



## State-Local Financial Relations in India

*K V Bhanu Murthy\**

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### ABSTRACT

*In a federal economy like India, it is important to understand the fiscal relations between different layers of government to bring out their implications for revenue generation, revenue sharing and taxation. This paper describes the functional responsibilities and sources of revenue of local bodies, explains the present constitutional arrangements relating to State-Local fiscal relations in India, and examines the role of various statutory bodies in this regard. It also discusses the recommendations of the various Finance Commissions which have successively emphasised the need to adequately empower Local bodies to enable them to provide basic services at the grass root level. The institution of State Finance Commission also needs to be strengthened so that it plays an effective role in the system of fiscal transfers to the third tier of government.*

**Keywords:** *Local bodies; State Finance Commissions; Municipal commercial borrowings; Budgetary gap.*

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### 1.0 Introduction

Rapid urbanisation has increased the functional responsibilities of municipalities in India. To meet the scale and challenge of urbanisation, municipal governments are always looking for additional funds from various sources. Since a significant part of national income originates in urban areas, efforts must be made to maintain and enhance urban productivity which, in turn, depends on the level and quality of urban infrastructure. The demand for urban infrastructure services has increased, and is likely to accelerate further, due to rising personal incomes, rapid growth of population, and general increase in economic activities. Inability of municipal governments to meet the rising demand would adversely affect growth prospects of the economy.

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*\*Professor, Delhi Technological University, Delhi, India; Formerly Dean, Faculty of Commerce and Business, Delhi School of Economics, University of Delhi, Delhi, India.  
(Email: bhanumurthykv@yahoo.com)*

## **2.0 Functions of Local Bodies**

Functional responsibilities of local bodies vary from country to country and within a country. Still some common patterns are discernible. Broadly speaking, the functions of a local body (e.g. a municipality) can be divided into the following three categories.

### **2.1 Essential civic functions**

The main function of a municipality is to provide and maintain core (or essential) civic services. These include: refuse collection, street lighting, water supply, sewage disposal, fire protection, abattoirs, and primary health services. These are services for which decision-making rests with the municipalities.

### **2.2 Regulatory functions**

These functions pertain to regulation of industry, trade and construction activities. Municipalities issue licences, permits and levy fees of various kinds, and also impose fines for violation of rules and regulations. Charges for regulatory functions should be so fixed as to cover at least the cost of administration and surveillance. If these services are subsidised it would put strain on resources.

### **2.3 Agency functions**

These are functions (e.g. protection of environment) which are funded out of State revenues by specific transfers.

## **3.0 Financing of Local Bodies**

In the public finance literature, the following general rules are mentioned as regards the financing of local bodies.

1. Where the benefits of a local public service are measurable and accrue to readily identifiable individuals/households within a jurisdiction, user charges are the most appropriate method of financing the service.
2. Local public services which are services to general public in the sense that identification of beneficiaries and measurement of benefits to individuals /households is difficult, should be financed by taxes on local residents. Such services include traffic control, street lighting, security, and general administration.
3. Services the benefits of which spill over to neighbouring jurisdictions should be

financed by intergovernmental transfers. These services include health, education, anti-pollution measures, and other social welfare activities.

4. Long-term borrowings are the appropriate source to finance capital projects with long-term gains.

Higher level governments generally assign certain taxes to local bodies to augment their resources. Tax literature suggests the following principles regarding assignment of taxes to local bodies.

1. Municipal governments should be assigned those taxes that are leviable on bases which are 'immobile' or 'location-specific' and those whose burden cannot be exported outside the municipal jurisdiction. Property tax is a case in point.
2. Local tax base should be easily identifiable and its incidence transparent.
3. Tax yield should be stable, predictable, and buoyant.
4. Rate schedule of the tax should possess a reasonable degree of progressivity.
5. The tax should be easy to administer.

Based on the foregoing considerations, the following taxes are generally assigned to local bodies: (a) property tax, (b) entertainment tax, (c) tax on professions, (d) tax on advertisements and (e) Octroi/tolls.

