REDEFINING STATE-MUNICIPAL FISCAL RELATIONS
Options and Perspectives for the State Finance Commissions

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TABLE OF CONTENTS

LIST OF TABLES

CHAPTER - 1

CHAPTER - 2

CHAPTER -3

CHAPTER - 4

CHAPTER - 5

LIST OF FIGURES

PREFACE

The National Institute of Public Finance and Policy is an autonomous non-profit making organisation, whose major functions are to carry out research, undertake consultancy work and impart training in the area of public finance.

Since the passage of the Constitution (Seventy-Fourth) Amendment Act, 1992 and the consequent establishment of the State Finance Commissions under Article 243 Y of the said Act, one issue that has assumed utmost importance relates to the setting out of principles governing -

i. the distribution between the State and the municipalities of the net proceeds of taxes, duties, tolls and fees leviable by the State and the allocation among the municipalities of such proceeds;

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

iii. the grant-in-aid to the municipalities from the Consolidated Fund of the State.

What factors and considerations should enter into the process of governing the principles? This study report entitled, " Redefining State-Municipal Fiscal Relations : Options and Perspectives for the State Finance Commissions" prepared with the support and initiative of the Planning Commission, examines this question and suggests steps that are important in setting out the principles.

It is important to point out that the overall financial position of municipalities in the country is far from satisfactory. In the existing intergovernmental fiscal arrangement, their access to elastic and buoyant sources of revenues is grossly limited. Also, they have not been able to adequately and efficiently put to use their limited revenue raising powers, and are dependent on State transfers for meeting their expenditure needs. The exercises that have been conducted as a part of this study show that there is a large untapped fiscal capacity with municipalities, which needs to be tapped and not be substituted by State transfers. We hold the view that transfers are crucial for meeting the fiscal needs of poorer municipalities. Transfers are also important for performing the redistributional and developmental functions that the municipalities may now be called upon to perform.

The establishment of the Finance Commissions at the level of States is a milestone development. It offers a unique opportunity to bring order to the otherwise ad-hoc and discretionary State-municipal fiscal relations. It is also an opportunity to establish a proper municipal finance data base for the future State Finance Commissions to rely upon for their deliberations. This report has suggested a set of data formats and recommended that the Planning Commission should take the initiative of supporting the establishment of a strong municipal financial data system.

For us at NIPFP, it has been an extremely productive and educational exercise. Notwithstanding the limitations of data, we have gained immense insights into the problems of municipal finance.

The Governing Body of the Institute does not take any responsibility for the views expressed in the report. This responsibility belongs to the staff of the Institute and more particularly to the authors of the report.

Raja J. Chelliah
Chairman & Hony. Director

May 1995.

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The present report is the cumulative result of earnest and sincere efforts made by all those associated with the Housing and Urban Finance Units at the National Institute of Public Finance and Policy.

We would like to express our gratitude to the Planning Commission, for entrusting this study to us. Within the Planning Commission, we would like to single out the most valuable assistance that Dr. D.N. Basu, Economic Adviser, extended to us in conducting the study. We would also like to thank the Chairmen and Members of the State Finance Commissions and several State Secretaries for their comments on the earlier drafts of the report when these were presented at the two meetings of the State Finance Commissions held in October 1994 and March 1995.

We have been very fortunate to get very useful advice and support from Dr. Raja J. Chelliah, the Chairman of the Institute. We would also like to thank Dr. Amresh Bagchi, whose expertise and wisdom have tremendously helped us in finalising the report. We would also like to acknowledge the assistance of all members of the local finance unit, who have worked hard to complete this report in time. Ms. Chandni Watal and Ms. Gauri Sood provided us with excellent research support by their able assistance in all stages of the study. Mr. Sandeep Thakur put hard work in creating the municipal data base, conducting computer analysis and designing data formats for municipalities. Very useful assistance was rendered by Mr. S. B. Maan in formatting and presenting the final report.

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SUMMARY

This report entitled, *Redefining State-Municipal Fiscal Relations : Option and Perspectives for the State Finance Commissions*, is the final product[1] under the Planning Commission's sponsored research project on Formulating Guidelines for the State Finance Commissions in respect of the Finances of Municipalities. The genesis of the research project lies in the Constitution (Seventy-Fourth) Amendment Act, 1992 which, under Article 243-Y, provides for the constitution in each State of a Finance Commission to review the financial position of Municipalities and make recommendations with respect to the principles governing -

i. the distribution between the State and the Municipalities of the net proceeds of taxes, duties, tolls and fees leviable by the State and their allocation between the Municipalities;

ii. the assignment of taxes, duties, tolls and fees to Municipalities; and

iii. the grant-in-aid to Municipalities from the Consolidated Fund of the State.

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1 NIPFP has earlier submitted three papers prepared as a part of this project. These are : (1) The Implications of the Constitution (Seventy-Fourth) Amendment for the Finances of Municipalities : An Interim Assessment, October 1994, (2) Operationalising Article 243-Y of the Constitution (Seventy-Fourth) Amendment, March 1995, and (3) Issues in Devolution of Functions and Fiscal Powers of Municipalities, March 1995.

The Finance Commissions are expected to also suggest measures for improving the financial position of Municipalities.

2. The primary concern of this research project is with the approach or approaches that the Finance Commissions may adopt to determining the "principles" in respect of (i) to (iii) above, and suggesting measures for improving the financial position of Municipalities. What considerations, for instance, should enter in determining the principles for the assignment of taxes, duties, tolls and fees to Municipalities? What considerations should guide the "transfers" to be made from the State government to Municipalities? What form should the transfers take -- sharing of taxes or grant-in-aid? What considerations should be used in determining the form of transfers? This report addresses these concerns.

3. The finances of Municipalities in India, it needs to be emphasised at the outset, are in a poor state. A recent estimate placed the total revenues raised by Municipalities in 1993-94 at about Rs.3,900 crores, which are a bare 4.6 per cent of revenues raised by the Centre and 8.5 per cent raised by the State. This amount is about 0.6 per cent of the country's GDP (at factor cost). On a per capita basis, own revenues of Municipalities work out to only about Rs.205.[2] Considering the fact that the Municipalities produce over 50 per cent of the country's GDP, it is obvious that the Municipalities have not benefitted from the multitude of activities that take place within their jurisdictions, and are thus peripheral to the Indian economy.

2 Comparable per capita figures for the Centre are Rs.986.8 and Rs.573.9 for the State. See, Table 2, in NIPFP (1994), "The Implications of the Constitution (Seventy-Fourth) Amendment for the Finances of Municipalities: An Interim Assessment".

4. The existing revenue base of Municipalities is extremely narrow, and generally limited to property taxes in the non-Octroi States and octroi in the Octroi-levying States. Property taxes have historically lacked buoyancy. The problems associated with octroi which has otherwise a high degree of liquidity are known and documented. Furthermore, only a few Municipalities are able to optimally use their taxable capacity. The central point is that the "own resources" of Municipalities are markedly inadequate for meeting their expenditure needs. The gap between what they are able to raise and what they need is often large (58 per cent in the case of West Bengal), and is met by State transfers. The degree of dependence of some of the Municipalities on States is extremely high.

5. It is broadly in this context that the State Finance Commissions are expected to evolve the "principles". The principles have necessarily to be such that these are able to meet not only the existing expenditure responsibilities of Municipalities but also those that the State governments may assign to them, in accordance with the 12th Schedule of the Constitution (Seventy-Fourth) Amendment. The principles have also to pass other "tests"- such as the financial autonomy which is implicit in the spirit of the Constitutional Amendment. The report is set in this context.

6. Determining the principles for assignment of tax powers, revenue-sharing, and grant-in-aid, as has been pointed out in earlier papers, is not an isolated or independent activity; rather it is a function of two important factors :

i. the functional domain of Municipalities, and

ii. the norms and standards at which the different functions are to be performed or services provided.

7. Clarity in respect of the functional jurisdiction of Municipalities is an essential first step in deciding upon the principles for assignment of revenue sources, revenue sharing, and grant-in-aid. Only after their functions are known can any decision be taken with regard to how these can be financed. In fact, the structure of the financing mechanism - the mix of taxes. user charge, and transfers, that is appropriate in a given context depends on the functions that may be assigned to Municipal governments.

8. What functions are appropriate for Municipalities vis-a-vis other levels of governments is generally determined on the criterion of efficiency.[3] The text book rule is to assign expenditure and service responsibilities according to the benefit area of each service, meaning that the services whose benefits are localised and for which there is a differential scale of preference should normally be assigned to and performed by the Municipal governments. Departures from the text book rule are, however, a common occurrence in India. An important point to make here relates to the 12th Schedule of the Constitution (Seventy-Fourth) Amendment which includes several functions having distributional and development attributes. Clearly, the inclusion of these functions imparts a new dynamism to the functional domain of Municipalities. For the purpose of determining principles this report has taken the broader functional domain as specified in the 12th Schedule.

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3 The public finance literature argues that the greatest efficiency will come from expenditure assignments which place the responsibility for each function with the lowest level of government capable of delivering it efficiently (the principle of subsidiarity).

9. Fixing the expenditure norm and standard in respect of the different municipal services and functions is an extremely important step in the process of determining the principles. Expenditure norms are dependent on a number of factors including the fiscal capacity of Municipalities (the supply side) and the ability of users to pay for the services (the demand side), and other non-economic factors. The Zakaria Committee (1963) examined this issue at some length and made important suggestions; however, the expenditure needs based on those norms are today outside the reach of most municipalities in the country. The Planning Commission's norms too bear little relationship to the fiscal capacity of municipalities. For the purpose of this study, the Municipality with the highest per capita expenditure in each size class of municipality is taken as the norm for all Municipalities in that class.[4] The average expenditure norm for all services that are presently provided by Municipalities calculated by using this method is estimated at Rs.625.50 per capita (1993-94 prices). It should be emphasised that norms, worked out this way, vary sharply between States.

10. Principles are expected to address the basic problems encountered by the Municipalities. A study of 293 Municipalities spread over seven States, namely, Andhra Pradesh (54), Assam (21), Gujarat (63), Kerala (57), Maharashtra (33), Punjab (33), and West Bengal (32) shows the Municipalities to be confronted with five major problems -

i. *the vertical imbalance* : in the aggregate, approximately 70 per cent of the total number of municipalities are not able to meet out from their own resources, their current expenditure levels. The gap between what they are able to raise and what they need to meet

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4 Municipalities are divided into four classes : A with a population of less than 100,000, B with a population between 100,000-200,000; C with a population between 200,000-500,000, and D with a population of over 500,000.

the expenditure levels is extremely large in the case of 50 municipalities. The extent of vertical imbalance is, however, not uniform between States.

ii. *the inability of the municipalities to adequately tap the potential of existing taxes and non-tax sources:* The untapped revenue potential is estimated at 61 per cent of the total own resources of the sampled municipalities and about 53 per cent of their total revenue, meaning that with increased efficiency, own revenues of municipalities which, in per capita terms, stand at Rs.205 can increase to about Rs.355.3.[5]

iii. *the horizontal imbalance :* the coefficient of variation in the per capita own revenues of Municipalities even within the same class is extremely large. It means that the same tax base and tax rate produce different levels of revenues. Such imbalances particularly when municipalities have the same tax base and use the same standard rate of taxation, are attributable to either the differences in the level of efficiency or uneven resource endowment.

iv. *the inability of municipalities to effect economies in administrative cost:* As would be noted, the average cost of administration in the different States ranges between 17-35 per cent of the total expenditure. Small sized municipalities incur an average of 27 per cent of total expenditure on administration as compared to 21 per cent by larger municipalities and corporations. What is important to note is that these costs vary sharply even within the same size class of municipalities, signalling that there is a large scope for reducing such costs. The

5 Taxable capacity has been worked out by taking the municipality with the highest per capita own revenues as the norm for all municipalities in each class of municipalities. Similar methods were used by the Zakaria Committee for estimating the taxable capacity. There are other methods too; however, data limitation did not permit their use.

exercises conducted on the basis of the average cost show that it is possible to bring down the administrative expenditure cost by about 14.5 per cent. Savings in administrative costs together with better utilization of the untapped fiscal capacity are extremely important instruments for enhancing the autonomy of local bodies, and meeting the current deficit levels.

v. *the high degree of arbitrariness in the system of fiscal transfers from the State governments to Municipalities* : The exercises conducted as a part of this research study show that -

a. in case of 80 per cent of the sampled municipalities which have below average per capita own resources, average per capita grants are also below average; and

b. in case of 62 per cent of the sampled municipalities which have above average per capita own resources, per capita grants are also above average.

If the objective of the grant is to compensate for lower per capita own resources of municipalities, then the objective is not being met. Similarly, if bringing about a horizontal balance by using a strategy of gap filling is the policy in the distribution of grants, then, once again, grants have not served their strategy.

11. It is in the light of the above that the following general principles for revenue assignment, revenue-sharing and grant-in-aid are enunciated.

i. Municipal governments should be assigned those taxes that are leviable on bases which are "immobile", and those whose burden cannot be exported outside the municipal jurisdictions. Based on this principle, the following taxes would qualify to fall within the municipal domain -

* Property taxes
* Octroi (until phased out)
* Tax on animals and boats
* Tax on advertisements other than those published in national dailies/TV, etc.
* Entertainment tax including show tax and theatre tax
* Tax on professions, trade and callings.
* Surcharge on duty on transfer of property

The exercises conducted as a part of this study show that the overall tax domain of municipalities is a critical factor in their fiscal health. Municipalities having access to octroi have uniformly higher levels of revenue yields (Maharashtra, Gujarat, and Punjab), followed by those that have entertainment or profession taxes within their jurisdiction (Kerala). Municipalities whose domain is restricted and deprived of these taxes have low per capita revenue yields.

Given this, it is important that municipalities have unqualified access to sources mentioned above. Municipalities in a number of States have lost control over entertainment tax and tax on professions. Even though a part of the yield of these taxes is reverted to Municipalities, there is no sound reason to hold them in the State fold. Restoring these sources to Municipalities appears to have a strong economic appeal, and to give them the much needed local autonomy in managing their functions.

ii. Optimal use of taxes, duties and levies by Municipalities should be a precondition for any transfer of devolution of funds from the State governments. As shown earlier, the revenue-raising capacity of municipalities is at least 61 per cent higher than what the Municipalities are able to tap today. Use of the untapped capacity combined with the assignment of entertainment and profession taxes to Municipalities and possible reduction in the administrative cost will, as the exercises show, reduce the dependence of Municipalities on State governments to about 7 per cent of their total expenditure requirements.

iii. The tax and the non-tax domain of Municipalities needs to be freed from excessive regulation in matters of particularly the fixation of rates, exemption policies, and the level of user charges. Although there are important reasons to restrict the kind of taxes municipal governments should be assigned, there appears to be little justification for the State governments to prevent a Municipality from imposing a price on itself. This would substantially meet the spirit of the Constitution (Seventy-Fourth) Amendment.

iv. Revenue sharing mechanism should be used to address fiscal imbalances or a mismatch of revenue means and expenditure needs arising out of assignment of taxes and expenditure responsibilities to local government. For this, the State governments should share at least one buoyant tax with the municipal governments. The rationale for this stems from the fact that the fiscal domain of municipal governments even with the addition of entertainment and profession taxes lacks buoyancy and there is need to provide to them a share in one of the more elastic/buoyant sources of revenues resting with the State governments. Many States provide to Municipalities a share in motor vehicle tax, stamp/registration duties, and land revenues. The manner in which it is done, however, is such that the benefit of the increased yield is not shared with Municipalities, as only a fixed amount is assigned to them.

A two-stage formula is required for the sharing of motor vehicle tax. The first stage would involve a predetermined percentage of revenues from the motor vehicle tax to be assigned to municipalities as a divisible pool. This pool can then be distributed on the basis of standard road units in each municipality.

v. Surcharges on stamp/registration fees should form an important source of revenue that would go a long way in meeting the growing expenditure responsibilities of Municipalities.

vi. Given the fact that there is scope for tapping the unused fiscal capacity and savings on administrative expenditure, and given the fact that shared taxes will provide to Municipalities a predictable source of elastic revenue, grant-in-aid to Municipalities would appear to be normally justifiable under two conditions:

a. *Where the taxable capacity of municipalities is low, and unable to meet their expenditure needs.* Grants rather than the higher level of taxes will be needed to finance the expenditure needs of such municipalities.

b. *Where municipalities are entrusted with functions that have spillover effect.* In the performance of many of the functions, municipalities often encounter the problems of social and private costs. Also, a part of the expenditure of municipal governments gives rise to benefits to communities over and above the benefits to local residents. Grants are a useful source to finance such expenditures. Grants will thus be necessary for functions such as poverty alleviation, urban forestry, and planning for economic and social development. Grants will, of course, be necessary if the norms of expenditure for different services are revised upwards.

12. Determination of principles requires firm data on the finances of municipalities. This study shows the municipal finance data base to be extremely sparse, fragmentary, and often contradictory. There exists no standard format for data collection at the level of Municipalities even within the same State. It is important to point out that of the 15 major States who were approached by NIPFP/Planning Commission for supplying basic municipal finance data, only seven were able to supply the same. This report has used that data base to arrive at its recommendations. This study strongly urges standardisation of municipal finance data collection system and its regular updating and dissemination. Municipalities are unlikely to take on this task unless it is accompanied by financial/technical assistance. It will be necessary to initiate a centrally sponsored scheme to provide financial assistance to municipalities for establishing such a municipal finance data system. A set of suggested data format constitutes an integral part of this report.

Chapter 1

INTRODUCTION

Historical Overview

The origin of local self government in India as it exists today, can be traced back to Sir Josia Child who obtained a charter from James II to set up a Corporation at Madras in 1642. Decentralisation as it is commonly understood was first introduced during the decade 1860-70, and was strengthened by Lord Mayo's resolution of 1870. It was the first attempt to make provincial governments responsible for the management of their local finances. In 1882, Lord Ripon issued a resolution aimed at fulfilling the urge for self-government and making local-self government an instrument of change. However, Lord Ripon's reforms failed to bring about the needed improvement in the functioning of local governments. The Royal Commission on Decentralization was set up in 1907 to study the financial and administrative relations between the Government of India and the provincial governments. The Commission provided evidence that the finances of local bodies were not adequate in relation to the duties and functions assigned to them.

The financial powers of local governments were considerably enlarged by the Government of India Act of 1919 which, for the first time, enumerated a number of taxes to be used exclusively by or for the local bodies in the schedule of taxes. This act was hailed as a landmark development in the evolution and establishment of local-self governments in

India. The act, however, failed to improve the financial condition of local bodies due to mismanagement and administrative lapses in the collection of taxes. The act of 1935, consequently, repealed the scheduled taxes included in the 1919 act and provided for three separate lists- the federal, provincial, and concurrent. The demarcation between the provincial and local taxation was done away with, and local bodies derived their tax powers from the provincial legislature.

At the dawn of independence and the enactment of a democratic constitution, the condition of municipalities was depressing and discouraging. The government of independent India was concerned with the capacity of local governments to carry out the work with which they were entrusted, and decided on limiting further the already narrow scope of their activities. Article 40 of the Constitution laid stress on village panchayats: "*the state should take steps to organise village panchayats and endow them with such powers and authority as may be necessary to enable them to function as units of self government*"; as such, the urban local bodies lost out in importance. The Committee of Ministers constituted by the Central Council of Local-Self Government in 1963 rightly remarked that"....after independence it is the rural sector that has been enjoying the main attention of the government".

The Constitution of India recognised the statutory position of local governments as an integral part of the Central government but did not confer any specific powers to them. Local government was enumerated in the state list of the 7th schedule of the Constitution which stated that the constitution and powers of municipal corporations... and other local authorities for the purpose of local-self government and village administration fell under the jurisdiction of the respective state governments. This position remains unchanged. The local bodies are the creation of state legislatures and derive their fiscal powers, functions, jurisdiction and authority from them.

Post Independence Efforts

Over the years after independence, the financial condition of urban local bodies has deteriorated considerably. With growing urbanization, local bodies are under constant pressure for providing better and adequate level of services under conditions of stagnant or declining revenues. The revenues of urban local bodies have not grown in relation to the responsibilities assigned to them. As early as 1953, the Taxation Enquiry Commission had observed that "the growth of municipal services... in almost all states the municipal budgets are curiously balanced". The Commission also stated that "it is obvious that with such low levels of income and expenditures, even the rendering of the obligatory services are open to question".

Since 1953, the issues relating to the finances of municipalities have been discussed and deliberated upon in India. Clear evidence of this is to be found in the reports of the various Commissions and Committees. These Commissions and Committees have tried to look at what ails the finances of municipalities and how their finances can be put on a sound footing. Many of the Commissions and Committees have looked at especially the issues related to the grant-in-aid, shared taxes, etc. At least one Committee - The Zakaria Committee, tried to fix the expenditure norms etc,.

In spite of all these studies, little has happened on the recommendation of the Committees and Commissions. There has been no perceptible change in the fiscal domain of municipalities. Nor has there been any improvement in the methods of giving grants-in-aid to municipalities and thus, the state of the finances of municipalities continues to be unsatisfactory. The basic structure of the revenue base of urban local governments is such that it does not allow them to cope with the changing socio-economic conditions. There is an urgent need for major reforms in establishing a transparent and predictable system of local finance. The responsibility to carry out the needed reforms rests equally with the state and municipalities. Establishing a new partnership between the state and municipalities will go a long way in putting the municipalities in a state of fiscal harmony.

The 74th Constitutional Amendment And the Finances of Municipalities

With the passage of the 74th Constitutional Amendment, the entire situation with respect to the finances of municipal bodies stands changed. Article 243Y of the Constitution 74th Amendment 1992, requires each state to set up a State Finance Commission to "review the financial position of municipalities (as also of Panchayats under Article 243-I of the 73rd Amendment), and make recommendations as to the principles which should govern -

1. the distribution between the state and the municipalities of the net proceeds of taxes, duties, tolls and fees leviable by the state and the allocation between the municipalities of such proceeds.

2. the determination of the taxes, duties, tolls and fees which may be assigned to, or appropriated by the municipalities; and

3. the grant-in-aid to the municipalities from the Consolidated Fund of the state.

Article 243Y does not limit the task of the State Finance Commissions to only setting out the principles, but extends to recommending measures for improving the financial position of municipalities, and dealing with such other matters as may be in the interest of sound finances of municipalities.

Thus, the State Finance Commissions, under the amendment, have important powers and responsibilities which, if used realistically, imaginatively and professionally can go a long way in strengthening of the municipal government institutions. According to the amendment, the State Finance Commissions are to decide not only on the principles but also on how to improve the finances of municipalities. This article in the amendment has wider implications, meaning that the door is open to the State Finance Commissions to suggest measures such as privatization and public-private partnership, if they find these to be relevant and important.

The State Finance Commissions are a new development in the history of local governments in India. Although, there are precedents such as the Municipal Finance Commission in West Bengal and the Gujarat Municipal Finance Board, the countrywide establishment of State Finance Commissions to decide upon the principles is perhaps the most important development since the time of Lord Ripon's resolution of 1882. The primary task of the State Finance Commissions is to ensure that, over a period of time, the municipal governments develop as units of self-government, and that they are able to become crucial centres of decentralised development. It is in this light that the task that has been assigned to the State Finance Commissions has to be envisioned.

Objective of the Study

The purpose of this study report is to assist the State Finance Commissions in carrying out the tasks assigned to them in a scientific manner. This study report attempts to lay down the steps that are crucial in determining the principles for tax assignment, revenue sharing and grants-in-aid. The study report also provides suggestions on possible ways for improving/augmenting the finances of municipalities.

It should be pointed out that there already exists in literature some broadbased principles on tax assignment, tax sharing and grants-in-aid. The federal finance literature, for instance, suggests that -

1. in revenue assignment, the ***Congruence Principle*** should be adopted. According to this principle, the less mobile a tax base, and the stronger the spatial concentration of the tax base and ownership, the lower the level of government to which those taxes should be assigned.

2. in revenue sharing the principle of transparency and predictability is relevant, and should be adhered to. This would require that each level of government understands the rules of revenue sharing and is able to understand and predict its entitlements under the system.

3. grants-in-aid should follow the principle of reducing or doing away with horizontal imbalances in revenue requirements.

The study report adapts these principles to the Indian conditions. The starting point of the study, for example, is that the principles should be able to effectively address the problems encountered by municipal bodies in raising resources and in utilising those resources for performing the functions assigned to them. Accordingly, it has examined at some length, the finances of sampled municipalities of different population sizes spread over seven states. The primary focus of our examination is to see, how effectively and efficiently the municipal bodies are able to use their tax domain for resource mobilization. It also analyses as to how well the municipalities are able to use up the transfers which accrue to them by way of grants as well as the degree of dependence of municipalities on the state governments. It also devotes a considerable part of the report on the role of transfers in meeting the requirements of municipalities.

The report looks at the emerging role of municipalities in the context of the 74th Constitutional amendment and of the process of country's economic liberalization. The Constitutional amendment provides a list of functions that it considers most appropriate for municipalities to become units of self-government. As may be seen in Annexure B, the list includes planning for economic and social development, urban poverty, urban forestry etc. as functions of municipal governments. These functions are new additions. Historically, the municipal governments have not been responsible for these functions. The addition of these functions is a significant advance in their role, and has vital implications for the finance of municipalities.

This study report argues that the principles for tax powers, revenue sharing and grants are crucially dependent on the extent and nature of the functional domain. Thus, principles can neither be developed in isolation of the functions, nor can the issue of augmenting their finances be examined without first ascertaining their functions.

Municipal Finance Data and the Composition of the Sample

The report relies for its assessment of the problems of municipalities, on the municipal finance data supplied by the states. It needs to be pointed out that there are serious deficiencies in the manner in which municipal finance data are maintained. Most states do not have a regular system of collection and maintenance of data. Even personal visits did not throw light for instance, on the issues of tax effort, tax capacity and the rationale behind the various kinds of transfers, grants etc. It is important to note that the tasks of the State Finance Commissions are dependent on the quality of data. This study has stressed the importance of data and proposed a set of formats, presented in Volume II of the report, for municipal finance data to be regularly collected and maintained.

The report uses the financial data of 293 municipalities from the states of Andhra Pradesh, Assam, Gujarat, Kerala, Maharastra, Punjab and West Bengal to understand the nature of problems they suffer from (table - 1).

Table - 1

Number and Population Size of Municipalities Forming the Sample

States	<100,000	100,000 to 200,000	200,000 to 500,000	>500,000	Total
Andhra Pradesh	21	22	9	2	54
Assam	19	2	-	-	21
Gujarat	48	9	2	4	63
Kerala	51	3	1	2	57
Maharastra	16	6	7	4	33
Punjab	23	6	1	3	33
West Bengal	12	16	4	-	32
Total	190	64	24	15	293

Relevance of the Report

It should be pointed out that even though the state municipal acts may look similar, and the powers and responsibilities also somewhat identical, there are vital differences in the tax bases, tax rates and the level of efficiency with which these are exercised. There are sharp variation in the per capita revenues and expenditures both within the municipalities of the same state and among different states. The problems too vary sharply. Therefore, what is relevant for one state may not necessarily apply to other states. *As such, this report is not state-specific; it only lays down the steps that have wider applicability, and should, therefore, be used only as a guide for further state specific studies.*

Structure of the Report

The report is presented in three volumes: Volume I has six chapters. The finances are analysed in four chapters - Chapter 2 covers own revenues of municipalities, Chapter 3 addresses the issue of shared revenues, and Chapter 4 analyses the grant to municipalities. Chapter 5 presents the expenditure pattern and needs of municipalities. The last chapter sums up the analysis, and discusses the steps that are important for determining the principles. It also makes suggestions for augmenting the finances of municipal bodies. Volume II presents a set of data formats and suggestions as to how these should be implemented. Finally, in Volume III all the supporting tables used in the analysis are provided.

Chapter 2

OWN REVENUES OF MUNICIPALITIES[1]

It is perhaps useful to begin by pointing out that the revenue importance of municipalities in the country's federal structure in terms of what they are able to generate with fiscal powers assigned to them is extremely low. By the criterion of revenue raised, municipalities in India are estimated to have raised in 1991-92, approximately Rs. 39.0 billion (table-2). This amount is 4.6 percent of the total revenues raised by the centre, and 8.05 percent of revenues raised by the states. Further, this amount is only 0.6 per cent of the country's GDP (at factor costs). Considering the fact that municipal areas produce over 50 percent of the country's GDP, it is evident that the municipalities are not able to establish effective linkages with activities carried out within their own jurisdictions, and thus remain peripheral to the Indian economy[2].

Table - 2

Revenue of the Centre, State and Municipalities

Unit	Total (Rs. Billion)	Per Capita (Rs.)
Centre*	833.2	986.8
State*	486.6	573.9
Municipalities#	39.0	205.3

*Source: Finances of State Governments, 1993-94, reprint from RBI Bulletin, Feb. 1994.
Estimated (excluding transfers).

1 The term municipalities refers to all urban local bodies including Municipal Corporations, Municipal Councils, Notified Area Committee, etc,.

2 Municipalities in some states, in particular Gujarat, Maharastra, and Punjab raise significantly larger amounts and display strong linkages with the economy. These are evidently exceptions to this rule.

Revenue Structure of Municipalities

To facilitate their functioning with a measure of autonomy, municipalities are assigned certain powers to raise revenues from a variety of taxes, duties, tolls, fees and charges[3]. These are however, subject to regulation and guidelines of the respective state governments. Thus, substantial variation across states is a common feature, not only in the assignment of tax powers to municipalities but also in the degree of regulation and control exercised by the states. In addition, municipalities are given shares in certain taxes such as motor vehicle tax, entertainment tax, profession tax, registration and stamp duty, and the entry tax in West Bengal. These sources of revenues and transfers in the form of grants, both general purpose and specific purpose, constitute the total revenue of municipalities in India.

Between 60-80 percent of revenues from own sources are derived from "taxes" and the balance from "non-tax sources"[4]. Approximately 40-70 per cent of the total tax receipts of municipalities are derived from property taxes in non-octroi states. Revenue from octroi is the major source of tax revenue in octroi states such as Gujarat, Maharashtra and Punjab. Other municipal taxes such as tax on trades and callings, tax on animals, tax on advertisements, show tax, etc., are much less important in terms of their share in the total tax revenue of municipalities.

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3 For summary of tax powers of municipalities, refer to Annexure C and respective municipal act of the states for details.

4 Own sources of revenue are that component of the total revenue which are directly collected by the municipalities and retained for their exclusive use.

Non-tax revenue of municipalities comprises of income from fees and fines, rents from municipal buildings, income from remunerative enterprises, and other miscellaneous sources incidental to the powers and functions of municipalities. The share of this source of revenue in the own revenue receipts of municipal bodies averaged around 28 percent in 1991-92.

Table - 3

Own Revenues by Size Class of Municipalities (%)

States	Class A <100,000	Class B 100,000-200,000	Class C 200,000-500,000	Class D >500,000	All
Andhra Pradesh	40.26	55.53	53.13	59.55	55.10
Assam	68.58	78.24	-	-	70.72
Gujarat	84.35	88.33	86.48	89.88	88.96
Kerala	78.19	81.55	72.87	74.24	76.79
Maharastra	67.01	59.01	83.60	92.89	90.81
Punjab	86.95	86.61	88.57	88.54	87.85
West Bengal	26.79	28.21	28.11	-	27.89

Source: Complied from municipal data base, NIPFP.

Going by the data for 1991-92, revenue from own sources forms an important component of the total revenue receipts of municipalities. These accounted for 55.1 percent of the revenue receipts in Andhra Pradesh, 70.7 percent in Assam, 88.9 per cent in Gujarat, 76.7 per cent in Kerala, 90.8 per cent in Maharashtra, 87.8 per cent in Punjab and 27.9 per cent in West Bengal[5] (table - 3). There are wide inter-state variations in own revenues of

[5] Municipalities in the states of Gujarat, Maharashtra and Punjab show high degree of fiscal autonomy due to their ability to raise substantial revenues from collection of octroi.

municipalities. While these inter-state variations in a strict sense are not the concern of the State Finance Commissions, the extent to which these are caused by the efficiency with which different states use their fiscal powers can be a source of concern to the State Finance Commissions. The issue of inter-state disparities would have to be addressed by the higher level of government[6]. The striking feature of the revenue raised by municipalities is their concentration in certain states like Gujarat, Maharashtra, Kerala, and Punjab, reflecting unequal distribution of revenue raising capacity across states. These patterns are evident even when octroi revenues are subtracted from the own revenues of municipalities of the respective states.

In per capita terms, the level of own revenues of municipalities in our sample as a whole, averaged Rs. 317.8 in 1991-92 (table - 4). Although this average seems to be high, the level varies widely across states and across the size classes of municipalities. A closer analysis of the per capita own revenues presents an interesting pattern which has relevance to the tasks assigned to the State Finance Commissions. As stated earlier, the State Finance Commissions cannot address the issue of inter-state variations. They may, however, take note of the inter-state imbalances in their report.

Since the task of the State Finance Commission is restricted to making recommendations to the state governments, it would be unlikely that the issue of inter-state fiscal imbalance can be effectively addressed by them. Correcting these disparities would more likely be the domain of the central government or the National Finance Commission.

Table - 4

Per Capita Own Resources of Municipalities (Rupees)

States	Class A <100,000	Class B 100,000-200,000	Class C 200,000-500,000	Class D >500,000	All
Andhra Pradesh	57.7	77.8	59.7	103.3	79.5
Assam	43.2	46.4	-	-	44.0
Gujarat	198.7	267.7	336.9	587.5	441.4
Kerala	130.6	122.5	143.2	133.9	131.9
Maharastra	305.2	301.7	397.0	849.9	737.5
Punjab	250.6	229.5	279.9	257.1	252.2
West Bengal	40.9	35.2	35.4	-	36.2
All	63.2	69.3	168.4	497.1	317.8

Source: Compiled from municipal data base, NIPFP.

Inter-State Differences in Per Capita Own Revenues

Of the seven states in the sample, Maharashtra has the highest per capita own revenues of Rs.737.5 followed by Gujarat with Rs. 441.4 and Punjab with Rs. 252.2. As against the high per capita own revenues of the octroi states, the per capita own revenues in the non-octroi states are estimated to be Rs. 79.5 in Andhra Pradesh, Rs. 44 in Assam, Rs. 131.9 in Kerala. Trailing the group of states in this category is West Bengal with only Rs. 36.2 (table - 4). Even when own revenues are adjusted for octroi, the per capita own revenues in Maharashtra are several times higher than that of Andhra Pradesh, Assam and West Bengal. This is a clear reflection of the inter-state variation in resource endowment and/or the level of efficiency in tax effort.

Inter-Class Differences in Per Capita Own Revenues

Municipalities of different class sizes suffer from extreme variation in per capita own revenues which is substantially large in some states. It is also noted that the per capita own revenues of smaller municipalities are uniformly low across most states in our sample. These large variations reflect on the inability of smaller municipalities to finance their services. In Gujarat, for example, per capita own revenues of larger municipalities are 195 percent higher than those of smaller municipalities. Similar trends are observed in Maharashtra where per capita own revenue differential is nearly as large as in Gujarat. Such differences have placed the smaller municipalities at a comparative disadvantage in adequately tapping their revenue potential.

Intra-Class Differences in Per Capita Own Revenues

Variations in the per capita own revenues are also present within each class-size of municipalities. The coefficient of variation in the total own revenues of smaller municipalities of less than 100,000 population happens to be as high as 0.50 in case of Andhra Pradesh, 0.60 in case of Assam, 0.37 in Gujarat, 0.80 in case of Maharashtra, and 0.38 in case of West Bengal. Municipalities in other classes also show unexpected variations. These variations are an indication that the application of identical set of taxes as well as tax rates can generate different levels of revenues depending on the tax base of the municipality in question. These findings are likely to have important implications for the design of grant systems and sharing mechanism to streamline the finances of municipalities.

