Chapter 3

LEGAL AND INSTITUTIONAL FRAMEWORK

3.1 Framework for Municipal Governance

This chapter makes an analytical review of the statutory provisions relating to the revenues and expenditure of municipalities in India. It covers the provisions relating to expenditure and revenue assignment contained in the Constitution of India and in the legislations passed by State Governments. An analysis has also been made of the recommendations made by the Central and State Finance Commissions. Lastly, the vertical imbalance ingrained in India's fiscal structure has been discussed.

The legal-institutional framework for the delivery of civic services in cities and towns as envisaged in the Constitution (74^{th} Amendment) Act, 1992 comprises a number of mandatory institutions:

- State Election Commission (Article 243K);
- Municipalities: Municipal Corporations, Municipal Councils and Nagar Panchayats (Article 243Q);
- Wards Committees and other Committees (Article 243R);
- State Finance Commission (Article 243I);
- District Planning Committee (Article 243ZD); and
- Metropolitan Planning Committee (Article 243ZE).

The responsibility for the creation and operationalisation of the legal-institutional framework – the aforesaid institutions and other entities, including para-statals impacting on civic service delivery, however, has been left to the State Governments.

The mandates of various key institutions as prescribed by the Constitution (74th Amendment) Act 1992 are as follows:

- State Election Commission to superintend, direct and control the preparation of electoral rolls, and conduct elections to all the rural and Urban Local Bodies (ULBs) [Article 243K(1)];
- Municipalities to function as 'institutions of self-government' - prepare 'plans for economic development and social justice', perform civic functions and implement schemes as may be entrusted to them by the State Government, including those related to the Twelfth Schedule [Article 243W(a)];
- Wards Committees and Special Committees to take Municipal Government physically closer to the people and carry out the responsibilities conferred upon them including those in relation to the Twelfth Schedule [Article 243W(b)];
- State Finance Commission to review the financial position of the rural and urban local bodies, and to make recommendations regarding the 'principles' of devolution of resources from the State Government to the local bodies and the 'measures' needed to improve their finances and functioning [Article 243I(1)];
- District Planning Committee to 'consolidate' the plans prepared by the Panchayats and the Municipalities in the district and to prepare a draft development plan for the district as a whole [Article 243ZD(1)];
- Metropolitan Planning Committee to prepare draft development plan for the Metropolitan area as a whole [Article 243ZE(1)].

3.2 Expenditure & Revenue Assignment

Governance of ULBs (and also rural local bodies) in India has remained a State subject in accordance with the stipulation of the Seventh Schedule and List II of the Constitution of India. Primarily, designed for a two-tier system, the Constitution of India has specified the expenditure responsibilities as well as the resource raising domains of the Union and States through three lists given under Schedule VII. This Schedule spells out the division of functions and finances into the Union List, the State List and the Concurrent List wherein the Union and the State Governments have joint jurisdiction. However, the scenario has changed substantially after the 74th Amendment, by which the ULBs have gained constitutional status and have become an integral part of India's decentralization strategy.

The 74th Amendment Act envisaged that elected Municipalities function as effective local self-government institutions preparing and implementing plans for economic development and social justice and discharging civic responsibilities envisaged in the 12th Schedule (Box 2).

In order to perform these tasks, the urban local bodies have to be financially sound and endowed with commensurate powers to raise resources. However, while the Constitution specifies the expenditure responsibilities, it has not listed out the sources of revenue of ULBs. Article 243X of the Constitution only stipulates that a State Legislature may, by law,

i) authorise a Municipality to levy, collect and appropriate such taxes, duties, tolls and fees in accordance with such procedure and subject to such limit;

ii) assign to a Municipality such taxes, duties, tolls and fees levied and collected by the State Government for such purposes and subject to such conditions and limits;

iii) provide for making such grants-in-aid to the Municipalities from the Consolidated Fund of the State and

iv) provide for the constitution of such Funds for crediting all moneys received, respectively, by or on behalf of the Municipalities and also for the withdrawal of such moneys there from, as may be prescribed by law.