#### **4.0 Constitutional Provisions**

Entry 5 of List II (State List) of the Seventh Schedule to the Constitution of India refers to local bodies as institutions created by State Governments. Furthermore, the Directive Principles of the Constitution (Article 40) requires the strengthening of the units of local self-government in the States, particularly *panchayati raj* Institutions. However, little was done in this regard during the first three decades of Independence. As a result, these institutions could not function effectively because of (a) inadequate devolution of functions and financial powers (b) failure to hold regular elections and prolonged supersession and (c) lack of participation from weaker sections of society. Consequently, local bodies in many States had become weak and ineffective as units of self-government in our democratic set up. It was only in 1991 that Bills were introduced in the Parliament to amend the Constitution for providing constitutional status to the *panchayats* and municipalities.

### 5.0 Decentralisation Initiative, 1992

The Seventy-third and Seventy-fourth Amendment Bills relating to *panchayats* and municipalities respectively were introduced in the Parliament in September 1991 to provide constitutional remedy for the inadequacies plaguing these bodies which were unable to perform effectively as vibrant democratic units of self-government. The Bills were referred to two joint bodies of Parliament and after necessary revision were reintroduced in July 1992, and passed by Parliament in December 1992. Both the Bills were ratified by the required number of States [Article 368(ii)] and the President gave his assent in April 1993. The Seventy-third Amendment Act relating to *panchayats* came into force from April 24, 1993. The Seventy-fourth Amendment Act relating to municipalities came into force from June 1, 1993. The changes made by the Seventy-third and Seventy-fourth Amendment Acts to the Constitution were of historical importance and are summarised in Table 1.

The passage of the Constitution (Seventy-third Amendment) Act, 1992 marked a watershed in the history of modern India. With this amendment, a uniform structure of *panchayats* emerged throughout the country.

**Table 1: Seventy-Third and Seventy-Fourth Constitutional Amendment Acts**

| Act   | Date on which came into force | Amendments made  |
|---|-------------------------------|--|
| Constitution (Seventy-third Amendment) Act 1992   | 24. 4. 1993                   | A new Part IX relating to Panchayats was inserted.<br>In clause (3) of Article 280, sub-clause (bb) was inserted which provides for measures to supplement the resources of the Panchayats.<br>Eleventh Schedule added to the Constitution which provides an illustrative list for the devolution of functions to Panchayats.  |
| Constitution (Seventy-fourth Amendment) Act, 1992 | 1. 6. 1993                    | A new Part IXA relating to Municipalities was inserted.<br>In clause (3) of Article 280, sub-clause (c) was re-lettered as sub-clause (d) and before sub-clause (d) as so re-lettered, sub-clause (c) was inserted which provides for measures to supplement the resources of the Municipalities.<br>Twelfth Schedule added to the Constitution which provides an illustrative list for the devolution of functions to Municipalities. |

Source: Government of India, Ministry of Law, Justice and Company Affairs, *The Constitution of India (Supplement to the Third Edition)*, 1994.

Article 243 G read with Eleventh Schedule of the Constitution explicitly requires the States to devolve powers and authority on *panchayats* which may be necessary to enable them to function as institutions of self-government. The Eleventh Schedule of the Constitution is reproduced in Table 2.

**Table 2: Eleventh Schedule of the Constitution (Article 243 G)**

|     |  |
|-----|--|
| 1.  | Agriculture, including agricultural extension.   |
| 2.  | Land improvement, implementation of land reforms, land consolidation and soil conservation.          |
| 3.  | Minor irrigation, water management and watershed development.  |
| 4.  | Animal husbandry, dairying and poultry.  |
| 5.  | Fisheries.   |
| 6.  | Social forestry and farm forestry.   |
| 7.  | Minor forest produce.  |
| 8.  | Small-scale industries, including food processing industries.  |
| 9.  | Khadi, village and cottage industries.   |
| 10. | Rural housing.   |
| 11. | Drinking water   |
| 12. | Fuel and fodder.   |
| 13. | Roads, culverts, bridges, ferries, waterways and other means of communication.                       |
| 14. | Rural electrification, including distribution of electricity.  |
| 15. | Non-conventional energy sources.   |
| 16. | Poverty alleviation programmes.  |
| 17. | Education, including primary and secondary schools.  |
| 18. | Technical training and vocational education.   |
| 19. | Adult and non-formal education.  |
| 20. | Libraries.   |
| 21. | Cultural activities.   |
| 22. | Markets and fairs.   |
| 23. | Health and sanitation, including hospitals, primary health centres and dispensaries.                 |
| 24. | Family welfare.  |
| 25. | Women and child development.   |
| 26. | Social welfare, including welfare of the handicapped and mentally retarded.                          |
| 27. | Welfare of the weaker sections, and in particular, of the Scheduled Castes and the Scheduled Tribes. |
| 28. | Public distribution system.  |
| 29. | Maintenance of community assets.   |

