply at household level	Less than 50%	50 to 60%	60 to 70%	70 to 80%	80 to 85%	> 85%	
	0 marks	4 marks	8 marks	12 marks	16 marks	20 marks	20 Marks
No. of cities	13	11	21	31	5	27	108
2. Coverage of toilets/ Open Defecation	Less than 50%	50 to 60%	60 to 70%	70 to 80%	80 to 85%	> 85%	
	0 marks	4 marks	8 marks	12 marks	16 marks	20 marks	20 Marks
No. of cities	11	15	24	29	8	21	108
3. Household level Coverage of SWM services	Less than 50%	50 to 60%	60 to 70%	70 to 80%	80 to 85%	> 85%	
	0 marks	4 marks	8 marks	12 marks	16 marks	20 marks	20 Marks
No. of cities	7	2	5	26	9	59	108
4. Extent of cost recovery (O&M) in Water supply service	Less than 30%	31 to 50%	50 to 70%	70 to 80%	80 to 85%	>85%	
	0 marks	4 marks	8 marks	12 marks	16 marks	20 marks	20 Marks
No. of cities	26^r	25	15	7	4	31	108
5. Efficiency in collection of Property Tax	Less than 30%	31 to 50%	50 to 70%	70 to 80%	80 to 85%	>85%	
	0 marks	4 marks	8 marks	12 marks	16 marks	20 marks	20 Marks
Total							100 Marks

The Performance Assessment System (PAS) Project

The Performance Assessment System (PAS) Project supports development of appropriate tools and methods to measure, monitor and improve delivery of urban water and sanitation services in the states of Gujarat and Maharashtra. The PAS Project includes three major components of performance measurement, performance monitoring and performance improvement. It covers all the 400+ urban local governments in Gujarat and Maharashtra.

CEPT University has received a grant from the Bill and Melinda Gates Foundation for the PAS Project. It is being implemented by CEPT University with support of Urban Management Centre (UMC) in Gujarat and All India Institute of Local Self-Government (AIILSG) in Maharashtra.

PAS Project

CEPT University
Kasturbhai Lalbhai Campus, University Road, Navrangpura, Ahmedabad - 380 009
Gujarat, India

Tel: +91-79-26302470
Fax: +91-79-26302075
www.pas.org.in