Box 2: Functions of Urban Local Bodies: Twelfth Schedule (Article 243W)

1. Urban Planning including town planning;
2. Regulation of land use and construction of buildings;
3. Planning for economic and social development;
4. Roads and bridges;
5. Water supply for domestic, industrial and commercial purposes;
6. Public health, sanitation conservancy and solid waste management;
7. Fire services;
8. Urban forestry, protection of the environment and promotion of ecological aspects;
9. Safe-guarding the interest of weaker sections of society, including the handicapped and mentally retarded;
10. Slums improvement and upgrading;
11. Urban poverty alleviation;
12. Provision of urban amenities and facilities such as parks, gardens, playgrounds;
13. Promotion of cultural, educational and aesthetic aspects;
14. Burials and burial grounds; cremations, cremation grounds and electric crematoriums;
15. Cattle pounds; prevention of cruelty to animals;
16. Vital statistics, including registration of births and deaths;
17. Public amenities, including street lighting, parking lots, bus stops and public conveniences; and
18. Regulation of slaughter houses and tanneries.

Thus, the 74^{th} Amendment has not clarified a critical area of fiscal federalism, *i.e.*, the matching of resources and responsibilities. The taxes, duties, charges and fees to be levied by the Municipalities, those to be assigned to them and the grants-in-aid to be provided to them have been left to the discretion of the State Governments. This has allowed the fiscal mismatches to continue in the absence of adequate decentralization of resources corresponding to the decentralization of expenditures envisaged in the Constitution (74^{th} Amendment) Act, 1992.

However, for strengthening the finances of the local governments, as described in Chapter 1, the two positive features in the Amendments to the Constitution are:

i) provision for the constitution of State Finance Commissions (SFCs) every five years;

ii) amendment of Article 280 of the Constitution of India by inserting section 3(C).

Article 243(I), inserted into the Constitution by the 73rd Amendment Act, makes it mandatory on the part of the State Governments to constitute SFCs once every five years to review the financial position of the Panchayats and the Municipalities.

It may be noted that the role of the State Finance Commission is envisaged to be much broader (as set out subsequently) than that of the Central Finance Commission, which is primarily related to the distribution of the central divisible pool of resources among the State Governments. As stated earlier, the Constitutional Amendments also provide a safeguard regarding the implementation of the recommendations of the SFCs. Article 280 of the Constitution, under which a CFC is appointed once every five years to assess the financial needs of the State Governments and to recommend a package of financial transfers from the Centre to the States, has been amended. It is now mandatory on the part of the CFC to recommend measures to augment the Consolidated Fund of a State to supplement the resources of the Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.

The provision for the establishment of a SFC every five years is an important step toward redressing the fiscal imbalance of ULBs. The additional responsibility cast upon the CFC, to recommended measures to supplement the resources of local self-government institutions is a clear acknowledgement of the mismatch between functions and finances at various tiers of the India federal system. Table 11 provides a comparison of revenue assignment across states till recently.

