

**RESEARCH AND POLICY NOTE**

**No. 2**

**IS IT DESIRABLE TO TAKE A WORLD BANK LOAN  
FOR STRENGTHENING LOCAL GOVERNMENTS IN  
KERALA?**

*This note is prepared by*

**V. Santhakumar and Pinaki Chakraborty.**

**In addition to contributing to the main text,  
Pinaki prepared the appendix on State Finances.**

---

*The views expressed here are those of the authors and does not represent  
the view of the Centre for Development Studies.*

February, 2008

## **ABSTRACT**

This note analyses the desirability of a loan from the World Bank for strengthening local governments of Kerala under two scenarios. First, is the case where the loan supplements the resources of the local governments in addition to the funds they are entitled to from the state government in the eleventh plan. In this scenario, the spending ability and effectiveness of the local governments are the important issues of concern. The paper identifies certain areas where additional resources may be required for the local governments. The second case is where the state government directly or indirectly substitutes a part of the resource that it has committed to give to the local governments, with the proposed loan. In this scenario, the cost of borrowing of the state government is the prime concern, and in this context there are significant advantages in taking a loan from the Bank. The paper also considers a similar loan provided by the Bank to the state of Karnataka to strengthen its local governments and the conditions it came with, and deliberates on the appropriateness of such conditions in the context of Kerala.

## FOREWORD

When there are speculations in the media about a proposal to take loan from the World Bank by the state government to strengthen local governments in Kerala, there were oppositional views in the public domain of the state. Much of the debate on the desirability of loan was based on ideology – on which a research organisation like CDS can contribute very little. However, we felt that some real and technically important issues are often overlooked in the ideologically charged debating atmosphere of Kerala. This affects the quality of public debates on such issues in the state. It is in this context that two researchers of the Centre namely V. Santhakumar and Pinaki Chakraborty put together some issues based on their experience of working on local governments and state finances respectively, for a healthy debate on this issue of taking a loan from the World Bank for the local governments of Kerala.

K. Narayanan Nair  
Director  
Centre for Development Studies  
Trivandrum 695011



## 1. Introduction

This note highlights a few issues to be considered in discussing the desirability of, or the need for, a World Bank loan for strengthening the local governments in Kerala. Since formal discussions on the loan have not started, the purpose of the note is to facilitate discussions on the desirability of taking a Bank loan in the current state of affairs of local self governments, and, in case it is found necessary, to formulate baseline ‘acceptable conditions’ for taking such a loan. Three streams of literature exist which inform this note (though they are not referred to explicitly): (a) studies or reviews of the current status of the performance of LSGs in Kerala; (b) status of public finance in the state; (c) project documents of the World Bank which bear evidence to its concerns and/or indicate the conditions it is likely to impose on local-governments, specifically the *Karnataka Panchayat Strengthening Project*.

In order to highlight some probable issues that arise, this note envisages two scenarios. (a) the loan will bring in additional resources for local government (in addition to what the state government would have given to LSGs in the absence of this loan); and (b) the loan would provide an opportunity to divert a part of the resources to other purposes, which the state government would otherwise have given to LSGs. Even if the loan is provided with a commitment that the whole amount should be transferred to the local governments, the availability of such a loan may allow the state government to reduce its plan allocation to LSGs.

We may have to consider these two scenarios, since the basic issue in the first scenario is the need for, and the ability to spend, additional funds for the LSG, whereas the core issue to be discussed in the context of the second scenario is the cost of borrowing from alternative sources, which the state government resorts to meet its current revenue and fiscal deficits.

This note contains three sections. The first section takes up the issues related to the desirability of borrowing with the first scenario in mind. The second section deals with the benefits loan might bring to the state finances. The third section takes up the provisions of the WB loan programme for strengthening panchayats in Karnataka, and analyses their relevance in the context of Kerala.