Similarly, the passage of the Constitution (Seventy-fourth Amendment) Act, 1992 was a landmark in the history of municipal administration in India. Article 243W read with Twelfth Schedule of the Constitution provides the illustrative list for the devolution of functions to the municipalities. The Twelfth Schedule of the Constitution is reproduced in Table 3. Many States have amended their municipal laws to ensure conformity with the new constitutional provisions.

In short, *panchayats* and municipalities are now constitutional bodies forming third tier to the federal polity of India. India's decentralisation initiative in the form of Seventy-third and Seventy-fourth Amendments poses challenges and offers opportunities.

**Table 3: Twelfth Schedule of the Constitution (Article 243 W)**

|     |  |
|-----|--|
| 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.  | Safeguarding the interests of weaker sections of society, including the handicapped and mentally retarded. |
| 10. | Slum improvement and upgradation.  |
| 11. | Urban poverty alleviation.   |
| 12. | Provision of urban amenities and facilities such as parks, gardens, play-grounds.                          |
| 13. | Promotion of cultural, educational and aesthetic aspects.  |
| 14. | Burials and burial grounds; cremations, cremation grounds and electric crematoriums.                       |
| 15. | Cattle ponds; 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.               |
| 18. | Regulation of slaughter houses and tanneries.  |

## 6.0 Constitution (Seventy-Fourth Amendment) Act, 1992

Through this amendment a new Part IX-A relating to municipalities was incorporated in the Constitution to provide for, *inter alia*, the constitution of three types of municipalities, viz. *Nagar Panchayat* for a transitional area, i.e. an area in transition

from a rural to urban area<sup>1</sup>; Municipal Council for smaller urban area, and Municipal Corporation for larger urban area (Article 243 Q).

The Constitution (Seventy-fourth Amendment) Act, 1992 conferred constitutional status to the structure and mandate of municipalities so as to enable them to function as vibrant democratic and self-governing institutions at the grassroots level.

The objectives of the Seventy-fourth Amendment included decentralisation of power and popular participation in the planning, management, and delivery of civic services. The salient features of the Seventy-fourth Amendment were the following.

### **6.1 Salient features**

1. It provides a framework for the assignment of appropriate governmental functions to municipalities through the Twelfth Schedule of the Constitution read with Article 243 W. The Twelfth Schedule defines the functional domain of municipalities. Many of the functions included in this Schedule have distributional and developmental attributes.

The Twelfth Schedule generally contains traditional functions of municipalities. However, some non-traditional functions are also discernible from the list. These are: (a) protection of the environment and promotion of ecological aspects, (b) safeguarding the interests of weaker sections of society including the handicapped and mentally retarded, (c) urban poverty alleviation, and (d) promotion of cultural and aesthetic aspects.

2. States are statutorily required to constitute a finance commission (Article 243-I and 243-Y), once in every five years, to recommend to their legislatures measures to improve municipal finances including (i) assignment of taxes, duties, tolls, and fees, (ii) sharing of state taxes, and (iii) provision of grants-in-aid.
3. The Finance Commission constituted by the Government of India is obligated to recommend measures to augment the Consolidated Fund of State Governments to supplement the resources of the municipalities on the basis of the recommendations made by the State Finance Commissions [Article 280(3)(c)].
4. It is mandatory to constitute in every State at the district level a District Planning Committee to consolidate and prepare development plan for the district as a whole (Article 243 ZD). Similarly, it is mandatory to constitute in every metropolitan area a Metropolitan Planning Committee to prepare a development plan for the metropolitan area as a whole (Article 243 ZE).
5. It mandates that a municipality if dissolved by a State Government, must be reconstituted within six months [Article 243 U(3)]. This is meant to ensure the

continuity of civic affairs by ‘elected’ representatives of the people.