Table 11: Revenue Powers of Municipalities across Major States 2004

State	Taxes		Fees
	Compulsory	Discretionary	
Andhra Pradesh	Property: (Lighting, Water, Scavenging, Drainage, General), Vehicles, Duty on Transfer of Immovable Properties, Animals	Advertisement	Advertisement Fee, Mutation Fee, Registration Fee, Market Fee, Trade License Fee, Compounding Fee, Slaughter House Fee, License Fee
Assam		Property : (Lighting, Water Drainage), Markets, Toll on Bridges, Transfer of Properties	License on Carts, Carriages, Animals, Dogs & Cattle, Boats, Betterment, Fire Brigade, Public Health
Bihar	Duty on Transfer of Property	On Persons in sole or joint occupation of Holding according to their circumstances and property (Lighting, Water, Latrine), Vehicles, Animals, Profession	Registration of Dogs, Carts, Vehicles, Vessels
Goa	Consolidated Property Tax: (General, Water, Lighting, Sanitary,) Advertisement, Profession, Theatre	Vehicle, Boats, Animals, Toll on Vehicles, and Animals not under above, Dogs, Garbage Treatment, Latrine, Drainage, Special Water Tax, Pilgrim, Special Education tax, Octroi	
Gujarat		Property, Vehicle, Boats, Animals, Motor Vehicles, Octroi, Dogs, Special and General Sanitation, Lighting, Sale of Cattle in the Market, Betterment Levy	Registration Fee, License Fee, Swimming Bath Fee, Slaughter House Fee, Building Construction Fee, Stock Registration Fee, Water Connection Fee, Cattle Pound Fee
Haryana	Property, Octroi, Duty on Immovable Property	Profession, Vehicles, Animals, Dogs, Show, Toll on Vehicles, Boats, Consumption of Electricity	License Fee, Building Application Fee, Teh Bazari Fee, Advertisement Fee, Slaughter House Fee, Cattle Pound Fee, Registration Fee, Street Fee
Himachal Pradesh	Property, Duty on Transfer of Immovable Properties	Profession, Non-motorized Vehicles, Animals, Dogs, Show, Toll on Vehicles, Boats, Consumption of Electricity, Advertisement, Building Application, Education Cess	Pilgrim, Drainage, Lighting, Scavenging, Latrines, Nature and Cost of Internal Service
Karnataka		Property, Advertisement, Boats, Animals, Lighting, Toll on Vehicles, Duty on Transfer of Immovable Property.	License Fee (Building, Trade & Hotel), Building Betterment Fee, Birth & Death Registration Fee, Food

Table 11: Revenue Powers of Municipalities across Major States 2004 *(Contd.)*

State	Taxes		Fees
	Compulsory	Discretionary	
			Adulteration Fee, Slaughter House Fee, Compounding Fee
Kerala		Property: (Lighting, Water, Drainage, General Purposes, Sanitary), Transfer of Properties, Profession, Animals, Vessels, Show, Timber, Advertisement	License Fee, Building Fee, Dangerous and Offensive Trade License Fee, Market Fee, Slaughter House Fee
Madhya Pradesh	Property, Water, Lighting, Sanitary, Fire, Local Body Tax on Entry of Goods	Latrine,Conservancy,Drainage, Profession, Vehicles, Animals, Dogs, Show, Toll on Vehicles and Animals not mentioned above, Betterment, Pilgrim, Persons occupying Houses, Buildings, Land according to circumstances and property, Toll on New Bridges, Entertainment, Advertisement, Terminal	License Fee, Market Fee, Animal Registration Fee, Hotel / Restaurant License Fee, Composting Fee, Teh Bazaar Fee, Building Application Fee, Compounding Fee
Maharashtra	Consolidated Property tax: (General, Water, Lighting, Sanitary) Advertisement, Profession, Theatre, Octroi	Vehicles, Animals, Dogs, Show, Toll on Vehicles, Boats, Animals not mentioned above, Dogs Latrine, Drainage, Special Water Tax, Pilgrim, Special Education Tax, *etc.*	License Fee, Slaughter House Fee, Building Permission Fee, Fee for Sale of Goods, Water Connection Fee, Warrant Fee, Prevent of Food Adulteration License Fee, Cattle Pounds Fee, Swimming Pool Fee, Birth & Death Registration Fee, Betterment/ Development Fee
Orissa		Property: (Lighting, Water, Drainage), Animals, Vehicles, Profession, Octroi, Education, Profession	License Fee, Advertisement Fee, Registration Fee, Market Fee, Slaughter House Fee, Cattle Pound Fee, Dog Registration Fee, Cart Stand Fee, Building Planning Fee
Punjab		Property, Profession, Vehicle, Animals, Menial Domestic Servants, Scavenging, Building Application	License Fee, Slaughter House Fee, Building Application Fee, Composition Fee, Teh Bazari Fee, Water Connection Fee
Rajasthan	Property, Octroi, Profession and Vocations	Vehicle and other Conveyance, Dogs, Animals, Toll on Vehicles, Boats, Scavenging, Latrine, Sanitary, Lighting, Water, Trade, and Calling, Artisans	Advertisement Fee, Building Permission Fee, Trade License Fee, Registration Fee, Cattle Pound Fee, Bus Stand Fee, Copying Fee