## **2. On the Need for Additional Resources for Local Governments and their Ability to Spend Money Effectively**

A question that immediately comes to mind to persons with even a preliminary knowledge of the functioning of local governments of Kerala, is whether in fact they need additional resources, given their not-so-good track record of spending even the allocated funds fully effectively and efficiently. Impressionistic evidence quoted in official and unofficial circles shows that even one-fifth of the allocated funds could not be spent after 7-8 months of the financial year<sup>1</sup>. There is enough anecdotal evidence to show that many panchayats take up activities and spend money without getting any significant benefits from them. Corruption and malpractices in spending money have also not been rare. Thus the most important task now is to improve the ability and the

---

1 Latest available figures are of 2005-06 at the state level; they reveal that the actual plan expenditure (all states) was 84.71 per cent of the plan allocation. In Kerala, it was much lower at 76 per cent. One needs to see the trends in plan allocation and actual plan expenditure and the reasons for their shortfall and in that context to examine the role of external assistance. Historically shortfall in plan allocation has been higher in Kerala than the all state average. This also indicates that the reasons are structural in nature and that the use of funds may not necessarily depend on the sources of funds.

incentives of local governments to spend money more effectively and efficiently to enhance the welfare of local people through provision of local public goods and improving basic service delivery. Securing more resources at this stage is only of secondary importance. However, this situation does not have to make us conclude that local governments do not need additional resources or that external assistance, such as WB loan, is not needed at all.

One issue that arose through our interaction with the local governments in Kasargode district (as part of the Research Unit on Local Self Governments of CDS) is that of housing. Despite spending significant amounts of resources on housing during the past 10 years, many areas still have around 10 to 12 percent households living in very poor quality housing. Solving such a problem requires not small allocations over long periods of time, but substantial sums that could be spent in one or two years. Moreover, the conventional practices such as providing Rs.50000 or so as grant may not be an appropriate strategy to solve this problem, since the difficulty in mobilizing the rest of the funds prevents a significant number of households from making good quality and reliable houses, thus keeping the problem of housing unsolved. It is not that the lack of resource alone is the reason for the problem; inflexible guidelines, spending of money on not-so-useful avenues, lack of adequate control and monitoring of expenditures, etc. also prevent local governments from spending money adequately on such important issues. However, even if these problems of ineffectiveness and inefficiency of spending are solved, additional resources may be needed for certain schemes and services to be provided by local governments.

Additional resources may be needed to improve effectiveness and efficiency as well (even though it is much more important to have procedural changes and to put in place realistic incentive systems for this purpose). It is well known that lack of adequate number of qualified staff is a major constraint for the functioning of local governments in

Kerala. Lack of proper accounting and financial management remains a major issue. We have realized through interaction that proper analysis of the (social and economic) viability of projects as well as their monitoring and evaluation, institutional design and management are some of the areas in which Kerala's local governments lack skills and capacity despite a decade long effort. It is also known that despite the creation of a number of application software by the Information Kerala Mission (IKM), computerization and the use of computers to enhance the performance and service delivery remains at a rudimentary stage in most panchayats. Though the panchayats are expected to meet the cost of computerization, it is not clear whether the lack of adequate resources on the part of the panchayats is the main hurdle in realizing the benefits of using computers. Lack of adequate financial management and monitoring is also partly due to the extremely slow pace of computerization. It may be possible that additional resources (and probably changed strategies) are needed to ensure that all local governments in Kerala derive the benefits of computerization, without further delay.

It is of utmost importance that even if additional resources are provided (through external assistance such as a WB loan), significant rethinking and procedural changes are needed to improve the effectiveness of local governments. (It may be noted that persons with different ideological backgrounds are all becoming disenchanted with the decentralization experiment in Kerala, and that some of the grave failures of local governments have aggravated the disenchantment). The need for rethinking becomes more important when we note that through some of the democratic mechanisms globally advocated (like participation in project identification and planning through *grama sabhas*, implementation of projects through beneficiary committees, social auditing, citizens' charters, etc.) have already been put in place in Kerala. Most of them are found 'inadequate' to improve the efficiency, effectiveness and service delivery of local governments. An easy option would be to 'blame' citizens for not adequately participating and making

use of these mechanisms, to attribute this laxity to their unawareness or lack of interest and to advocate more awareness creation, and communication efforts, and so on. It may now be the right time to think about the effectiveness of this approach itself. We may have to think about a less explored, but apparently more promising approach of analyzing the incentives systems to different stakeholders in the whole process, and to see how these incentive (not only monetary but others too) mechanisms could be improved to ensure that elected representatives and officials perform their expected functions effectively, and that citizens participate democratically in discharging their functions of oversight and pressure-building. In the absence of such critical thinking, putting additional resources to generate awareness on *grama sabhas*, social auditing, and so on, as has been attempted in the case of other WB loans, for strengthening local governments, may not turn out to be very effective in Kerala.