6. It ensures reservation of seats for women and other disadvantaged categories (Article 243 T).

The situation existing before and after the Seventy-fourth amendment is summarised in Table 4.

**Table 4: Status of Municipalities in India**

| Before the 74 <sup>th</sup> Amendment  | After the 74 <sup>th</sup> Amendment  |
|--|---|
| No all-India framework for devolution of functions   | 12th Schedule read with Article 243 W of the Constitution provides guide points for assignment of functions to municipalities.  |
| High degree of arbitrariness in the system of fiscal transfers from the State Governments to municipalities. No periodic assessment of financial needs of municipalities | State Finance Commission (SFC) to be constituted statutorily in every State every Fifth year (Article 243-I and 243-Y) to review the financial position of municipalities and suggest measures to improve the same.       |
| No role for the National Finance Commission as regards the finances of urban local bodies.   | National Finance Commission is required to augment the Consolidated Fund of State Governments to supplement the resources of the municipalities on the basis of the recommendations made by the SFCs [Article 280(3)(c)]. |
| Absence of constitutional bodies to prepare development plans for local areas.   | Mandatory constitution of District Planning Committees (Article 243ZD) and Metropolitan Planning Committees (Article 243ZE) for consolidation and preparation of development plans.                                       |
| Failure to hold regular elections and prolonged supersessions.   | A municipality if dissolved by a State Government must be reconstituted within six months [Article 243 U(3)].   |
| Lack of participation from weaker sections of society  | Reservation of seats for women and other disadvantaged categories (Article 243 T).  |

### 6.2 New status of municipalities

The Seventy-fourth amendment was made with the intention to make municipalities self-governing units. Are they so?

In the federal polity of India, local bodies are institutions created by the State Governments (entry 5 of List II of the Seventh Schedule). They enjoy only those powers



and responsibilities which are assigned to them. Twelfth schedule of the Constitution lists the functions and responsibilities that may be transferred to municipalities. The permissive nature of Seventy-fourth Amendment is clear and the State Governments enjoy full discretion as regards the transfer of functions to municipalities.

No doubt, municipalities have acquired constitutional status after the said Amendment, they are completely dependent on respective State Governments in terms of self-governance.

### **6.3 Desirability and feasibility of uniformity in municipal functions**

A careful reading of the Twelfth Schedule shows that many of the functions listed in it found place in the Municipal Acts of various States even before the enactment of the conformity legislations by them. Hence, the Twelfth Schedule has been generally accepted as a guiding list of municipal functions.

Should there be all-India uniformity in delegating functions and financial powers to local bodies? There is a weak case for all-India uniformity as regards functional domain of local bodies. State Governments and their local bodies have diverse economic and social conditions. It is by no means rational to expect uniformity in the functions and powers of the Greater Bombay Municipal Corporation and the municipality of a small township of a backward State. Similarly, it is debatable if local bodies should have uniform taxation powers.

Though it will be useful to prepare a reference list regarding functions (Eleventh and Twelfth Schedules), assigned taxes, shareable taxes, user charges, fees etc., all-India uniformity in these matters would be too much to expect.

Feasibility of all-India uniformity as regards the functional jurisdiction of municipalities is poor in view of the permissive nature of Seventy-fourth Amendment. It is highly unlikely that the 25 States of India would make uniform transfer of functions and financial powers to their respective municipalities. All-India uniformity in the functions of municipalities has to be ruled out in view of inter-State disparities.

Even at the level of a State, uniformity is not desirable in view of diverse city conditions and intra-State disparities. This fact has been recognised by the Constitution while providing for the constitution of three types of municipal bodies: Nagar Panchayats, Municipal Councils, and Municipal Corporations (Article 243 Q). However, it does not distinguish between the functional domains of the three types of municipal bodies. The determination of the functions of municipalities of different sizes is left to the wisdom of the State Governments.

However, there exists a case for uniformity of functions among similar municipalities in a State. If a State chooses to allocate dissimilar functions and powers to

similar municipalities (say Municipal Councils), there can be genuine resentment among the municipalities discriminated against. It is here that objective criteria based on population size, geographical area, or constitutional categorisation (Article 243 Q) are needed to prevent misuse of political authority.