Table 11: Revenue Powers of Municipalities across Major States 2004 *(Concld.)*

State	Taxes		Fees
	Compulsory	Discretionary	
Tamil Nadu		Property, Profession, Carriage and Animals, Advertisement, Servants (hill stations)	License Fee (Building, Hotel, Restaurant, Dangerous and Offensive Trade), Market Fee, Slaughter House Fee, Cart Stand Fee, Encroachment Fee
Uttar Pradesh		Property, Trade, Calling, Vocation, Entertainment, Vehicle, Boat, Dogs, Animals, Inhabitants assessed on property and circumstances (Water, Drainage), Scavenging, Conservancy, Transfer of Property	
West Bengal	Profession, Property, Advertisement, Vehicles, Toll on Ferries and Bridges		License Fee, Advertisement, Building, Planning / Development Fee, House Connection Fee, Permission Fee, Market / Slaughter House Fee, Birth and Death Registration Fee, Fees from burning ghats

Notes: 1. Vehicles imply non-motorized vehicles unless otherwise specified

2. Rajasthan: Tax on Trade and Calling is different from Tax on Profession and Vocation which is a Compulsory Tax
3. General components like Water, Lighting, Sanitation *etc.* are included under a Consolidated Property Tax
4. Octroi has since been abolished in all States excepting Maharashtra and Gujarat.

Sources : Mathur and Thakur (2004), Budgets of Municipal Corporations.

3.3 Finance Commissions

3.3.1 Central Finance Commission

The Tenth Central Finance Commission was the first CFC to have the additional responsibility in its "Terms of Reference" (ToR) to consider the SFCs' recommendations regarding ULBs and PRIs, while recommending transfer of Centre's resources to the States. However, a major problem faced in the process was the mismatch in the timing of the constitution of the Tenth CFC and first generation of SFCs. The Tenth CFC could not incorporate the recommendations of the first generation of SFCs and as a result much of its recommendations towards augmenting the resources of local bodies were made arbitrarily.

The ToR for the Eleventh CFC required the CFC to make its own assessment about the manner and the extent of augmentation of the Consolidated Funds of the States to supplement local resources. Much of the recommendations of the Eleventh CFC were made arbitrarily in the absence of the Second SFCs' reports. The situation remained the same in case of the Twelfth CFC. The Twelfth CFC could not make a realistic assessment of the resource gaps of the local bodies, which would have been the basis for the earmarking of funds. Due to non-availability of authentic and reliable data, the Twelfth CFC made its recommendation on an *ad hoc* basis.

It may be stated that the assistance recommended for the ULBs via the institution of the CFC is not only inadequate but also, importantly, bears no relation to what the Municipalities need for maintaining services at minimum levels.

The reports of the CFCs, research studies conducted by academic institutions and the estimates made by the various Departments / Agencies of the Government do not provide either a realistic picture of the fiscal position of local bodies or a comprehensive agenda for municipal finance reforms to address the problems of mismatch between functional responsibilities and financial capability of ULBs in India.

The terms of reference, recommendations, criteria for distribution of grants and conditionality made by the Central Finance Commissions are given in Table 12.

All the three CFCs which gave reports after the 74th Amendment Act came into existence have made allocations to local bodies based on certain *ad hoc* criteria in the absence of the relevant SFC Reports.