Thus it may be concluded that though additional resources are needed for local governments in Kerala, extreme caution is required to ensure that additional resources would be spent in socially beneficial ways.

### **3. On the Need for more Resources for the Government of Kerala**

A detailed analysis of the state finances is not intended here. However, considering the continuation of revenue deficit (and not only fiscal deficits) in the state, and also taking into account the borrowing that the Government of Kerala makes periodically to fill revenue gaps from several sources, including small saving schemes, where the cost of borrowing is around 10 percent, including interest, the state government seems to be hard-pressed for resources.

The past three fiscal years have seen a significant improvement in the fiscal situation of all states. However, Kerala still continues to have large fiscal imbalances and high revenue and fiscal deficits, though there

has been improvement in the fiscal balance of Kerala during the same period. Also the state's committed liabilities have steadily increased before it started stabilizing from 2006-07 onwards. However, the share of primary expenditure has declined over the years indicating declining fiscal space for the government to undertake productive development expenditure. Declining fiscal space affects spending in many planned schemes, not only in the social sector including health and education, but also in key infrastructure projects including roads for which attracting private investments is not easy. Thus the state government is pressed to reduce its planned allocation to local governments, and it finds it difficult to honour commitments in terms of allocations. Hence, the state government may be interested in taking loans such as those from WB (which earns 0.25% interest and 35 years repayment period for the part from IDA). (Even if a part is given by the more market-oriented IBRD, the combined cost of borrowing from WB would be significantly lower than the market rates). In this context, it needs to be mentioned that the state government has been able to increase its capital spending from 0.78 per cent to 1.68 per cent of GDP by the end of 2006-07 only through an increase in the volume of fiscal deficit as the state still continues to have revenue deficit. In the face of the large deficits, it needs to be examined how soft loans could affect the debt structure, the average cost of debt and the maturity and in turn the fiscal space, through lower interest outgo. Of course one needs to examine also the conditionalities attached to these loans.

External Assistance (EA) is usually considered undesirable as it causes conditionalities and penal provisions attached to it if the negotiated funds are not utilized. We need to see the conditionalities attached with such assistance and examine how these conditionalities are different than those of other tied funds for plan or other developmental or non-plan projects. It is also to be noted that normal central assistance has been declining over years and that it has reached a level as low as 32 percent by the end of 2007-08. In other words, the rest of the plan funds is also

tied. So the problem is larger and more serious in the context of state level independent planning. Focusing only on EA will not help resolve the issue of fiscal autonomy. In this context, one might even emphasize that in the case of EA fiscal autonomy of states is more as states themselves negotiate these loans and decide upon their implementation strategy, unlike in various centrally sponsored schemes which are almost thrust upon the states by the Centre without due consideration of local needs and preferences.

In this context, it is important to analyze the characteristics of external assistance in general. We do not have enough data for a detailed analysis of state-level EA, but at the all-India level, EA forms only less than 8 per cent of central plan assistance. The central budget for 2007-08 (BE) shows that out of the total central assistance for state plan of Rs. 47127 crores for all states, Additional Central Assistance (ACA) for Externally Aided Projects (EAP) came to only 3690 crore, i.e. around 8 per cent of the total plan resources.

The state government would benefit from a WB loan in strengthening local governments only under certain conditions. One condition is that the government should be able to reduce the allocation of plan funds to local governments when this loan becomes available. It is obvious that there are financial and political pressures to reduce plan allocations to local governments in the state. Financial pressures arise because of the perceived need for allocating more resources to other 'schemes' and also to reduce the plan size which causes huge revenue deficit. There are political pressures in Kerala to reduce allocations to local governments, since the line departments and the ministries (other than that of local self-government) often envisage such allocations outstripping available resources, though some significant parts of the activities of a few of these departments (such as agriculture or dairy) have already been transferred to local governments. In general, there is a negative feeling building up among many state-level politicians (of all parties) that allocations made to local governments reduce the resources

available to other state government departments. Whether due to political reasons or to financial pressures, if the planned allocation of state's resources to local governments, comes down and if a loan from the World Bank could (at least partially) be used to meet their requirements, the cost of borrowing would be low for the State government.