The Constitution should provide, at least, a list of minimum functions to be transferred to municipalities of various types by the State Governments.

#### **6.4 Role of State Finance Commissions**

The State Finance Commission is set up under Article 243-I read with Article 243-Y of the Constitution. It is required to review the financial position of the municipalities and make recommendations as to

- (a) the principles which should govern –
  - i. the distribution between the State and the Municipalities of the net proceeds of taxes, duties, tolls and fees leviable by the State, which may be divided between them, and the allocations between the Municipalities of their respective shares of such proceeds.
  - 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 Municipalities from the Consolidated Fund of the State.
- (b) the measures needed to improve the financial position of the Municipalities.
- (c) any other matter referred to the Finance Commission in the interest of sound finance of the Municipalities.

As required under the Constitution, all State Governments have set up Finance Commissions. These State Finance Commissions (SFCs) are expected to strengthen local bodies so that they may function as democratic units for the socio-economic development of urban and rural areas of our country.

The task of the First Finance Commission of a State was difficult and arduous in the absence of precedence and it was expected to make suo moto all such studies in areas which never existed before. Nevertheless, the work of the First Finance Commission was crucial because it paved the way for subsequent commissions. The following observations may be made in this regard.

1. The new Constitutional arrangement (Seventy-fourth Amendment) implies that the whole range of a State's tax revenue is open to sharing with municipalities. SFCs are expected to evolve principles of tax assignment, tax sharing, and grants to municipalities with a view to mitigate their weak financial position. They are also required to evolve criteria with regard to adequacy and objectivity of grants.
2. Sharing of State tax revenue with municipalities depends wholly on the

discretion of State Government.

3. In determining devolution of funds, the SFCs would do well to keep in mind, *inter alia*, the following factors.
  - (a) Resource position of the State.
  - (b) Normative deficits of municipalities. Any system which underestimates the gap between revenue and expenditure should be discouraged.
  - (c) The degree of dependence of municipalities for funds on the State Government.
  - (d) Capacity of a municipality to utilise devolved resources.
  - (e) A State Finance Commission may consider introduction of a system of incentives and disincentives into the entire governmental grants on objective lines. Municipalities which are able to raise resources through levy of user charges and benefit taxes should be considered for incentive grants from the State Government.

### **6.5 A determination and filling of budgetary gaps**

A State Finance Commission has to determine the budgetary gaps of municipalities for the period of its award. Thereafter, it has to devise formulae for filling the gaps so determined.

### **6.6 Determination of the budgetary gaps**

Two approaches may be followed for this purpose: (a) trend growth rate and (b) normative approach.

Under the first approach, average annual growth rate in a variable during a reference period (say 1994-95 through 2003-04) is worked out and the same is projected for a future period (say 2004-05 through 2008-2009). It is assumed that past behaviour of the variable will be repeated in future. Thus, 'actuals' or 'accounts' of revenue and expenditure of a government may be used to compute the average annual growth rate of the two aggregates over a stated period. Applying the computed average to a future period, one can work out estimated revenue, expenditure and budgetary gap for any future year.

Under the second method, revenue of a government is assessed normatively and certain norms are applied to assess expenditure. In other words, 'needs' and 'capacities' of different governments are assessed normatively and such normative assessments are used to meet budgetary gaps of the governments. More specifically, fiscal performance of a government is judged on the basis of *what ought to be* rather than *what it actually is*.

In the context of the work of a State Finance Commission, normative approach

should apply to both the State Government and municipalities and that the assessment of revenue and expenditure should be done in a manner so as to maintain incentives for greater revenue efforts and economy in spending.

### **6.7 Filling the gap**

Once budgetary gaps of municipalities are determined, the next task of a State Finance Commission is to devise formulae for filling these gaps. For this purpose, it has to work out a judicious mix of tax devolution and grants.

It is noteworthy that the term 'gap-filling' in the context of State-municipal fiscal relations has a different connotation than at the national level.