Table 12: Central Finance Commission and Municipal Finances

Items	Tenth Finance Commission (1995-2000)	Eleventh Finance Commission (2000-2005)	Twelfth Finance Commission (2005-2010)
Terms of Reference relating local bodies	Not specified. However, since Article 280 had been amended before the expiry of the term, the Commission felt that it was obliged to deal with the issue in terms of the amended Article 280.	To make recommendations to augment the Consolidated Fund of the states to supplement the resources of local bodies on the basis of SFC recommendations. The EFC was asked to make its own assessment, if the recommendations of SFCs were not available.	The measures needed to augment the Consolidated Fund of a state to supplement the resources of the panchayats and municipalities in the state on the basis of the recommendations made by the Finance Commissions of states.
Recommendations	Recommended Rs.1000 crore for municipalities to be distributed amongst the states.	Recommended ad hoc annual grant of Rs.400 crore for municipalities. Activities such as maintenance of accounts, development of database and audit to be the first charge on this grant.	Recommended a sum of Rs.5,000 crore for the period 2005-2010 as grants-in-aid to augment the Consolidated Fund of the states to supplement the resources of municipalities.
Criteria for distribution of grant among states	Inter-state ratio of slum population derived from 1971 census.	Based on the following factors and weights: 1. Population 40% 2. Geographical area 10% 3. Distance from Per Capita Income (PCI) 20% 4. Index of decentralization 20% 5. Revenue effort 10%	Based on the following factors and weights: 1. Population 40% 2. Geographical area 10% 3. Distance from highest PCI 20% 4. Index of deprivation 10% 5. Revenue effort 20%
Conditions	Local bodies were required to raise 'suitable' matching contribution for the purpose. No amount was to be used for expenditure on salaries and wages.	Matching contribution was not imposed.	No conditionality. No requirement of matching grant. Suggested that 50 per cent of the grants provided to each state should be earmarked for collection, segregation and transportation of solid waste. Central Government should not impose any conditions for releasing the grants-in-aid.

Source: Central Finance Commission Reports.

3.3.2 State Finance Commissions

As mentioned earlier, Article 243(I) of the Constitution (Seventy-fourth) Amendment empowers the SFCs, to review the financial position of the Municipalities and to make recommendations to the Governor of the State as to the principles which should govern:

i) the distribution between the State Government and the Municipalities of the net proceeds of the taxes, duties, tolls and fees that can be levied by the state which may be divided between them, and the allocation of such proceeds between the Municipalities at all levels;

ii) the determination of the taxes, duties, tolls and fees which may be assigned to, or appropriated by the Municipalities;

iii) the grants-in-aid to the Municipalities from the Consolidated Fund of the State;

iv) the measures needed to improve the financial position of the Municipalities; and

v) any other matter referred to the SFC by the Governor in the interest of the sound finance of the Municipalities.

The Twelfth CFC has reviewed the progress of the setting up of First and Second SFCs and the action taken on them by the respective State Governments. In case of First SFCs, 25 States had constituted their Commissions, of which 23 Commissions have submitted their reports. Further, 20 States have submitted the action taken report (ATR). Regarding the Second SFCs, only 19 states had constituted their Commissions, of which 16 Commissions have submitted their reports by November 2004. However, only 6 states submitted the ATRs (see Appendix 3).

With regard to the implementation of the SFC reports, the Twelfth CFC reported as follows:

i) several States did not initiate a follow-up action;

ii) recommendations under examination, met with “natural death”;

iii) very few States have honoured their commitment for the release of additional resources and

iv) budgetary provision regarding the recommendations have fallen short. It appears that the initial enthusiasm shown by the State Governments in constituting the SFCs got lost at the time of implementing the recommendations in their reports as it would have put undue pressure on the finances of the State Governments.

The analysis made by the Twelfth CFC indicates a clear time lag between the submission of reports of SFCs, actions taken by State Governments on the recommendations of SFCs and the constitution of CFCs.

The 74th Amendment, in addition to not specifying a municipal revenue list in the Constitution also did not make any stipulation regarding the period within which the recommendations of SFCs are to be implemented by the respective State Governments. As a consequence, most of the SFC recommendations were far from being implemented.