The variations observed within each class of municipalities are the result of differences in the fiscal domain of the municipalities, differences in the tax base and tax rates, differences in the levels of administrative efficiency, and uneven endowment of local bodies. Thus, giving to municipalities the same tax rates/bases is not an adequate response to the problem of differences in the taxable capacity of municipalities.

Measures of Variation: An Overall Analysis

Table - 5 presented below, provides a picture of the nature and extent of inter-state and within-state variation that exists in the own revenues of municipalities.

Table - 5

Measures of Variation in Per Capita Own Revenues

Own Sources	AP	ASM	GUJ	KER	MAHR	PUN	WB	ALL
Highest	216.6	105.4	745.5	532.3	1284.1	838.4	92.3	1284.1
Lowest	14.6	13.9	94.3	29.1	109.7	101.8	9.4	9.4
Mean	82.9	45.5	234.8	141.6	403.7	244.1	46.6	205.3
St. Dev	38.6	25.8	124.8	96.6	304.5	144.3	20.1	177.3
Coef.of Var.	46.6	56.6	53.2	68.3	75.4	59.1	43.3	103.9

Source: Compiled from municipal data base, NIPFP.

Wide variations exist around the mean which are evidenced by the highest and the lowest per capita own resources of municipalities within each state and across states. The range also varies from a high of 1174 in case of Maharashtra to a low of 82.9 in case of West

Bengal[7]. The coefficient of variation[8] also provides evidence to our hypothesis that variations are wide spread. Several observations based on the information presented in table - 4 deserve special attention:

The highest per capita own revenue raised by any municipality in Assam and West Bengal are Rs. 105.4 and Rs. 92.3 respectively. These figures are below the figures for the municipality that raises the lowest per capita own revenue in Maharashtra (Rs. 109.7).

The mean of per capita own revenues of municipalities in Gujarat, Maharashtra and Punjab is greater than the highest values of per capita own revenue of municipalities in Andhra Pradesh, Assam and West Bengal.

In identifying the differences in per capita own revenues of municipalities, it is seen that there are essentially three types of differences. There are sharp differences between municipalities in different states, between municipalities of different population size classes and between municipalities of the same population size class. These sharp differences are essentially an indication of the different forms of horizontal imbalances which can be attributed to the following four factors.

The range is defined as the difference between the highest and the lowest values in a data set. The range may be influenced greatly by unusual values in the given data. If there are unusual values in the data, either very small or very large, the range may not be a proper measure of variation for the group of values.

The coefficient of variation is derived by dividing a measure of absolute dispersion by a measure of central tendency. The coefficient of variation used here is the standard deviation divided by the arithmetic mean converted into percentage terms.

1. Inter-regional or inter-state differences in the fiscal domain of municipalities. States such as Maharashtra, Gujarat, and Punjab levy octroi which is a very elastic source of revenue; thus, it has enhanced their tax base substantially. States such as Andhra Pradesh, Assam, Kerala, and West Bengal suffer from low tax base with no elastic source of revenue.

2. Differences in the tax base and tax rates, etc, of municipalities of different population size.

3. Differences in the level of efficiency with which municipalities use their resource raising powers; and

4. Uneven resource endowment resulting in different yield levels even with the application of the same tax base and tax rates.

Principles of Tax Assignment

The power delegated to the urban local bodies for the purpose of collection and use of revenue from specified taxes is here referred to as tax assignment. It is important to point out that tax assignment should be considered only after expenditure assignment has been clearly specified. The theoretically optimal structure would assign to the higher levels of governments the stabilization and redistributional functions and those allocational functions whose benefits are spread over a large area. Other activities are allocated to those levels of government, where the group that directly benefits from the service is involved.[9] Thus, functions that can be performed most efficiently at lower levels of government and primarily benefit residents of particular jurisdictions should be assigned to the local governments. The public finance literature argues that the greatest efficiency will come from expenditure assignments which place the responsibility for each function with the lowest level of government capable of delivering it efficiently (*the principle of subsidiarity*)[10]. Once expenditure assignments have been agreed upon, it becomes necessary to assign tax powers so as to provide a reasonable matching of expenditure needs with revenue means.

Given the importance of the functions to be performed by each level of government, it is essential that each level of government should have some revenue sources of its own to perform the functions allocated to them. These different types of revenues are to be allocated on the basis of the *Congruence Principle: the less mobile a tax base, and the stronger the spatial concentration of the tax base and ownership, the lower the level of government to which those taxes should be assigned.* Local government taxes then are those which are based on local consumption goods, services and business. Based on this principle, the following taxes could be identified to be local in nature, and thus, there is a case for their collection and use by the local bodies.

1. Property Tax
2. Octroi (until phased out)
3. Entertainment tax including show tax and theatre tax
4. Tax on professions ,trades and callings
5. Tax on advertisements other than those published in national news papers
6. Tax on animals and boats

Oates, Fiscal Federalism, Chapter 2.

J. Martinez-Vazquez, 1994; The expenditure-assignment reform in Russia. Government and Policy 1994, volume 12, p 279.

7. Surcharge on Duty on transfer of property
8. Tolls

In some states such as Kerala, entertainment tax has already been given to the local bodies for their exclusive use. In Andhra Pradesh, 85 per cent of both the entertainment tax and profession tax are apportioned to the municipalities. However, in many other states these are shared taxes. The congruence principle would require these sources of tax revenues to be assigned to local governments in order to strengthen their fiscal position and to permit them to perform the functions delegated to them efficiently.

Mobilizing Revenues From Internal Sources

The autonomy of local bodies can be enhanced only by reducing their dependence on the state governments, and by taking steps to enhance their internal sources of revenues. In the post 74th amendment period, mobilization of internal sources of revenue should be considered one of the primary objectives of municipalities in order to bring some level of fiscal robustness to local finances. In the past, states have not taken any step in this direction and the municipalities seemed to have had little initiative of their own in this regard. In the current scenario, it would be expected that if the autonomy of local governments is to be achieved, then municipalities will have to initiate major reforms in the administration and management of their affairs. To encourage such efforts by municipalities it would be necessary to introduce incentives and disincentives into the design of fiscal relations between the states and the municipalities. These issues are important to the task of the State Finance Commission and should be taken into account when suggesting the principles for devolution of funds from the states to municipalities.

The State Finance Commissions in performing their tasks would also have to address the issue of mobilizing the revenues of municipalities from their internal sources. International experience suggests wide diversity in the structure and effectiveness of local revenue systems. Both the theory and experience show that user charges and property taxes traditionally provide the primary base for an effective and stable local revenue system.[11] These two sources of revenues have been identified as having a large potential for reform and restructuring to enhance the revenues. We have addressed these two issues in greater detail in the pages that follow. It is however, pointed out that more comprehensive and detailed studies would be called for in order to determine the extent of the potential of these sources in different states and municipalities. Our observations are based on a limited set of data.

Property Tax Structure

Although property tax is listed as a state tax, due to its localized character this tax has been in all cases delegated to the local bodies. Municipalities are responsible for both its collection and the use of revenues generated from this source. The state exercises some control over the rate determination of this tax; however, municipalities are free to charge rates within the maximum and the minimum rates specified by the state government. As has been stated earlier, property taxes are the most important source of tax revenue for the non-octroi states like Andhra Pradesh, Assam , Kerala, and West Bengal. Within the tax component of non-octroi states, property taxes account for anywhere between 40-70 percent of the own revenues (table - 6).

Bahl R, And Linn J, 1992 Urban Public Finance and Management in Developing Countries (oxford University press, New York)

Table - 6

Property Tax Revenues of Sampled Municipalities as a Percentage of Own Resources, 1991-92

State	Class A	Class B	Class C	Class D	All
Andhra Pradesh	62.2	52.9	65.3	83.1	69.7
Assam	38.7	34.8	-	-	37.8
Gujarat	10.7	12.4	12.8	16.7	15.6
Kerala	33.6	35.7	41.3	59.6	41.6
Maharastra	12.5	15.4	10.9	16.5	15.9
Punjab	7.7	7.9	10.6	11.35	9.9
West Bengal	57.8	71.1	64.4	-	66.5

Source: Compiled from municipal data base, NIPFP

The total yield from property taxes is however, uniformly low. In 1991-1992, the per capita yield from property taxes was only Rs. 55.4 in Andhra Pradesh, Rs. 68.7 in Gujarat, Rs. 117.3 in Maharashtra, and Rs. 24.1 in West Bengal (table - 7). Figures 1 & 2 show property taxes as a percentage of own revenues for the non octroi and octroi for octroi states respectively. This low level of yield from property taxes shows that the property tax system in the country has remained unchanged and continues to suffer from the problems of narrow base (exemption of a large number of properties from payment of property taxes)[12], persistent undervaluation, high tax rates (ranging between 20-160 per cent of the rateable values)[13], and, most of all, poor enforcement. The low level of yield is hardly reflective of the dramatic escalation in the real estate prices that has occurred over the past two decades in the country.

12 Suggestions have been made to introduce some form of presumptive taxes for such properties.

13 The tax rates on property varies considerably from municipality to municipality ranging anywhere from 25 per cent of the rateable value to 160 per cent of the rateable value in Greater Bombay. It is found that in many instances that rates have to be deliberately kept high to maintain the revenue from the tax receipts as the taxable base has not been increasing.

Table - 7

Per Capita Property Tax Revenues of Sampled Municipalities in Rupees, 1991-92

State	Class A	Class B	Class C	Class D	All
Andhra Pradesh	35.9	41.2	39.0	85.9	55.4
Assam	16.7	16.2	-	-	16.6
Gujarat	21.3	33.1	43.1	98.2	68.7
Kerala	43.9	43.7	59.2	79.8	54.9
Maharastra	38.0	46.4	43.6	140	117.3
Punjab	19.3	18.2	29.7	29.2	24.9
West Bengal	23.7	25.0	22.8	-	24.1

Source: Compiled from municipal data base, NIPFP.

Recent years have witnessed in a few states introduction of changes in the property tax valuation system; however, in order to tap the potential of this tax to the maximum it is necessary to undertake major reforms of property taxes[14]. In all the states in our sample, property tax is levied on the basis of the rateable value of the property. Large variations are found in the rates of property taxes not only across states but within states. It is also seen that both the flat rate and the progressive rate system prevails in the taxation of property. There are also differences in the rates as per the municipal schedules and the effective rates

[14] Except the Corporations of Hyderabad, Vishakapatanam, and Vijaywada, all municipalities in Andhra Pradesh have introduced area based taxation. The yield from property tax has doubled as a result of this change.

Figure 1

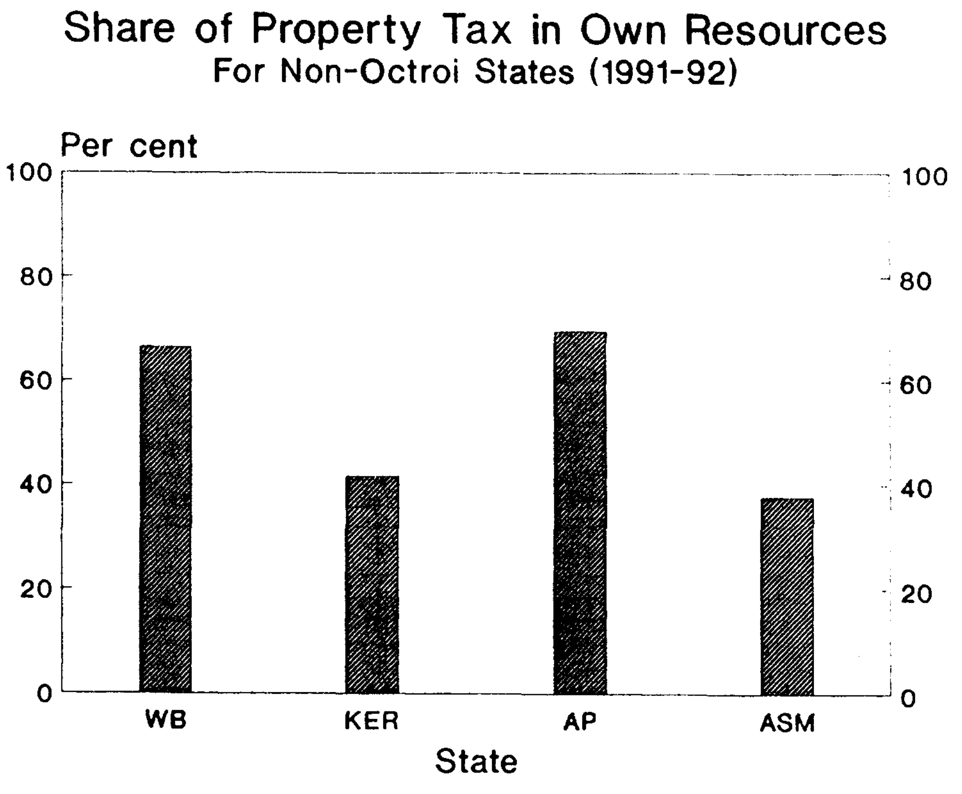
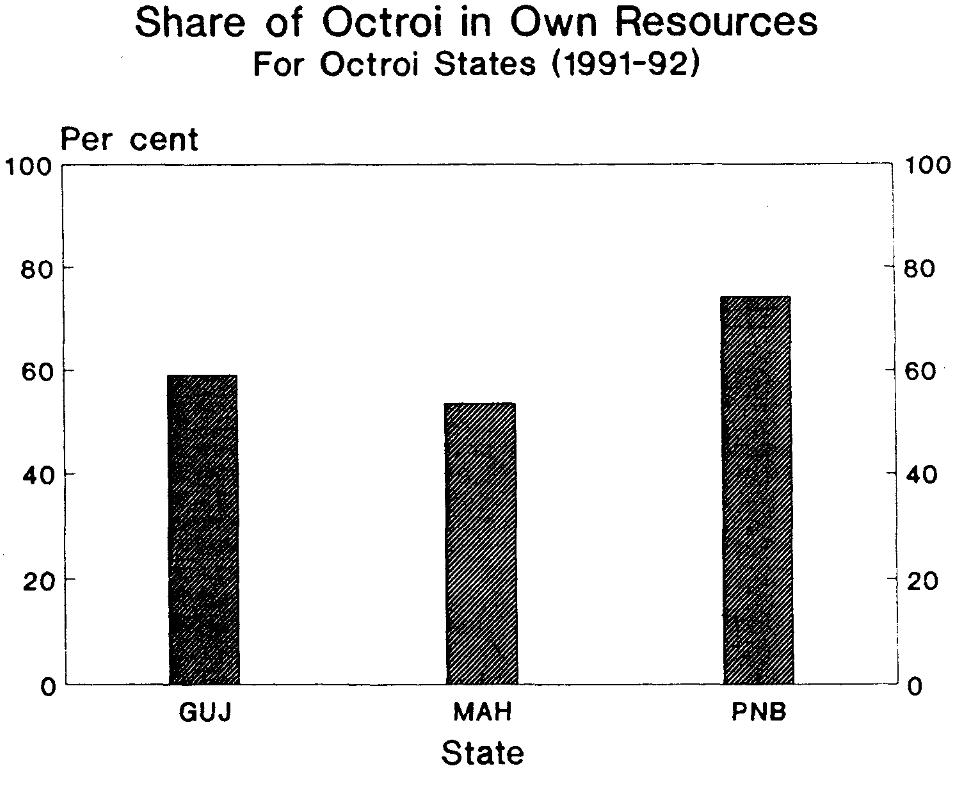


Figure 2



of property taxes. There is no effective system of standard norms in the valuation of property across municipalities. As such the current system of property taxes has several major flaws which need to be addressed.

From the data furnished by the sample states in our study, it was not possible to determine what percentage of the current property tax demand is being collected. It is however, believed that defaults are large, and are shown as arrears year after year. The real unexploited potential of property tax rests in the identification of undervalued properties. Undervaluation takes place mainly due to the subjective assessment by untrained officials, collusion between landlords and tenants, static rental values due to the provision of the Rent Control Act, and the undervaluation of self occupied properties. At present, the municipalities are losing large revenues because of the static rents as fixed under the Rent Control Act. The full potential of the tax cannot be exploited until major reforms are brought about in the administration, assessment and collection of property taxes. The municipalities will have to take steps to restructure the property tax system to make it a more lucrative and elastic source of revenue. The following are some of the important issues that may have bearing on the revenue yield from this tax.

1. The municipalities will have to make efforts to broaden the tax net and lower the tax rate to encourage payment of property taxes. The property tax structure should be kept as simple as possible with minimum exemptions and uncomplicated rate structures.

2. Area or zone based taxation of property may have a greater revenue generating potential even under conditions of lower tax rates. This proposed reform is only one alternative to the existing system, and its feasibility has to be further studied in light of its introduction in the municipalities of Andhra pradesh.

3. All properties should be assessed on the fair market rent prevailing in each area or zone of the municipality.

4. In case of properties under the Rent Control Act, necessary amendments should be introduced in the legal provisions so that additional property tax liability can be passed on to the tenants who are the beneficiaries of municipal services.

5. It would be appropriate to tax vacant land at rates that would discourage speculation, especially in larger growing municipalities.

6. There must be periodic revision and valuation of property to account for appreciation in rental values.

7. Marginal rebates may be offered for timely payments and heavy penalties for delays in payment of property taxes.

8. Administrative cost of property tax may be reduced by following self assessment schemes in the payment of taxes. This will however, require that a predetermined percentage of returns is audited.

9. Banks may be authorised to accept property tax payments. This will make the payment of taxes easier on the property owners. Some municipalities in Andhra Pradesh have introduced door to door collection of taxes. This system has resulted in the improvement in collection to as high as 96 percent in some municipalities. These types of innovative schemes will go a long way in improving the finances of municipalities.

It is important for the local governments to direct their efforts to improving property tax policy and administration. International experience shows that major push for reform is found in the developing countries. There are four lessons to be learnt from the reforms of property tax undertaken in many developing countries[15].

1. Property tax reform requires strong political and operational support.

2. Property tax reform must be undertaken on a comprehensive basis, integrating policy and administration.

3. Property tax reform must be implemented strategically, and

4. Property tax reform must involve a simplification of policy and administrative procedures.

15 R. Kelly, 1993, Implementing property-tax reform in transitional countries: The experience of Albania and Poland. Government and Policy 1994, volume 12, p 321.

Non-tax Revenues of Municipalities

Non tax revenues comprise of charges, fees and fines levied by municipalities in different states. These are mostly received in the form of payments in return of services rendered by the municipality to the residents of the municipal jurisdiction. The main heads of non tax revenues in the sampled municipalities broadly comprise of rents on municipal land and buildings, sale proceeds of land and building of the municipality, licence fees, market fees, fees and revenues from slaughter houses, income from commercial or remunerative enterprises and income from other sources incidental to the functions of municipalities.

Although the non-tax revenues comprise a smaller proportion of the total revenue of municipalities, their significance in the internal sources of revenue can be gauged from the figures presented in table - 8 below. In 1991-92, they formed 21.3 per cent of the own revenues of municipalities in Andhra Pradesh, 42.7 per cent in Assam, 18.9 per cent in Gujarat, 26.3 per cent in Kerala, 29.5 per cent in Maharashtra, 14.1 per cent in Punjab and 30.7 per cent in West Bengal. It is also observed that smaller municipalities have a larger percentage of their own revenues derived from non tax sources compared to larger municipalities. This may be due to the fact that the tax capacity and the tax base of smaller municipalities are generally seen to be smaller, forcing them to increasingly rely on non tax sources within their jurisdictions.

Table - 8

Non-Tax Revenues of Sampled Municipalities as a Percentage of Own Resources, 1991-92

States	Class A	Class B	Class C	Class D	All
Andhra Pradesh	32.6	28.4	33.2	9.6	21.3
Assam	41.6	46.3	-	-	42.2
Gujarat	25.8	26.9	12.8	17.7	18.9
Kerala	31.0	18.5	26.7	19.8	26.3
Maharashtra	31.3	15.3	7.9	20.9	29.5
Punjab	16.5	16.6	16.9	12.0	14.1
West Bengal	36.4	26.7	33.6	-	30.7

Source: Compiled from municipal data base, NIPFP, New Delhi.

An analysis of per capita non-tax revenues of municipalities shows that in the non octroi states, smaller municipalities are able to raise larger amounts compared to the larger municipalities. The per capita non-tax revenue tends to fall as the size of the municipality increases. Thus, it would seem that in the non octroi levying states, those municipalities that have larger income from tax revenues tend to be relativily inefficient in exploiting their non tax revenues. However, this does not seem to be the case in the octroi levying states of Gujarat, Maharashtra and Punjab. There are also vast inter-state variations in the per capita non-tax revenue raised by the municipalities ranging between a high of Rs. 217.3 in Maharastra to a low of Rs. 11.1 in West Bengal and 16.9 in Andhra Pradesh (table - 9).

Table - 9

Per Capita Non-Tax Revenues of Sampled Municipalities in Rupees, 1991-92

States	Class A	Class B	Class C	Class D	All
Andhra Pradesh	18.8	22.1	19.8	9.9	16.9
Assam	18.0	21.5	-	-	18.8
Gujarat	51.1	72.2	43.1	104.1	83.6
Kerala	40.5	22.7	38.3	26.5	34.7
Maharashtra	64.0	23.7	60.7	265.9	217.3
Punjab	41.4	38.2	47.6	30.9	35.7
West Bengal	14.9	9.4	11.9	-	11.1

Source: Compiled from municipal data base, NIPFP, New Delhi.

It is also found that municipalities in those states that have a higher dependence on transfers tend to demonstrate lower levels of per capita revenues from non-tax sources. States such as Andhra Pradesh, Assam And West Bengal are relatively more dependent on the transfers from the state. These are also the states that tend to have lower per capita receipts from non-tax revenues. This conclusion is only a general observation and the relationship would have to be studied in more detail in order to see if there is sufficient evidence to support this hypothesis.

(a) **User Charges and Fees**

Within the class of non-tax revenues, user charges and fees occupy a special place in the finances of municipalities both due to the existing potential and also because of the numerous impediments to applying the concept of charges to many of the services provided by the municipalities.

There is wide measure of agreement that services provided by local governments and financed through charges are in a bad shape[16]. This belief has been reinforced in our study in spite of severe data constraints. It is believed that the cost of services such as water and waste disposal far exceed the revenue received from them. These services are "trading services" which are expected to derive their revenues mainly from charges to its users[17]. However, in practice, they tend to be highly subsidized and municipal authorities lack information on cost of providing these services. let alone the recovery of the costs of the service.

Economic principles suggest that any public service yielding at least partial direct benefits to residents can and should be financed by charges instead of taxes, or if the use of charges is difficult, by a tax directly related to use[18]. The key criterion for the possibility of use of a charge is excludability, which necessitates direct provision of the service to individuals rather than in a joint fashion to the community.

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16 The general definition of user charge according to Richard Bird is that it is the amount of money per unit of good or service produced or provided by the government which is collected from the recipient.

17 See, Local Government Finance: Report of the Committee of inquiry, May 1976, London, p.135

18 For a comprehensive discussion on the principles of benefit taxation, the reader may refer to Richard M. Bird (1976), Charging for Public Services: A new look at an Old idea. Canadian Tax Foundation, Toronto. Canada.

The use of the price system offers significant advantages in terms of both resource allocation and equity. Financing of services by charges instead of taxes allows the price system rather than the political process to determine the amount to be produced. With user charges the output can be adjusted automatically to the amounts purchased at the established prices. User charges curb the demand for expandable public sector activity by making their costs apparent to the prospective beneficiaries in a meaningful fashion and they correctly reflect the opportunity cost and people's evaluation of the services in question[19]. This leads to efficient allocation of resources. It also ensures that the determination of output and resource use are in conformity with the preference of the general public. It should also be pointed out that when the demand for service such as water supply is elastic, the imposition of user charge ensures that the service will not be used excessively or wastefully.

The use of charges also has merit on equity grounds[20]. Except where special circumstances dictate otherwise, usual standard of equity dictates that individuals pay for what they get. In sum, user charges, where possible, could be regarded as more justifiable when:

1. Benefits are primarily direct, so that charges will not cause significant loss of external benefits.
2. Demand has some elasticity, so that the use of charges aids resource allocation and eliminates excessive utilization.
3. Charges do not result in inequities to lower income groups, on the basis of acceptable standards.
4. Cost of collection is relatively low.

19 Richard M. bird (1976). Charging for Public Services: A New Look at an Old Idea. Canadian Tax Foundation, Toronto, Canada.

20 For a detailed discussion on user charges and pricing of services, see Roy Bahl and Johannes Linn: Urban Public Finance in Developing Countries. April 1992, Oxford University press.

In view of the deficiencies that exist in the current practice of pricing public services and the discussion presented above, extensive use of charges for local services would lead to better utilization of resources and the preference of the residents could be clearly identified. This would also permit the balancing of cost against what the residents may be willing to pay for the service.

(b) **Criteria For Pricing Services Through Charges**

In enhancing the scope of charges in financing services it is useful to consider some general principles[21].

1. Services that can be linked to users should be charged at a minimum on the basis of cost recovery.

2. Delinking service charges from rateable value of property could enhance collections and could lead to pricing of services on the principle of cost recovery.

3. There must be clear identification of subsidies so as to provide a degree of discipline in costs.

4. The subsidies should be designed in such a way as to provide benefits to the target populations only.

5. There must be periodic revision of charges to bring them at par with current cost conditions.

6. Proper accounting procedures should be designed so as to ensure that the various elements of costs are taken into account when fixing charges for specific services.

21 Due to the importance of the subject in municipal finance, NIPFP is conducting a comprehensive study on user charges and pricing of municipal services. The study is expected to be completed by end of December 1995.

(c) Municipal Fees and Fines

A municipal fee is collected for a benefit received by thc payer from the municipality either for a particular period of time or for a specific work. The objective of these fees is largely to introduce an element of control and regulation. Examples of such fee in our sampled municipalities are building license fee, license fee for trade, birth and death registration fee, and bus and tax stand fee.

License fees, building permit fees, and various other types of fees and fines that arise within the municipal jurisdiction have not been in line with the existing cost conditions. It is important that the revenue generated from these sources be streamlined. The improvement in the structure of fees and fines will at a minimum require that the municipalities take the following steps.

1. License fee at a minimum should cover the full cost of administration.
2. If the fee is designed to perform a regulatory function, they will have to set at higher levels than that is required to cover the administrative costs.
3. There will have to be substantial improvement in the collection machinery of the municipalities.
4. The exceedingly large number of fees and fines should be reduced to a few selected, such that the cost of collection is minimized, and economies of scale are realized.
5. A system of incentives for agencies that provide the service could be introduced to promote service performance. Such incentives could provide for retention of a fraction of the collections for use by the departments concerned.

Tax Capacity and Revenue Potential

The total revenues realised by municipalities do not reflect the taxable capacity or the revenue potential of urban local bodies. Often, what they collect is significantly lower than the potential. The exercise of estimating the taxable capacity and revenue potential is essential in determining how expenditure needs of municipalities be met and what should be the role of transfers.

Tax capacity can be defined as the amount of tax collection by a municipality if it were to apply a standard tax rate to its existing tax base. The tax capacity of all municipalities is judged by applying the same standard tax rate which could be the average of the tax rate of all municipalities in the state for a particular tax. In the absence of data on specific tax rates and tax base we have resorted to making some projections for the potential of total own revenue from internal sources. This also provides us with a rough estimate of the own revenue capacity of municipalities. However, no effort has been made to estimate tax capacity independent of the non tax sources of municipalities.

Assumptions and Norms Applied

The 293 municipalities in our sample of seven states were first classified into population size classes for each state. For each class of municipality in a state, the municipality with the highest per capita own revenue was taken as the standard for all municipalities in that class in each state. It is assumed that the differences in the tax base of municipalities within each class of a state would be lower than the differences in the tax base of municipalities falling in different classes, across the same class and across the states. The highest per capita own revenue of a municipality within a class is used as a standard for the amount of per capita revenue that could be raised by any municipality in that class. Thus, the difference between the per capita own revenue of each municipality falling in a class and that of the standard per capita own revenue for that class (highest per capita own revenue for that class of municipality)was determined. This provided a rough estimate of the amount of revenue that could be raised by each municipality in the class[22]. There are two important assumptions that must be highlighted.

1. It is assumed that variation in the revenue base of municipalities within each class in a given state is minimal, and

2. That the municipalities would apply the rate that prevails in the municipality with the highest per capita own revenue (used here as a standard municipality). Although municipalities in a class may have the same revenue base it is not necessary that they are applying the same rate of taxes and charges.

Analysis of Revenue Potential of Municipalities

Table 10 presents the estimates of revenue potential of municipalities comprising the sample. Based on these estimates, the potential from own sources of revenue for class A municipalities is Rs. 2,679.3 million, as against Rs. 991.5 million for class B. Rs. 1,464.1

22 Similar methods were used by the Zakaria Committee as one of the ways to arrive at the estimates for expenditure needs of municipalities.

million for class C, and Rs. 7,090.4 million for class D municipalities for a combined total of Rs. 12,225.5 million for all sampled municipalities across the seven states. Figure 3 shows the potential own resources as a percentage of current own revenues of municipalities for the various states.

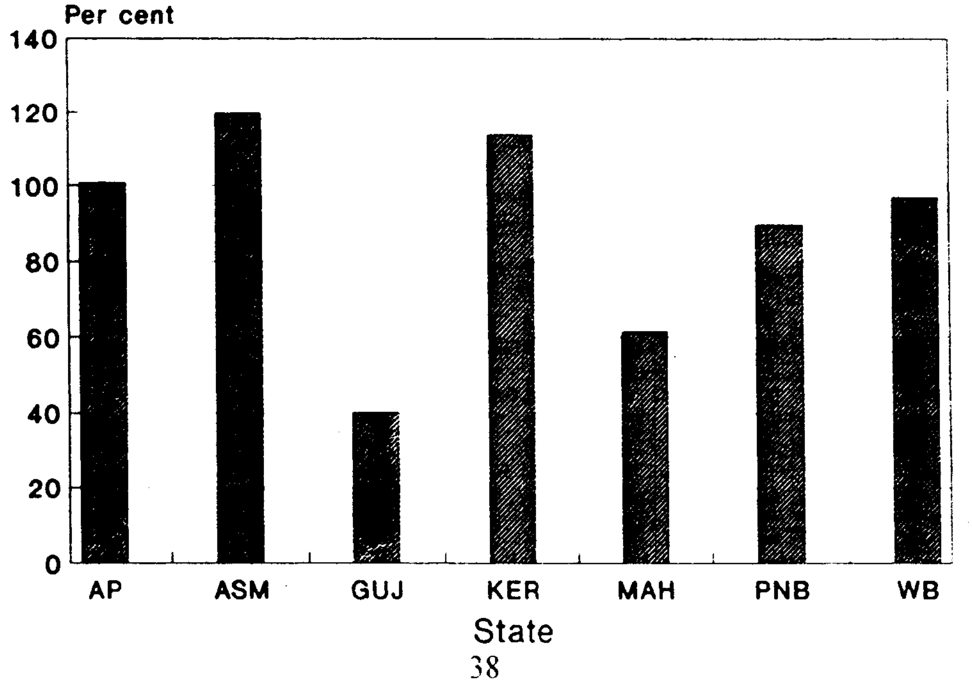
Table - 10
Revenue Generating Potential From Own Sources of Municipalities
Based on the data for 1991-1992 in Rs. Million

Class Size of Municipality	Potential of Own Sources of Revenue of Sampled Municipalities	Per Capita Revenue Potential of Municipalities
Class A	2679.3	284.1
Class B	991.5	112.1
Class C	1464.1	186.9
Class D	7090.4	268.6
All Sampled Municipalities	12225.5	232.9

Source: Computations based on the data supplied by the state governments of sampled states.

Figure 3

Potential Own Resources as a Per cent of Total Own Resources



These figures translate to a per capita potential revenue from own sources of Rs. 284.1 in class A municipalities, Rs. 112.1 for class B, Rs. 186.9 for class C and Rs. 268.6 for class D municipalities. The average for all sampled municipalities works out to Rs. 232.9 per capita. This figure is the potential over and above what is being already collected. The estimated potential revenue turns out to be approximately 61 per cent of the total own resources of the sampled municipalities and about 53 per cent of their total revenues on current account.

The estimates presented show that the municipalities in India have not made efforts to adequately mobilize their revenue potential. If the spirit of the 74th Constitutional ammendment is to be retained, municipalities would have to take steps in this regard and to pull themselves out of the current fiscal crunch. This implies that in the assignment of tax powers and the extent of transfers to urban local bodies, the State Finance Commissions would have to take into account the existing potential of the urban local bodies in order to reduce the burden on states such that there are no adverse effects on states'own resources.

Chapter 3

SHARED TAXES AND THE FINANCES OF MUNICIPALITIES

Shared taxes in states such as Andhra Pradesh and West Bengal form a considerable proportion of the total transfers to urban local bodies. As indicated earlier, entertainment tax, profession tax, stamp duty, and motor vehicle tax form the major shared taxes in the sample states. The share of these taxes in the total revenue receipts of urban local bodies across states varies considerably. They account for 30.2 per cent of the total revenue in Andhra Pradesh and over 27 per cent in West Bengal (table - 11). The importance of these taxes is very low in Maharashtra where it accounts of only 0.5 per cent of the total revenue of the sampled municipalities. There are also wide variation in the methods used for determining the share of urban local bodies from these taxes. In some states, municipalities receive a fixed amount of tax collection based on the average of the last three years collection, prior to the take-over of the tax by the state government. In others, municipalities receive a small fixed percentage of the tax collected.

In terms of the per capita share, the state of Andhra Pradesh (Rs. 43.5) and West Bengal (Rs. 35.5) have the greatest dependence on this source of revenue. The significance of this source for the other states is minimal (table - 12). Municipalities in states such as Maharashtra with their ability to raise substantial revenue from internal sources depend little not only on shared revenues but on transfers as a whole.

Table 11

Shared Revenues as a Percentage of Total Revenue of Sampled Municipalities (1991-1992)

State	Class A	Class B	Class C	Class D	All
Andhra Pradesh	28.0	28.3	31.4	31.3	30.2
Assam	7.7	4.1	-	-	6.9
Maharastra	1.2	0.8	1.6	0.3	0.5
Kerala	5.9	9.6	10.2	21.3	11.1
West Bengal	25.1	27.5	28.4	-	27.3

Source: Compiled from municipal data base, NIPFP.

1. Excise on liquor is the only tax that is shared between the state and local bodies in Punjab. It is however given to the local bodies as a compensatory grant.

2. No information on the breakdown for transfers was available for the state of Gujarat.

Table - 12

Per Capita Receipts From Shared Revenues in Sampled Municipalities 1991-92

State	Class A	Class B	Class C	Class D	All
Andhra Pradesh	40.2	39.6	35.2	54.3	43.5
Assam	4.9	2.4	-	-	4.3
Maharastra	5.5	4.2	7.4	2.8	3.7
Kerala	9.9	14.4	20.0	38.4	18.9
West Bengal	38.3	34.4	35.7	-	35.5

Source: Compiled from municipal data base, NIPFP.

1. Excise on liquor is the only tax that is shared between the state and local bodies in Punjab. It is however given to the local bodies as a compensatory grant.

2. No information on the breakdown for transfers was available for the state of Gujarat.

Urban local governments are listed as a state subject under entry 5 of the 7th schedule of the Constitution. It is the responsibility of the state governments to make these governments a viable form of institution of local government. As discussed in the previous section, urban local bodies are vested with some tax powers but it has also been shown that firstly, these are far from elastic, and secondly, the revenue generated from those taxes are not sufficient to perform the functions delegated to them by the states. It is thus important that the state governments find additional sources of revenue for the municipalities.

One area of the additional source of revenue for the municipalities is the sharing of certain elastic sources of state tax revenues. In light of the 74th Constitutional amendment and the provision of additional functions to be delegated to municipalities, it is important that a better system of revenue sharing between the state and municipalities be worked out so as to strengthen the finances of municipalities. The issue also becomes relevant since there is no Constitutional reservation of the sources of revenue for urban local governments nor is there any mention of sharing mechanism between the states and urban local bodies in the Constitution.