At the national level, even after the transfer to the States of a share of divisible taxes, the resources of some of the States may remain inadequate to meet their needs. Thus, a Finance Commission determines the grants equal to deficit of each State so that the non-Plan revenue accounts of the States are balanced or left with a surplus every year. In other words, deficits of non-Plan revenue account which remain after tax devolution are covered through grants. This is called the gap-filling approach (or more appropriately net gap-filling approach).

It is possible that even before tax devolution from the Centre, some high-income States have surplus in their non-Plan revenue account. Thus, while a State cannot be denied a part of a shared Central tax even if it has no demonstrated financial need, grants are given upon genuine financial needs of the States.

However, the working of a State Finance Commission is different. Like the National Finance Commission, it is not bound by any constitutional restrictions regarding the type of taxes to be shared with municipalities. In fact, the whole field of State taxation is open to it for determining tax devolution. In other words, tax devolution and grants are to be used simultaneously to cover the budgetary gaps of municipalities. In this case, gap-filling means how to cover the projected budgetary gaps of municipalities through a judicious mix of tax devolution and grants with due regard to the underlying principles of the two methods to effect transfers from a higher to a lower level government.

### **7.0 Municipal Commercial Borrowings**

Plan allocations of Central and State Governments are the chief source of financing capital projects of municipal governments. Other sources of finance include (a) internal resources of municipalities, (b) institutional resources (HUDCO etc.), and (c) multilateral agencies.

The scope for additional funds from Central and State Governments is limited in view of the pressing need to reduce fiscal deficit. Similarly, institutional finances at low cost are unlikely to be available in the wake of financial sector reforms. Under such circumstances, municipal authorities should be permitted access to the capital market to mobilise additional resources. Recent expansion and modernisation of capital market in India suggests that inflow of capital into equity and debt market is quite high if attractive rate of return is offered.

### **7.1 Rationale for municipal commercial borrowings**

It is both fair and efficient that projects with long-term benefits are financed through long-term borrowings. If long-term capital projects are financed out of current revenues and/or short-term borrowings, the future generations would enjoy free-riding. Since the benefits of a capital project are reaped over a long period of time, i.e. by more than one generation of tax payers, the financing of such projects should place the repayment burden on the present as well as future generations.

### **7.2 Limitations**

Municipal access to capital market, though desirable, is hindered by a variety of factors which may be classified into two categories: (a) restrictions imposed by the higher level government, and (b) other constraints.

The Constitution of India imposes various types of restrictions on the borrowing powers of the State Governments which, in turn, impose restrictions on the borrowing powers of the municipalities under them. Since borrowings by the lower level government are guaranteed, in most cases, by the higher level government, the latter has a right to impose such restrictions. These restrictions apply to (a) type of debt, (b) amount of debt, (c) term of the debt, and (d) use of debt funds. Approval of the higher level government, which is often cumbersome, is needed before the debt is floated.

Thus, no municipal authority can borrow without an explicit sanction of its State Government. When the loan amount exceeds Rs. 25 lakh or the repayment period is over 30 years, local borrowings need Central approval under the provisions of the Local Authorities Loan Act, 1914 (a Central Legislation).

Among the 'other constraints', the more important are the following: Low credit worthiness of municipalities, their poor track record as borrowers, and lack of trustworthy financial intermediaries.

Despite the foregoing hurdles, some municipalities in India have successfully tapped the bond market.

### **7.3 Factors determining success of municipal bonds**

To attract a share of capital market for municipalities, the following conditions need to be satisfied.

1. Urban infrastructure projects should be commercially viable.
2. Municipal bonds are rated by some recognised credit rating institution. This will help build confidence of investors in the bond issue as well as help in its subsequent trading on the secondary market.
3. Such bonds should carry tax concessions.
4. Revenues accruing to the municipal entity are sufficiently elastic.
5. Security behind the debt taken by the municipal entity is sound.
6. Municipal entity makes provision for the creation of debt-servicing funds and the legal procedures for seeking recourse in the event of default.
7. Municipal entity is competent to pledge revenues for debt-servicing and extend collateral in terms of commercial property, plant and machinery and other assets.

### **8.0 Privatisation of Municipal Services**

The scope for privatisation of some municipal services in order to reduce costs is a moot question.