Moreover, the 74th Amendment did not specify the composition of the SFCs. Unlike the CFCs which always had eminent personalities as members, in many States the procedure of selection of SFC members has been routine and without regard to the expertise needed in areas of fiscal federalism, local government finance, public service delivery *etc.*

The very procedure of empowering the local governments appears to be misleading, without much of their financial strengthening coming to reality. In this context, the Twelfth CFC recommended that:

i) the SFCs should follow a normative approach in the assessment of revenues and expenditure in order to arrive at the gap that may be considered by the CFC,

ii) principal recommendations of the SFCs may be accepted without modification as in the case of CFC,

iii) the States should constitute SFCs with people of eminence and competence,

iv) the States should compile disaggregated time series data on finances of local bodies, and

v) there is a need for synchronization of time period of the SFCs with that of CFCs.

Some of the shortcomings of the SFCs have been brought out by research as follows (Oommen, 2004):

i) Most SFCs have failed to emphasize the link between revenue-raising and expenditure responsibilities, a link that is needed to induce fiscal responsibility.

ii) No SFC seems to have devoted attention to aspects of fiscal management or the need to impose a hard budget constraint at the local level. The accounting and budgetary practices leave many things to be desired.

iii) No suggestion has been made by any SFC so far to reduce the multiple channels of devolution that exists at the local level, *viz.*, Line Departments, State Planning Boards, SFC devolution, MP, MLA programmes, District Rural Development Agency and the like. This may not be their direct task; yet, there is a need for suggestions to place State-Local fiscal relations on a more rational footing.

iv) In the pre-Amendment days state-local grant system was unsystematic, *ad hoc*, dependency-promoting and above all operated through numerous channels; many SFCs have failed to fully address these shortcomings.

Furthermore, there has been a lack in uniformity of the SFCs across the States with regards to their approaches for delegation and devolution of resources to the ULBs.

3.4 Central-State-Local Finance Linkages

In the literature review carried out for this study, it has been noted that a vertical imbalance in the fiscal position of local bodies, in a federal set up, is prevalent across countries and provinces within countries and India is no exception to this trend. The vertical imbalance, *i.e.*, mismatch between the division of the expenditure liabilities and revenue-raising powers of the union and the states and states and local bodies, is constitutionally in-built in India. The link among the Central, State and Local finances, operating through the mechanisms of CFC, SFCs, Planning Commission, Centrally-sponsored Schemes, State Planning Boards *etc.* is attempted to be established to correct this imbalance so that the lower level governments can perform the tasks assigned to them effectively.

In case of the Central Government, the powers to raise resources are enormous. It has most of the elastic sources of revenue, which grow with the growth of the economy. It can resort to deficit financing by borrowing from the market or the RBI. The next layer (*i.e.* the States) has relatively less elastic sources of revenue and it has limits on borrowings and accessing funds from the RBI. The last layer (*i.e.* the local bodies) has only limited powers to raise resources. Further the taxes and duties collected by it (based on the decision taken by the State legislature) are not as elastic as in the case of Central and State revenue sources.

The ULBs cannot have deficit in their budgets as stipulated under law. The ULBs also need to take permission from the respective State Governments for resorting to debt-financing. Hence, the difference between total expenditure needed and 'own' revenues of Municipalities, called 'fiscal gap', is very high as compared to the Central and State Governments. The gap is expected to be filled by way of inter-governmental transfers recommended by the CFCs and SFCs and allocations made by the Planning Commission, Planning Boards of respective States, and Centrally-sponsored and State Plan schemes. Hence, urban local bodies have to depend on a number of institutions to have resources to perform the tasks assigned to them by the State Legislatures.

Furthermore, due to a shortage of resources, the services and facilities provided by the ULBs are inadequate, thereby affecting faster growth of cities and towns and exploitation of agglomeration economies. It has been reported time and again that some of the cities are not able to attract private investment in industrial and service sectors due to the poor quality of their civic infrastructure facilities and services. Vertical imbalance, fiscal dependency and borrowing constraints and limits affect the functioning of ULBs in India to a significant extent.