The local governments have inadequate revenues to meet the current demands for services. The result of the inadequacy has meant for the local governments a perpetual fiscal crisis. Given the need for additional services and the resistance to tax increases at the local level, the inevitable tendency has been for the state to provide more and more conditional grants. This has, on the one hand, reduced the fiscal autonomy of local governments and on the other hand, led to the taking over by the state government of functions and tax powers, that legitimately belong to the lower levels of governments.

Tax base and/or a revenue sharing mechanism are frequently used to deal with fiscal imbalances - mismatch of revenue means and expenditure needs arising from the assignment of taxes and expenditures to local governments. The tax base sharing refers to two or more levels of government levying own rates on a common base. The tax base determination usually rests with the higher level of government and the lower level of governments piggyback rates on the same base. The tax is generally collected by the higher level of government and lower levels of government share the proceeds from these taxes.

A second alternative to address the question of fiscal imbalance is to structure some type of revenue sharing mechanism from the revenues of the state. This provides an access to a predetermined share of revenue collected by the state or revenue from selected state-level taxes. As will be discussed in the concluding Chapter, the use of only sharing machenism for correcting fiscal imbalances may not be a viable solution and that these imbalances are better addressed by grants. The sharing machenism should be designed to address the issue of revenue inelasticity and to a limited extent the issue of imbalances.

Principles Governing Sharing of Taxes

Any system of transfer, be it the sharing of taxes or grants, should be designed in such a way as to lead to a fully transparent system of intergovernmental finance in which all levels of governments are aware of the rules of revenue sharing and thus understand their entitlements and obligations under the system. It has been argued that it is much more difficult to design an equitable and efficient tax system at the local level than at the higher levels of government[23]. This would imply that both equity and efficiency characteristics of the local tax system can be enhanced by shifting more of the taxation functions onto the state governments. One way to accomplish this would be through the mechanism of revenue sharing. The principle of shared revenue requires that some proportion of the tax collected in municipal jurisdiction be returned to the local government. In doing so, many states have followed the derivation principle of revenue sharing[24]. However, the mechanism whereby shared taxes are distributed on the principle of origin (full derivation based system), can result in wide disparities in fiscal capacity and presumably in the public service levels[25].

The higher level of government may share a tax that it imposes and administers on the basis of geographical origin of revenue. This would tend to increase the fiscal capacity of local governments by giving them access to revenue from taxes not in their domain. However, this method does not address the problem of unequal fiscal capacity. It does not meet the argument that governments are less cautious about the use of taxes they do not themselves impose. While this method of revenue sharing reduces duplication of tax administration and compliance, it fails to address the problem of allocation.

To meet the problem of variation in revenue requirements and the usual refrain that governments are less cautious in the use of revenues from taxes they do not impose, a surcharge on a tax source may be used in lieu of tax sharing. The state would collect, along

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23 See Wallace E. oats: "The Role of Intergovernmental Grants in the U.S. Economy with Special Attention to Countercyclical Policy" in Wallace E. Oats: Studies in Fiscal Federalism.

24 See Roy Bahl and Johannes Linn (1992); Urban Public Finance in Developing Countries; Oxford University Press, New York.

25 See Roy Bahl and S. Wallace: Revenue Sharing in Russia, Government and Policy, Vol. 12 p. 293-307.

with its own levy, a surcharge imposed by the local government. A number of states employ this technique in case of registration and stamp duty. However, the surcharge being a fixed percentage does not allow for diversity in rates among local governments within the state. The one major advantage of this system like tax sharing is that it is based on the origin of the revenue. It also avoids duplication of administration and compliance and ensures uniformity of the base of the tax. This system works best when the rate of the surcharge is low and it is applied universally so as to avoid tax competition. The greatest disadvantage of this method is that it does very little to meet the problem of unequal fiscal resources.

In general, the analysis of the data from the seven sampled states shows that the sharing mechanism fails to take into account the stakes of municipalities in determining the devolution from the states. Many of the taxes shared between the states and urban local bodies seem to fit the definition of local taxes. Thus, they should in the first place be within the fiscal domain of municipalities. Such taxes include entertainment tax and profession tax. It is claimed that entertainment tax is a purely local tax on the ground that bulk of the tax is paid by local residents. In the past, several states argued that since a part of this tax is paid by the floating population the state has the right over this tax. However, this argument of the states does not hold much validity since the floating population also uses the services of the local area for which it does not pay in the form of taxes or charges. Similar arguments could be forwarded in support of profession tax which in all respects is a local tax.

The argument presented in favour of entertainment tax and profession tax as local taxes does not apply to the case of motor vehicle tax. Much of the expenditure on roads is incurred by the states and thus they have a justifiable claim to a larger part of the tax revenue from this source. It should however, be pointed out that since a significant proportion of the trade and economic activity in the country is carried on within the jurisdiction of municipalities, they could rightfully claim a share in the revenue generated by motor vehicle tax as a return on the use of their roads by vehicles engaged in such activity.

The sharing of taxes with local bodies if made more systematic and transparent could reduce their dependence on grants. However, such revenues would not provide any direct relationship between the receiving municipality and its residents. Thus, they would fail to meet the test of accountability. Since these would be revenues transferred from the state taxes and distributed on some predetermined basis, they would not in principle be any different from grants. However, if shared taxes remain a stable proportion of state taxes, they would have the advantage of providing municipalities with a degree of predictability and elasticity necessary for efficient implementation of their expenditure plans. It would also enhance the autonomy of local governments if no conditions are attached to the transfers.

Transfers in the form of shared taxes have their limitations depending on the principle used for horizontal transfer. If they are allocated on the basis of origin, they induce a sense of revenue elasticity, but they are not equalizing, and run counter to the goal of reducing inter-municipal disparities in fiscal capacities[26].

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26 See David R. Morgan and Michael Hirlinger; The Dependent City and Intergovernmental Aid: The Impact of Recent Changes; Urban Affairs Quarterly, Vol.29, No.2, December 1993.

In the light of the 74th Constitutional Amendment, it is clear that the states will, in all likelihood decentralize some of their functions and powers. In such a case it would be appropriate that the states guarantee to the local governments a share of the locally generated revenue going into the state treasury. The states may also agree to collect and share some of the local taxes on the ground that the local governments do not have the administrative capacity or the political will to carry out the collections.

Criteria For Sharing of Taxes

The criteria for sharing of taxes should be consistent with the objective of strengthening the finances of municipalities. This being the objective, the sharing mechanism would have to be designed to correct the municipal fiscal gap and would be a much needed elastic source of revenue to the urban local bodies. With this in mind, the following set of criteria are suggested.

1. Taxes such as motor vehicle tax and advertisement tax which are fairly elastic should be serious candidates for sharing. Additional taxes such as sales tax should also be considered for sharing even though they have, in the past, never been a part of the shared taxes.

2. Taxes such as entertainment tax and profession tax which are currently being shared between the states and municipalities may be assigned to the municipalities as local taxes. These taxes do not qualify for sharing since they are by their character local in nature and should fall within the domain of municipalities own taxes.

3. The share of local bodies in these taxes should be based on the expenditure needs of the community.

4. The share of the urban local bodies should be dependent on a formula which would take into account some measure of standard road units in the municipalitiy.

5. The collection of motor vehiles tax should be delegated to that level of government that can best do the job. Most shared taxes have the tendency of being collected efficiently at the state level.

6. The interest of the municipalities is best served if the distribution of the shared taxes between the states and the urban local bodies is determined on a percentage basis rather than fixed amounts.

In practice, this would involve two different formulas for the transfer mechanism to be operational. The first, would be applicable for the determination of the divisible pool and the second, for distribution of the divisible pool to the different urban local bodies.

Sharing of Motor Vehicles Tax

Within the class of taxes that are currently shared between the states and urban local bodies, the motor vehicles tax has the reputation of being most inequitable to the municipalities. This tax is very elastic and it has the advantage of increasing with the growth of the economy. Motor vehicles tax was, in fact, a local tax in several states but was taken over by the states on the ground of low collection record of municipalities. The states now pay a certain fixed amount to municipalities as a compensation for the loss of revenue from this source. In Andhra Pradesh, municipalities receive a sum of about Rs. 45 lakhs as compensation for motor vehicles tax. The state, at the time of provincialising this tax gave the municipalities a sum of Rs.16 lakhs which was equal to the average of the three year collection by the municipalities at that period of time. Subsequently, the state increased the share of the municipalities to Rs. 45 lakhs. In the meantime however, the revenue generated from this source to the state of Andhra Pradesh has crossed the Rs. 200 crores mark. The municipalities however, still continue to receive Rs.45 lakhs. There is a clear cut evidence that even though, the motor vehicles tax continues to be shared between the states and the municipalities, the benefit of the increased yield from this tax is not being shared with the municipalities.

Needless to say, it is important to point out that such schemes of sharing have put severe strain on the finances of local bodies and are not in tune with the realities of the present scenario in which municipalities are expected to function. Although, on theoretical ground there is strong support for this tax to continue to be within the state domain, there are very valid arguments for streamlining the methods for sharing this tax with the municipalities. Thus, it cannot be argued that the entire proceeds of this tax be transferred to the municipalities. It should also be pointed out that the case for retaining this tax as the state tax becomes stronger as state agencies like the PWD spend far more than the municipalities on the maintenance of the roads.

As far as the motor vehicles tax is concerned the share being paid to local bodies cannot be based on the average of the actual collection figures for the three years proceeding its takeover by the state. It should be based on the a percentage of the total yield from this source. This pool of funds can then be actually distributed to the municipalities on the basis of either the per capita incidence multiplied by the population of the municipality or a formulae that would take into consideration the total population of the municipality, the total length and type of roads maintained, and the volume of traffic in the municipal area. Specific suggestions in this respect are made in the final chapter of this report.

The share of the motor vehicle tax forming the divisible pool will depend on the fiscal condition of municipalities and the extent to which the state is willing to assign to the municipalities additional tax powers. The share can vary between 10 to 25 per cent of the total receipt from this tax. It is important to note that if the pool of funds from the motor vehicle tax is distributed on the basis of origin, it will more likely increase the already existing fiscal disparity.

Chapter 4

STATE GRANTS TO URBAN LOCAL BODIES

Grants-in-aid have a special role in the finances of urban local bodies. Although, they are only one component of a large spectrum of financial relationship that bind the states and municipalities, their design and distribution can have far reaching implications for the finances of municipalities. The system of giving grants-in-aid to municipalities has evolved out of necessity. In fact, the principle that grants -in-aid should form an important source of revenue of municipalities has been accepted all over the world. It is estimated that in the USA, grants-in-aid constitute about 40 per cent of the total receipts of local authorities.

Over the last twenty years, the design of grants to municipalities has been a subject matter of close scrutiny[27]. The Committee of Ministers constituted by the Central Council of Local Self governments in its report entitled "Augmentation of Financial Resources of Urban Local Bodies" considered grants to local bodies to be necessary for various reasons. In the opinion of the committee, grants provided to local authorities are a sound basis for administration and planning of their activities. They assured balanced growth among local units by providing a uniform minimum standard of service to all the people regardless of the financial condition of local governments. They could also be used as an instrument to encourage and streamline certain policies and programmes which are considered desirable in

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27 In July 1969, the state of Gujarat set up the grant-in-aid committee for municipalities and municipal corporation to look into the matters related to design of grants. The government of Kerala had appointed an official committee in March 1963, to conduct a probe into the various aspects of connected with the question of municipal grants and to evolve general principles to be adopted in this behalf.

the larger state and national interests.

The amount of grants received by all municipalities from a sample of 293 municipalities across seven states during the year 1991-1992 amounted to Rs. 1749 million. Out of this, the amounts received by municipalities of various class size are presented on table-13. The information presented on the table provides a picture of the distribution of grants to municipalities. It is seen that 50 per cent of the total grants distributed to urban local bodies are accounted for by municipalities with a population of over five lakhs. The remaining 50 per cent is more or less distributed equally between the A, B, and C class municipalities.

Table - 13

Distribution of grant to Urban Local Bodies for 1991-1992

Municipality Class	Sample Size	Population Size	Rupees Millions	% of total grants
A Class	190	Less than 100,000	310.8	17.8
B Class	64	100,000 - 200,000	263.2	15.0
C Class	24	200,000 - 500,000	308.9	17.6
D Class	15	More than 500,000	867.0	49.6
Sample Total	293	All	1749.0	100.0

Source : NIPFP calculations based on data furnished by municipalities.

Note : Data on grants does not include grants for implementing centrally sponsored schemes.

Multiplicity of Grant to Urban Local Bodies

Another striking feature of the design of grants-in-aid to local bodies across all states in our sample is the prevalence of a large number of heads under which grants are made (table-14). Under such circumstances it is fair to assume that the cost of administering the grants in many cases would far exceed the benefits derived from them since the amount of grant under various heads is very small. Most of these grants can be discontinued without adversely affecting the finances of municipalities, while on the other hand the system of grants to local bodies could become simpler and uncluttered.

Grants-in-aid form a relatively significant proportion of the total revenue of municipalities in the sample states. In West Bengal grants account for over 30 percent of the total revenue of municipalities. There is however, a sharp variation in the share of grants in total revenues across states ranging from a low of 3.4 per cent in Kerala to a high of 30.8 percent in West Bengal (table - 15). Variations also exist across different size class of municipalities but their intensity is much lower compared to the variations across states. With the exception of Punjab and Kerala, there is a tendency for the share of grants in total revenue to fall as the size of municipality increases. Thus, smaller municipalities exhibit lower shares compared to larger municipalities.

Table - 14

Statement Showing Multiplicity of Grants to Urban local Bodies

No	Name of the Grant	Gujarat	Maharastra	Kerala
1	Basic per capita general purpose grant	X		X
2	Grant in aid from Non-Agricultural Assessment	X	X	
3	Grant in aid from land revenue	X	X	
4	Grant in aid from entertainment tax			
5	Grant in aid from Education Cess	X		
6	Grant in aid from water supply and drainage	X	X	X
7	Grant in aid for primary education	X	X	
8	Grant in aid for maintenance and repairs of roads	X	X	
9	Grant in aid towards expenditure on dearness allowance.	X	X	X
10	Grant in aid for maintenance of dispensaries and hospitals	X	X	X
11	Grant in aid for maternity homes and maternity hospitals.	X	X	
12	Grant in aid for maintenance of maternity homes and child welfare centres.	X		X
13	Grant in aid for building and equipment for dispensaries and hospitals, maternity homes and hospitals and maternity and child welfare centres, etc.	X	X	
14	Grant in aid for appointment of health officers and sanitary inspectors.	X	X	
15	Grant in aid for anti-epidemic measures	X	X	
16	Grant in for vaccination	X		
17	Grant in aid for anti-leprosy works	X		
18	Grant in aid for mosquito control	X		X
19	Grant in aid for triple vaccine	X		
20	Grant in aid for municipalities for purchase of wheel barrows, carts, replacements for carrying night soil as head load.	X		
21	Grant in aid for construction of quarters for conservancy staff.	X	X	

Cont'd.

No	Name of the Grant	Gujarat	Maharastra	Kerala
22	Grant in aid for secondary education	X		
23	Grant in aid under motor vehicles act	X	X	
24	Grant in aid for administration of cattle pounds			
25	Grant in aid under public conveyance act	X		
26	Grant in aid under shops and establishment act	X		
27	Grant in aid from fines in cases under municipal and other acts tried by magistrates.	X		
28	Grant in aid under poison act			
29	Grants for colleges			
30	Grant for public library			
31	Grants for population census			
32	Grants for cattle census			
33	Grants for maintenance of gardens			
34	Grants for Balashrams			
35	Grants for open air theatres			
36-49	Grants for other miscellaneous works			
50	Grants for development plans			
51	Grants for bridge construction		X	
52	Grants for town improvement works or schemes such as improvement of roads, drains, construction of urinals etc.			X
53	Grants for conversion of dry latrines into flush latrines and for providing public latrines			X
54	Grants for family planning centres	X	X	X
55	Grants for poor homes, beggar homes or relief centres			X
56	Grants for maintaining public free ferry system			X
57	Grants for town planning and survey.			X
58	Grants for maintaining fire fighting services and grants on account of slum clearance.		X	

Table - 15

Share of Grants-in-Aid to total revenue for sample municipalities for the year 1991-1992 (Per Cent)

State	Class A	Class B	Class C	Class D	All
Andhra Pradesh	18.5	13.3	13.4	6.8	11.2
Assam	8.8	4.1	-	-	7.8
Gujarat	15.7	11.7	13.5	10.1	11.0
Kerala	3.6	3.1	3.6	3.0	3.4
Maharastra	27.7	26.1	13.5	2.8	4.9
Punjab	10.5	10.1	9.5	10.1	10.2
West Bengal	38.8	34.6	24.4	-	30.8

Note: Grants as listed in the above table do not include grants for implementing centrally sponsored schemes.

In terms of per capita grants, A class municipalities tend to receive on an average more than the municipalities in class size B, C or D (table - 16). Municipalities in Gujarat are the only exception to this rule.

Table - 16

Per capita Grants-in-Aid in sample municipalities for the year 1991-1992

State	Class A	Class B	Class C	Class D	All
Andhra Pradesh	26.5	18.6	15.0	11.8	16.1
Assam	5.5	2.5	-	-	4.8
Gujarat	36.9	35.4	52.7	66.1	54.8
Kerala	6.1	4.6	7.0	5.4	5.9
Maharastra	126.3	133.5	64.2	26.1	39.6
Punjab	30.4	26.6	30.0	29.3	29.2
West Bengal	47.1	43.3	30.8	-	40.1

The two tables above provide an aggregate picture of the importance of grants in total revenue in sample municipalities. There are three features of the grant-in-aid that need to be noted.

1. that the share of grants to total revenue is greater in smaller municipalities than in larger municipalities. This could however, be due to lack of a strong resource base of smaller municipalities and thus their inability to raise sufficient revenue from own sources.

2. that the per capita grant in smaller municipalities is higher than that in larger municipalities. This would tend to imply that the design of the grants-in-aid is guided in the case of sampled municipalities by a system that has tended to reduce (if not equalise) the size class differences in total per capita revenues.

3. the number of accounts\heads on which grants-in-aid is made is extremely large. There are over 60 different heads under which grants are given to municipalities. This multiplicity of system involving grants which are general purpose and others that are specific purpose, ultimately tend to be cumbersome and complex in nature.

These findings are consistent with the accepted view that smaller municipalities which also tend to be generally poor in resources should receive larger share of grants from the states and that in per capita terms their share should be higher. Thus, a casual observer might be inclined to accept the view that there are essentially no problems in the design of grants and that they are adequately performing the task of bringing about a horizontal balance in the finances of municipalities.

The aggregate figures, however fail to put forth the reality of the system of grants as it prevails today. They tend to underestimate the real problem in the system of grants. Since the class sizes in themselves are quite large one would expect large variation within each class of municipality.

Equalizing Features of Intergovernmental Grants

One way of measuring the efficiency of the allocation of grants from states to municipalities is to analyse the relationship between per capita grants accruing to each municipality and the per capita level of revenues raised from own sources. Grants, it is argued, should either equalise the service levels, or the income levels. Personal income data for individual municipalities are not available. It is possible, however, to examine the degree to which grants reduce the inter-municipal disparity in per capita revenues raised from internal sources. If the distribution of grants among municipalities is intended to be expenditure equalising, there should be a negative relationship between grants and revenues raised from internal sources.

In order to understand this equalizing feature of grants in the sample states more fully, an analysis at the level of municipality is necessary. For this purpose, we focus on the per capita own resources of municipalities and the per capita grants made to municipalities. Here, we try to relate the per capita grant with per capita own resource of municipalities. The per capita grant, and per capita own resources were calculated for each municipality for the year 1991-92. Municipalities were then classified in two ways: (1) according to the per capita own resources, i.e whether these were above or below average for the municipalities of the sample states as a whole, and (2) as to whether their per capita grants were above or below the average for the municipalities of the sample state as a whole. For each municipality, average per capita own resources and average per capita grants were calculated and the difference was taken between each of these values and the average for municipalities of the sample states (deviation from the mean).

Figure 4 plots the difference from the mean per capita grant and the mean per capita own revenue for each municipality for all states (241 municipalities; of the 293 municipalities only 241 contained usable data). As per capita grants are measured on the vertical axis, any observation falling to the right of the midway point on the horizontal axis indicates above average per capita own resources and any observation falling above the midway point on the vertical axis indicates above average per capita grants. The same graph has been reproduced for each state in our sample and is included in the state-wise analysis presented in Annexure A.

A majority of the municipalities in our sample (154 out of 241) have below average per capita own revenues; compared to these, 74 municipalities have above average per capita own revenues. It is interesting to note that 153 municipalities receive below average per capita grants compared to 75 municipalities that receive above average per capita grant.

Figure 4

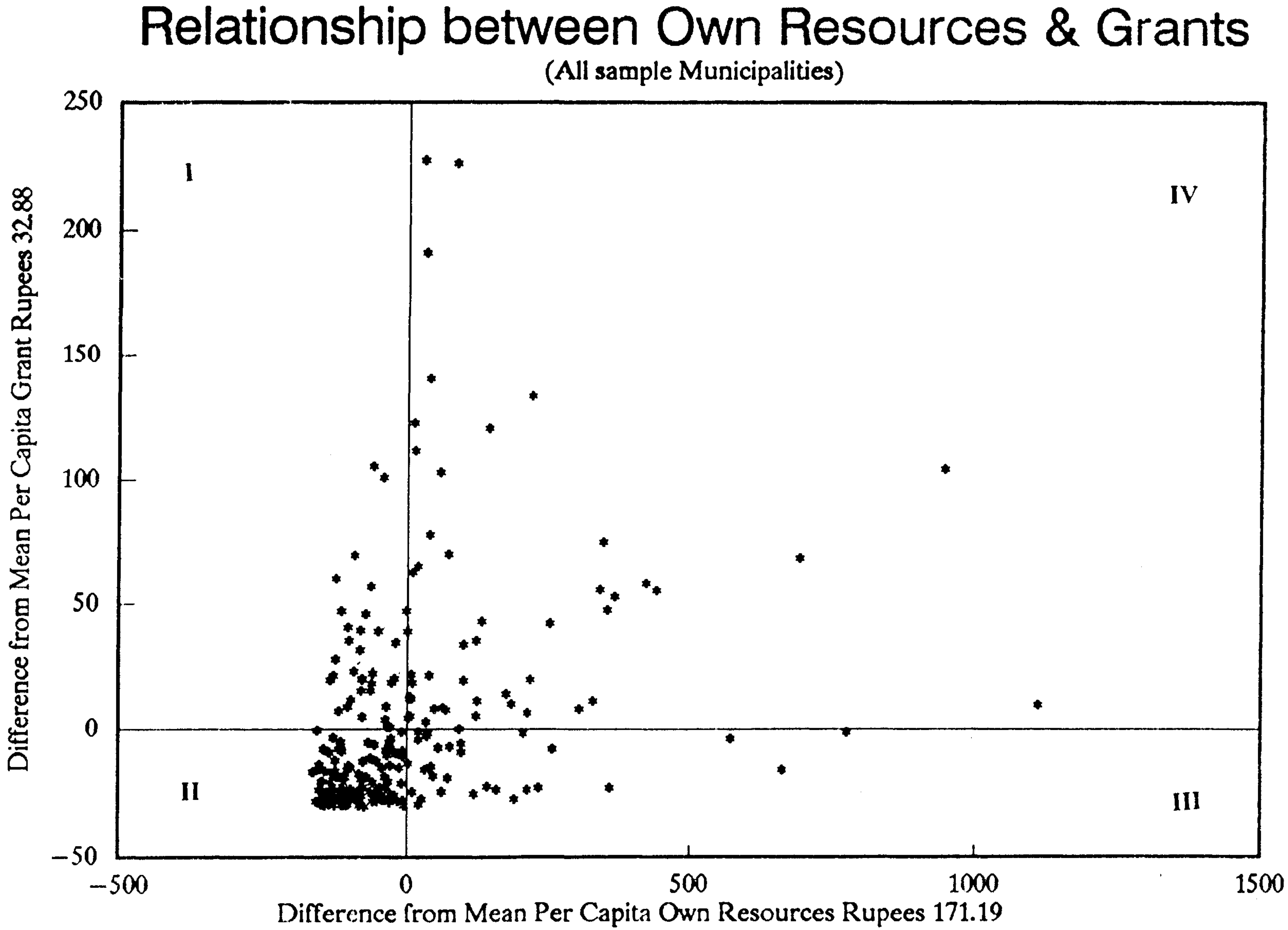
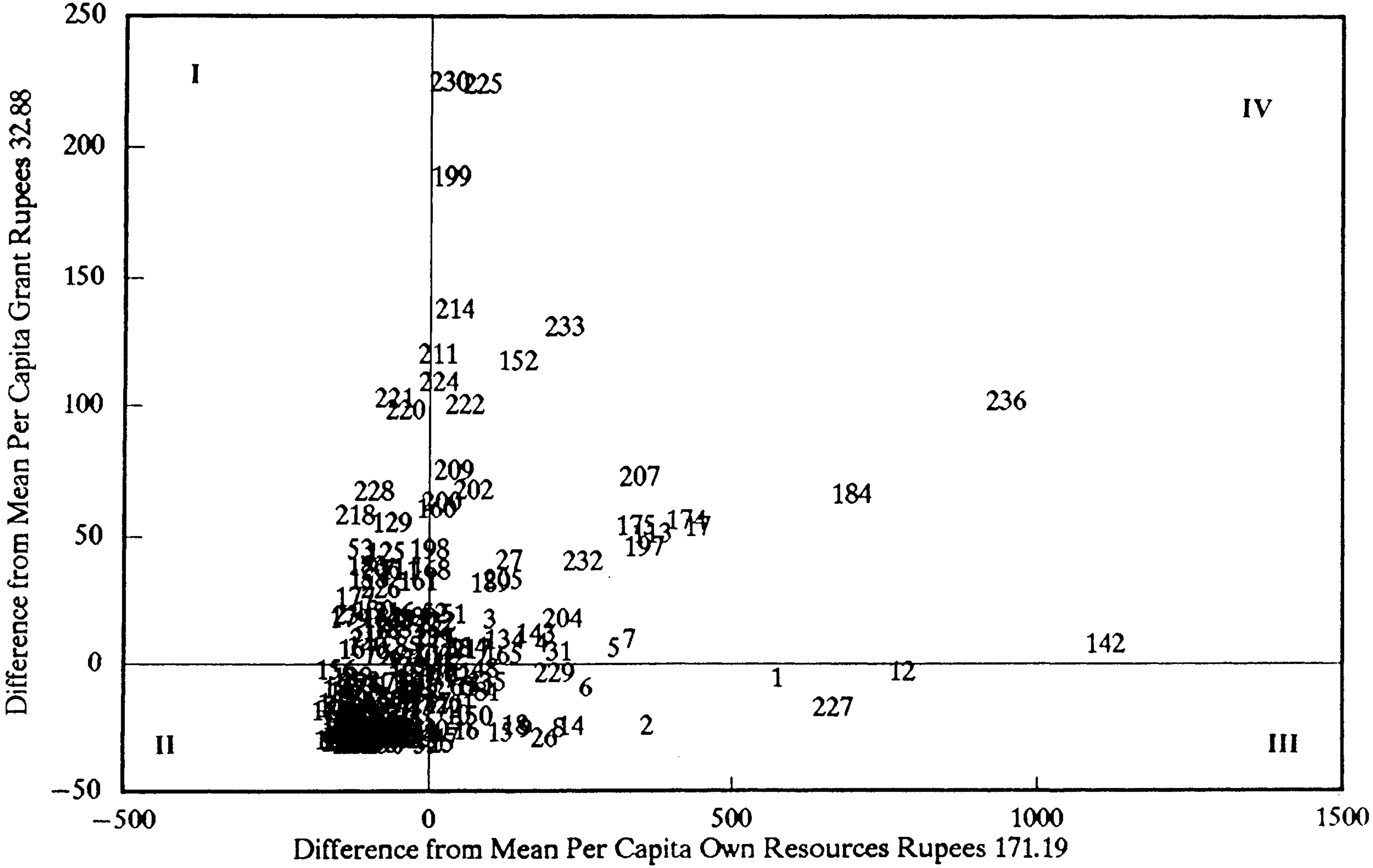

Relationship between Own Resources & Grants
(All sample Municipalities)
250
200
150
100
50
0
−50
−500
0
500
1000
1500
I
II
III
IV
Difference from Mean Per Capita Grant Rupees 32.88
Difference from Mean Per Capita Own Resources Rupees 171.19

Figure 5

Relationship between Own Resources & Grants

By size of Deficit (All sample Municipalities)

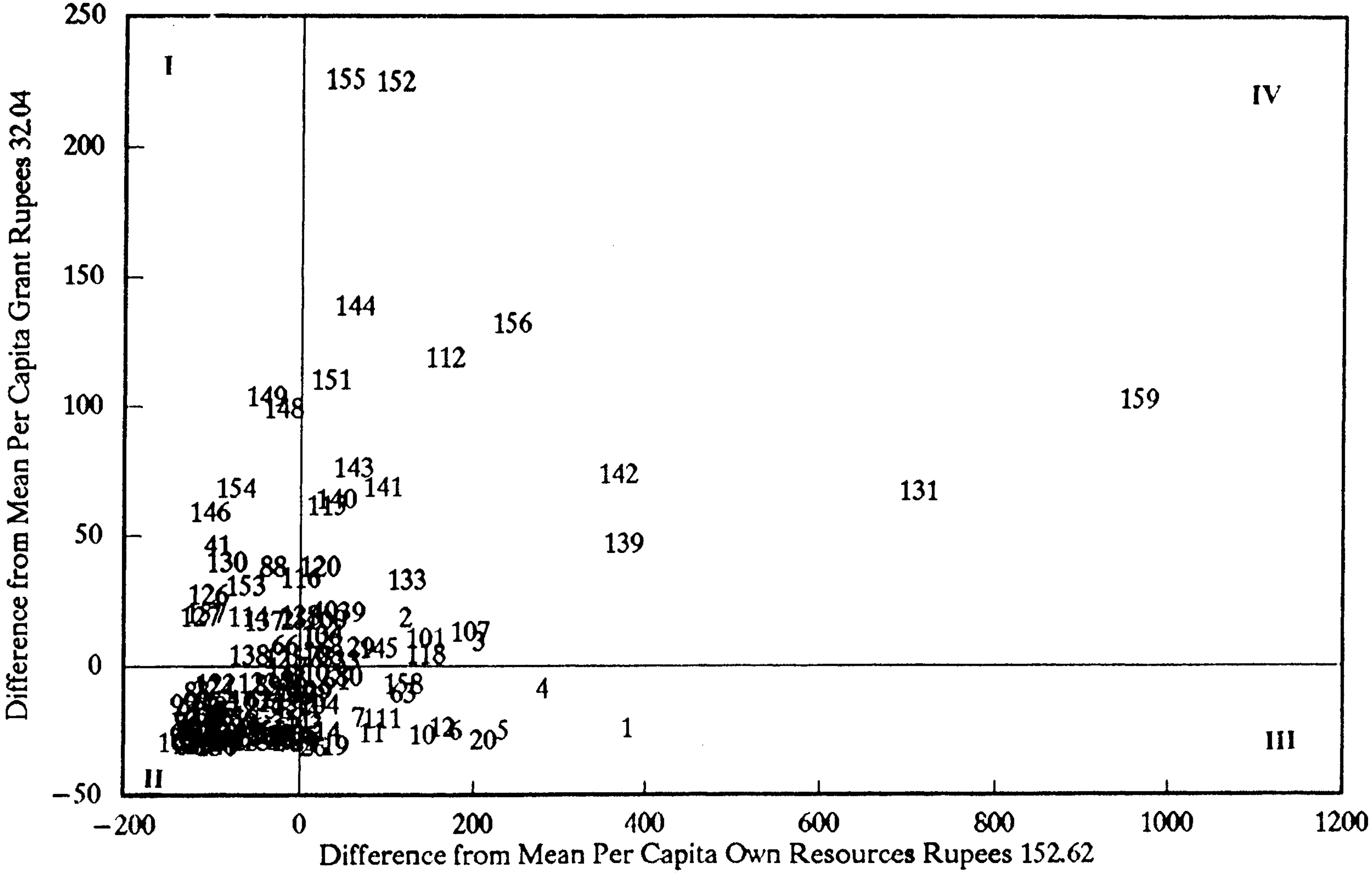


Note : Rank 72 and onwards shows Deficit Municipalities

Figure 6

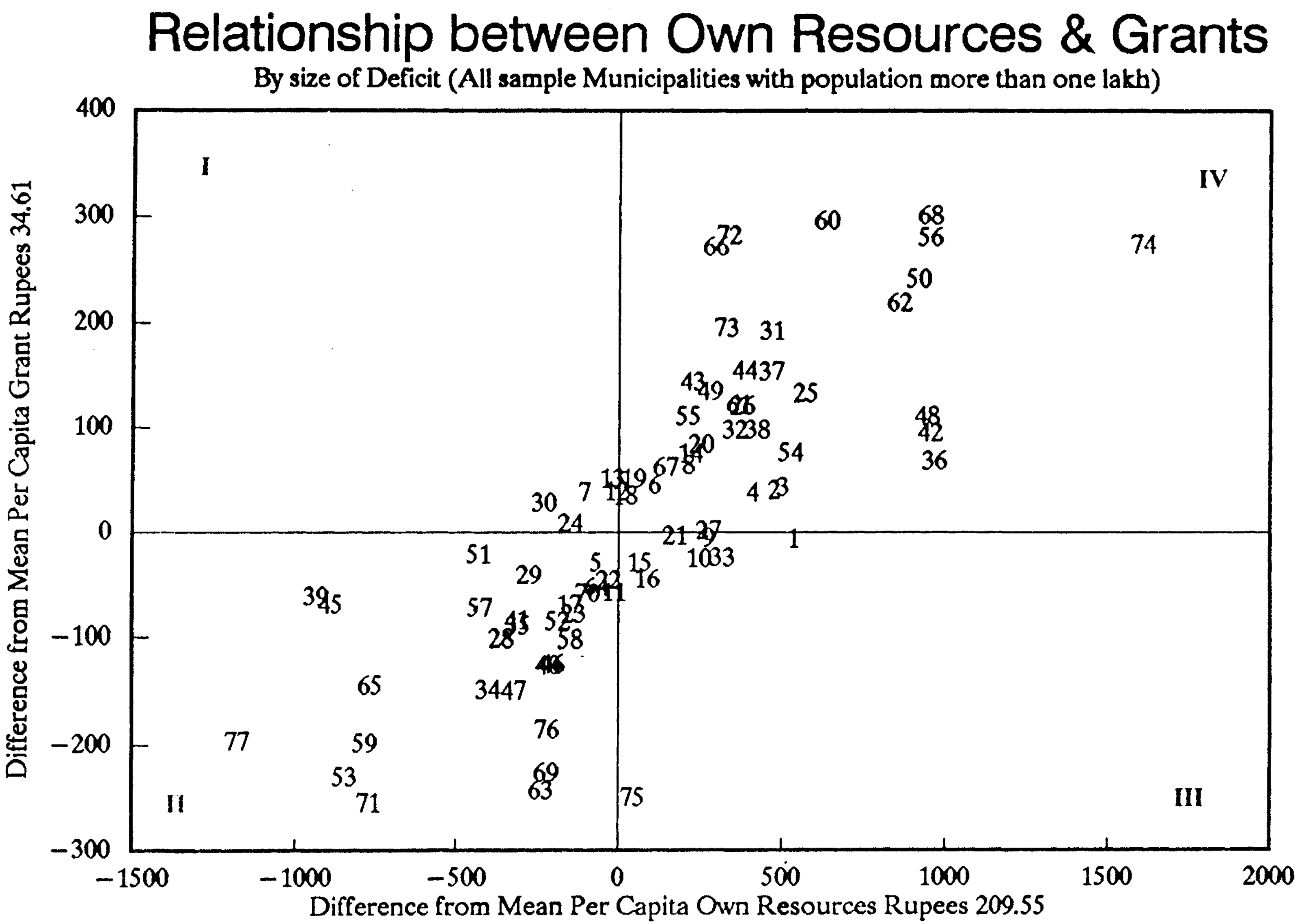
Relationship between Own Resources & Grants

By size of Deficit (All sample Municipalities with population less than one lakh)



Note : Rank 59 and onwards shows Deficit Municipalities

Figure 7



Note : Rank 14 and onwards shows Deficit Municipalities

Several inferences can be drawn from this figure which provides an overview of the relationship between per capita own resources and per capita grants. Four different scenarios emerge from the analysis. These are represented by the four blocks of the figure.