However, it is unlikely that the World Bank or any such external funding agencies would agree to a reduction of the state's allocation to local governments; they might even insist on the continuation of reasonable, stable allocations as has been in the case of the Karnataka project. However, since the planned allocation to local governments in Kerala is relatively high, there may be a possibility of pegging future allocations at a percentage lower than the current levels (and such a possibility is real, given the likelihood of reductions in plan size and utilization problems of local governments). Such reduction in future allocation (for the next three-four years) would also be beneficial to the state government (without affecting the resource availability of local governments due to the security of external loan funds).

In order to use the World Bank loan for local government purposes and as a route to reduce the cost of borrowing for the state government, considerable changes are required in the planned pattern of allocation as well as deft bargaining with the Bank.

#### **4. In comparison with the Karnataka Panchayat Restructuring Project of the World Bank**

The Karnataka project started in 2006 with a loan of US \$133.33 million (under IDA terms) was meant for providing block-grants to panchayats, providing information to constituents (awareness creation effort and capacity building of organizations of the poor like SHG), building the capacity of panchayats (which include production of expertise at the Taluk level, and putting in position a monitoring mechanism at the district level to survey the state of service delivery, training for panchayat functionaries, introducing computerized financial

management system, and environmental guidelines for panchayats), and building the capacity of the state with regard to decentralization (through strengthening training institutions and by conducting studies and supporting the state finance commission).

The loan conditions include the following : (a) state government will maintain financial commitment to LSGs as per the formula agreed with IDA, and will honour this commitment in a timely and predictable manner, (b) state government will release funds only to those LSGs who plan as per the suggested procedures (like *grama sabhas*), (c) mechanisms will be created to monitor at the state level, (d) financial management guidelines acceptable to IDA will be followed, along with the usual conditions for any loan, in terms of reporting, monitoring, no involuntary resettlement, etc.

Some observations may be made on the relevance of the loan programmes and the conditions of the Karnataka loan, in the context of Kerala.

1. The real problem in Kerala is not the absence of block grants. Though it is desirable to obtain additional block grants to local governments through the loan, the crucial issue is how to improve the quality of spending (and not simply of increasing the quantum of spending). Some loan components like providing information to strengthen *grama sabhas* may not be relevant for Kerala because mechanisms for such activities are already in place in this state (and *grama sabhas* do not seem to have been an effective monitoring or demand-raising mechanism);
2. Improvement of the capacity for financial management and associated capacities would be an important contribution in the context of Kerala;
3. Enhancement of computerization for service delivery is another urgent requirement. It is necessary to make an in-depth analysis

of the experience of IKM in this regard, identify the critical factors that prevented the spread of computerization during the past ten years despite the work of IKM and to channelise resources in such a manner as to overcome the constraints;

4. Panchayats lack capacity on certain skills especially project planning, financial management, accounting, computerized documentation, monitoring and evaluation. Future training programmes need to be directed at establishing such crucial capacities.

### **Appendix 1:**

#### **A Short Review of the Finances of the Kerala State**

The all-state fiscal situation, in India during the past 3 fiscal years has shown significant improvement. The improvement is characterized not only by a reduction in fiscal imbalance measured in terms of all-State fiscal deficit to GDP ratio, but also by an improvement in the quality of fiscal deficit as reflected in the sharp reduction in revenue deficits of States. The all-State fiscal deficits as a percentage of revenue deficits reached the high level of 57.1 percent during the period 1998-99 and 2003-04. In other words, the States used more than 57 per cent of their current borrowing for consumption expenditure purposes. However, revenue deficit as a percentage of GDP declined sharply from an average of 2.4 per cent of GDP during 2000-01 -2003-04 to 0.1 per cent in 2006-07 (RE) with a corresponding decline in the primary deficit; as per the 2007-08 (BE) all-state revenue account would generate a surplus of Rs.11973 crore amounting to 0.3 per cent of GDP.