In addition to their 'own' revenues, a major source of revenue for ULBs is the grants-in-aid received from the concerned State Governments. However, the fiscal position of the States themselves has been weak with high level of deficits and outstanding liabilities. Hence, the State Governments are not in a position to provide sufficient funds to local bodies as per the recommendations of SFCs. Further, most of the States are committed to reducing the deficit, as per their Fiscal Responsibility and Budget Management Acts enacted in the recent times.

An option available to urban local bodies is to borrow from financial institutions and the market, which, however, needs State Government guarantees[2]. Given their poor financial position, the ULBs are not able to raise loans or issue bonds without such guarantees. With the introduction of ceiling on Government guarantees by some of the States, the ULBs may not be able to get State guarantees for all their projects in the future. In this scenario, the urban local bodies themselves will have to take measures to improve their financial position. It is also necessary for the Government to undertake structural, institutional and administrative reforms to make them more efficient (Bagchi, 2001). Only with comprehensive reforms, will the urban local bodies be able to raise

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2 According to Mathur & Ray (2003), as of March 31, 2001, the State Governments had accumulated contingent liabilities of Rs. 52.5 billion on behalf of the municipalities.

funds from financial institutions and the capital market to undertake long-term infrastructure projects.

In view of having a three-tier federal system and inter-governmental fiscal transfers as an integral mechanism for solving the problem of vertical imbalance, any meaningful examination and assessment of the fiscal sector of the country has to take into account the finances of Central, State and Local bodies together. This is particularly relevant in the context of some of the State Governments, which are directly assuming the responsibility for repaying the loans taken by urban local bodies from external lending agencies, e.g. Kerala. This is directly increasing the outstanding liabilities of the States.

Presently the fiscal position of the country, especially with respect to the combined fiscal deficit, is analysed only in terms of the finances of Central and State Governments. To get a comprehensive idea about the fiscal sector, it is essential to consider the finances of local bodies as constitutional entities engaged in providing a variety of civic amenities and infrastructure.

A study of both theory and practice of fiscal federalism suggests that inter-governmental finance can be used as an effective tool to correct the vertical imbalance in the assignment of responsibilities and fiscal powers between the Centre and federating units, reduce the inequalities amongst such units due to a variety of factors including fiscal power, cost disabilities, revenue effort, *etc.* and to promote public spending in certain desired sectors like education, health, *etc.* In addition to the above factors of vertical balance, equalization principle and externalities, administrative justification in terms of economies of scale in tax collection at the Central and State levels also stand as arguments in favour of inter-governmental transfers.

Inter-governmental transfers can take the form of share in common pool of taxes, grants-in-aid and various centrally-funded schemes; they are closely intertwined with Sub-national Government financing in most developing and transition countries. As noted by

Bahl (2000), they serve the twin objectives of enabling the Central Government retaining overall control of the public finance system and offering a way to channel money into budgets of Provincial and Local Governments. However, there are serious problems in the inter-governmental finance system in India, especially at State and local body levels as elsewhere in the world.

Some of the major learnings from a cross-sectional study of intergovernmental fiscal relationships undertaken by the Institute on Governance (1998) have been summarized in Box 3.

Box 3: Learnings from Cross-sectional Study of Intergovernmental Fiscal Relationships

- There is no 'one best way' or magic formula on which to base a fiscal relationship between levels of government;
- Both case studies and international experience elsewhere confirm that revenue equalization approaches are relatively straight forward;
- All the case study countries have equalization mechanisms that provide an incentive for raising own source revenue by using tax potential and a standard tax rate as the main equalizing variables;
- Case studies and the principles both confirm the importance of establishing a robust set of own source revenues for sub-national governments;
- Expenditure equalization, in contrast to revenue equalization, appears to be fraught with political controversy;
- Fiscal transfer mechanisms create continual tension between the principles of simplicity and equity;
- Case studies reveal a wide variety of mechanisms available to enhance accountability;
- They also reveal a continuing tension in the degree to which the Central Governments 'control' or influence the activities of Sub-national Governments;
- Another contentious issue is that in any fiscal relationship between levels of government is the determination of the total amount to be transferred to all Sub-national Governments and the size or scale of Sub-national Governments appears to matter; and
- It is important to establish an ongoing process or mechanism for managing fiscal relationship given the inherent problem of dividing a fixed sum among a number of competing entities.