Block I: represents those municipalities that have below average per capita own revenue and receive above average grant from their respective state governments (31 municipalities).

Block II: represents those municipalities that have below average per capita own revenue and receive below average per capita grant from their respective state governments (123 municipalities).

Block III: represents those municipalities that have above average per capita own revenue and receive below average per capita grant from their respective state governments (30 municipalities), and

Block IV: represents those municipalities that have above average per capita own revenue and receive above average per capita grant from their respective state governments (48 municipalities).

Based on a thorough examination of the existing literature on municipal finance and the information furnished by the state and local bodies. grants in most states are expected to be distributed on a formula or on principles that should take into account the following information on urban local bodies.

1. The population of the municipality.
2. The resource base of the municipality.
3. The current revenue gap (expenditure - own revenues) and.
4. The tax effort of the municipality.

A casual look at Figure 4 shows that block II has the highest concentration of municipalities among the four blocks. If the objective of the grant is to bring about a balance and to compensate for lower per capita own resources of urban local bodies as is argued in the literature as being one of the objectives of grants, then these municipalities should be receiving above average grants from the state governments. Thus, they should all fall in block I of the figure. The implication is clear that those municipalities that have below average per capita own revenues are being penalised and the states are voilating the general principle of grant distribution.

Below average per capita own resources can result from one of the two reasons. First, a municipality may have a very low resource base of its own. Second, it may be inefficient in exploiting its resource base. It would then be appropriate for the states to reduce the grant if the municipality is not making efforts to exploit its sources of revenues. In our analysis however. we find evidence to the contrary. A large number of municipalities that fall in block-I have shown improvements in their tax effort but a corresponding improvement has not taken place in terms of receiving grants from the states[28]. Again, it seems that the principle on which states are supposed to distribute grants seem to have been violated.

Further analysis was conducted to get some insights from the resource gap position of municipalities that fall in block-II of our figure. Since one of the factors for the distribution of grants to urban local bodies is the level of current deficit, we would expect that on an average municipalities in block-I should have lower deficit since they receive below average per capita grants. Figure 5 shows the placement of individual municipalities with respect to the level of current deficits (per capita own sources- per capita expenditure). Each municipality shown in Figure 4 is ranked in terms of the level of the current deficit. Those municipalities that receive a rank of 72 or more have shown current account deficits. The rank assigned increases as the deficit becomes larger. Those municipalities that are assigned a rank of less than 72 have shown surplus on their current account. Thus, the municipality ranked number 1 would have the largest current account surplus.

It is evident from Figure 5 that the system of grant distribution does not follow any pattern at all. It is seen that a number of municipalities that fall in block-IV of Figure 5 have large surpluses (municipalities ranked 4,6,8,28,32,52, etc). These are municipalities that raise above average per capita own revenues but also receive above average per capita grants. These municipalities have the resources necessary to finance much of their expenditure through own

28 As the available municipal data are inadequate for the calculation of tax effort by the municipalities, we have resorted to indirect measure of tax effort. Assuming that within a period of two years the tax base of the municipalities would not change dramatically except in a few isolated cases, we have used the growth in tax revenues between 1990-91 and 1991-92 as an indicator of the tax effort of the municipalities.

sources of revenue. Thus, the fact that they receive above average per capita grants is a questionable policy and a clear indication of the flaws in the current system of grant distribution. On the other hand, a large number of municipalities with large current deficits fall in block II of the figure. These municipalities are poorer in terms of per capita own resources and are unable to finance even half of their expenditure from their own sources of revenue. These municipalities have however, continued to receive below average per capita grants from the states.

If bringing about a horizontal balance in the finances of municipalities using the strategy of gap filling is the policy in the distribution of grants to municipalities, then on that account the evidence presented does not support the hypothesis. It is clear that there are major lapses in the implementation of grant policy. Contrary to expectations, the analysis provides support to a theory that the larger the size of the current deficit the greater is the likelihood for municipalities to receive below average per capita grants. This is particularly true for the smaller municipalities across all states (refer to Figures 6 & 7). When municipalities are classified by the size of population, it is found that for those municipalities that have a population of less than one lakh, the pattern is almost identical to that of Figure 4 (total sample). However, an interesting pattern emerges for municipalities that have a population of more than one lakh. Figure 7 shows this pattern. It is interesting to note that all the municipalities fall in only two blocks of the figure. Ideally one would expect them to fall in block-I and block-III; instead they are concentrated in block-II and block-IV.

The ad-hoc nature of the grant distribution policy of state governments is also evident from the fact that municipalities having per capita own sources of revenues close to the average of all municipalities in the sample receive varying of per capita grants ranging from Rs.35 below the average to a high of Rs. 220 above average (notice the observations that fall close to the vertical line dividing Figure 4 and Figure 5). Such variations are found in all the four blocks of the graph. Thus, it seems clear that the state governments have either failed to take into account the rules on which grants should be distributed or that no set of rules is being currently followed by states and grants are just random in nature. Given the distribution of municipalities as shown on the graph it seems more likely that grants have over time acquired a large degree of randomness, and no clear cut policy statement seems to emerge from the relationship that we have tried to establish. Several important findings that emerge from the analysis are highlighted below.

1. In general, municipalities with per capita own revenues below the average for the sample as a whole, also receive below average grants. If the objective of grants is to bring about a horizontal balance and to compensate for the lower per capita own revenues of urban local bodies, then the system of grants as currently practised seem to have failed in its objective.

2. Municipalities with below average per capita own resources and receiving below average per capita grants, have made efforts to enhance their revenues but a corresponding improvement has not taken place in terms of receiving grant from the states. Again it seems that the principle on which grants are based seemed to be nebulous.

3. There is no evidence to suggest that the system of grants takes into account the principle of gap in the allocation of grants to local bodies. Contrary to expectations, there is evidence to suggest that larger the size of the per capita deficit the greater is the likelihood for municipalities to receive lower than average grants.

4. The disparities and violations of the general principles of grants are much more pronounced in case of municipalities which have a population of less than one lakh compared to those with populations of more than one lakh.

5. From the evidence presented it is clear that grants are not only non-equalizing but they have the tendency of being counterequalizing. In general, there is no effective guiding rationale in the distribution of state government grants to urban local bodies.

Measures of Variation in per Capita Grants

As a part of our analysis, we attempt to explain the interstate and within State variation in grants to municipalities. Our investigation is focused on finding clues as to why some municipalities receive more grants than others as also to the reasons and principles on which these variations are justifiable.

We find that wide dispersions exist about the mean which are evidenced by the range of per capita grants as shown in row 1 and 2 of table - 17. Comparison across states shows that the municipality with the highest per capita grant in Maharashtra receives on an average more than nine times as much for each of its citizens as compared to the State of Assam which receives only Rs.24.78 as the highest per capita grant for any sampled municipality in the state.

Table - 17

Measures of Variation in Per Capita Grant to Municipalities 1991-92

Measures	AP	ASS	GUJ	KER	MAHA	PUN	WB	ALL
Highest	99.72	24.78	150.0	50.15	257.13	-	90.17	257.13
Lowest	0.17	0.39	1.73	0.30	7.29	-	0.09	0.09
Mean	21.44	5.68	38.30	9.21	96.70	-	33.57	32.65
St.Dev	28.83	5.62	27.08	9.39	66.59	-	22.38	42.00
Coef. Var.	134.4	98.98	70.77	101.9	68.86	-	66.67	128.64

Source: Computed from information contained in municipal data base, NIPFP.

In order to compare the amount of variation in grants the coefficient of variation was computed[29]. This measure is presented for municipalities in each state in the last row. Comparison across states shows that the coefficient was lowest in case of West Bengal (66.67) followed by Maharastra (68.86) and Gujarat (70.77). The states of Andhra Pradesh and Kerala show the highest variation in per capita grants.

It is also noted that for each state examined above, the variation was greater in case of grants than for any other revenue category that was examined. It would be interesting to examine whether this is due to a large random component for grants, or whether this larger

[29] The coefficient of variation is derived by dividing a measure of absolute dispersion by a measure of central tendency. The coefficient of variation used here is the standard deviation divided by the arithmetic mean

variation can be explained by some systematic variables. Two observations stand out in the analysis of the measures of variation.

1. Municipality with the highest per capita grant in Maharashtra receives on an average more than nine times as much for each of its citizens as compared to highest per capita grant receiving municipality in Assam. This indicates that the inter-state variation in grants to local bodies is widespread.

2. There are also extreme variations in per capita grants within states. For example, the lowest and the highest per capita grant of municipalities in West Bengal, a state that relies to a great extent on state transfers, are Rs. 0.09 and Rs. 90.17 respectively.

Regression Analysis

In order to pursue this line of thought, a thorough examination of the existing literature on municipal finance was conducted. Also taking into account the information furnished by the state and local bodies, it was clear that either implicitly or explicitly, grants in most states were being distributed on a formula or principles that directly or indirectly took into account information on the size, the resources base, the current revenue gap, and the tax effort of the municipality. Using this information, several regressions were designed with different combination of variables to explain the relationship between grants and such variables as the level of own resources, the current deficit of municipalities, the population size, density of population, expenditure on public works, and growth in revenues which are thought to be important in explaining variation in grants across states and across municipalities.

Hypothesis Regarding Variation in Per Capita Grants

That wide variation exists in the per capita grants to municipalities is evident from our earlier analysis. But why is it that some urban local bodies in states receive more grants per capita than local bodies in other states? Based on our earlier analysis, it is our undertaking that variation in the levels of per capita grants is the result of various political decisions - current decisions and decisions of the past which have become embodied in legislations, statutes, ordinances and in customary practices and procedures. However, our objective here is to test if there are certain systematic variables which might explain a part of these variations, or are these differences primarily the result of random forces or political whims? We proceed on the assumption that a number of factors that affect per capita grants can be quantified in such a way as to make possible the study of the association which exists between a given factor and the level of grants. Our objective here is to try to isolate those factors which can explain the variation in per capita grants to urban local bodies both within and across states.

As in the case of most economic studies it would however, not be possible to isolate one factor while keeping all external forces fixed unchanged. While the dependent variable changes, more than one independent variable changes simultaneously. In general, we observe not the effect of one variable upon another, but a set of simultaneous relationships and interrelationships.

Methodology and Specification Errors:

The methodology used in our analysis is the Ordinary Least Squared technique with linear specification of variables. In a linear regression analysis with "n" independent variables it is assumed, that the variations in the dependent variable are associated with the changes in "n" independent variables. If, however, variations in the dependent variable are due not only to changes in "n" independent variables but due to variations in n+1, n+2,.., and n+m, then an error due to the improper specification of the equation will be introduced. Incorrect conclusions may be reached if we do not consider all independent variables which might have a significant effect on the dependent variable.

The Regression Model

An ordinary least squre regression model has been estimated to test the relationship between the dependent variable (per capita grants) and several independent variables as indicated above. Although, several equations with different combination of independent variables were estimated, the equation reproduced below was eventually selected on the basis of its performance in relation to other equations and functional forms estimated.

$$\boxed{TD = (\beta_0 + \beta_1 F_2 + \beta_2 F_3 + \beta_3 F_4 + \beta_4 TAB + \beta_5 TC + \beta_6 TH + \epsilon_i}$$

Variables in the Model

The dependent variable TD measures the per capita grants to municipalities. The independent variables F2, F3, and F4 represent the per capita expenditures by municipalities on public health, public safety and public works respectively. Since a substantial part of the the state grants to municipalities is given for meeting expenditure on these categories, we would expect that movements in these variables should explain some of the variation in grants received by municipalities. It is also expected that the per capita own revenues of municipalities should have some bearing on the movement of grants. It is expected that the relationship between per capita own resources and per capita grants would be negative. Those municipalities that are able to raise larger per capita own resources should be receiving lower per capita grants. Two other independent variables namely the growth of population and the per capita shared taxes have also been included in the model. If population is a factor in the distribution of grants then we would expect a positive relationship between per capita grants and population growth. In case of per capita shared taxes, the relationship may be open ended. However, we expect the relationship to be negative in most cases. That would imply that there is some degree of substitution between grants and shared taxes.

Analysis of Regression Results

The results of regression for all the seven states are presented in a summary form in table - 18 below. Comparison of the regression results across states fails to provide any substantive statistical relationship between grants and the variables indicated in the model except in a few isolated cases (See complete regression results in Annexure D). Most of the explanatory variables could not achieve acceptable levels of significance. A log form of the regression was also attempted. However, the results were no better than what were achieved from the linear form of the regression equation.

Table - 18

Results of the Regression Estimates for Individual States

TD	Andhra Pradesh R^2 =.34	Assam R^2 =.28	Gujarat R^2 =.	Kerala R^2 =.15	Maharast ra R^2 =.23	Punjab R^2 =.27	West Bengal R^2 =.52
F2	.326 (2.17)*	.050 (.296)	-	.160 (1.59)	-.017 (-.103)	.147 (1.30)	.327 (1.97)*
F3	.724 (3.82)*	.225 (1.09)	-	.166 (.752)	.174 (.281)	-.142 (-.532)	-.212 (-.182)
F4	-.074 (-.71)	-.095 (-.444)	-	-.124 (-1.89)	.033 (.165)	.162 (2.69)*	.237 (.988)
TAB	.139 (1.07)	.029 (.296)	-	-.028 (-1.05)	-.024 (-.302)	-.137 (-2.3)*	.337 (1.20)
TC	-.026 (-.198)	-.200 (-.832)	-	-.123 (-.793)	-3.06 (-1.10)	-	-.373 (-.917)
TH	-.184 (-.317)	-.113 (.082)	-	-1.95 (-.787)	-6.44 (2.25)*	.753 (.346)	.165 (.138)

Note: Regressions were not conducted for the state of Gujarat due to data problems.

Comparison of results across states shows that per capita expenditure on public heath is significant only in the case of municipalities in Andhra Pradesh. Thus, the overall interpretation would suggest that the relationship between per capita grants and per capita expenditure on public heath is weak. For most states the movement in per capita expenditure on public heath do not correspond with movements in per capita grants. Expenditure on public safety is again significant only in the case of Andhra Pradesh.

One of the interesting results that stems from this analysis is that in case of Punjab the coefficient of the Variable TAB (per capita own resources) turns out to have a negative sign and is significant. The coefficient also takes on a negative value in case of Kerala and Maharashtra although, the t values are statistically insignificant. There is some indication of substitution between grants and own sources of revenue of municipalities. In case of Punjab it is clear that a one rupee increase in per capita grant to municipalities will on an average reduce the per capita own resources of municipalities by 13 paise.

It should also be pointed out that the population growth variable is consistently insignificant for municipalities in all states except in Maharashtra. What is, however, troubling is that the coefficients take on a negative value for most of the states. Clearly, the relationship seems to be just the opposite of what is expected theoretically.

Several explanations could be put forward to explain the erratic behaviour of the regression results. First, that the variables included in the regression are not the true explanatory variables and that movement in grants is explained by a set of variables not included in the regressions. This would however, mean that the principles of grant distribution as stated by the states and referred to in the literature are not being seriously adhered to. Thus, states would be in violation of their own rules for distribution of grants. Second, the specification of the regression equation may be incorrect. To verify this possibility, a log form of the regression equation was attempted but no significant improvement in the results were found. Finally, there may be serious inconsistencies in the data furnished by the municipalities. There is no way this information can be verified since published sources for such information are few. As such we have relied on the data furnished by the states for our analysis.

A closer examination of the data using a graphical technique, detailed study of the regression results and the analysis of variation provide strong support to the hypothesis that grants from states to urban local bodies do not follow any pattern and they are, at best, explained only by a random process which cannot be quantified. There is no coherent system of grant-in-aid in any of the seven states in our sample. There is confusion of responsibility and a lack of accountability. At best, the existing system of grant-in-aid code for allocation of grants to urban local bodies seems to have emerged as a result of the often ad-hoc decisions of state governments. These decisions, in the absence of a well articulated overall policy on grants seem to emerge from the best judgement of the respective state governments. Seen in their totality, the present grant-in-aid system has contributed little towards solving the fiscal problems of distressed municipalities, and are not in tune with the evolving needs of local governments.

Design of Intergovernmental Grants

In examining the various problems concerning the finances of municipalities we have observed the impact of the present grant-in-aid system. It would seem that a change in attitude is required to assist the municipalities in meeting their financial needs. This raises the question of when the state governments should substitute for the local revenue needs. On the basis of evidence presented earlier, one is inclined to conclude that grants should be used primarily to bring about a balance in the fiscal capacity of the municipalities which is consistent with their expenditure needs. Thus, grants should be used as a more realistic and effective means of directing resources to the low income poorer municipalities to assist them in carrying out their functions and to ensure that certain disadvantaged groups are not deprived from receiving adequate public services.

The purpose of this section is to discuss the rationale for grants and to briefly analyse the economic effects of such grants. We shall discuss three theoretical justifications for grants and consider the appropriate form the grant should take in each case.

Theoretical Justification of Grants

There are three important theoretical justification for grants from the state to municipalities. First, *"the spillover effect"*: in the performance of many of the responsibilities assigned, municipalities often encounter the problem of social and private costs. These are generally termed as externalities or spillover effects. We find that a part of the expenditure of local governments gives rise to benefits to the community as a whole over and above the benefits to local residents. The most obvious examples are expenditure on roads, education and health. Major roads are constructed and financed by the state, but even those roads which are the responsibility of the local governments to build and maintain are often used by people from outside the local area. Similarly the benefit of expenditures on education and health is derived by the nation as a whole even when a large part of the expenditure may be financed through local taxes. If the expenditure on functions with large spillover effect is financed by local tax payers who are taxed only according to the benefits they derive, then this will result in the allocation of resources to collective consumption which will be below the optimum if all the benefits are taken into account. In the absence of grants, expenditures on such functions will fall unevenly on local bodies who do not derive the full benefits of those expenditures.

Second, *"the fiscal capacity effect"*: the tax capacity of municipalities varies considerably. Potential tax base and expenditure needs are unevenly distributed across municipalities. It is reported that the more prosperous an area is, the greater is its taxable base and thus its tax raising capacity. Some municipalities may contain larger number of low-income families who place heavy demands on expenditures, but add very little to the overall local tax capacity. On the other hand, some municipalities have a high proportion of residents translating into high tax potential.

Under such conditions it is found that taxes would have to be higher in poorer municipalities even to maintain a minimum level of service that is far below that in the prosperous municipalities. Not only may these differences be regarded as inequitable, but by retarding development in poorer municipalities they perpetuate and aggravate the difference. In order to bring about a balance in fiscal capacity the state would have to base its allocation of grants on the measured "need" and "fiscal capacity" such that municipalities with larger populations and smaller tax base receive proportionately larger amounts[30]. Here, the intent of grant is to bring about horizontal equalization in fiscal capacity and not to stimulate public

[30] While these types of grants (lump sum) may serve to reduce the fiscal differences among municipalities, they are not an effective device for achieving desired distribution of income among individuals.

spending. Matching grants would seem to be a better instrument if the objective is to stimulate public spending.

Lastly, there are variations in the cost of providing services not only in different size-class of municipalities, but even in the same size-class. Some municipalities need to spend more to provide the same standard of services as compared to others, either because the volume of service required in its area is much greater, or because the cost of each unit of service in its area is greater.

Important Considerations in the Design of Grant

The amount of grant to any municipality should depend on the fiscal capacity of the recipient government. By fiscal capacity is meant the ability of a municipality to raise revenues to finance public expenditures. Most often, per capita income is used as an approximate measure of fiscal capacity in grant formulas. However, it is only an accurate measure of fiscal capacity for raising income tax revenues. A more accurate reflection of fiscal capacity might require taking into account the ability to raise revenues from a variety of sources. For example, in determining the fiscal capacities of various municipalities one might find out how much revenues per capita could be raised in each municipality by applying a common set of tax rates for each municipaliy's tax bases. This common set of rates might be taken as the state average of the various municipal taxes.

Yet another factor that may be considered in the design of grants to urban local bodies is the "need" of various municipalities. Even if two municipalities have the same fiscal capacity and levy the same tax rates, they may not be able to provide the same level of service. This may be reflected in the grant formula by the inclusion of an index of "need". This index will reflect the difference in the ability of different municipalities to provide particular services due to such things as cost differentials and the number of users per capita. Here population may be used a very crude indicator of need and the formula for grant may include the size of the population as a factor.

Musgrave(1961) has suggested another index which might be used to allocate grants is the "tax effort". By this is meant the extent to which the municipality is actually obtaining tax revenues relative to its tax capacity. For example, the tax effort of a municipality might be measured by the amount of tax revenue being raised as a proportion of the amount of tax revenue that would be raised using the state average of the various tax rates in municipalities.

Operationalising the Grant Formula

The problems of reduction in overall fiscal capacity and the unequal fiscal capacity of various municipalities is so closely related that solutions must be considered in terms of both problems. Specific purpose grants determined solely on the basis of external benefits make only limited contribution to the solution of these problems. The logical solution to the fiscal capacity problem is the general purpose grants, adjusted in terms of fiscal capacity and provided without specification as to the use or control. The allocation can be based on population weighted by the reciprocal of per capita income and perhaps also by an index of the tax effort of the municipality to reduce the danger that the grant might be used to lessen their own tax liabilities.

While all municipalities will receive some money, the payment to poor municipalities would be relatively greater. Accordingly, not only would the overall fiscal capacity of the municipalities be increased, but the inequalities in fiscal capacity would be lessened or eliminated. The absence of control on the use of funds would protect the financial autonomy of municipalities and avoid distorting their budget patterns.

The appropriate type of grant from the state to the urban local bodies should depend upon the purpose for which the grant is being given. If the purpose is to encourage a particular type of public expenditure by the recipient government, a subsidy or conditional matching grant on that expenditure would be appropriate. This type of grant would be applicable if the state governments were attempting to internalise the inter-municipal spillover or externality arising from municipal expenditure. The rate of subsidy or the matching formula should appropriately depend on the magnitude of the marginal spillover. Municipal expenditures that would qualify for grants could include among others, expenditures on education, health, and maintenance and construction of roads.

On the other hand, if the purpose of the grant is simply to transfer purchasing power from the state to municipalities, an unconditional general purpose grant would be more appropriate. This grant would be a lump-sum grant with no strings attached and can be used by municipalities in meeting the cost of any service or function. Since it would give more discretion to local authorities and also fulfill a number of criteria outlined earlier, this type of grant may form the largest proportion of the total grant given to the municipalities. It would also fulfill several objectives such as simplicity, flexibility, predictability and the preservation of autonomy. However, using only population as a factor in determining the share of each municipality will defeat the purpose of strengthening the finances of municipalities. In practice the formula for the distribution of the general purpose grant would have to take into account the fiscal capacity, the need, and the tax efforts of municipalities. A grant based on such a formulation will not only be equalizing in nature, but it will also achieve the objective in an equitable manner as differential tax capacities and tax efforts will enter the formula.

Criteria for the Design of Grants to Municipalities

The problems that have emerged from our review of the grant-in-aid policy of the states and the theoretical considerations can be used as a guide in defining the principles that should govern the design for grants to municipalities. In what follows are a few general principles which bear on the design of grants.

1. Grants should be so designed that municipalities are able to predict their share of the allocation for each year. Thus, they would be able to plan their expenditure priorities before receiving any grant.

2. The grant design should enable municipalities to maintain sufficient independence and flexibility in setting their priorities according to the needs of the local community. The structure of the grant mechanism should not be associated with the uncertainty in decision-making at the state level, so as to constrain the efficiency of municipalities.

3. Grants should be based on objective and measurable factors over which individual units have very little control and the resulting formula are easy to comprehend.

4. In order to build an equity consideration, grants would have to vary positively with the fiscal need of the municipalities and inversely with their taxable capacity.

5. Choice of local government's priorities in the development of services and the performance of the functions delegated should remain neutral to the amount and type of grant allocated.

6. Grant mechanism should incorporate provisions to ensure that over time, the proportion of non-plan grants to total non-plan resources of the state remains fairly stable. It should also be designed so as to neutralise the effects of inflation.

7. An element of incentives to municipalities for sound management and use of resources should be built into the design of grants.

8. Provision should be made such that states can exercise discretion on expenditures that rank high on their priorities through additional grants or special grants.

9. The multiplicity of grants should be reduced and they should be distributed under a limited number of heads.

10. Finally, any mechanism of grant should include provision for proper monitoring and

review of the use of grants to municipalities. The release of grants may be subjected to the condition that municipalities make efforts to adopt scientific methods of accounting and budgeting practices to ensure transparency in the use of grants.

Chapter 5

EXPENDITURE PATTERNS AND NEEDS OF MUNICIPALITIES

One of the important aspects in the overall fiscal structure of municipalities which has received very little attention in the past, is the service and the expenditure patterns, and how these affect the functioning of municipalities. Growth of urban centers and the process of urbanization have placed severe pressure on local governments to increase their expenditure levels and provide a better quality of service to the public.

The service and the expenditure measures that we have used in our analysis show that there is wide variation in the level of services in municipalities, both within states and across states. The largest variation in per capita expenditure is found in the states of Maharashtra with a coefficient of variation of 66.7, followed by the states of Assam (59.6), Punjab (57.8), West Bengal (55.6), Kerala (55.0), Andhra Pradesh (50.4) and Gujarat with (42.7). Municipalities in Maharashtra spend on an average Rs. 534 per capita compared to only Rs. 57 in Assam. It is also found that the highest per capita expenditure in Andhra Pradesh, Assam, Kerala, and West Bengal is lower than the average per capita expenditure of Rs. 534 in Maharashtra. The analysis clearly shows that variation in per capita expenditures of municipalities both within states and across states is a common feature in the country.

If these per capita expenditures are taken as an indication of the level of services provided by the local bodies, then it is clear that service levels vary drastically. There is also the evidence of variation in service levels by functional categories. For example, for municipalities in Andhra Pradesh, public health are an important expenditure category while in West Bengal education seems to be more important. It should be pointed out that municipalities in different states place different priorities in spending funds. These choices are only a reflection of local demand. They also indicate that under resource constraints local governments are forced to choose between various services.

Table - 19

Percentage of Expenditure Financed by Own Revenues in Municipalities of Different Population Size Groups (1991-92).

State	Class A	Class B	Class C	Class D	All
Andhra Pradesh	48.7	54.1	53.1	54.5	53.5
Assam	78.9	86.2	-	-	79.6
Gujarat	86.3	105.1	87.5	120.4	112.2
Kerala	107.8	90.8	99.0	107.9	104.9
Maharastra	67.1	63.2	74.9	101.3	98.5
Punjab	94.4	85.7	83.6	98.8	94.4
West Bengal	24.4	31.7	30.7	-	29.9

Source: Calculations based on municipal data base, NIPFP.

Table 19 shows that municipalities in Andhra Pradesh are able to meet only 53 per cent of their total revenue expenditure from their own revenues; the percentage in Assam and West Bengal are 79.6 and 29.9 respectively. Figure 8 provides a glimpse of the expenditure needs of municipalities in sampled states in relation to their current expenditures, while Figure

9 shows the distribution of expenditure needs by class-size municipalities. The municipalities in Gujarat, Maharashtra and Punjab (octroi states) are differently placed as, in the aggregate, they are able to not only meet the expenditure from their own resources but are also able to generate some surpluses. It should be noted that these are aggregate estimates for the sample as whole and are not reflective of any individual municipality within a state.

The expenditure pattern is highly concentrated toward general administration. Other dominant expenditure categories include, public health, public works, public safety and education. As will be shown later in this chapter there is a large potential for saving in the category of expenditure on general administration.

Expenditure Needs of Municipalities

The current levels of per capita expenditure of municipalities are a reflection of the level of services being provided by urban local bodies. Since data on other measures of service levels for municipalities are scarce, we have used differences in per capita expenditure as indicators of the levels of municipal services across municipalities.

It is assumed that municipality with the highest level of per capita expenditure in its own class (standard municipality) is able to provide a better level of service compared to a municipality with a low level of per capita expenditure in the same class in each state. Thus, the difference between the per capita expenditure of a standard municipality in each class, and the per capita expenditure of any other municipality in that class of a state, provides a rough

Figure 8

Expenditure Need as a Per cent of
Current Expenditure by State

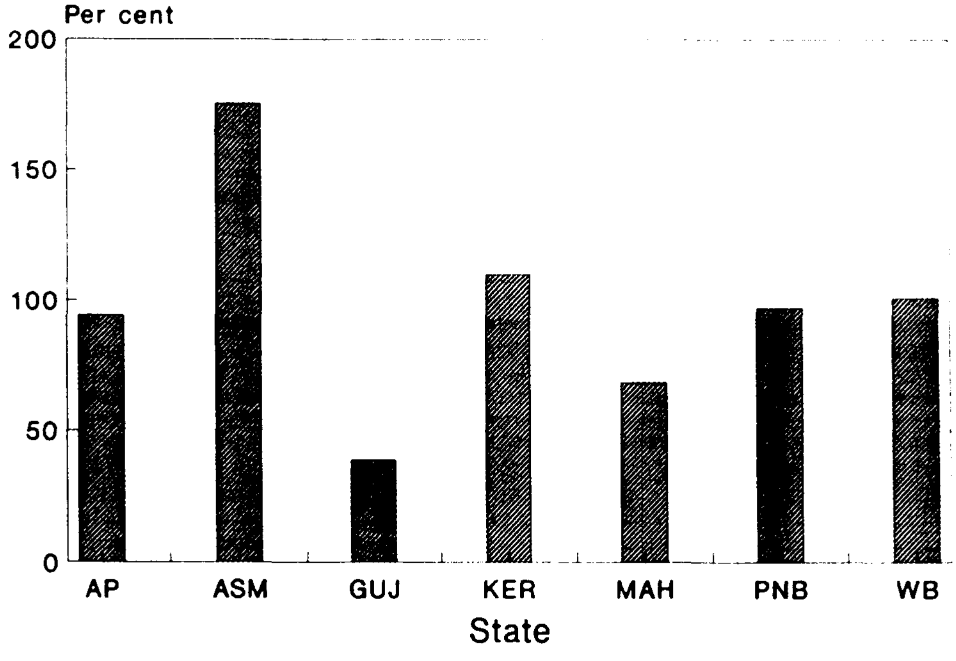
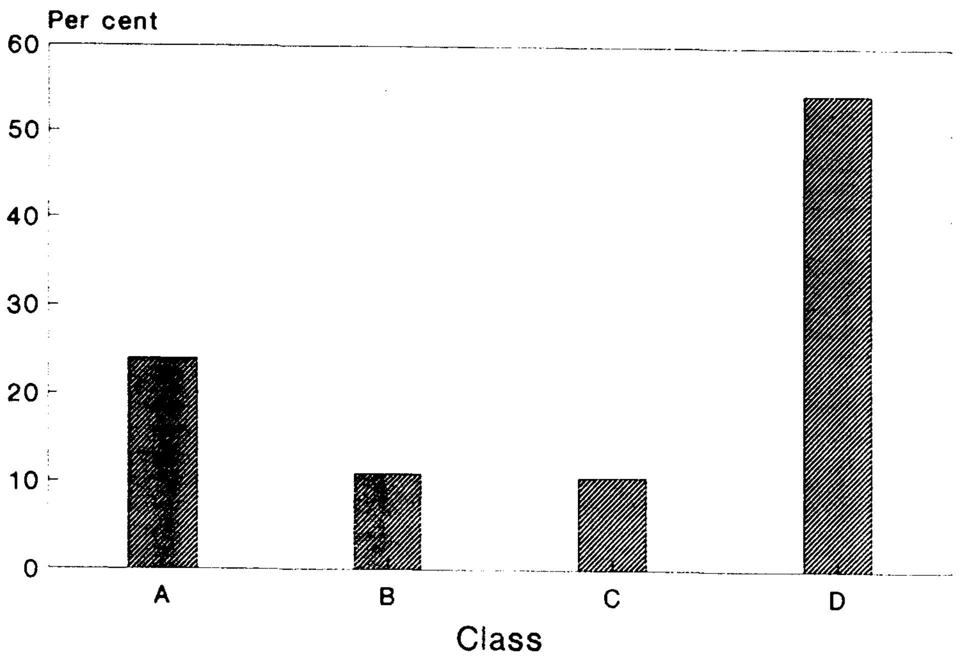


Figure 9

Percentage Distribution of Total
Expenditure Needs by Class Size



estimate of the per capita expenditure required to match the level of service of the standard municipality.

Table 20 presents the estimates of the expenditure requirements of different class of municipalities based on this methodology. The estimates show that the total additional expenditure that would be required to match the service standards of the standard municipality of each class is Rs. 14,410.4 million which translates to an <u>additional</u> Rs. 274.5 per capita[31]. It is also seen that the expenditure needs of municipalities in different class size vary. The per capita requirement for class A municipalities is Rs. 366.1 as against Rs. 178.7 for class B, Rs. 195.6 of class C, and Rs. 279.2 for class D municipalities (table - 20). This is an indication that there are vast variations in the level of services in class A municipalities compared to municipalities in other classes[32].

Table - 20

Estimated Expenditure Need of Municipalities in the Sample in Millions of Rupees

Class Size of Municipality	Estimated Expenditure Needs	Per Capita Expenditure Needs
Class A	3452.6	366.1
Class B	1579.5	178.7
Class C	1532.0	195.6
Class D	7846.3	279.2
All Sampled Municipalities	14410.4	274.5

Source: Computations based on the data supplied by the state governments of sampled states.

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31 The per capita expenditure need denotes only the requirement to match the service level of the best municipality. It, in no way, implies that the service level of the best municipality is adequate.

32 We consider this way of measuring the expenditure needs to be far more realistic and achievable. Using the expenditure norms as laid down by the Zakaria Committee (Rs. in 1991 prices) or the Planning Commission (Rs. in 1991 prices), would enhance the total

Further analysis of expenditure on general administration shows that there is an estimated potential for saving from reduction in expenditure on general administration to a tune of Rs. 1,167.3 million, translating to a per capita figure of Rs. 22.2 in the sampled municipalities (table 21).

Table - 21

Estimated Savings from Reduction in Expenditure on General Administration (estimates based in the standard municipality)

Class Size of Municipality	Estimated Savings	Per Capita Savings
Class A	324.8	34.4
Class B	168.6	19.1
Class C	238.0	30.4
Class D	435.9	16.5
All	1167.3	22.2

Note: Estimates based on the per capita expenditure on general administration for the standard municipality.

The savings from reduction in expenditure on general administration accounts for 8.1 per cent of the total expenditure needs of the municipalities.

Potential Fiscal Gap

The potential gap here is calculated as the difference between the estimate for the potential revenue from own sources and the potential expenditure requirements of sampled municipalities. As per the estimates made in this study, the present potential gap amounts to

Rs. 2,184.9 million (estimated expenditure requirements = Rs. 14,410.4 and estimated potential revenue = Rs. 12,225.5). In terms of per capita figures these turns out to a potential gap of approximately Rs. 42. What this suggests is that if we pursue a policy of standardizing the per capita expenditure of all municipalities to match that of the standard municipality in each class, then the municipalities should be able to meet approximately 85 per cent of their expenditure needs from their potential own revenues, and leave an unfilled gap of 15 per cent of the estimated expenditure requirements.

As has been shown in table - 21, there is a potential saving Rs. 1167.3 million from reduction in expenditure on general administration. This results in a further closing up of nearly 50 per cent of the unfilled gap of Rs. 2184.9 million. Thus, the potential gap reduces to a mere 7 per cent of the total expenditure requirements of the sampled municipalities.