Municipalities alone cannot handle huge infrastructural projects like water supply, sewage disposal, and urban transport. Involvement of central, state, and private sector is required to meet the scale of investment needed in these areas. Similarly, greater participation of private sector is desirable in the provision of civic services, particularly those the consumption of which can be attributed to individuals/households. There are many types of arrangement in respect of public-private partnership depending on situation. However, care should be taken not to dilute current social commitments while embarking on public-private partnership.

The historical and ideological resistance to private sector participation persists in most places. Consequently, few local bodies have tried out private sector participation in civic services on any significant scale. Wherever it has happened, the experiment has remained limited to disposal of solid wastes, and maintenance of parks.

The disenchantment with utility enterprises of municipalities is not conceptual but borne out of their inefficient and sometimes corrupt management. The merits of privatisation are seen in terms of improvement in efficiency and reduction in the budgetary burden of state-owned enterprises.

Though the need for private sector participation is widely felt, it is not openly expressed. Very rarely political parties have spoken publicly against the public sector.

Contrarily, there is a stiff opposition by political parties to any move to undermine the importance of public sector. The strong unions of public sector enterprises come in handy for politicians to prevent the erosion of state and municipal activities.

### **9.0 Tenth Finance Commission on Local Bodies**

The Tenth Finance Commission did not have any mandate, in its terms of reference, to make recommendations for the local bodies. However, the 73rd and 74th Constitutional amendments had become effective before the Commission had finalised its report and, therefore, it took the view that in terms of the sub-clauses (bb) and (c) of the article 280(3), it was obliged to make recommendations regarding measures needed to augment the Consolidated Fund of the States for supplementation of the resources of the panchayats and the municipalities. The Commission analysed the scope of such duty cast on it and made the following observations:

1. The need for augmentation of the Consolidated Fund of the States should first be ascertained and only thereafter the measures for such augmentation be recommended.
2. Such measures need not necessarily involve transfer of resources from the Centre.
3. Once the SFCs complete their task, the Finance Commission becomes duly bound to assess and build into the expenditure stream of the States the funding requirements for supplementing the resources of the panchayats and the municipalities. Measures needed for augmentation of the Consolidated Funds of the States may be determined accordingly.
4. The responsibility for sharing and assigning taxes and providing grants to the local bodies rests with the States and does not stand transferred to the Centre.
5. The transfer of duties and functions listed in the Eleventh and Twelfth Schedules of the Constitution would also involve concomitant transfer of staff and resources. Transfers of duties and functions to the local bodies should, therefore, not entail any extra financial burden.

Since the recommendations of the State Finance Commissions were not available to the Tenth Finance Commission, the latter was in doubt whether it could recommend measures for augmenting State resources for the purpose of supplementing the resources of panchayats and municipalities. To resolve the dilemma, it decided to make ad hoc provision of specific grants to States in the following manner.

1. An ad hoc provision of Rs. 100 per capita of rural population in each State to be distributed amongst panchayats over and above their due by way of their share

of the assigned taxes, duties, tolls, fees etc.

2. A provision of Rs. 1,000 crore for the five year period (1995-2000) covered by its recommendations for urban local bodies.

While making these provisions for grants to panchayats/municipalities, the Commission made it clear that this need not necessarily be a precedent for future Commissions.

### **10.0 Eleventh Finance Commission on Local Bodies**

EFC was the first to be required by the President, in terms of the 73rd and 74th Amendments to the Constitution, to recommend 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 of the State Finance Commissions.

The EFC recommended grants totalling Rs. 10,000 crore for local bodies during 2000-2005, to be utilised mainly for maintenance of civic services. Of this, Rs. 1,600 crore per annum is for rural local bodies and Rs. 400 crore per annum is for urban local bodies. EFC recommended that the amounts of Rs. 1,600 crore and Rs. 400 crore provided for the panchayats and municipalities respectively, for each of the five years (2000-05) be distributed among the States on the following criteria and weights.

1. Population 40 percent.
2. Index of decentralisation 20 percent.
3. Distance from highest per capita income 20 percent.
4. Revenue effort 10 percent.
5. Geographical area 10 percent.

The grants given to local bodies are primarily meant for maintenance of civil services including primary health and family welfare, education as well as other public utility services.