In fact, 2007-08 estimate of all-State fiscal deficit is 2.3 per cent of GDP. The capital outlay as a percentage of GDP also increased from an average of 1.5 during 1998-99 to 2.3 percent for the period from 2003-04 to 2006-07. The decomposition of fiscal deficit shows that the share of capital outlay in the total fiscal deficit is expected to have been

89.9 percent in the year 2006-07 (BE). In other words, states are borrowing primarily for capital expenditure due to the near-elimination of revenue deficits from the state budgets in 2006-07. In 2007-08, as the states are expected to generate revenue surplus, a part of the capital expenditure is planned to be financed through non-debt revenue.

However, this aggregate picture hides more than it reveals. There exist sharp differences among States in the matter of fiscal imbalances. States like Kerala, Uttar Pradesh, West Bengal, Orissa, Bihar, Jharkhand, Madhya Pradesh and Rajasthan are operating at high levels of revenue and fiscal deficits while States like Gujarat, Karnataka, Tamil Nadu and Haryana are operating at comfortably low levels of fiscal deficits. As our focus is on Kerala, the question naturally arises what the possible reasons for Kerala's high fiscal imbalances are and how they could be contained? In this context, the following issues are found critically important:

Are the fiscal deficits due primarily to low revenue effort?

Is it true that high expenditure is not generating adequate financial returns?

Is the decline in central transfers the reason for fiscal deficits?

Kerala's own tax revenue effort has historically been very impressive, averaging more than 9 per cent of the state GSDP, as against the all-state average of around 6 per cent of GDP. In recent years, tax revenues have been particularly buoyant and during the past two years it has been more than one compared to the situation during 1999-00 and 2003-04, when tax buoyancy had been below unity. The growth rate of own tax revenue between 2005-06 and 2006-07 (BE) was as high as 22 per cent, with buoyant growth not only of VAT alone, but also of stamp duty, registration fees and motor vehicle taxes. The own tax buoyancy between 2005-06 and 2006-07 was spectacularly high particularly due to the increase in VAT revenues from Rs. 2950 crore to Rs. 4470 crore, the corresponding figure for 2007-08 is expected to be

Rs. 6000 crore. The upkeep of such a rate of increase on a sustained basis is not feasible but the buoyant VAT revenue would be of help to improve the own resources position and thereby the relative fiscal situation of the state.

Despite high rates of growth of own tax revenue, revenue deficit persists due to high and rising revenue expenditure and sharp decline in non-tax revenue mobilization. The non-tax revenue to GSDP ratio, which had been 1.68 per cent in 1987-88, declined to 0.88 per cent in 2006-07. The revenue expenditure to GSDP ratio increased sharply over the years due to increase in committed liabilities, viz. interest payment and pension obligations. The capital expenditure to GSDP ratio declined over the years to as low as 0.78 per cent of GSDP in 2004-05. However, a reversal of this trend seems to have begun with the capital expenditure -GDP ratio increasing to 1.68 per cent of GSDP by the end of 2006-07(BE). The increase has been more than two fold compared to the 2004-05 level. The high fiscal deficit in the state has also been due to increase in capital expenditures in 2006-07. However, the level of revenue deficit and thereby the composition of the fiscal deficit remain matters of concern. At the end of 2004-05, the share of revenue deficit was as high as 82.5 per cent of the fiscal deficit in Kerala. However, the share of revenue deficit in total fiscal deficit started showing a tendency to decline during the past two years due to the increase in capital expenditures. Although, generally speaking, fiscal deficit driven by current consumption expenditure is considered unsustainable in the long run, it needs to be highlighted here that Kerala's fiscal profile historically has been driven by high social sector expenditure, largely revenue expenditure in nature, due to the unique development paradigm followed by Kerala with high priority for social sector development. The level of revenue deficit therefore needs to be judged in terms of the expenditure priorities and the commitment of the government, which has long run social and growth benefit through higher human development and skill, but much less in terms of short run financial returns. This is a very complex public

policy issue and the fiscal parameters, particularly revenue deficit, would behave according to the fiscal policy stance taken by the State towards the social sector. Similar is the case with decentralized planning in Kerala. The fiscal policy stance, which gives emphasis to decentralized planning with adequate fiscal autonomy to the local level of government, with large-scale devolution of untied plan-funds, needs to find the required resources given the constraint of growing fiscal imbalance. In this specific context, multilateral lending is indeed a desirable option.