Comparision of the potential revenue and the expenditure needs suggests that, not all municipalities are financially poor. Many are poor only in terms of the initiative and the willingness to improve their finances. Thus, in determining the principles for any devolution of funds from the state to the municipalities, the State Finance Commissions may consider this aspect of municipal finances in the country.

Chapter 6

CONCLUSIONS AND OBSERVATIONS

The purpose of this chapter is to present the main observations of the study report. It also outlines the key factors that should carry weight in the design of the principles for the devolution of funds, the transfer of tax powers and the sharing of state revenues with municipalities. This report provides the options and perspectives for the State Finance Commissions; moreover, it is intended to be taken in the form as general guidelines for the State Finance Commissions. The main objective is to draw the attention of the State Finance Commissions to some of the key issues that are considered important in the design of the principles. These observations are based on the study of the finances of municipalities in the sampled states, and are consistent with the theoretical literature on local finance. While emphasizing on the key factors, the study team has examined the fiscal conditions of the municipalities, the role of transfers, and issues of resource mobilisation. Above all, the resources at the disposal of states have played an important role in our consideration of the various options open to the State Finance Commissions.

Summary of Approach and Principles

In addressing the question of the principles that should be used for the assignment of taxes, sharing of state revenues and the grants-in-aid, it is necessary to keep in mind three important aspects that emerge from the analysis of the financial data for the sampled municipalities across the seven states. These three issues need to be further elaborated so as to understand the context and the framework in which the principles should be designed.

1. Resource Inadequacy of Municipalities: The first of these issues is the resource inadequacy of municipalities. It is found that a large number of municipalities are very poor in resources at their command. Their existing revenue base is extremely narrow, and generally limited to property taxes in the non-octroi states and octroi in the cctroi-levying states. Property taxes have historically lacked buoyancy. The central point is that "own resources" of municipalities are markedly inadequate for meeting their expenditure needs. The gap between what they are able to raise and what they need is often large.

2. Inelastic Revenue Base: Given that the property tax is the major source of revenue in the non-octroi states and that increase in property tax collections has not kept pace with the rise in real estate prices, it is evident that the elasticity of tax revenues from this source is very low. Other taxes such as a tax on advertisement, tax on animals, and other smaller taxes are also seen to be characterized by inelasticity. In a dynamic environment in which our municipalities are going to be expected to function and continue to provide higher levels of service to the ever increasing population, it is necessary that they have access to at least one major elastic source of revenue. This would ensure that there is continuing growth in their revenues to meet the future expenditure requirements.

3. Increasing Horizontal Imbalances: The system of local finance in India is such that there is a built-in tendency for the fiscal imbalances across municipalities to perpetuate. The share of overall economic growth is neither distributed

equally across states nor across municipalities in the same state. These differences can be explained by the unequal distribution of resources both across states and across municipalities. In the emerging environment of liberalization, it would not be far fetched to expect that these imbalances may become more pronounced since the beneficiaries in the initial stages of liberalization would more likely be the rich municipalities which tend to present a better infrastructure for prospective investors. Thus, it would seem that any design of the principles of tax assignment, sharing of taxes and the grants-in-aid would have to resolve these three important issues.

Each of the three issues would have to be addressed by different fiscal instruments. The issue of the inadequacy of resources can be addressed by assignment of new tax powers to municipalities, mobilization of municipal revenues and privatisation of some municipal services and some flexibility in setting the rates. The issue of the inelasticity of revenue base can be addressed by new sharing mechanisms and the issue of horizontal imbalances could be better addressed by appropriate grants-in-aid policies and systems. Thus, the principles have to be consistent with the objective of addressing the above three problems of local finances. These are essential for strengthening of the finances of the urban local bodies.

Approach and Principles for Meeting Resource Inadequacy

The resource inadequacy problems of municipalities can be tackled by adopting three different strategies. Some of these would require the initiative of the municipalities while others may require interventions on the part of the state governments. The following are the four strategies appropriate to address this problem.

1. *Assignment of Additional Tax Powers to Municipalities*

Municipalities by virtue of their status derive their tax powers from the state legislature. The state determines the extent of tax powers it is willing to bestow in the hands of the urban local bodies so as to enable them to perform the functions assigned to them. In doing so, it would be expected that the states must take the legitimate rights of municipalities into account when determining the extent of tax powers it wishes to handover to the urban local bodies. What constitutes a legitimate right of a municipality should be governed by the accepted principles of local finance. It follows that municipal governments are assigned those taxes that are leviable on bases which are "immobile", and those whose burden cannot be exported outside the municipal jurisdiction. In other words, they must follow the *Congruence Principle* in the assignment of tax powers. The Congruence Principle states that -

> "the less mobile a tax base, and the stronger the spatial concentration of the tax base and ownership, the lower the levels of government to which those taxes should be assigned."

This principle then defines the tax sources over which municipalities have a legitimate right and the states may take steps to assign the tax powers which fall within the purview of this principle. Based on this principle, the following major taxes would qualify to fall within the municipal domain.

* Property taxes
* Octroi (until phased out)
* Tax on animals and boats
* Tax on advertisements other than those published in national dailies/TV, etc.
* Entertainment tax including show tax and theatre tax
* Tax on professions, trades and callings

The above list contains two new taxes namely, the entertainment tax and the profession tax that should fall in the domain of municipalities. In Kerala, the tax powers with respect to these taxes are already assigned to the urban local bodies. In Andhra Pradesh, the State collects these taxes and 85 per cent is given to the municipalities. According to principles, these are local taxes and should either be assigned to municipalities or that the yield from these taxes are transferred to them on the basis of origin after deduction of the cost of collection. In the event the state collects and transfers the collection to municipalities, no formula method need be used in the distribution of revenues collected. This would be consistent with the argument that municipalities that receive larger amounts of tax revenue from these sources also tend to spend larger amounts in providing municipal services. Any other method would appear to be discriminatory, and would be contrary to the purpose for which the principles are to be designed.

The disadvantage of assigning these tax powers to municipalities or the distribution on the basis of the origin in case the state continues to collect these taxes, is that it could lead to an increase in horizontal imbalances between the municipalities[33].

2. *Mobilising Internal Sources of Revenue*

An important but often not receiving a great deal of attention is the strategy for mobilising the internal revenues from the existing tax and non-tax sources of the municipalities. This study has clearly showed that there is tremendous potential for augmenting the resources of the urban local bodies. Although the potential varies across states, nevertheless the potential does exist for the municipalities to tap. Doing so would substantially reduce the resource inadequacy problem currently being faced by the municipalities. The efficiency with which municipalities tap their resources is an important element in putting their overall finances on a strong footing. Financial assistance from the state is not a long lasting solution to the problems of municipalities unless it is accompanied by efforts at the municipal levels. It should be pointed out that autonomy cannot be achieved when a substantial part of the total expenditure continues to be financed through transfers. As municipalities learn to become self-sufficient and are able to finance a larger part of their expenditure need, fiscal autonomy will automatically be achieved.

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33 No attempt was made to determine the extent of horizontal imbalance that would be created. It would not be surprising to find that no additional horizontal imbalance is created as most municipalities will receive some amounts of the revenues from these two tax sources. Further analysis would be required to arrive at some meaningful conclusion and is beyond the scope of the current study. The State Finance Commissions, may however, like to initiate some studies on such issues in their own states.

The first element in the resource mobilization effort by the municipalities would be the streamlining of the overall structure of the property taxes. The current system of property taxation has several problems in the area of valuation, assessment, tax base, and collection and recovery of dues. If these problems are addressed by municipalities property taxes could become a major source of additional revenue for the municipalities. A system of area based taxation of properties has been attempted in municipalities in the state of Andhra Pradesh. Based on the information available, it is found that the yield from property tax has increased by an additional Rs. 20 crores, and some municipalities have shown collection rates as high as 93 per cent. Such innovative methods will go a long way in improving the finances of the municipalities. In determining any new method of property taxation or any other tax the following two principles would have to kept in mind -

1. The first principle that should govern the reform of any municipal tax should the *Principle of Simplicity*. This would require that the system of tax be simple for the tax payer to understand and the local government to administer so as to eventually make the possibility of self assessment a reality.

2. The second principle calls for *fairness of the tax system*. This principle requires that equals be treated equally. If two properties with the same characteristics are present, then the tax system must not discriminate between the two properties in the levy of the tax.

A number of other issues relates to the mobilization of property taxes that have been discussed in greater detail in the report, broadly under these two principles of taxation. It is also important to point out that the tax system should be transparent at the local government levels. This would require that the tax payers not only know how they are being taxed but at the same time how their tax money is being utilized by the government. This would also lessen the resentment that tax payers express when tax rates are increased.

The second element in the mobilization of internal revenues of the municipalities is the non-tax component of revenues such as duties, charges and fees. Given the state of revenues from this source, there is little doubt that there is a potential for generating additional income by the municipalities. Municipalities would have to adopt principles that would address the following two problems related to non-tax sources of revenue -

1. Timely revision of duties, fees and charges for providing municipal services. Some of the municipal services for which charges and fees are levied are being provided at the expense of the tax payers. Revisions should be made in the fees and charges so as to shift the burden from the tax payers on to the users of the services who receive the direct benefits from the services.

2. Cost recovery and self-sufficiency should be the guiding principles in case of services which are expected to be financed through duties, fees and charges. It makes economic sense that those who use these services should pay for them. These services should be provided on the basis of cost recovery to ensure self-sufficiency over the longer period of time.

Besides these, the municipalities would have to use the full potential of development charges, charges of water supply and garbage disposal charges to enhance their revenues. Municipalities would also have to make efforts to introduce innovative programmes such as the remunerative enterprises on the lines being followed in states such as Kerala.

3. *Privatization of Municipal Services*

Reduction in expenditures should become the hall mark of municipal finances in the years to come. This will require that municipalities be willing to privatise those services where the private sector has a cost advantage. On this principle, there would appaer to be a case for privatization of the following services on an experimental basis.

1. Collection and disposal of garbage
2. Maintenance of street lights; and
3. Maintenance of public parks

These services could be contracted out to the private sector or could be initiated under a joint public-private arrangement. The municipalities would still be responsible for the overall supervision of these activities. If these services can be performed by the private sector at a cost below (cost estimates should include both direct and indirect costs) what the municipality currently incurs, then there is a strong case for privatization. Such schemes are being tried in municipalities such as Rajkot in Gujarat, Hyderabad in Andhra Pradesh, and Allahabad in Uttar Pradesh. Although, it is too early to review the financial results of these experiments, initial response from the public shows that the schemes are very promising as far as the residents are concerned.

4. *Flexibility in Setting Rates of Taxes, Charges and Fees*

Municipal governments levy a number of taxes; they also collect fees and charges for services rendered. However, these rates of taxes, charges and fees in most instances are determined by the state government. The extent of the involvement of the state government varies from state to state. In majority of the cases minimum and the maximum rates of tax are determined by the state governments. The municipalities can vary these rates within the prescribed limits after the approval of the state government.

In the light of the 74th Constitutional Amendment and with the objective of making urban governments responsible for their actions, it is necessary to allow the municipalities some flexibility in setting the rates of taxes, charges and fees within their jurisdictions. The states should still have the overall responsibility for determining the maximum and the minimum rates for the municipalities. However, the need for getting the approval of the state for varying the rates within the limits prescribed would be an unnecessary step in the efficient functioning of the municipalities. It is important that flexibility in setting the rates be provided to the urban local bodies in order to permit them to fully use the resources at their disposal.

Approach and Principles to Address Inelasticity of Revenue Base

Municipalities are faced with the problem of inelasticity of their revenue base. Research done by NIUA has shown that there is a tendency for revenues of municipalities to lag behind their expenditures. That the expenditure needs of municipalities increase at a rate much faster than their revenues has also been established. This would mean that even if the system of fiscal relations between the state government and the urban local bodies were designed to address the current problems of resource inadequacy and the horizontal imbalance, there is every likelihood that over time, these problems will emerge again. It would then require that a new formula for sharing and grants-in-aid be worked out. Thus, it becomes even more important that municipalities be provided with at least one source of revenue that can address both the issues of future stability in the finances of municipalities and their resource adequacy.

The taxes that are currently within the domain of the urban local bodies or those additional taxes which qualify to fall within the municipal domain, i.e., entertainment and profession tax, do not posses the dynamic character to address this issue. It is well known that most of the elastic sources of revenue tend to be concentrated in the hands of the state. Therefore, it becomes necessary to address the issue of the inelasticity of revenues, future stability and resource adequacy through a mechanism of shared taxes.

Providing a strong fiscal base with some element of elasticity in the revenue base of municipalities should, then, be the guiding principle in sharing of taxes between the state and the municipalities. The immediate question that arises is, which sources of revenues qualify to be considered for sharing with the urban local bodies? Clearly, much will depend on the extent to which the state is willing to address the condition of resource adequacy discussed earlier. The motor vehicle tax and the sales tax seem to be the state level taxes that could fulfill both the conditions discussed earlier. However, it should be pointed out that the case for sharing the sales tax arises only when the resource inadequacy and the revenue inelasticity problems cannot to fully addressed by assigning additional tax powers and the sharing of the motor vehicle tax. Here we are proceeding on the assumption that the need for sharing the sales tax would not arise.

In practice the sharing mechanism should be a two stage process. In the first stage, the share assigned to all urban local bodies should be clearly identified. In the second stage, a sharing mechanism will have to be adopted to distribute the funds to the municipalities from the predetermined pool of funds from the first stage. The principles that may govern the division of funds at both the stages are outlined below.

Approach and Principles for Revenue Sharing

In the past there has been no practice of determining a divisible pool from the state revenues to be shared between the municipalities. States, in most cases have either been given a fixed amount from the revenues of some taxes to each municipality as discussed earlier or they have given a small percentage of tax revenues to municipalities. In general, the first method is a more common approach used by the states across the country.

The two step approach of revenue sharing would call for the determination of the pool of funds to be distributed to municipalities from the revenue generated by the motor vehicle tax. This pool will be based on a fixed percentage of the total revenue collected from the tax. This method of determining the divisible pool has the advantage of increasing over time which is not possible under the fixed sum method. Thus, the objective here is to ensure that the municipalities will also be entitled to the revenue increases from this tax.

Once a divisible pool has been determined, it becomes important to address the question of division of the pool among the various urban local bodies. Several different sharing methods can emerge. However, any formula for the distribution will have to be fair with all municipalities. In the opinion of the research team, it is important that some elements of road length, per capita expenditure on roads or density per km of road be included in the mechanism.

Formula for Sharing the Divisible Pool From Motor Vehicle Tax

The sharing of the motor vehicle tax should be based on standard road unit which should depend on the total length of different types of roads in a municipality adjusted for the maintenance cost of each type of road. Thus, it would be necessary for the state to list out the maintenance cost per k.m. of different types of roads. Here, we present an operational form of the formula by using an example. The numbers used do not represent any state nor are they real. Their use is only for the purpose of putting the formula in its proper perspective.

Let there be four different types of roads in the municipalities. Their cost of maintenance as per the state government are as follows

Type of Road	Maintenance Cost/K.m.
A	Rs. 4000
B	Rs. 5000
C	Rs. 6000
D	Rs. 8000

Now we could take the maintenance cost of road type A as the base for calculating the standard road unit for the municipality. Thus, the number of road units for different types of roads is calculated as follows.

1 k.m. of type A road	=	4000/4000 = 1.00 unit
1 k.m. of type B road	=	5000/4000 = 1.25 units
1 k.m. of type C road	=	6000/4000 = 1.50 units
1 k.m. of type D road	=	8000/4000 = 2.00 units

Using these standard units, the total number of units for each municipality could be calculated by multiplying the standard unit of each type of road by the length of the road of each type in each municipality. The value of each road unit can then be determined by dividing the total divisible pool by the total number of road units in the state and then determining for each municipality accordingly. Thus for example, if the total revenue from motor vehicle tax in a state is Rs. 200,000,000, and 20 per cent forms the divisible pool in that case the following calculations become relevant in determining the value of each road unit.

Total tax collected from motor vehicle tax	Rs. 200,000,000
Divisible pool @ 20% of collections	Rs. 40,000,000
Total number of road units calculated	50,250
Value of each road unit	40,000,000/50,250 = Rs. 796

The amount of money to be paid to each municipality can then be determined by multiplying the total number of standard road units by the value of the standard unit. This system of sharing would have the advantage of transparency and predictability as discussed earlier in the section.

Approach and Principles for Addressing Horizontal Imbalances

Grants-in-aid are the most suitable instrument for addressing the problem of horizontal fiscal imbalances of municipalities. The approach suggested in this study report is based on the assumption that the problems of resource inadequacy and revenue inelasticity can be addressed by the methods outlined above. However, in doing so imbalance in the fiscal resources could rise. Grants-in-aid, under such circumstances, take a new role in the finances of municipalities, particularly those municipalities that have a poor resource base and can not increase their revenues.

This study has clearly shown that the design of grants as practised today has added to the problem of fiscal imbalances of the municipalities. It has also been shown that in practice, no principles are followed in the distribution of grants to urban local bodies. Although, it is true that the requirements of municipalities in general have not been met through grants, it is especially true in the case of poorer municipalities. In essence, the current system of grants perpetuates and aggravate the extent of fiscal poverty in poorer municipalities. Thus the new design of grants should take into account the following principles.

1. The resource poor municipalities should receive more than the rich municipalities.

2. There should be independence and flexibility in the use of the grants by the local bodies.

3. Grants should vary positively with the fiscal need of the municipalities and inversely with their taxable capacity even within the class of poor municipalities..

4. The number of heads of grants should be substantially reduced.

The State Finance Commissions will have to look closely into the problems in grant design in their respective states to determine the exact weight that is to be assigned to the factors that have been discussed in the report. Our purpose here, is only to highlight the key issues for the consideration of the State Finance Commissions.

Suggestions for Data Collection

The study team encountered a number of data related problems during the course of this study. To draw the attention of the State Finance Commissions and the respective state and urban local bodies, the report has suggested a set of data formats which could provide the type of information necessary for analysis of the financial condition of municipalities in the country. These formats are designed for universal applicability and the study team proposes that municipal data be collected and maintained in the given format. This will ensure that the State Finance Commissions in future will have access to sound information for background studies in order to make their recommendation.

It is however, not likely that such a practice would come into effect unless there was some incentive from the higher level of government for the municipalities to make efforts in this direction. In light of the current fiscal condition of municipalities, it is expected that they would not be able to devote their scarce resources to this type of an activity. Thus, the exercise of the collection and maintenance of the data in the proposed format should be undertaken under a Centrally Sponsored scheme.

Further Research

The 74th Constitutional Amendment has opened up the possibility for a new state-municipal fiscal relation. The reports of first State Finance Commissions will set the tone for the future development of this relationship. It is thus, important that many areas of local finance that have not been clearly understood in the past be studied in detail. It is necessary to understand the effect and the impact of various alternatives to augmenting the resources of municipalities, the effect of additional tax powers ,and the alternative design of grants.

This study provides an assessment of the overall finances of municipalities based on a sample from seven states. State specific studies would be required to make an assessment of the fiscal conditions of municipalities in each state. Such studies although necessary and desirable, are beyond the scope of this report. Thus, it is imperative that much more detailed work at the state level on the various aspects of municipal finance should be undertaken. It is our suggestion that the following studies will help the State Finance Commissions in their task.

1. The impact on state governments and urban local bodies of any additional tax powers to municipalities.
2. The effect of property tax reform on the finances of municipalities.
3. Mobilization of non-tax sources of revenues on the finances of municipalities.
4. Pricing of municipal services and the principles of user charges.
5. Impact of alternative grant design on the finances of states and municipalities.
6. Effect of alternative sharing mechanism on the finances of states and municipalities.

Research Support for the State Finance Commissions

The work of the State Finance Commissions will determine the future of the local governments in the country. As such, it is necessary that a mechanism of continuous research support for the State Finance Commissions be established. This could be done by creating a special cell at the state level which will engage in research activities in areas related to state-municipal fiscal relations and the overall finances of local governments. The task of this cell will be to centralise municipal data, create a database and conduct background studies for the benefit of the successive State Finance Commissions.

ANNEXURE - A

State-wise Analysis of Finances of Municipalities

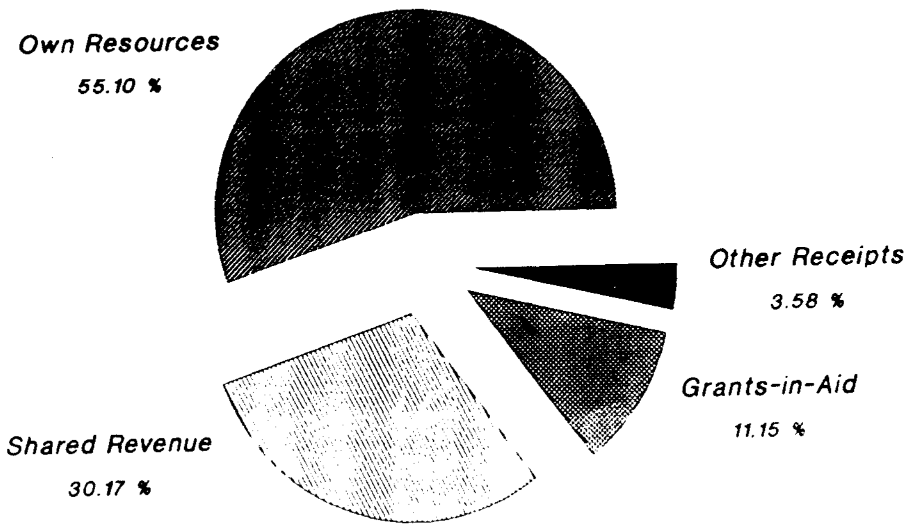
FINANCES OF MUNICIPALITIES IN ANDHRA PRADESH

The fiscal condition of municipalities in Andhra Pradesh, in the recent past has showed a dramatic turn around. This has been made possible due to the restructuring of the property tax system and the efforts to mobilize the non tax revenues such as water charges. In spite of these recent changes, the aggregate picture in comparison to the other states in our sample is not very good.

Own revenues account for only 55 per cent of the total revenues of the municipalities which is lower than all states in the sample except West Bengal. Own revenues in class A municipalities account for only 40 per cent, in class D municipalities, own revenues account for about 60 per cent of the total revenues.

Figure 1

Andhra Pradesh
Revenue Break-Up



In terms of per capita own revenues, municipalities in Andhra Pradesh are able to raise close to Rs. 80 which is the highest per capita own revenues in comparison to the non-octroi states of Assam and West Bengal in our sample.

There are variations in the per capita own revenues of municipalities of different class size. Class A municipalities are able to raise Rs. 58 per capita as compared to Rs. 78 in class B, Rs. 60 in class C and Rs. 103 in class D. Thus, in per capita terms the larger municipalities (class D) are able to raise almost twice the amount raised by the small municipalities (class A). The analysis shows that the difference between the municipality with the highest per capita own revenues and the municipality with the lowest per capita own revenues is over Rs 200. The average per capita own revenues raised by municipalities in Andhra Pradesh stands at Rs. 83 and wide variations are evidenced around the mean.

Revenues Shared with the Municipalities

Municipalities in Andhra Pradesh derive over 30 per cent of their total revenues through the mechanism of sharing the revenues with the state. This share is the highest for any state in our sample. Even in West Bengal which is highly dependent on transfers for its functioning, the share is only 27 per cent of the total revenue. Profession tax and entertainment tax are the major taxes which are shared with the municipalities. The state assigns over 85 per cent of both the profession tax and the entertainment tax to the urban local bodies.

In per capita terms, these figures turn out to be about Rs. 43 and the variations across different class size of municipalities is fairly low. It is also seen that in per capita terms, the municipalities receive a higher amount as shared revenues compared to states like Assam, Maharashtra, Kerala and West Bengal.

Grants to Urban Local Bodies

Grants account for only 11.2 per cent of the total revenues of the municipalities in Andhra Pradesh. Grants as a percentage of the total revenues of class A municipalities stands at 18.5 per cent, for class B at 13.3 per cent, for class C at 13.4 per cent and for class D 6.8 per cent. The aggregate analysis of municipalities in each class shows that class A municipalities on an average receive higher per capita than other size-class municipalities.

There are however, large variation in per capita grants within each class of municipality. There are municipalities in the same size class that receive per capita grants from a low of Rs. 0.17 to Rs. 99.7. These disparities in distribution of grants have perpetuated the horizontal fiscal imbalance of the municipalities in the state.

Expenditure Pattern of Municipalities

The expenditures are concentrated in public works, public health and general administration. In general the municipalities in the state are able to finance only about 53 per cent of their current expenditures from their internal sources of revenues.

Potential Revenues and Expenditure Needs

Sampled municipalities in Andhra Pradesh have the potential of generating an additional Rs. 886.2 million from their internal sources. This is however only 57 per cent of their estimated expenditure needs which are estimated at Rs. 1552.5 million.

Figure 2

Relationship between Own Resources & Grants

Andhra Pradesh

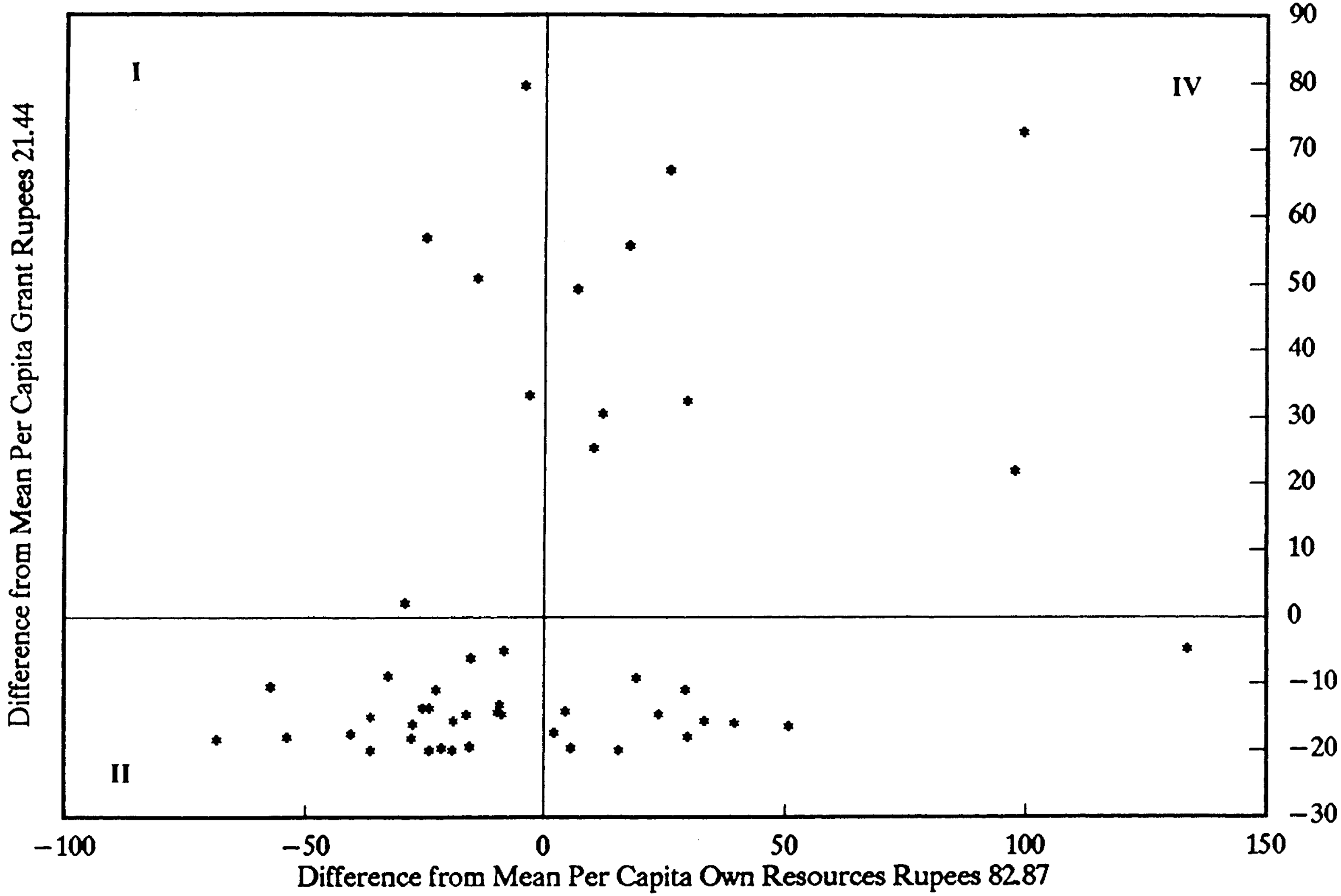
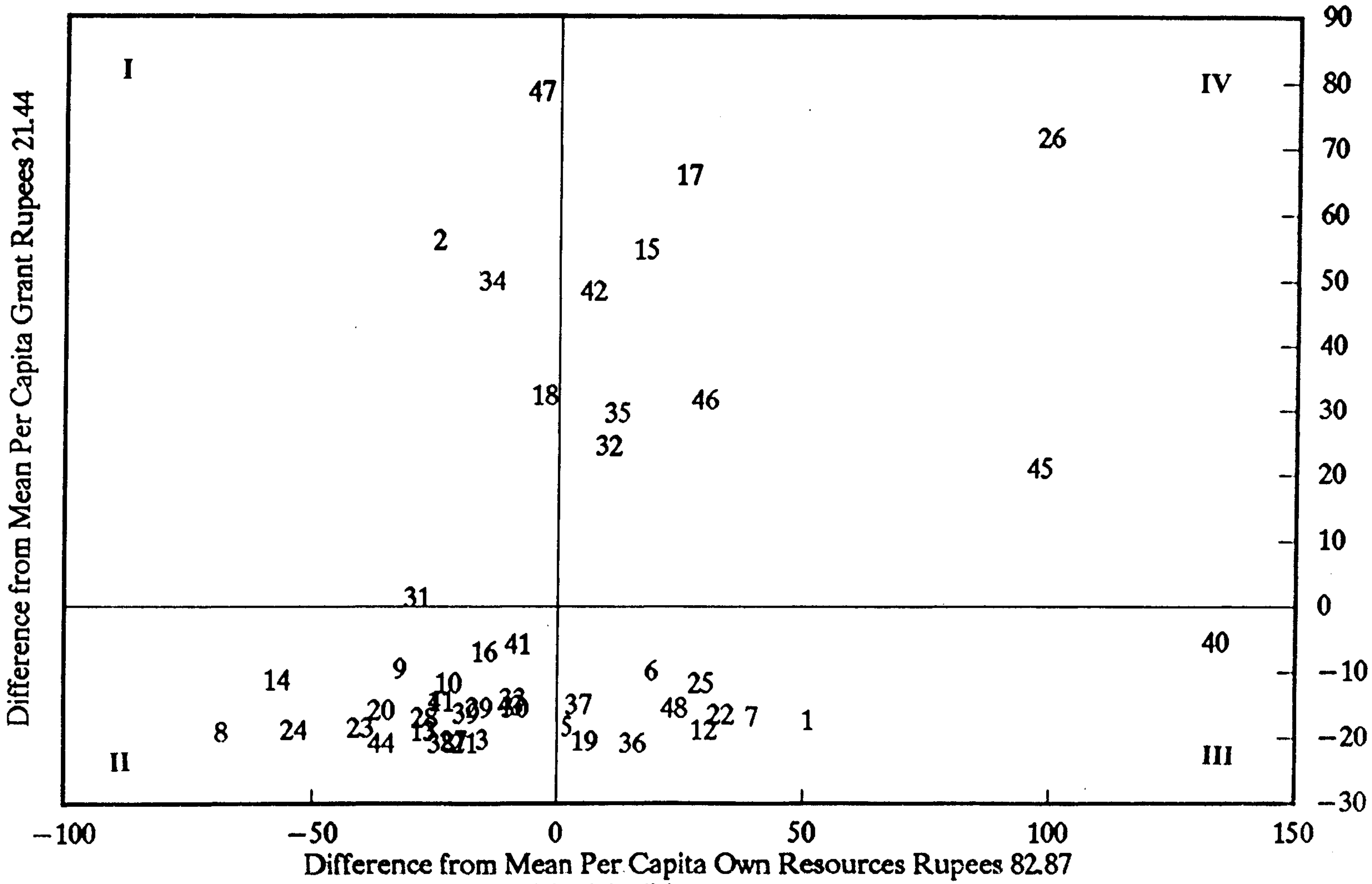


Figure 3

Relationship between Own Resources & Grants

By size of Deficit Andhra Pradesh

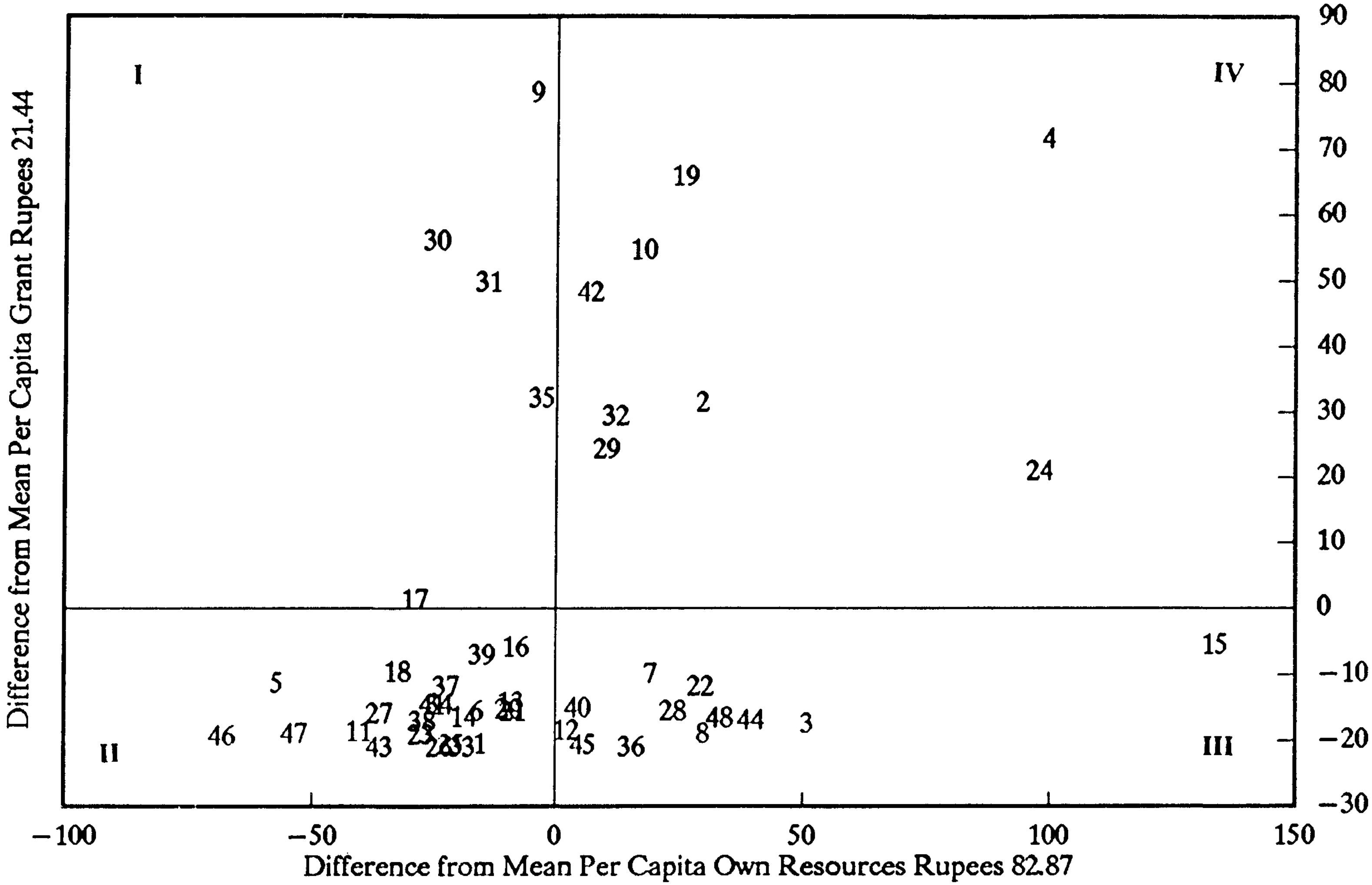


Note : Rank 4 and onwards shows Deficit Municipalities

Figure 4

Relationship between Own Resources & Grants

By Growth in Own Resources (1991–92) Andhra Pradesh

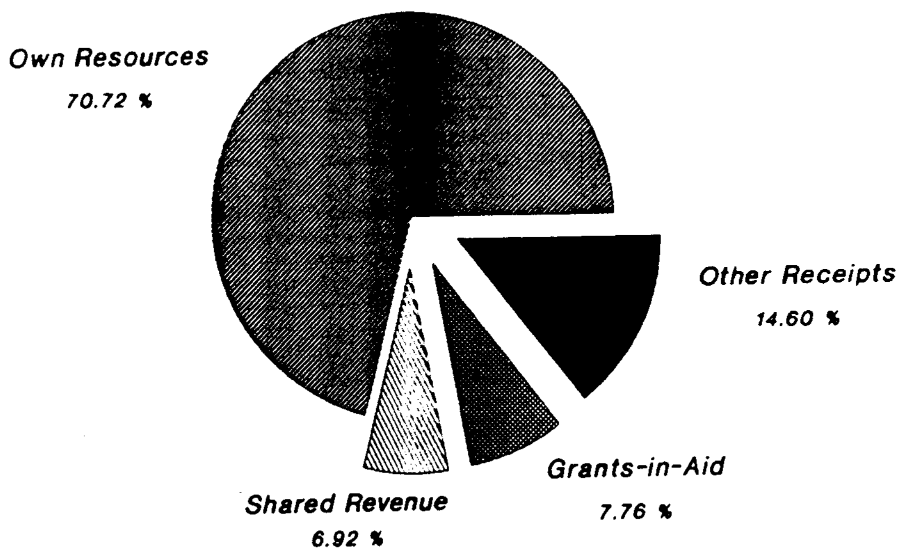


Note : Rank 43 and onwards shows negative Growth in Own Resources

With the tax powers vested in the hands of the municipalities in Assam, they are able to raise substantial amounts from their internal sources. Own revenues account for over 70 per cent of the total revenues of the urban local bodies. In Class A municipalities, own revenues as a percentage of the total revenues stand at about 68 per cent, while class B account for 78 per cent. In comparison to the states of Andhra Pradesh and West Bengal, the situation is better in Assam.