### **11.0 Twelfth Finance Commission on Local Bodies**

The Commission made the following recommendations regarding local bodies. A total grant of Rs. 20,000 crore for the Panchayati raj institutions and Rs. 5,000 crore for the urban local bodies may be given to the states for the period 2005-10. The PRIs should be encouraged to take over the assets relating to water supply and sanitation and utilize the grants for repairs/rejuvenation as also the O&M costs. The PRIs should, however, recover at least 50 percent of the recurring costs in the form of user charges.



Out of the grants allocated for the panchayats, priority should be given to expenditure on the O&M costs of water supply and sanitation. This will facilitate panchayats to take over the schemes and operate them. At least 50 percent of the grants provided to each state for the urban local bodies should be earmarked for the scheme of solid waste management through public-private partnership. The municipalities should concentrate on collection, segregation and transportation of solid waste. The cost of these activities, whether carried out in house or out sourced, could be met from the grants.

Besides expenditure on the O&M costs of water supply and sanitation in rural areas and on the schemes of solid waste management in urban areas, PRIs and ULBs should, out of the grants allocated, give high priority to expenditure on creation of data base and maintenance of accounts through the use of modern technology and management systems, wherever possible. Some of the modern methods like GIS (Geographic Information Systems) for mapping of properties in urban areas and computerization for switching over to a modern system of financial management would go a long way in creating strong local governments, fulfilling the spirit of the 73rd and 74th Constitutional amendments.

The states may assess the requirement of each local body on the basis of the principles stated by us and earmark funds accordingly out of the total allocation recommended by us. Grants have not been recommended separately for the normal and the excluded areas under the fifth and sixth schedule of the Constitution. The states having such areas may distribute the grants recommended by us to all local bodies, including those in the excluded areas, in a fair and just manner.

The central government should not impose any condition other than those prescribed by us, for release or utilization of these grants, which are largely in the nature of a correction of vertical imbalance between the centre and the states. The normal practice of insisting on the utilization of amounts already released before further releases are considered, may continue and the grants may be released to a state only after it certifies that the previous releases have been passed on to the local bodies. The amounts due to the states in the first year of our award period i.e. 2005-06 may be released without such an insistence.

State governments should not take more than 15 days in transferring the grants to local bodies after these are released by the central government. The centre should take a serious view of any undue delay on the part of the state. The central government should take note of our views on the issues, while formulating or revising various policy measures. In particular, action may be taken to raise the ceiling on profession tax. The state should adopt the best practices to improve the resources of the panchayats.

The suggestions made by us in respect of state finance commissions should be acted upon with a view to strengthening the institution of SFCs, so that it may play an effective role in the system of fiscal transfers to the third tier of government.

### **12.0 Thirteenth Finance Commission on Local Bodies**

Regarding the functioning of local bodies, the FC-XIII observed, “There has been considerable progress in the empowerment of Panchayati Raj Institutions (PRIs) and municipalities since the Tenth Finance Commission (FC-X) first made a provision for explicitly supporting local bodies through grants, subsequent to the passage of the 73rd and 74th amendments to the Constitution in 1993. Approximately 30 lakh representatives are regularly elected to about 2.5 lakh local institutions all over the country. Providing basic services at the grassroots level makes them the primary interface of the citizens’ interaction with the government. The principle of subsidiarity implies that matters are best handled by the least centralised competent authority. Following this, these institutions need to be adequately empowered—both functionally and financially—to enable them to fulfil the role envisaged for them in the Constitution. The State Finance Commissions (SFCs), which buttress the functioning of local bodies, also need to be strengthened so as to make their functioning more predictable and the process of implementing their recommendations more transparent. A number of recommendations were made by FC-XI and FC-XII towards this end. Some of these recommendations, though important, have not been implemented so far. More needs to be done to promote effective decentralisation.”<sup>2</sup>

### **Endnotes**

1. Here, ‘a transitional area’, ‘a smaller urban area’, or ‘a larger urban area’ means such area as the Governor may specify by public notification having regard to the population of the area, the density of the population, the revenue generated for local administration, the percentage of employment in non-agricultural activities and such other factors.
2. *Report of the Thirteenth Finance Commission*, December 2009, p. 149.