Mismatches of resources and responsibilities between the Centre, States and local bodies in India are similar across most parts of the country. Suitably designed inter-governmental transfers need to be adopted as appropriate instruments to address these imbalances. Mechanisms for an effective system of inter-governmental transfers are institutionalized by the Constitution of India through Article 280 and Article 243Y. Article 280 provides for transfers from the Centre to the States in the form of tax devolution and grants-in-aid through the institution of CFC constituted every five years.

The 74th Constitutional Amendment Act has provided a role to the CFC to recommend "measures" needed to augment the Consolidated Fund of the States to supplement the resources of Municipalities in the States on the basis of the recommendations made by the SFCs. In addition to the Finance Commission transfers, there are provisions of resource flow through the Planning Commission and various Centrally-sponsored Schemes.

Article 243(I) inserted into the Constitution through the 73rd Amendment Act provides for the institution of SFC to address State-Local transfer issues. The SFCs are required to make recommendations to the Governor of the State as to the principles of revenue assignment and transfers and the measures needed to strengthen the fiscal positions of the Municipalities.

Given the Constitutional provisions, what appears to be a problem in the context of instituting appropriate inter-governmental transfer systems for urban local bodies in India is the lack of adequate database and research support to CFCs and SFCs to scientifically examine the issues of fiscal federalism and make recommendations for ULBs. Further, a sound practice at the State level to establish SFCs with eminent personalities and seriously act upon the SFC recommendations also needs to be nurtured.

The 74th Constitutional Amendment has envisaged greater autonomy and responsibilities for elected Municipalities for promoting social and economic development of the country. The Municipalities have been assigned the task of drawing up plans for economic development and social justice, and implementing the schemes relating thereto including the 18 functions included in the Twelfth Schedule of the Constitution. Though autonomy and discharging of the responsibilities require greater access to resources, yet the institutional mechanisms in place are not adequate to ensure a match between municipal functions and finances. Two important reforms urgently called for are: broadening the revenue base of ULBs and reforming inter-governmental transfer system. Given the limitations to raise own resources, there is a strong argument for institutionalizing resource flow from the higher level of Governments to ULBs based on principles. However, the issues of inter-governmental transfers to local bodies have not received due attention in India owing to a variety of reasons. Moreover, as noted by Mathur and Thakur (2004), the transfers to Municipalities in India remain discretionary in nature. As these are not determined based on any normative analysis, they are highly unpredictable sources of revenue for the Municipalities. This contrasts the fact that the transfers from the Centre to States based on the recommendations of the CFCs have always been determined by objective formulae.

3.5 Some Observations

The discussions in the foregoing paragraphs reveal that the fundamental concerns of municipal finance reforms in India revolve around the two basic issues of fiscal federalism, namely revenue assignment must be clear and revenue assignment must correspond to expenditure assignment. Addressing clarity, consistency and predictability in the systems of taxes, user charges, inter-governmental transfers, borrowings *etc.* is the starting point. However, that would not lead us far. We need to clarify what resources need to be aligned to what expenditures so that the delivery of the services most required by citizens takes place effectively. Once the revenue assignment is clarified, the next step is to institute systems to manage revenues and expenditure effectively to ensure one-to-one linkages between outlays and outcomes.

As per the 74^{th} Constitutional Amendment, enormous responsibilities have been assigned to ULBs. However, it did not specify the sources of revenues. Legally, urban local bodies have only limited powers to raise resources. They cannot have deficits in their budgets and their borrowing capacities have been contained. These local bodies have to depend on a number of institutions for resources to perform the tasks assigned to them by the Constitution and State Legislatures. They also need to be professionalized to convert outlays to outcome efficiently and effectively. In short, the issues of vertical imbalance, fiscal dependency, borrowing constraints and inefficiency in municipal management are affecting the functioning of local bodies. They need to be addressed holistically.