Figure 5

Assam
Revenue Break-Up



There is very little evidence of inter-class variation in per capita own revenues, however, within class variations are a striking feature of municipalities in the state. The measure of variation in per capita own revenues show that the difference in per capita own revenues between the highest (Rs. 105.4) and the lowest (Rs. 13.9) municipality is high. Such variations have added to the fiscal imbalances of the municipalities. It is also seen that these imbalances have not been corrected either through the sharing mechanism or the grants-in-aid to urban local bodies.

Revenues Shared with the Municipalities

Based on the sample, shared revenues account for only 6.9 per cent of the total revenues of the municipalities in the state. Class A municipalities account for 7.7 per cent while those in class B account for 4.1 per cent. The per capita receipts from shared revenues turns out to only Rs. 4.9 for class A as compared to Rs. 2.4 for class B municipalities.

Grants to Urban Local Bodies

Grants-in-aid account for only 7.8 per cent of the total revenues of sampled municipalities in Assam. These figures may be biased due to the absence of the class C and class D municipalities in our sample for the state of Assam. Thus, caution should be used in interpreting these figures. The per capita grant to sampled municipalities stands at about Rs. 4.8 being the lowest of any state in the sample. Class A municipalities receive Rs. 5.5 per capita while those of class B receive Rs. 2.5 per capita.

The variation in per capita grants are reflected by the fact that the municipality with the highest per capita grant receives Rs. 25 as compared to only Rs. 0.39 for the municipality with the lowest per capita grant.

Expenditure Pattern of Municipalities

Much of the revenues of municipalities in Assam are spent on public works, public health and general administration. In general municipalities are able to finance over 79 per cent of their current expenditure needs from internal sources.

Potential Revenues and Expenditure Needs

Estimates made by the study team show that sampled municipalities in the State of Assam have an additional potential of Rs. 54.8 million as compared to their expenditure needs of Rs. 100.8 million. Thus they are capable of financing only about 54 per cent of their estimated expenditure needs from the potential revenues. Thus it would be necessary to use grants to finance some of their expenditure needs.

Figure 6

Relationship between Own Resources & Grants

Assam

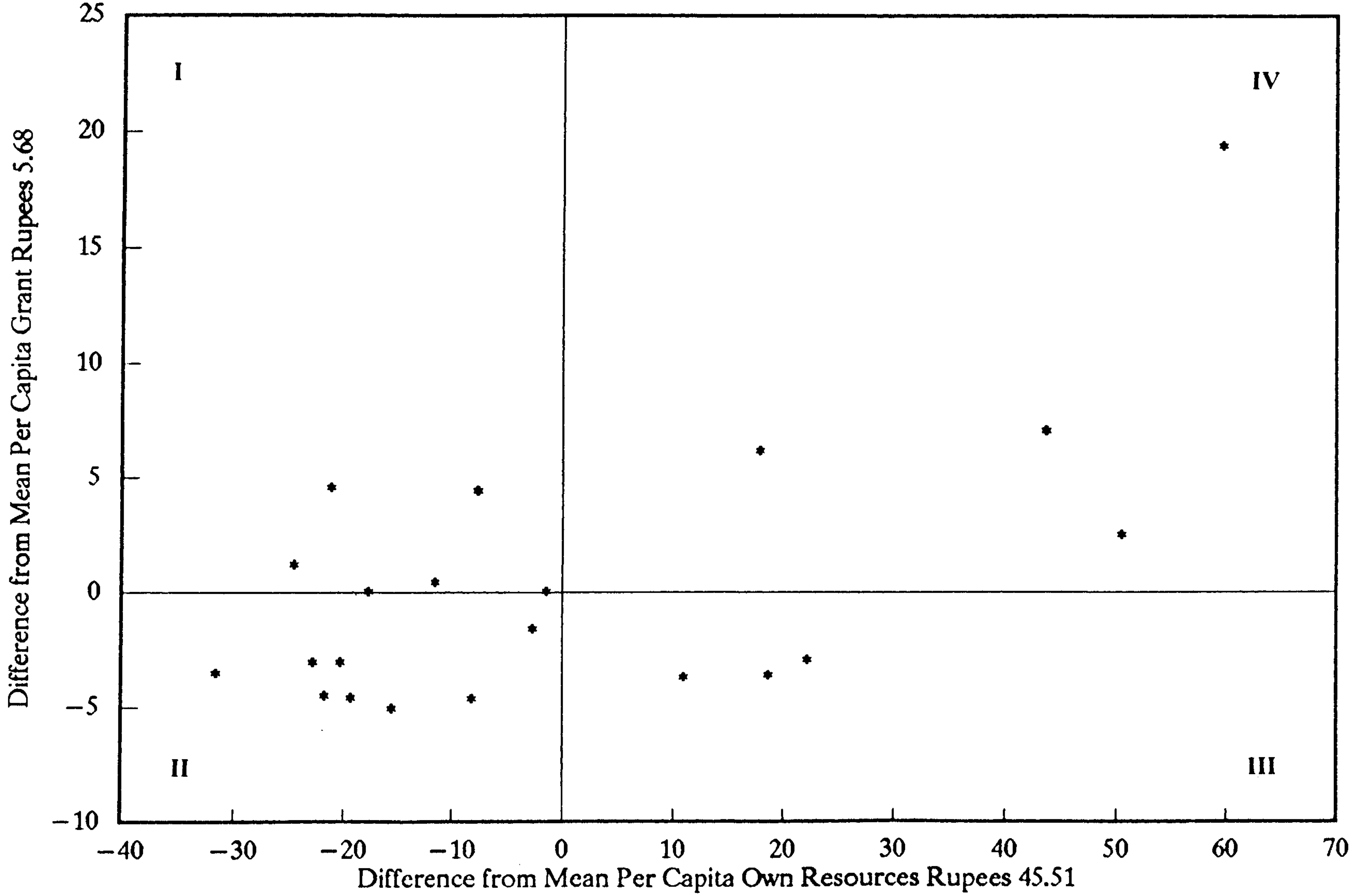
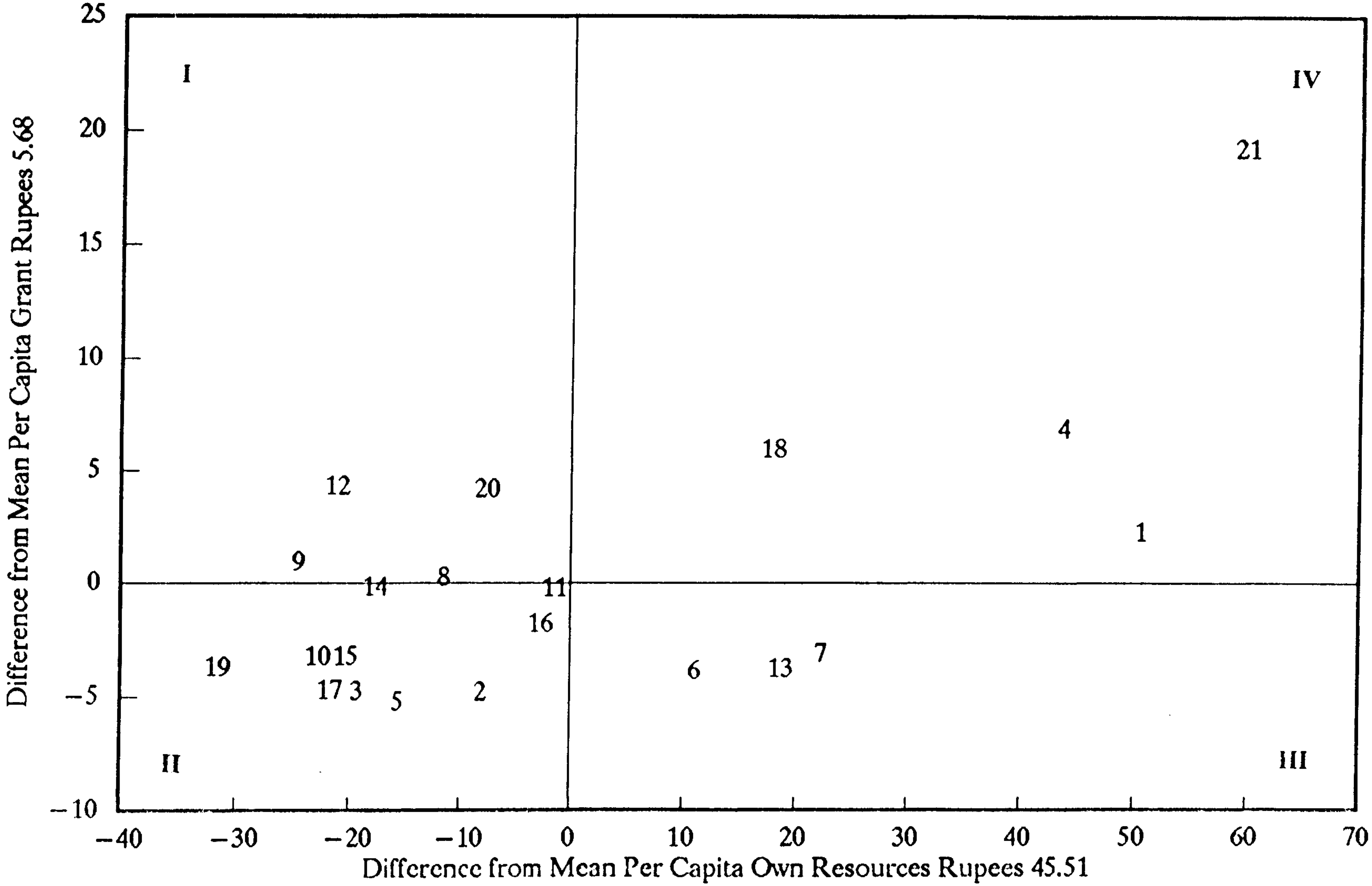


Figure 7

Relationship between Own Resources & Grants

By size of Deficit Assam

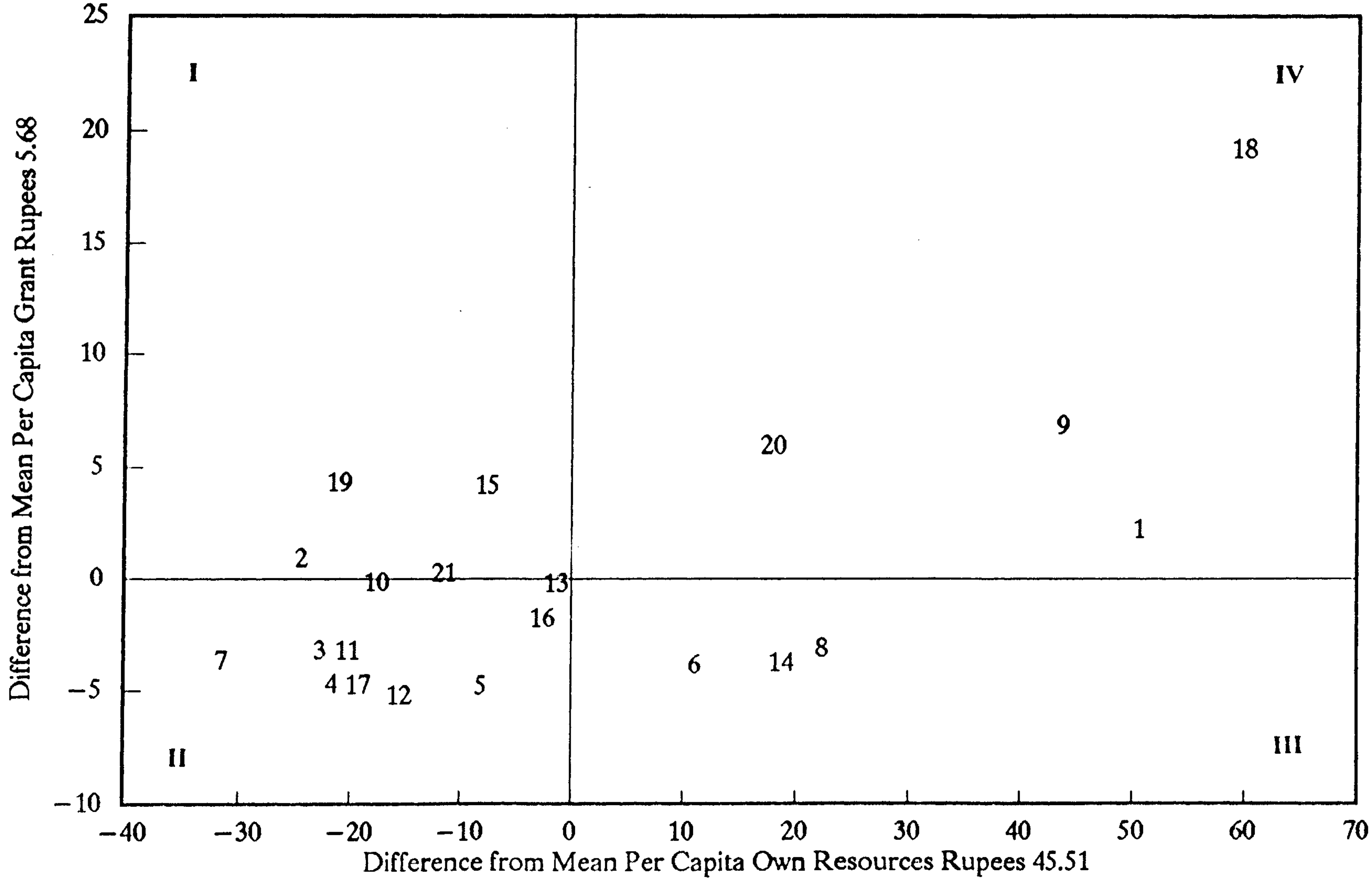


Note : Rank 6 and onwards shows Deficit Municipalities

Figure 8

Relationship between Own Resources & Grants

By Growth in Own Resources (1991–92) Assam



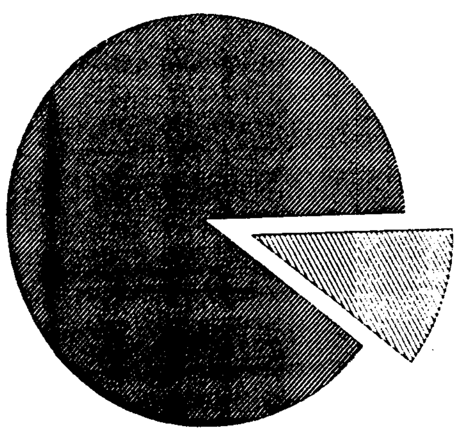
Note : Rank 2 and onwards shows negative Growth in Own Resources

FINANCES OF MUNICIPALITIES IN GUJARAT

Over 85 per cent of the total revenues of municipalities in Gujarat comes from own sources which includes both the tax and non-tax revenues that are levied, collected and used by the municipalities. Gujarat has the advantage of being an octroi levying state and thus bulk of the revenues from internal source is derived from the octroi income. Property tax stands only second to the octroi income in of the municipalities. This source has been responsible for a stronger fiscal condition of the municipalities in comparison to the municipalities in the states of Andhra Pradesh, Assam and West Bengal which do not levy octroi.

Figure 9

Gujarat
Revenue Break-Up



The per capita income from internal sources in 1991-92 for all municipalities as a whole stood at Rs. 441.4. However, there are vast variations among the different class size of municipalities. The per capita own revenues of municipalities in class a was only Rs. 198.7 compared to Rs. 267.7 in class B , Rs. 336.9 in class C and Rs. 587.5 in class D. These variations are the result of the unequal distribution of octroi earnings in the state. Larger municipalities derive more in terms of octroi revenue due to the virtue of the trade that takes place within their jurisdictions. It is also seen that property tax revenues are only 15.7 per cent of the total revenues of the municipalities in Gujarat with a per capita property tax revenues of only Rs. 68.7.

Variations in Per Capita Own Revenues

One of the striking feature of the per capita own revenues in comparison to the non-octroi state is the in-class and inter-class variations that exist. These extreme variations have again resulted due to the unequal distribution of octroi revenues across the municipalities. The per capita own revenues of municipalities in Gujarat range from a high of Rs. 745.5 to a low of Rs. 94.3. with a mean of Rs. 234.8 for all municipalities.

Revenues Shared with the Municipalities

As per the information furnished to us by the state of Gujarat, there are currently no major taxes that are shared with the state government. The municipalities mainly depend on their internal sources of revenues.

Grants to Urban Local Bodies

Grants account for only 11 per cent of the total revenues of the municipalities. These figures demonstrate the low level of dependence on the state government. There are wide variations in all aspects of the finances of municipalities both across different class size and also within the different size class of municipalities. Grant distribution in the state is based on a formula. however, our analysis shows that the principles in the distribution of grants have not been followed and their distribution can be best explained by a random process.

Expenditure Pattern of Municipalities

The general picture that emerges from the analysis of expenditure of municipalities in Gujarat, shows that municipalities on an average are not only capable of financing all their current expenditures from own revenues but are also able to generate some surpluses. Larger municipalities generate larger surpluses compared to the smaller municipalities. Much of the expenditure is concentrated in public works, public health and general administration.

Potential Revenues and Expenditure Needs

It is estimated that the sampled municipalities in the state have a potential of generating an additional Rs. 1888.9 million from their internal sources. This about 115.6 per cent of their estimated expenditure needs which stand at Rs. 1633.2 million.

Figure 10

Relationship between Own Resources & Grants

Gujarat

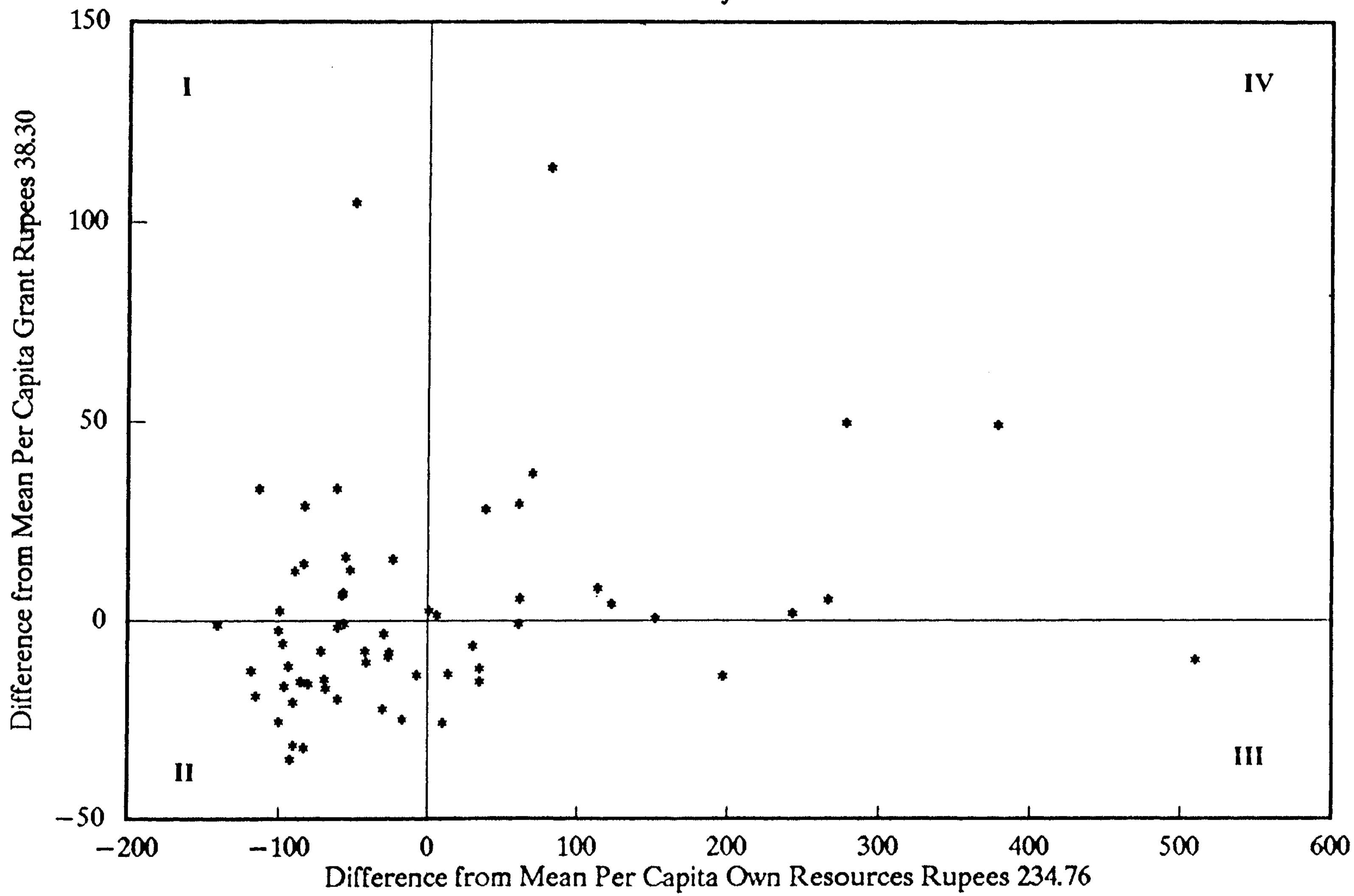
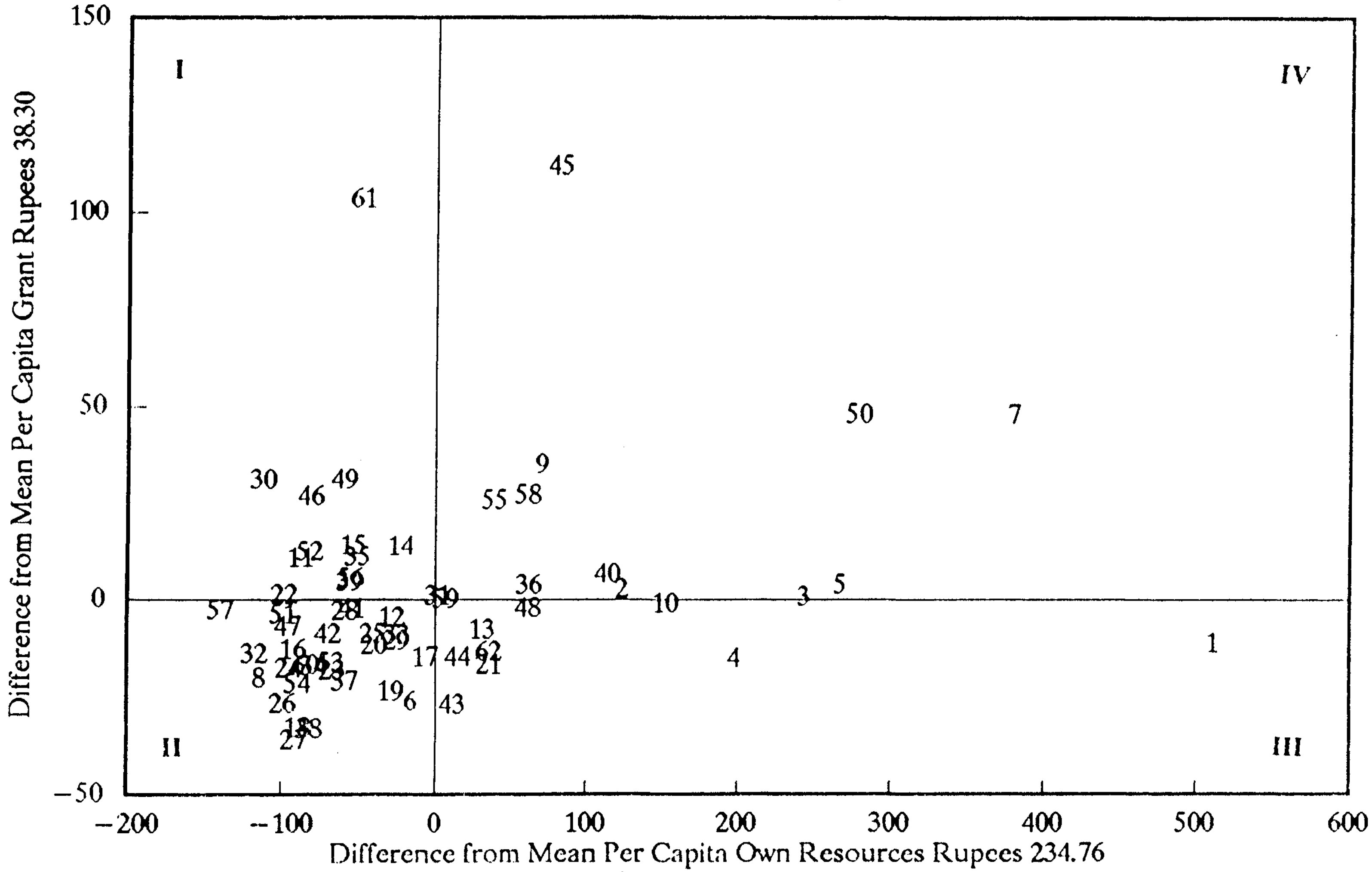


Figure 11

Relationship between Own Resources & Grants

By size of Deficit Gujarat

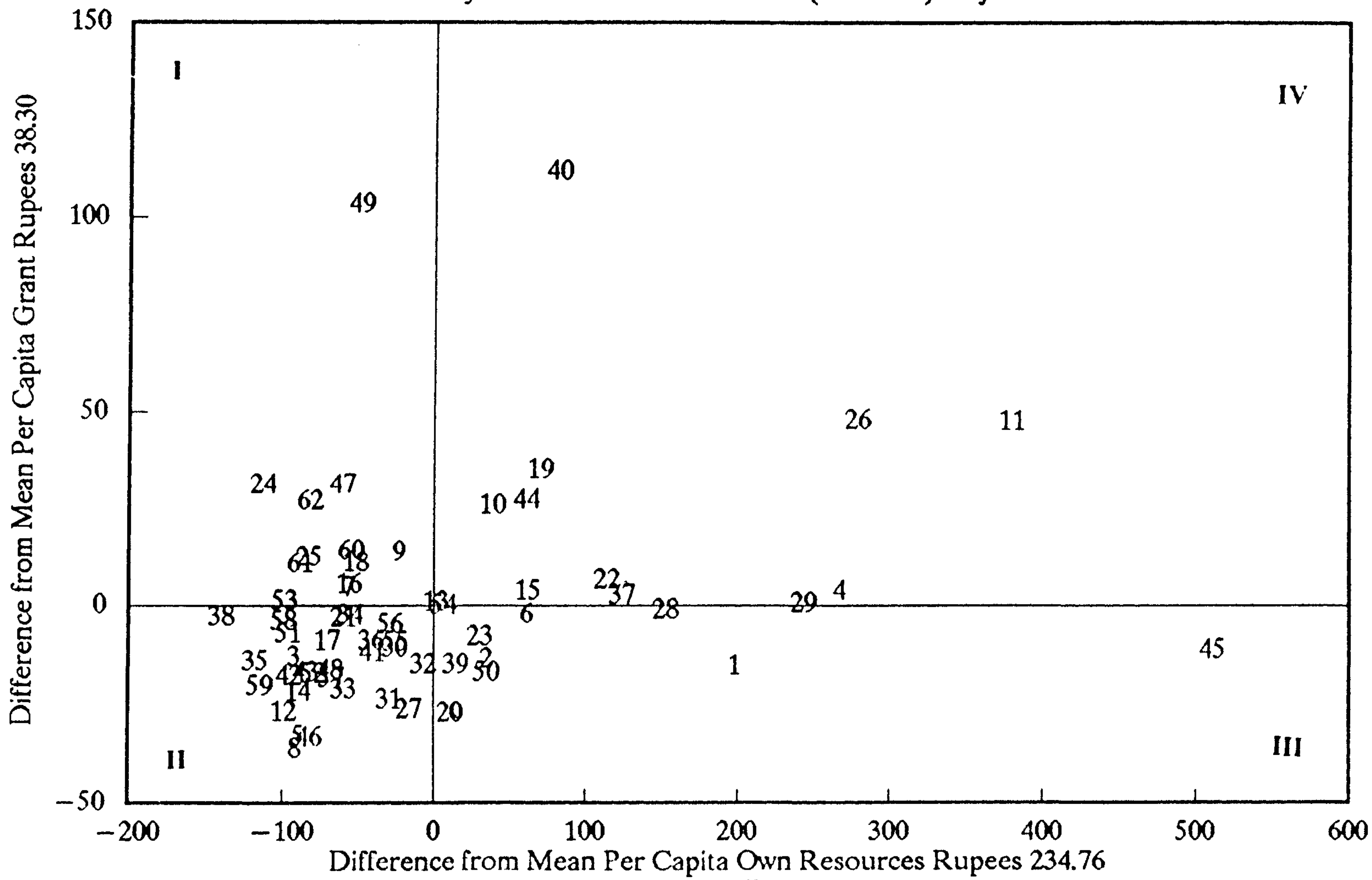


Note : Rank 19 and onwards shows Deficit Municipalities

Figure 12

Relationship between Own Resources & Grants

By Growth in Own Resources (1991–92) Gujarat



Note: Rank 54 and onwards shows negative Growth in Own Resources

FINANCES OF MUNICIPALITIES IN KERALA

Of the seven states in the sample, municipalities in the state of Kerala stand out as unique in terms of their fiscal condition. They are better placed in comparison to the states of Andhra Pradesh, Assam and West Bengal. However, their finances are not as good as the octroi state of Gujarat, Punjab and Maharashtra. It should be pointed out that Kerala has a different pattern of urbanization in comparison to the other sates in our sample. The distinction between poor and rich municipalities is very narrow in terms of their fiscal strength.

There are two important factors that have contributed to this uniqueness.

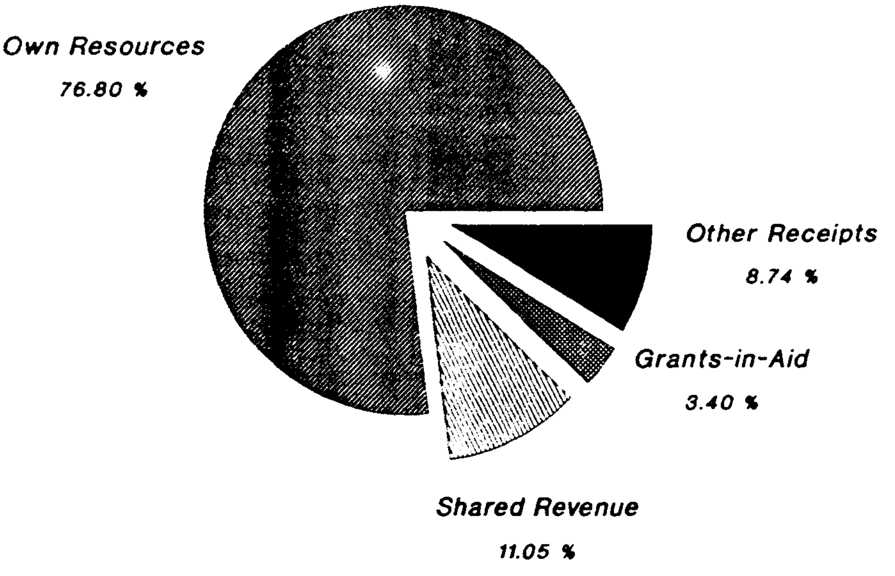
1. In comparison to the non-octroi state of Andhra Pradesh, Assam and West Bengal, municipalities in Kerala enjoy more tax powers. The entertainment tax and profession tax are within the domain of the municipalities in Kerala, while they are state taxes in the other non-octroi states and municipalities receive only a share of the revenues derived from this tax.

2. Municipalities in Kerala have been able to exploit their non-tax revenues, especially the income from remunerative enterprises. Income from remunerative enterprises accounts for over 25 per cent of their own resources in more than 20 municipalities of the 57 municipalities in the sample. This has been made possible due to the financial assistance for remunerative enterprises from the Kerala Urban Development Finance Corporation which was set up in 1970.

In general, over 76 per cent of the total revenue of the municipalities is derived from internal sources. On analysis it is seen that major sources of income of municipalities are property tax, entertainment tax and income from municipal properties which is a non-tax revenue. Property tax is the major income in 28 municipalities, entertainment tax in 20 municipalities and income from municipal properties in 9 municipalities. Taking all municipalities together, the major source of revenue is the property tax. Next comes entertainment tax. Income from properties occupies third position.

Figure 13

Kerala
Revenue Break-Up



Municipalities in Kerala generate from their own sources of revenue about Rs. 132 per capita. The differences across size class are small with Rs. 130 for class A, Rs. 123 for class B, Rs. 143 for Class C and Rs. 134 for class D.

Revenues shared with the state account for only 11 per cent of the total revenues of the municipalities in Kerala. Grants-in-aid on the other hand account for 3.4 per cent of the total revenues of the municipalities. It is clear that the dependence of municipalities on the state is very low.

On a per capita basis, shared taxes account for Rs 9.95 in class A municipalities. Rs. 14.4 in class B, Rs. 20.0 in class C and Rs. 38.4 in class D municipalities. Thus it is seen that on a per capita basis larger municipalities tend to receive more than those in smaller municipalities. Per capita analysis of grants do not present such variations.

Size-Class Analysis of Revenue Composition

The analysis shows that the revenue composition of municipalities in Kerala across different size-class of municipalities is more or less identical. Own sources account for over 73 per cent of the total revenues of municipalities in all size-class. Similar trends are seen for both tax and non-tax components as well.