One of the major criticisms against borrowing from multilateral lending institutions, in this case the World Bank, is the conditionalities that they impose. We need to examine these conditionalities and the ways in which they differ from those of the other tied funds received by the State. It is to be noted that normal central assistance within the overall central assistance programme has been declining and that it has reached as low a level as 32 per cent by the end of 2007-08 for all the states taken together. In other words, around two-thirds of the plan funds devolved to all-states are tied funds, having very little flexibility for state governments in design, implementation and spending. The problem is therefore larger and more serious in the context of state level independent planning and has to be looked into in the context of changing centre-state fiscal relations. Focusing only on external assistance would not help resolve the issue of fiscal autonomy and state level independent planning. Despite conditionalities, why does multilateral funding still remain a preferred option for funds for many states? We do not have a ready answer and the question requires close scrutiny. However, in the case of multilateral lending, at least the states are in a position to negotiate and to decide the agenda of implementation, which is not the case in all the flagship centrally sponsored schemes. Central allocations under such schemes do not even get spent through State budgets. Instead, they go directly to district level implementing agencies and to lower local bodies. But states are required to make matching contributions for these schemes. Nevertheless, such centralization tendencies are on the increase.

Carrying out genuine decentralization in the context of growing centralization tendencies on the part of the higher levels of government is difficult and poses challenges for the states, especially so for states like Kerala, which have made outstanding progress in decentralization through People's Plan Campaigns and effective empowerment of local bodies compared to other states in the country. If the large-scale process of decentralization initiated in Kerala after the enactment of the 73rd and the 74<sup>th</sup> constitutional amendments has to be sustained and made more effective, resource requirements would be high and the State has to look for alternative funding sources without compromising on fiscal autonomy.

The World Bank loan may be an option for Kerala, from the point of view of debt management also. A soft loan like this may help to reduce the average cost of debt. It needs to be emphasized that the outstanding debt to GSDP ratio for Kerala has increased sharply over the years, from around 25 per cent in 1987-88 to 43 per cent by the end of 2004-05. In the past two years, it has remained at this level. A large debt overhang invariably reduces the fiscal space for productive expenditures of government. Besides, large scale accumulation of debt has taken place in Kerala in an era of high interest rates. The effective rate of interest<sup>2</sup> on state debt has increased sharply due to deregulation of interest rates as a component of financial liberalization, which inflicted a macroeconomic shock to the state government which had to adjust itself to the increasing strain of interest payment arising out of the hardening interest rate regime. However, the average cost of debt has tended to decline in recent years due to the softening of the rates of interest and also the introduction of debt- swap schemes. It is quite likely that if the average cost of debt declines, it would result in a decline in the interest outgo and a corresponding increase in the fiscal space for higher primary expenditure for Kerala. In this context, additional soft loans like the one

---

2 Effective rate of interest is calculated by dividing interest payment in current year with the stock of outstanding debt of the previous year.

for LSGs from the World Bank which carry very long maturity periods may help in altering the debt structure, towards lower cost higher maturity and lower over all burden.

Finally, if we look at the fiscal transfers, while the state government expenditure has increased over the years, central transfers have not shown corresponding growth. In fact during the 1990s, central transfers as a percentage of GSDP declined by more than one percentage point. However, the transfers to GSDP ratio has started increasing in recent years due to the buoyant growth of central revenues and the increase in the share of divisible pool of taxes from 29.5 percent to 30.5 per cent of the central taxes<sup>3</sup> based on the recommendations of the Twelfth Finance Commission. But transfers as a percentage of total expenditure declined sharply from 26 per cent in 1990-91 to 17 percent in 2003-04; thereafter it has increased and is expected to become 23 per cent by 2006-07. However, the state's own revenues have continued to cover more than 50 per cent of the total expenditure and remained more or less at that level except very few deviations. The manner in which the state would be placed in terms of transfers can be understood only after the Thirteenth Finance Commission brings out its recommendations. One only hopes that transfers would help improve the fiscal space for individual states to pursue their independent fiscal policies, be it greater degrees of decentralization or rising levels of autonomy in spending.

---

3 Excluding surcharge, cess and cost of collection.