It is seen that within class variation in per capita own revenues of municipalities is much higher than those for municipalities across class size. Thus, grants which are fairly small in relation to the total revenue of municipalises, are unable to address the within size class variations. They have however, not perpetuated in-class variation in the finances of municipalities. This is however, not true for the other states in our sample.

Expenditure Pattern of Municipalities

Our analysis shows that 14 of the 57 municipalities in Kerala are able to meet out their current expenditures from own sources of revenues and are also able to generate a small surplus. This is not the same in case of Andhra Pradesh, Assam and West Bengal. Even the octroi state of Maharashtra and Punjab and able to meet only 98 and 94 per cent of their current expenditures from their own revenues compared to over 107 per cent in case of Kerala (this figure represents aggregate of all municipalities). Thus, the ability of municipalities in Kerala to finance their current expenditures is better than most states in our sample.

The major components of expenditure are public works, public health and general administration. Their share in total expenditures stands at 34 per cent, 28 per cent and 22 per cent respectively. The expenditure on general administration follows the same pattern as with the other states in our sample. In per capita terms these figures translate to Rs. 59, Rs. 43 and Rs. 37 respectively.

Potential Revenue and Expenditure Needs

Our estimates show that municipalities in Kerala have an additional potential of Rs. 623 million. This would imply that they could more than double their own revenues if efforts are made to exploit all sources of revenue fully. It is aiso seen that this potential revenue would be able to meet about 80 per cent of their potential expenditure needs, thus leaving a gap of about 20 per cent to filled by transfers.

Figure 14

Relationship between Own Resources & Grants

Kerala

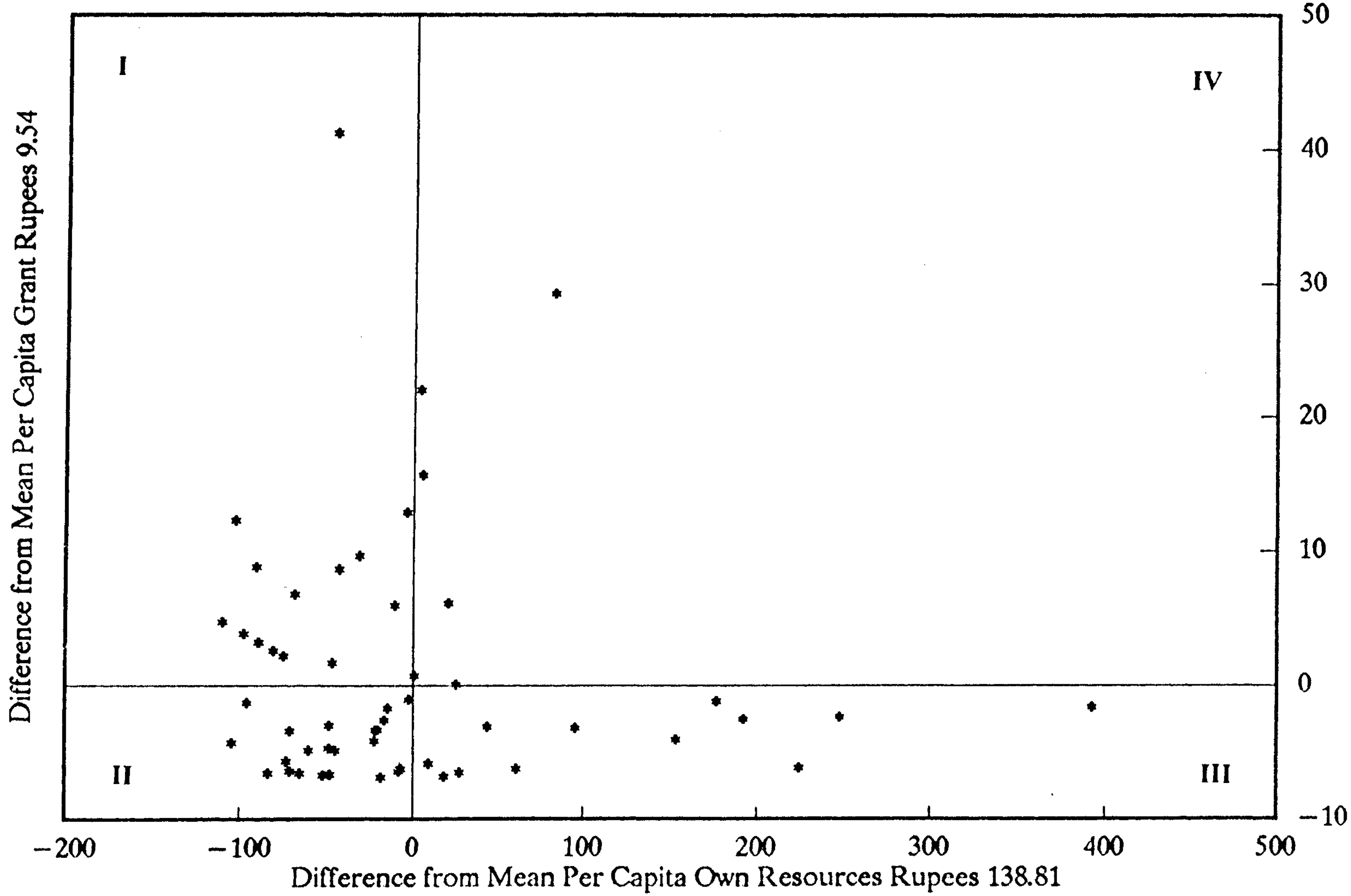
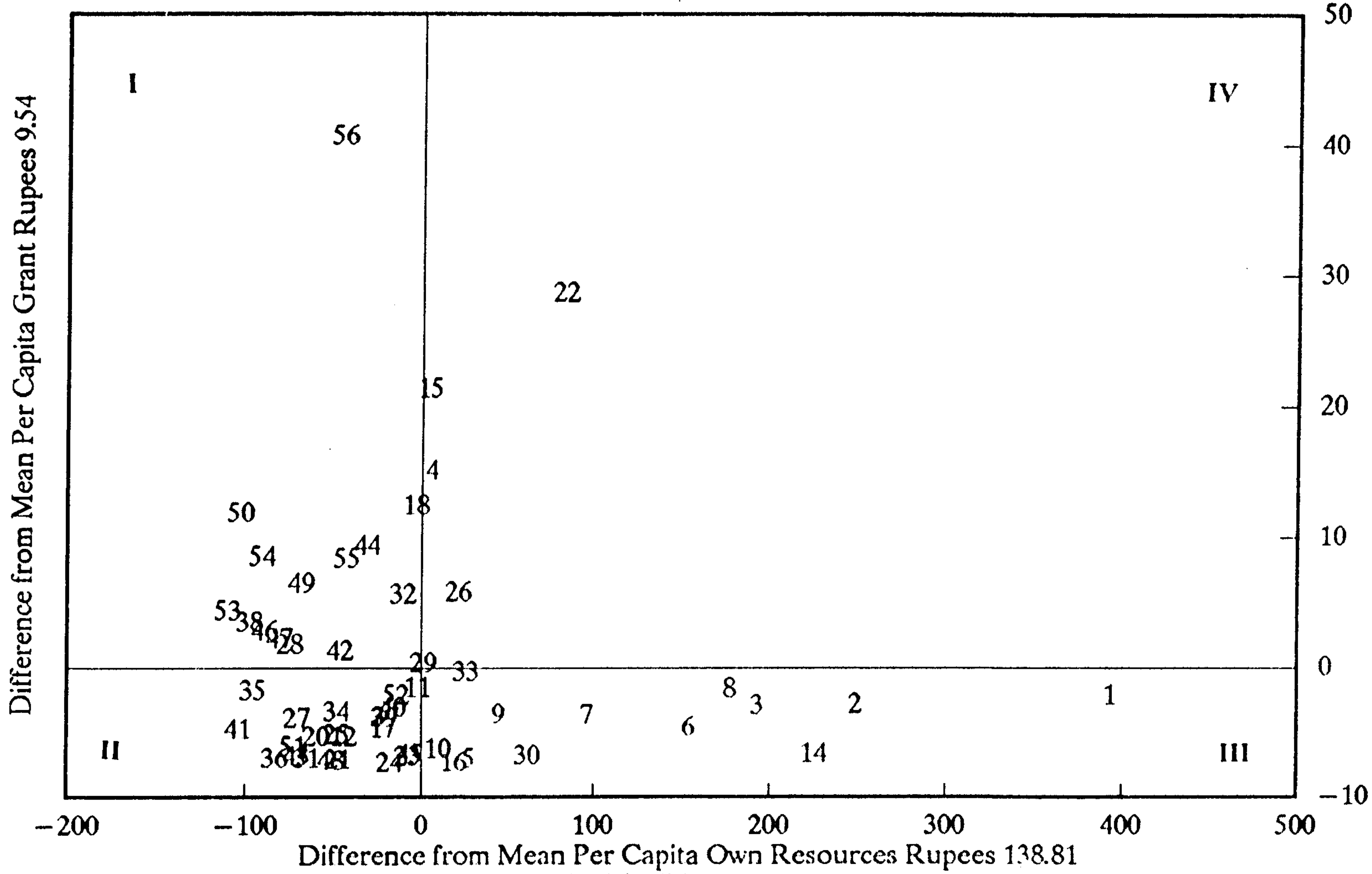


Figure 15

Relationship between Own Resources & Grants

By size of Deficit Kerala

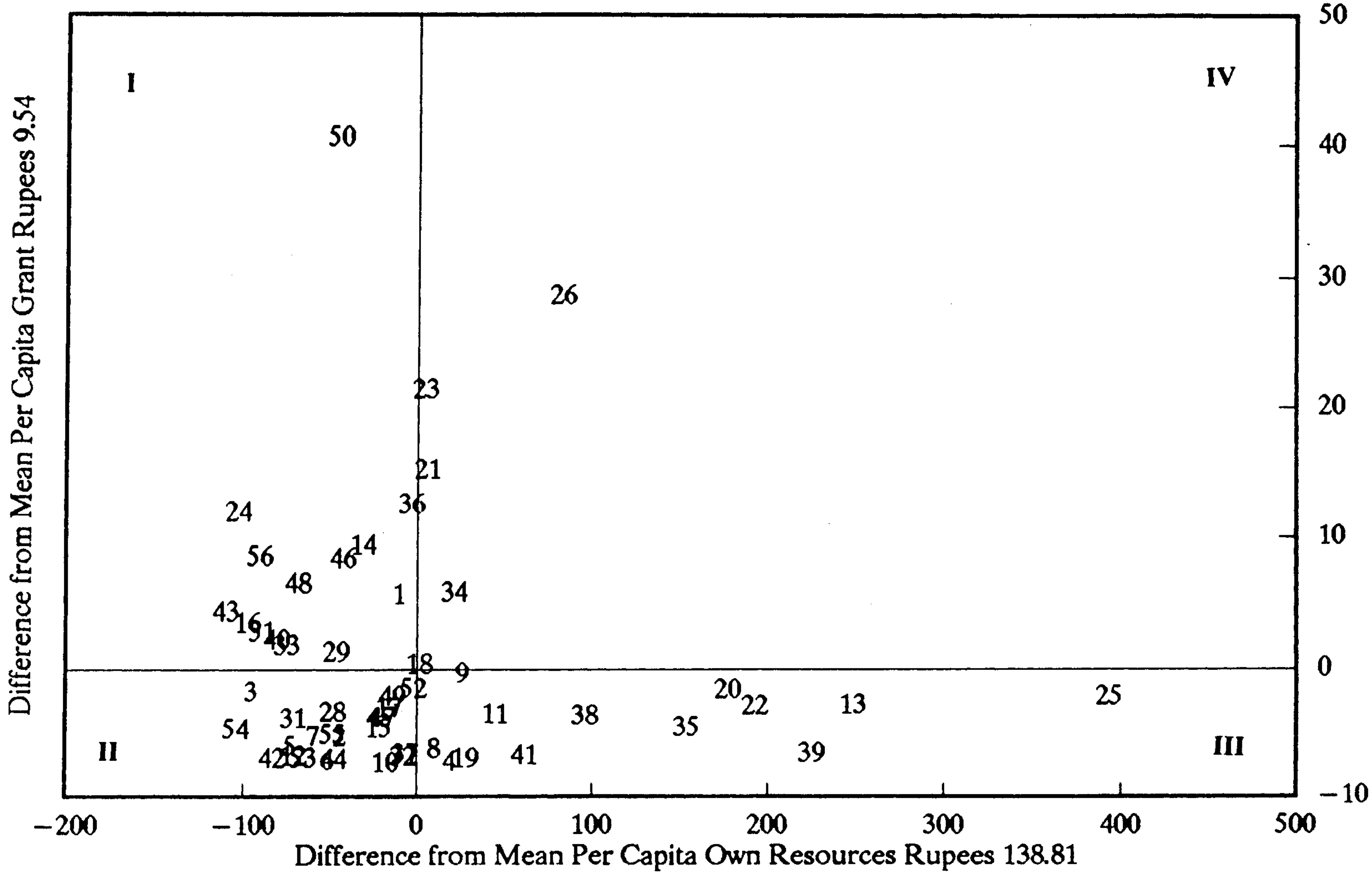


Note : Rank 43 and onwards shows Deficit Municipalities

Figure 16

Relationship between Own Resources & Grants

By Growth in Own resources (1991–92) Kerala



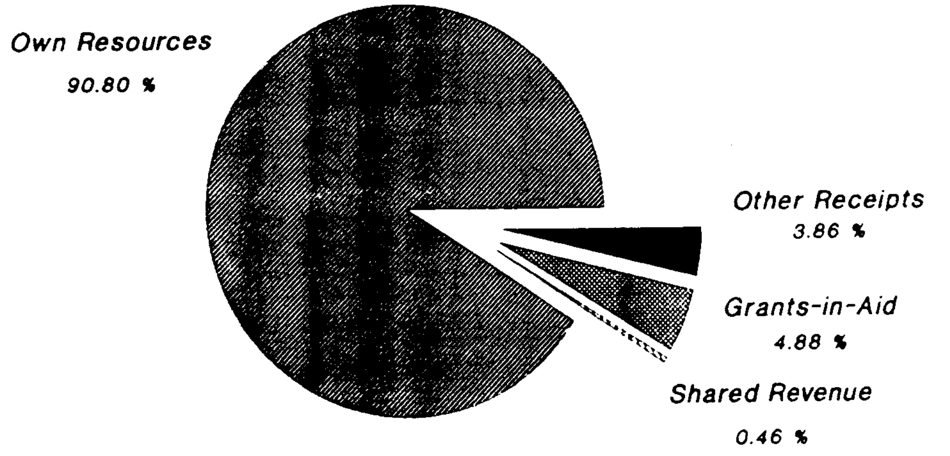
Note : Rank 40 and onwards shows negative Growth in Own Resources

FINANCES OF MUNICIPALITIES IN MAHARASHTRA

Own revenues are a major component of the total finances of municipalities in Maharashtra. They account for over 91 per cent of the total revenues of all urban local bodies. It is seen that the per capita own revenues are lower in smaller municipalities. Thus, there is a tendency for the per capita revenues to rise with the size of the municipality. This is a reflection again of the effect of the unequal distribution of economic activity and thus, the revenues from octroi which depend on the extent of trade that takes place within their jurisdictions.

Figure 17

Maharashtra
Revenue Break-Up



Class A municipalities generate on an per capita basis about Rs. 305.2 as compared to Rs. 302 for class B, Rs. 397 for class C and Rs. 849.9 for class D municipalities. These variations exist not only across different class of municipalities but also exist within the different size class of urban local bodies. The highest per capita own revenues for municipalities in Maharashtra stood at Rs. 1284.1 as compared to a low of only Rs. 109.7 for the municipality with the lowest per capita own revenue. The mean for the state as a whole for the year 1991-92 stood at Rs. 403.7 in per capita terms.

Octroi is the major source of internal revenue of the municipalities in the state followed by the property tax which are only 15.9 per cent of the own resources of the municipalities. The contribution of the non-tax revenue sources is greater than the contribution of the revenues from property taxes in many of the municipalities. This indicates that the potential for generating additional revenues from property taxes may be very high.

Revenues Shared with the Municipalities

In view of the strong fiscal condition of municipalities in Maharashtra, there are no major taxes that are shared with the state. Thus shared taxes occupy a insignificant position in their finances. During the period 1991-92, they accounted for only 0.5 per cent of the total revenue of the sampled municipalities in the state. In per capita terms, shared revenues stood at only Rs. 3.7. Not much variation is seen even in case of different class size of municipalities. Being a octroi levying state, the dependence of municipalities on their own sources of revenues is very high.

Grants to Urban Local Bodies

Grants account for only 4.9 per cent of the total revenues of municipalities in Maharashtra. There are wide variations in the distribution of grants to urban local bodies. Class A municipalities receive on an average Rs. 126 per capita compared to Rs. 133.5 for class B, Rs. 64.2 for class C and Rs. 26.1 for class D. The variation ranges from a high of Rs. 257.1 to a low of Rs. 7.3 per capita. These variations exist not only across the different class of municipalities but also with in different size class of municipalities. The mean per capita grant received by municipalities in Maharashtra stood at Rs. 96.7 during the year 1991-92.

Expenditure Pattern of Municipalities

One pattern that is clearly evidenced across the octroi levying states is that their ability to finance their current expenditure is very high and Maharashtra is no exception to that general trend. On an average more than 98 per cent of the current expenditures can be financed from own revenues for the municipalities as a whole. However, there are some variations in the ability of municipalities to finance their expenditures when we look at the different class size of municipalities. The larger the size of the municipality the greater is the ability to finance it \s expenditures from own revenues.

Potential Revenues and Expenditure Needs

Our estimates show that both the potential revenues and the expenditure needs are very high for municipalities in the state of Maharashtra. Potential revenues are estimated to be around Rs. 7625.2 where as the expenditure needs are estimated at Rs. 8676 million. Thus municipalities in general are capable of financing over 87 per cent of their expenditure need through their own revenue mobilization efforts.

Figure 18

Relationship between Own Resources & Grants

Maharashtra

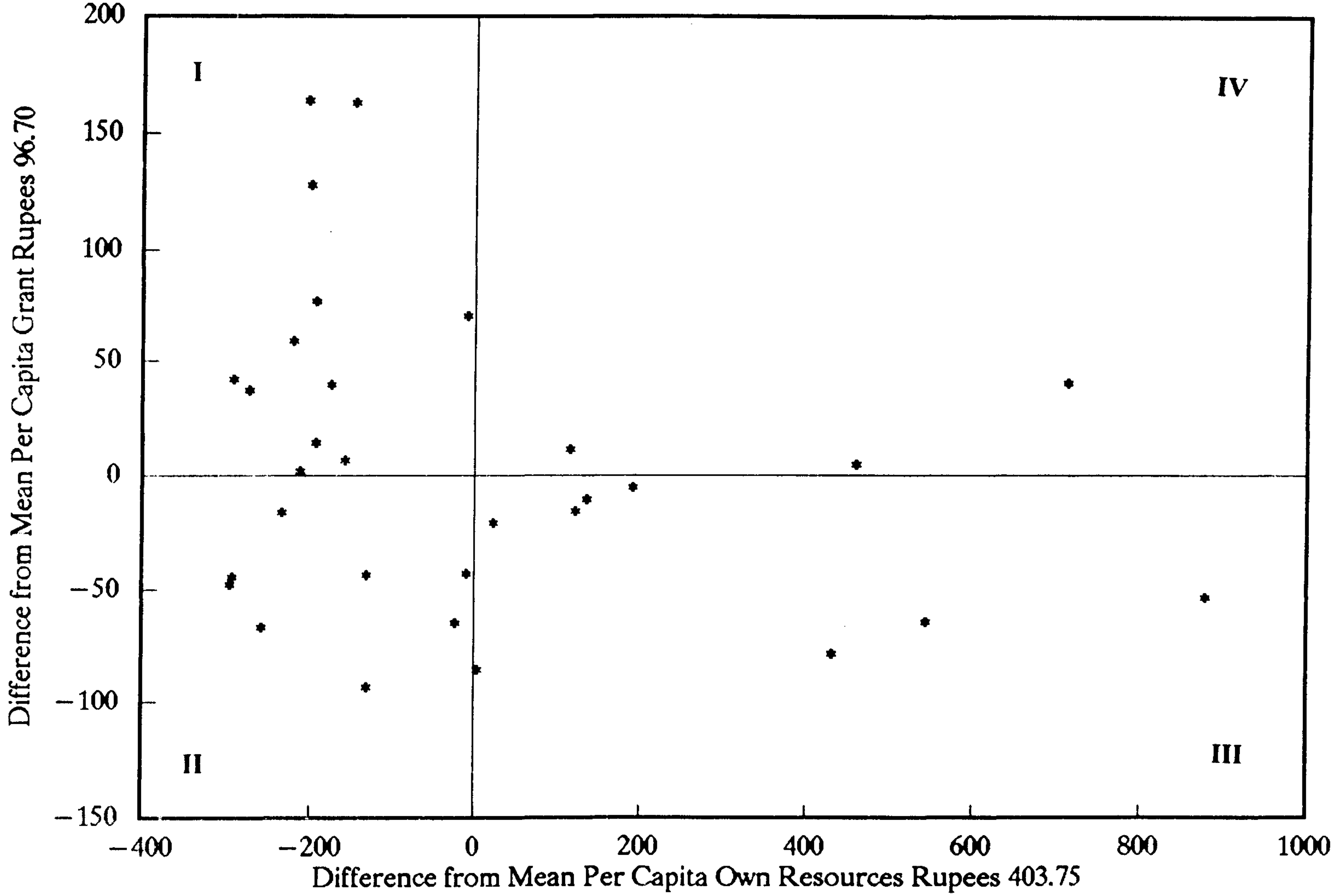
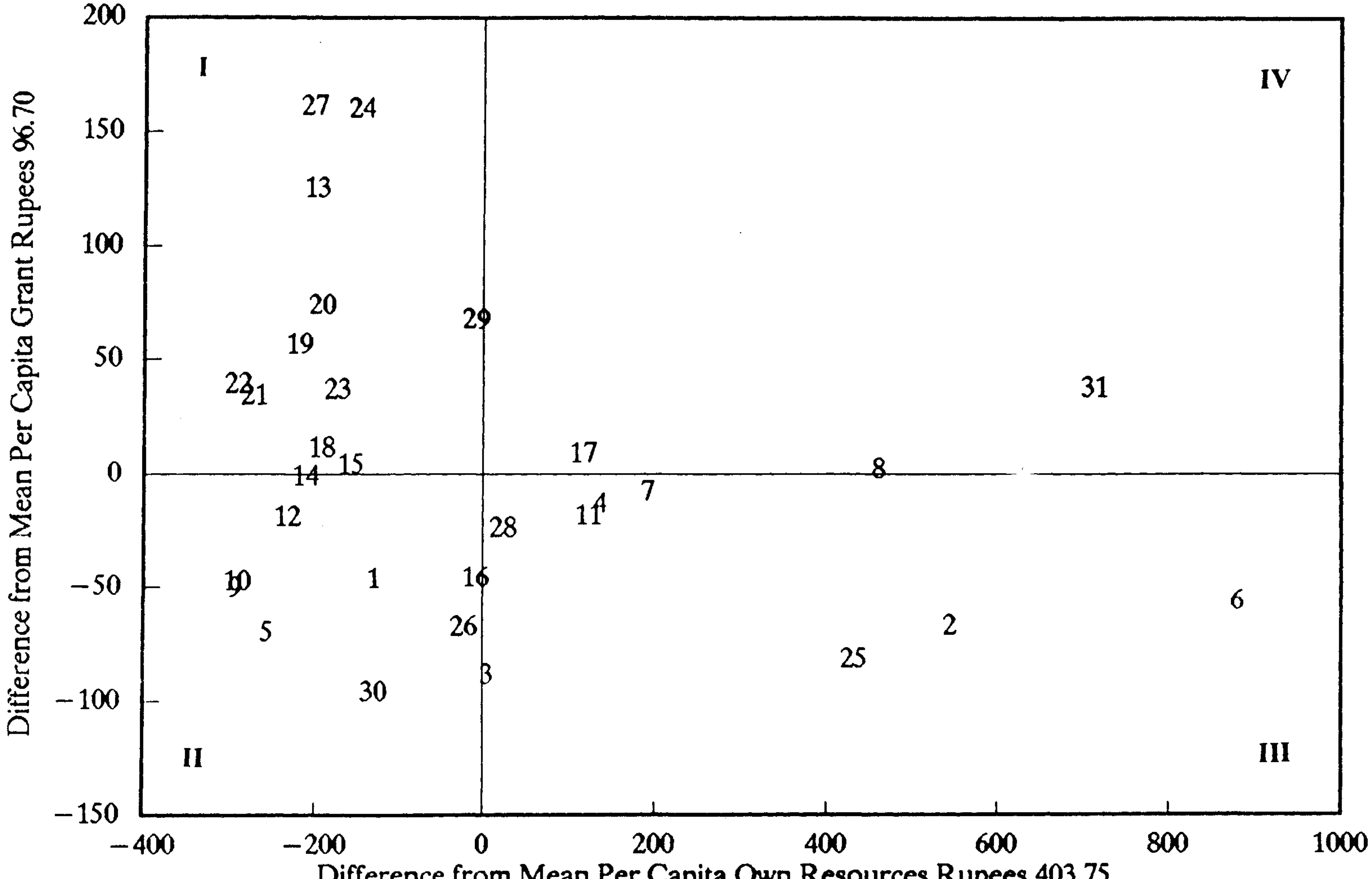


Figure 19

Relationship between Own Resources & Grants

By size of Deficit Maharashtra

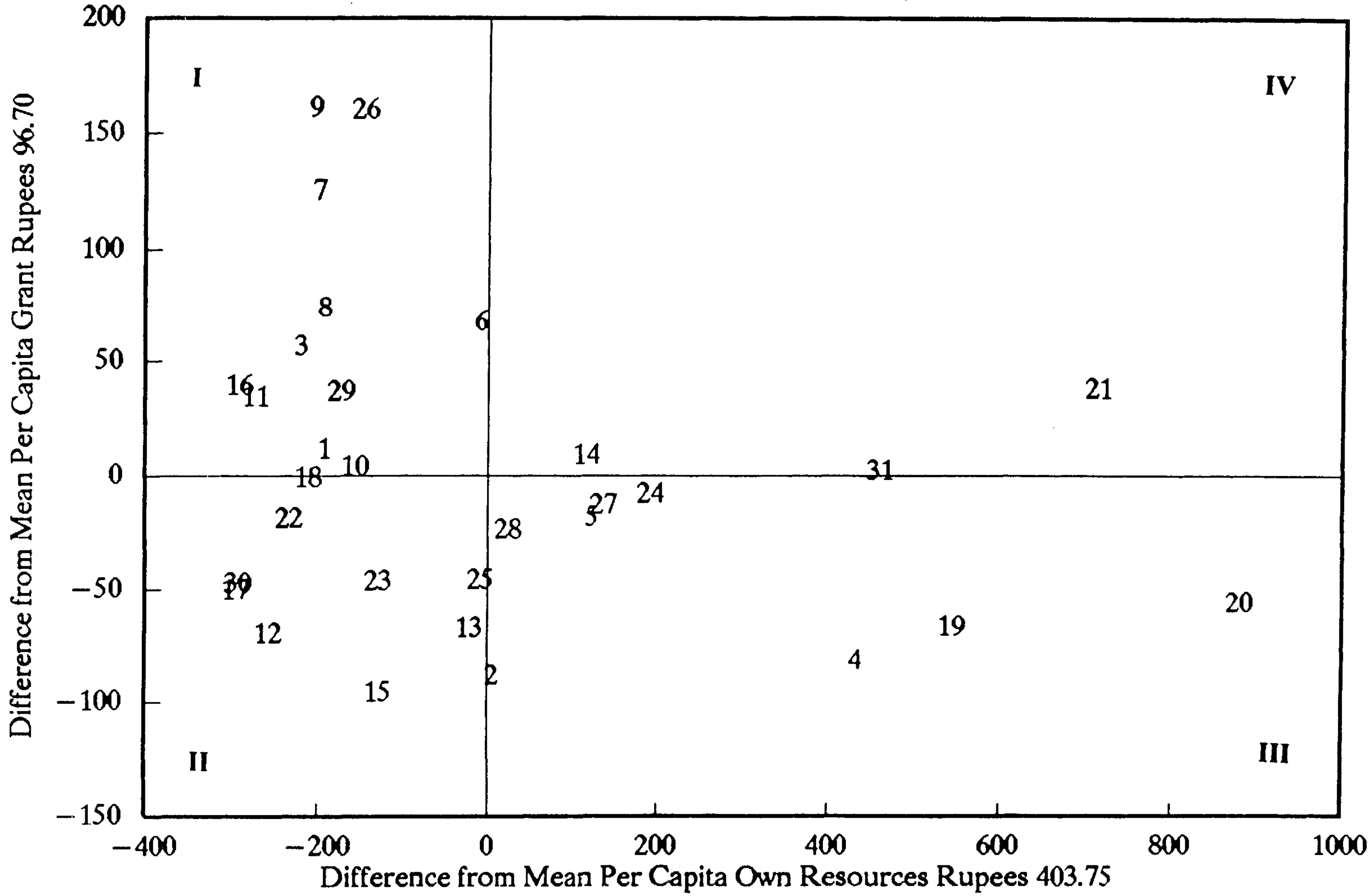


Note : Rank 4 and onwards shows Deficit Municipalities

Figure 20

Relationship between Own Resources & Grants

By Growth in Own Resources (1991–92) Maharashtra



Note : Rank 27 and onwards shows negative Growth in Own Resources

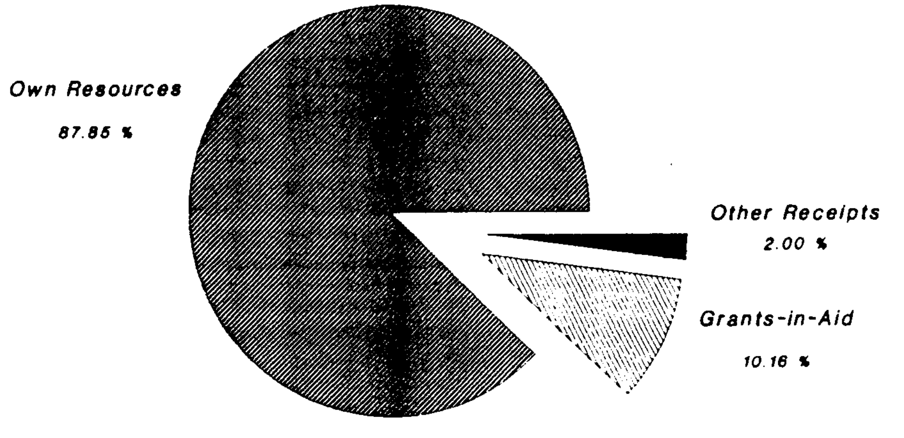
FINANCES OF MUNICIPALITIES IN PUNJAB

Municipalities in Punjab depend to a large extent on their internal sources of revenues to finance their expenditures. The dependence on the state is limited to only one type of tax revenue, i.e. the share of the excise on liquor which is given to urban local bodies in the form of compensatory grant. No other transfers take place from the state to urban local bodies on the revenue account.

Figure 21

Punjab

Revenue Break-Up



Over 87 per cent of the total revenue is derived from internal sources (own revenues). The own revenues for the municipalities as a whole during the year 1991-92 stood at Rs. 252

per capita. It is also seen that the variation across the different size-class of municipalities is negligible. However, within class disparities are striking with a per capita own revenues ranging from a high of Rs. 838.4 to a low of Rs. 101.8. These are again influenced by the octroi income of different size-class of municipalities.

Octroi is the major source of revenue for the municipalities followed by the property tax which accounts for only 9.9 per cent of the own revenues of the urban local bodies.

Revenues Shared with the State

The state of Punjab does not share any of its revenue with the urban local bodies. As stated earlier, excise on liquor is the only state revenue shared with the municipalities, however, it is given to them as compensatory grants and thus, has been included under grants-in-aid to municipalities.

Grants to Urban Local Bodies

Municipalities in Punjab receive only compensatory grant against the revenue collected from excise on liquor by the state. This is the only type of grant on the revenue account as per the information furnished by the state government. This grant accounts for about 10.2 per cant of the total revenue of the municipalities.

In per capita terms this translated to about Rs. 29.2 for sampled municipalities as a whole. Not much inter-class variations is found in the grant structure, however, in class variations are a striking feature and in general are in line with the other states in the sample.

Expenditure Pattern of Municipalities

Municipalities in the state of Punjab are rich in comparison to the municipalities in the states of Andhra Pradesh, Assam and West Bengal. They can finance over 94 per cent of their current expenditures from their internal sources of revenues. The situations does not change drastically when one looks at the different class size of municipalities as well.

Potential Revenues and Expenditure Needs

Municipalities in Punjab are capable of raising an additional Rs. 1005.5 million from their internal sources. The class A municipalities have the largest potential for raising additional revenues (Rs. 652 million) compared to only Rs. 253 million in class D municipalities.

The estimated expenditure needs stand at around Rs. 1152.7 million for all municipalities as a whole. Thus the potential revenues can cover over 87.2 per cent of the expenditure needs of the urban local bodies.

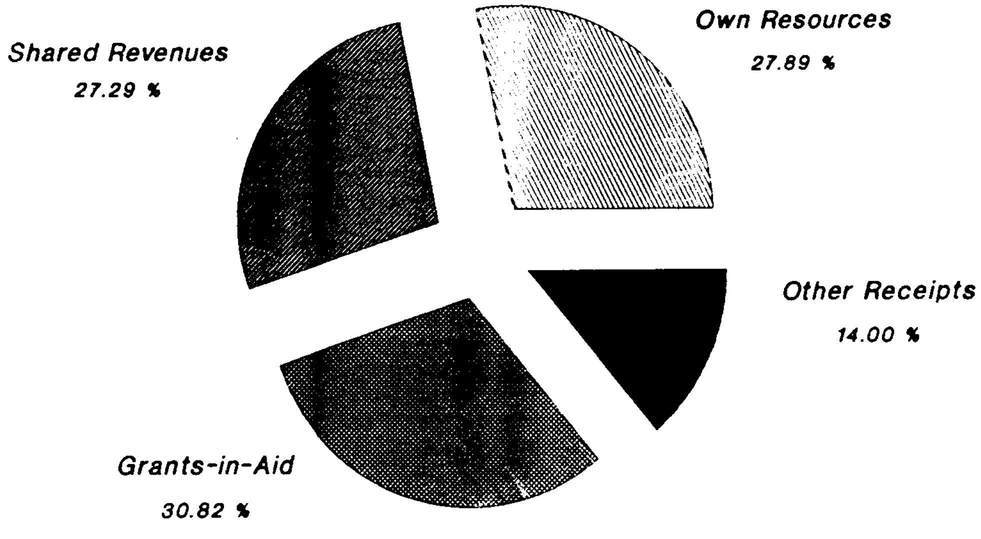
FINANCES OF MUNICIPALITIES IN WEST BENGAL

Municipalities in West Bengal are highly dependent on the assistance from the state. Their total transfer are over 68 per cent of their total revenues. Thus the importance of the own revenues in the finances of the urban local bodies is limited. Own resources of municipalities are only about 37 per cent of the total revenues of municipalities.

Urban local bodies generate on Rs. 37.2 per capita which is the lowest of any state in our sample. There are wide variation in the own revenues of the municipalities ranging from a high of Rs. 92.3 per capita to only Rs. 9.4 per capita. This indicates that many municipalities have either not used the tax powers at their disposal or that they have been inefficient in exploiting their internal sources of revenues.

Figure 22

West Bengal
Revenue Break-Up



Revenues Shared with the Municipalities

Shared revenues account of over 27 per cent of the total revenues of the municipalities in West Bengal. The major shared taxes are profession tax and entertainment tax. There are wide variations in the shared revenues across municipalities both within the same size-class and across different size-class.

Grants to Urban Local Bodies

Municipalities in West Bengal to a large extent depend on transfers for their functioning. Over 30.8 per cent of the total revenue of the urban local bodies comes in form of grants of various types. The per capita receipt of grants on revenue account stood at Rs. 40.1 for the sampled municipalities as a whole. As in other states, the structure of grant distribution does not follow any pattern and can be explained only by a random process. Both inter-class and within class variations are evidenced in the analysis.

Expenditure Pattern of Municipalities

Municipalities in West Bengal are able to finance only 29. 9 per cent of their current expenditures from their internal sources of revenues. Thus, over 70 per cent of their expenditure needs are met through transfers of various types.

Potential Revenues and Expenditure Needs

Based on the estimates of the study, municipalities in West Bengal could almost double their revenues from internal sources. The estimates show that the potential revenues from own resources is about 96.9 per cent of the current level of own resources of urban local bodies. Of this the largest potential exist in class B municipalities.

In relation to the potential revenues the expenditure needs of the municipalities in West Bengal is much higher. In fact the potential revenues are only 27.5 per cent of the expenditure needs of the municipalities.

Figure 23

Relationship between Own Resources & Grants

West Bengal

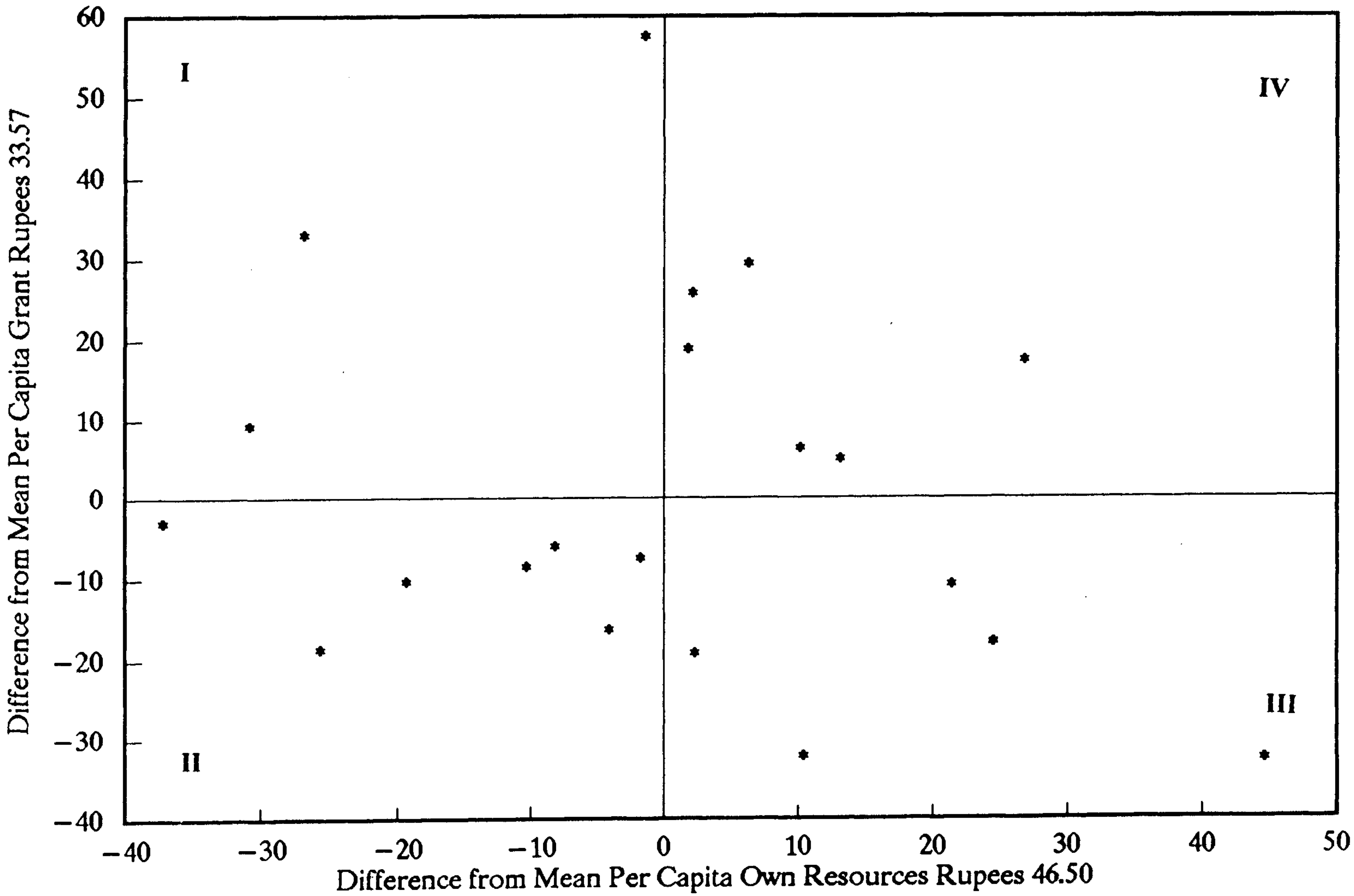
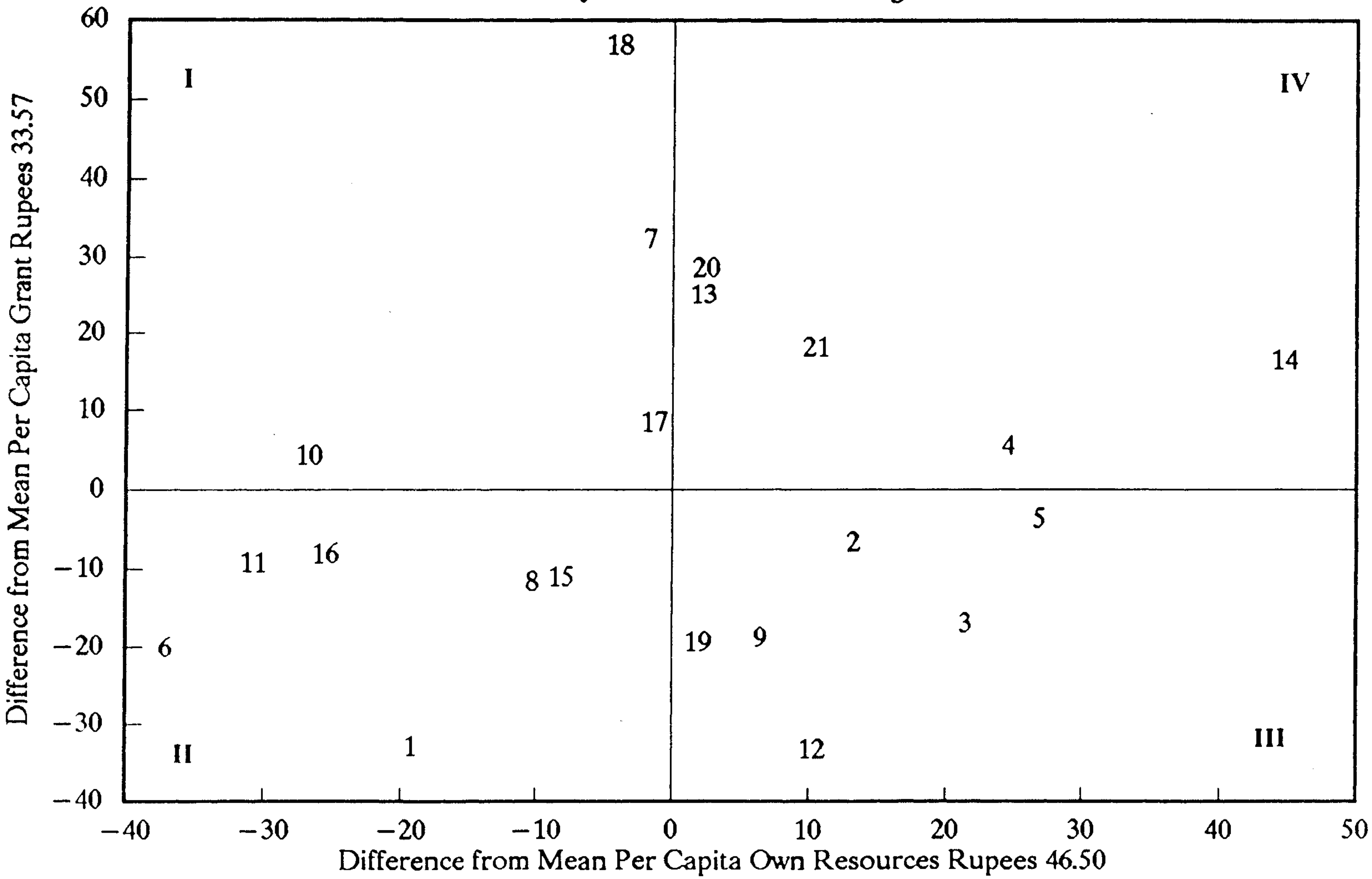


Figure 24

Relationship between Own Resources & Grants

By size of Deficit West Bengal

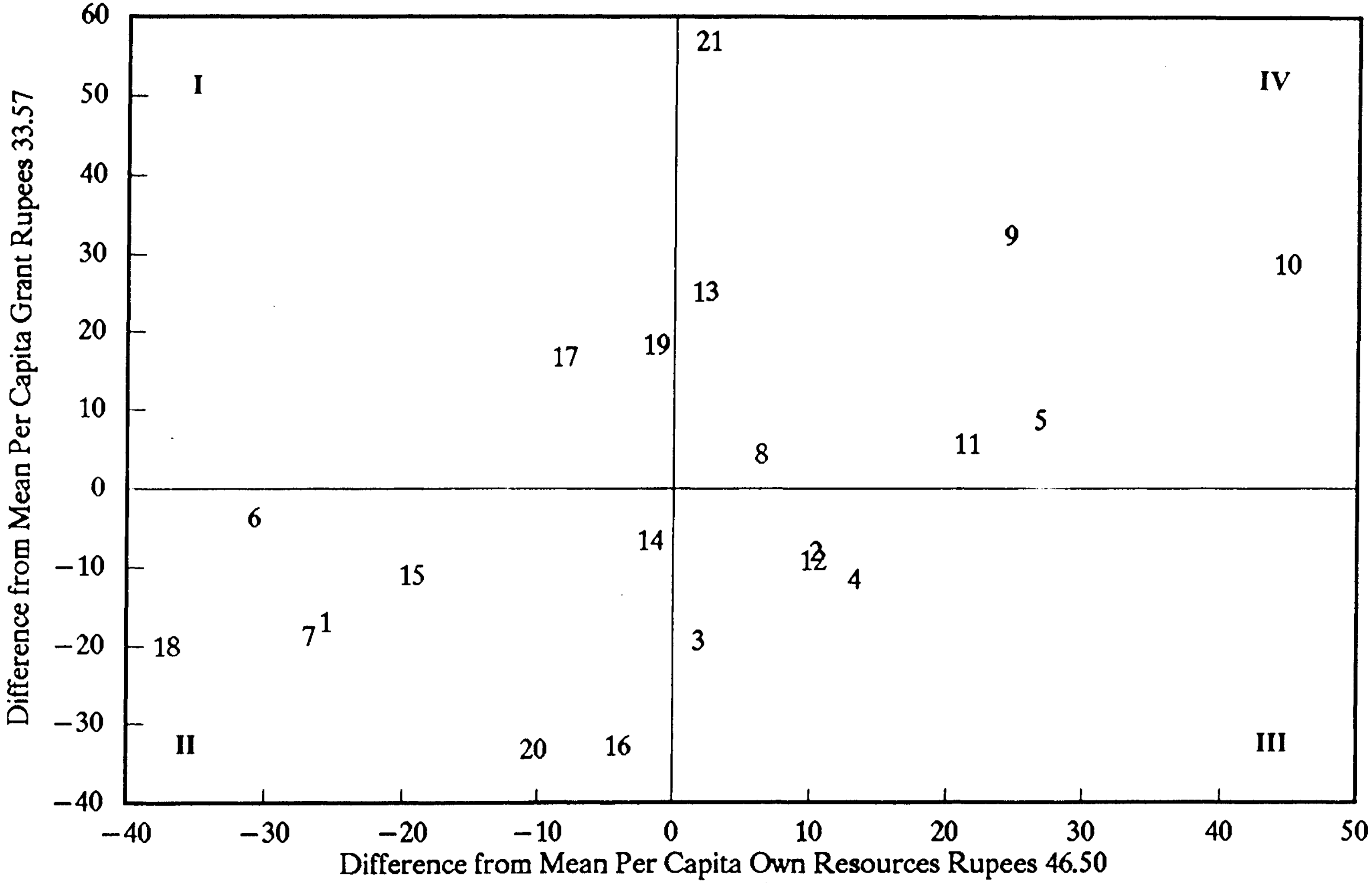


Note : Rank 2 and onwards shows Deficit Municipalities

Figure 25

Relationship between Own Resources & Grants

By Growth in Own Resources (1991–92) West Bengal



Note : Rank 16 and onwards shows negative Growth in Own Resources

ANNEXURE - B

12th Schedule of the 74th Constitutional Amendment

THE CONSTITUTION SEVENTY-FOURTH AMENDMENT ACT 1992

Powers, Authority and Responsibilities of Municipalities

Subject to the provisions of the constitution, the Legislature of the State may by law, endow -

(a) The municipalities with such powers and authority as may be necessary to enable them to function as institutions of local self-government and such law may contain provisions of the devolution of powers and responsibilities upon Municipalities, subject to such conditions as may be specified therein, with respect to -

(i) the preparation of plans for economic development and social justice;

(ii) the performance of functions and the implementation of schemes as may be entrusted to them including those in relation to the matter listed in the Twelfth Schedule;

(b) The Committees with such powers and authority as may be necessary to enable them to carry out the responsibilities conferred upon them including those in relation to the matters listed in the Twelfth Schedule.

TWELFTH SCHEDULE
(Article 243W)

1. Urban planning including town planning.
2. Regulation of land-use and construction of buildings.
3. Planning for social and economic 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 the weaker sections of society,including the handicapped and mentally retarded.
10. Slum improvement and upgradation.
11. Urban poverty alleviation.
12. Provisions of urban amenities and facilities such as parks, gardens, playgrounds.
13. Promotion of cultural, educational and aesthetic aspects.
14. Burial 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.
18. Regulation of slaughter houses and tanneries.

ANNEXURE - C

Tax Powers and Functions of Municipalities in Sample States

Duties, Functions and Tax Powers of Municipalities in Andhra Pradesh as provided by Andhra Pradesh Municipalities Act, 1965.

Functions of Municipalities in Andhra Pradesh
(the municipal act does not make any functions obligatory)

1. Lighting of the streets;
2. Water supply and public drainage system including public latrines and urinals etc.;
3. Removal of rubbish, filth and various substances from public places, preparation of compost out of filth and rubbish;
4. Maintenance and watering of streets, removal of obstruction and encroachments on the public streets and places;
5. Cleaning of debris and maintenance of municipal buildings;
6. Naming of streets and numbering of buildings and premises;
7. Removal of dangerous and nuisance structures, trees from public places;
8. Extinction of fires;
9. Maintaining of slaughter houses, milk trade, markets, butchers etc.;
10. Disposal of the dead;
11. Registration of births and deaths;
12. Action in case of contagious disease with appropriate medical relief measures;
13. Vaccination and Inoculation;
14. School hygiene and mosquito control; and
15. Maintaining public hospitals, dispensaries and anti-disease relief measures.

Tax Powers of Municipalities in Andhra Pradesh

1. A general property tax
2. A Water and drainage tax
3. A lighting tax;
4. A scavenging tax;
5. Profession tax;
6. Tax on carriages and carts;
7. A tax on Animals;
8. A tax on advertisements; and
9. Duty on transfer of property.

Major Heads of Effective Taxes, Shared Revenues and Grants in Andhra Pradesh

Own Sources of Revenue

Taxes:

Property Tax
Advertisement Tax
Carriage and Carts
Tax on animals

Non-Tax Sources:

Water Charges
Charges from markets
Rents from shops and rooms
Trade licence fees
Building licence fees
Encroachment fees
D & O Trades

Shared Revenue

Entertainment Tax
Profession Tax
Surcharge on Stamp Duty

Grants-in-Aid

50% D.A. Grant
Per Capita Grant
Property Tax Compensation
Octroi Tax Compensation
Road Grant
M.V. Compensation
Grant for repayment of principle to LIC

Duties, Functions and Tax Powers of Municipalities in Assam as provided by Assam Municipal Act, 1956; modified in 1968.

Obligatory Functions of Municipalities in Assam

1. Removal of sewerage and rubbish from all public places, undertaking of public health, work for eradication of mosquitoes;
2. Vaccination and inoculation;
3. Registration of births and deaths;
4. In the event of prevalence of an infectious disease provision of medicines, appliances etc.; and
5. Provision of sufficient supply of drinking water.

Discretionary Function of Municipalities in Assam

1. The provision and maintenance of public latrines and urinals;
2. Undertaking of compost making schemes;
3. Provision of fire extinguishing services;
4. Provision and maintenance of burial and burning grounds;
5. Establishment and maintenance of dispensaries, hospitals, maternity houses and child welfare centres etc.; and
6. Provision and maintenance of sufficient and satisfactory system of public drains.

Tax Powers of Municipalities in Assam

(no distinction is made between obligatory and discretionary functions as such all taxes are discretionary in nature)

1. A tax on land and building;
2. A water tax, lighting tax, a latrine tax and drainage tax assessed on annual rental value of property;
3. Tax on private markets;
4. Toll on bridges;
5. Betterment fee on holdings;
6. Duty on transfer of property; and
7. Any other tax which the State Government in empowered to levy.

Major Heads of Effective Taxes, Shared Revenues and Grants in Assam

Own Sources of Revenue

Taxes
Property Tax
Conservancy
Tax on public markets
Betterment levies
Profession Tax
Advertisement Tax
Water Tax (incl. in prop. tax)
Laterine Tax (incl. in prop. tax)
Light Tax (incl. in prop. tax)
Trade and Calling
Tax on animals
Duties on transfer of property
Drainage Tax (incl. in prop. tax)
Tolls on ferries and bridges

Non-Tax Sources
Rents
Fees on carts, carriages, and animals
Fees on dogs
Ghat fees
Licence fees
Polls on municipal markets
Rents on municipal buildings and markets
Betterment fee on holding in any area
Maintenance of fire brigades

Shared Revenue
Entertainment Tax
Motor Vehicles Tax
Land Revenue

Grants-in-Aid
Population cum area
Grant for holding municipal elections
Clearance of hullas
Cash allowance to sweepers
Ad hoc G.P.
P.W.D. Roadside Drain
Communication Grant

Duties, Functions and Tax Powers of Municipalities in Gujarat as provided by Gujarat Municipalities Act , 1963.

Obligatory Functions of Municipalities in Gujarat

1. **Education**: to establish and maintain pre-primary schools such as *balwadies*, *balmandirs*, primary schools etc., the introduction and promotion of the state policy of compulsory free education.

2. **Public Health and Sanitation**: water supply and drainage, sanitation, conservancy, vaccination, the control of epidemics and regulation of offensive and dangerous trades, watering and cleaning of public streets and other places, disposal of night soil etc.

3. **Medical Relief**: to establish and maintain or aid public hospitals, maternity and child welfare centres etc., public medical relief and special medical aid and accommodation for sick, in times of dangerous disease.

4. **Town Planning, Development and Public Works**: Construction and maintenance of roads, markets, slaughter houses etc., improving agriculture including crop protection etc., accommodation of cattle or buffaloes, preparation of Master Plan and town planning schemes and their implementation.

5. **General Administration**: lighting public streets, places and buildings, protecting life and property from fire, removing obstructions in public streets and places, erecting boundary marks, registering births, marriages etc.

Discretionary Functions of Municipalities in Gujarat

1. Education: provide for Playgrounds, theatres, libraries, reading rooms, social education etc.

2. Public Health and Sanitation: Provide for disposal of sewerage, setting up of dairies.

3. Public Works: Make provisions for parks, gardens, lunatic asylums, dharamshallas, supply of electric energy, transport, housing etc.

4. Agriculture and Cooperation: reclamation of waste land, construction of warehouses etc.

Agency Functions of Municipalities in Gujarat

(these functions may be transferred by the State Government)

1. Collection of land revenue;

2. Functions and duties relating to Government under any enactment, which the State legislature is competent to enact or otherwise in the executive power of the state and appear to relate to matters arising within a municipal jurisdiction and to be of an administrative nature;

3. Developmental functions which are performed by the following departments, viz., Agriculture, Animal Husbandry, Public Health and Medical Relief, Public Works Department, Social welfare, Revenue, Prohibition, Co-Operatives, Cottage Industries, and district Statistical Office.

<u>Tax Powers of Municipalities in Gujarat</u>

The Gujarat Municipalities Act does not make any tax obligatory and thus all of the following taxes are discretionary.

1. A tax on land and building;
2. A tax on vehicles, boats and animals;
3. A toll on vehicles and animals not covered under 2;
4. An octroi;
5. A tax on dogs;
6. A general sanitary cess;
7. A drainage tax;
8. A general water rate or special water rates;
9. A lighting tax;
10. A fee on pilgrims;
11. A special education cess;
12. A special education cess;
13. A tax on sale of cattle;
14. A betterment levy; and
15. Any other tax that the State Government is empowered to levy.

Duties, Functions and Tax Powers of Municipalities in Kerala as provided by Kerala Municipal Act, 1960.

Obligatory functions

1. Public Health and Sanitation :
   a) Water Supply
   b) Regulation or abating offensive or dangerous trades, callings or practices;
   c) Removing noxious of wild vegetation and abating all public nuisances;
   d) Public vaccination and inoculations, prevention and control of communicable diseases;
   e) Disinfection of buildings and articles;
   f) Prevention of pollution of water and air;
   g) Rodent control;
   h) Acquiring, maintaining and regulating places for the disposal of dead bodies including crematoria, cremation grounds and burial grounds and disposal of unclaimed human bodies and carcasses of animals;
   i) Disposal of stray dogs and wild animals;
   j) Sweeping, cleaning and watering of streets and removal of sweepings there from;
   k) Cleaning public streets, places and all spaces which are open for enjoyment to the public;
   l) Collection and disposal of night soil and rubbish and preparation of compost manure and its sale;
   m) Construction and maintaining public latrines and urinals causing the same to be daily cleansed and kept in proper order;
   n) Construction, maintenance and cleaning of drains, drainage works and sewage works;
   o) Prevention of food adulteration; and
   p) Reclamation of unhealthy localities.

2. Medical Relief :
   a) Construction and maintenance of public hospitals, dispensaries, maternity and child welfare centres;
   b) Maintaining and assisting the maintenance of veterinary hospitals.
   c) Sending indigent inhabitants of the municipality to institutions outside the municipality for treatment;
   d) Planting and maintaining trees on road sides and other public places;
   e) Training of medical subordinates, midwives, nurses, health offices, sanitary inspectors and analysis.

3. Public Works :
   a) Construction, maintenance, alteration and improvement of public streets, bridges, subways, culverts, cause ways and the like;

b) Control and regulation of building activities;
c) Lighting public streets, spaces and buildings;
d) Planting and maintaining trees on road sides and other public places;
e) Provision of housing for conservancy staff;
f) Control, supervision and removal of dangerous buildings and places;
g) Construction and maintenance of cattle pounds.

4. Education :
 a) Establishing and maintaining primary schools;
 b) Providing for the instruction in schools of all children of school going age.

5. Development :
 a) Constructing, altering and maintaining markets, shopping centres, slaughter houses,baths washing places, dhobi ghars, drinking water stand posts, wells, public parks,gardens. water trough for cattle and maintaining tanks and grazing grounds;
 b) Construction and maintenance of parking places and vehicle stands;
 c) Reclamation of waste land in the rural pockets inside municipal limits;
 d) Preparation of comprehensive plans for development and growth of the town.

6. Administrative and General :
 a) Maintenance of public property and monuments vested in the municipality;
 b) Maintenance and development of municipal property;
 c) Preparation and publication of annual financial and administrative reports;
 d) Giving name to or altering the names of any public street;
 e) Numbering of buildings;
 f) Erection substantial boundary marks defining the limits of municipal areas;
 g) Regulation of traffic and provision of traffic signs;
 h) Registering births and deaths and vital statistics;
 i) Extinction of fire;
 j) Conduct of elections to the municipal council;
 k) Payments in connection with the establishment and maintenance of village courts within the municipal areas;
 l) Maintenance of principal municipal office and record room and payment of salaries and pensionary and P.F. contributions, gratuities and pensions of the municipal officers and servants;
 m) Payment of interest on and amortization of debt;
 n) Fulfilling obligations imposed by law and enforcement of rules. bye-laws, etc.

Discretionary functions

1. Public Health and Sanitation :
 a) Acquiring or assisting in the acquisition of suitable places for carrying on offensive and protected trades;
 b) Establishing and maintaining farms and factories for the disposal of sewage;
 c) Organisation, maintenance and management of chemical and bacteriological laboratories for detection of diseases. adulteration of food stuffs and drugs and research in the field of public health.

2. Public works :

a) Construction of model dwelling for the poor and houseless;

b) Providing housing accommodation for employees of local body;

c) Establishing and maintaining relief worms at the time of natural calamities like fire, famine, flood, scarcity etc.

3. Educational and Social Welfare :

a) Provision for the inspection of schools ,maintained by it whether wholly from the municipal fund or by grants-in-aid therefrom;

b) Provision for the training of teachers for schools aided or maintained from the municipal fund;

c) Provision for the instruction and training of persons for practice of medicine or of vaccination or of any technical or industrial training;

d) Provision for the maintenance of public libraries, reading rooms, gymnasia, or any other institutions connected with the diffusion of education;

e) Provision of milk or mid-day meals for school children;

f) Undertaking cultural activities and assisting cultural institutions;

g) Establishing, maintaining and assisting institutions of physical culture;

h) Origination, maintenance and assistance to institutions for infirm, sick or incurable persons;

i) Undertaking measures for and assisting adult literacy and social education;

j) Undertaking urban community development programme and promoting public participation;

k) Organisation, maintenance and assistance to institutions for infirm, sick or incurable persons;

l) Supply of milk to expectant or nursing mothers or infants;

m) Providing and assisting the establishment of homes for orphans and destitute;

n) Maintenance of lunatic asylums;

o) Constructing, establishing and maintaining community halls, swimming pools, museums, places for entertainment and recreation, etc.

p) Maintenance of public monuments;

q) Provision of music and radio receiving sets for the public.

4. Development :

a) Development of building sites, construction of housed and their disposal;

b) Encouraging formation of co-operative house building societies by loans, grants of land or prizes.

c) Undertaking schemes of slum clearance and programmes of development;

d) Provision of suitable accommodation for calves, cows, etc.

5. Public Utilities :

a) Provision, purchase, exploitation and maintenance of electric, gas or other undertakings for ligation and private streets, places and buildings;

b) City transport services;

c) Milk supply schemes and settling of dairies, poultry and dairy farms;

d) Provision and maintenance of public clocks and clocks towers or time-guns and sirens.

6. Administration :

a) Contributing to and participation in the activities of the local government institutes, training centres and associations of local bodies;
b) Arranging public receptions, ceremonies, entertainment. sports, etc.
c) Arranging and controlling fairs, melas and exhibitions;
d) Construction and regulation the use of lodging houses, camping grounds, tourist bureau and rest houses;
e) Establishment and maintenance of printing presses and work-shops for Municipal and private work;
f) Taking measures to control beggars and vagrants and providing for their relief;
g) Undertaking commercial and industrial activities;
h) Conduction census and surveys; and
i) Erection of memorials for celebrities and historical personages.

Miscellaneous :

a) Establishing and maintaining nurseries for trees, plants and vegetables;
b) Constructing and maintaining granaries, godowns, cold storages, warehouses and soils for preservation of food grains, food stuffs and vegetables;
c) Regulation of weights and measures, provision of standard weights, scales and measures and public weighing places.

Tax Powers of Municipalities in Kerala

(no distinction is made between obligatory and discretionary functions as such all taxes are discretionary in nature)

1. Property tax;
2. Tax on professions;
3. Tax on entertainments;
4. Tax on animals, vechiles (other than moter vechiles) and vessels;
5. Show tax.
6. Tax on advertisment; and
7. Duty on transfer of property.

Duties, Functions and Tax Powers of Municipalities in Maharashtra as provided by Maharashtra Municipalities Act ,1965.

<u>Obligatory Functions of the Municipalities in Maharastra</u>

1. Lighting public streets, places and buildings;
2. Watering public streets and places;
3. Cleansing public streets, places and sewers etc., removing noxious vegetation and abating all public nuisances;
4. Extinguishing fires and protecting the life and property when fire occurs;
5. Regulating or abating offensive or dangerous trades or practices;
6. Removing obstructions and projections on public streets or places etc.;
7. Securing or removing dangerous buildings or places, and reclaiming unhealthy localities;
8. Acquiring and maintaining, changing and regulating places for the disposal of the dead;
9. Constructing, altering and maintaining public streets, culverts, municipal boundary marks, markets, slaughter houses, privies, urinals, latrines, drains, etc.;
10. Obtaining a supply or additional supply of water etc.;
11. Naming Streets and numbering of premises;
12. Registering births and deaths;
13. Public vaccination;
14. Suitable accommodation for calves, cows or buffaloes etc.;
15. Establishing and maintaining public hospitals and dispensaries and providing public medical relief;
16. Establishing and maintaining primary schools;
17. Disposal of night soil and rubbish and if so required by the government, preparation of compost manure from such night soil and rubbish;
18. Construction and maintaining residential quarters for the conservancy staff of municipality;
19. Provide special medical relief aid and accommodation fro the sick in time of dangerous disease etc.; and
20. Give relief in times of famine or scarcity to the destitute etc.

<u>Discretionary Functions of Municipalities in Maharastra</u>

1. Laying out new public streets;
2. Construction of public parks, libraries, gardens, lunatic asylums etc.;
3. Planting roadside trees;
4. Taking census and making surveys;
5. Distraction of stray dogs etc.

Tax Powers of Municipalities in Maharastra

Compulsory Taxes: Subject to any general or special orders which the State Government may make in this behalf, the Council shall impose, for the purpose of this act, the taxes listed below:-

1. A consolidated property tax on land and building;
2. An octroi;
3. A tax on professions, trades, callings and employment;
4. A theatre tax;
5. A tax on advertisements other than advertisements published in the newspapers.

Voluntary Taxes: The municipality may impose any of the following taxes implying that they are discretionary.

1. A tax on vehicles and animals;
2. A toll on vehicles;
3. A tax on dogs;
4. A special sanitary tax;
5. A drainage tax;
6. A special water tax;
7. A tax on pilgrims;
8. A special educational tax; and
9. A lighting tax.

Major Heads of Effective Taxes, Shared Revenues and Grants in Maharastra

Sources of Own Revenue

Taxes

Building Tax/Property Tax
Tax on animals and vehicles
Octroi
Tax on animals
Theatre tax
Advertisement tax

Compulsory Taxes

Property tax
Octroi
Entertainment tax
Advertisement tax

Discretionary Taxes
Vehicles other than motor vehicle
Tax on animals (dogs)
Sanitary tax
Drainage tax
Water tax

Shared Revenue
Stamp Duty
Entertainment tax
Assignment of L.R. and non-agricultural assessment of L.R.
Royalty on mining/minerals

Grants-in-Aid
Grant in lieu of pilgrim tax
D.A. grants
Primary education grant
Secondary education grant
Motor vehicle grant
Tax on Professions
Grant for water supply and drainage.

Duties, Functions and Tax Powers of Municipalities in Punjab as provided by Punjab Municipalities Act , 1911; modified in 1931.

Obligatory Functions of the municipal committees in Punjab

1. It shall unless relieved by the State Government maintain a sufficient police establishment;
2. To maintain a fire brigade;
3. Supply of wholesome water;
4. Provision of burning and burial grounds;
5. It shall take necessary steps to avert danger causing from dangerous or insanitary buildings or places;
6. It shall take necessary measures to regulate or prevent offensive or dangerous trades;
7. Slaughter houses.

Discretionary Functions of the municipal committees in Punjab

1. Setting apart suitable places for the purpose of bathing and washing animals and clothes etc.;
2. Arranging for the disposal of mad and stray dogs and other animals;
3. Directing the owner of any building to provide move or remove drains,privies,latrines,cesspool etc.;
4. Carrying any cable, wire, pipe, drain, sewer or channel of any kind for the purpose of carrying out telephonic or other simmlar communucations or of carrying out and establishing or maintaining any system, lighting, drainage etc,;
5. Arranging for removing patients suffering form infectious diseases and such other arrangements for prevention or control of dangerous diseases.
6. Prohibiting any specified part of the municipality for keeping a brother or the residence of any person practicing prostitution; and
7. Arranging for laying out, maintaining, altering and construction of public streets and buildings; naming streets and numbering buildings.

Tax Powers of municipalities in Punjab

Subject to special or general orders issued by the state government, the committee may impose:

1. A tax payable by the owners on buildings and lands;
2. A tax on proffessions, art, trades or callings:
3. A tax on vehicles and animals:
4. A tax payable by the employer on menial domestic servants;
5. A tax payable by the occupier of any building in respect of which the committee has undertaken the house scavenging:
6. A tax on building applications: and
7. Any other tax with the prior sanction of the State Government.

Duties, Functions and Tax Powers of Municipalities in West Bengal as provided by West Bengal Municipal Act 1932; modified in 1966.

Obligatory Functions of Municipalities in West Bengal

1. The removal and disposal of sewerage, rubbish and offensive matter from all public latrines, urinals, drains and all public streets; and
2. Provision and maintenance of public latrines and urinals.

Discretionary Functions of Municipalities in West Bengal

1. Provision of primary and middle schools;
2. Provision of water supply;
3. Control of epidemic and vaccinations;
4. Control and sale of food and drugs;
5. Regulation of offensive and dangerous trades;
6. Registration of births and deaths;
7. Provision of public hospitals and dispensaries;
8. Construction and maintenance of roads, bridges, public markets and slaughter houses;
9. Lighting and watering of public streets;
10. Establishment and maintenance of public gardens; and
11. Maintenance of fire brigades etc.

Tax Powers of Municipalities in West Bengal

(All taxes as per the West Bengal Municipal Act are discretionary)

1. A property Tax
2. A water, lighting, conservancy, latrines and drainage rates;
3. A tax on animals and vehicles; and
4. A profession tax;
5. Education cess.

Major Heads of Effective Taxes, Shared Revenues and Grants in West Bengal

Own Sources of Revenue

Taxes

Property Tax
Tax on Carriage
Tax on Advertisement

Non-Tax Sources

Rent and fees from markets and slaughter houses
Supply of water by tankers
Removal of sludge from septic tanks
Sale of forms
Building land sanction fees
Mutation fees

Shared Revenue

Entertainment Tax
Profession Tax/Trade and Calling
Motor Vehicles Tax
Entry Tax

Grants-in-Aid

D.A. and A.D.A. Subvention
Grant to supplement water supply and drainage
Communication Grant.

ANNEXURE - D

OLS Regression Results

Ordinary Least Squares Estimation
For sample Municipalities in **Andhra Pradesh**

Dependent variable is TD (Per capita Grants)
54 observations used for estimation from 1 to 54

Regressor	Coefficient	Standard Error	T-Ratio
CON	-1.7484	8.6498	-.2021
F2	.3266	.1505	2.1706
F3	.7244	.1895	3.8231
F4	-.0744	.1041	-.7146
TAB	.1394	.1297	1.0745
TC	-.0266	.1341	-.1986
TH	-.1844	.5817	-.3171

R-Squared	.3366	F-statistic F(6, 47)	3.9742
R-Bar-Squared	.2519	S.E. of Regression	21.8752
Residual Sum of Squares	22490.6	Mean of Dependent Variable	17.9813
S.D. of Dependent Variable	25.2912	Maximum of Log-likelihood	-239.4831
DW-statistic	2.4192		

Diagnostic Tests

Test Statistics	LM Version	F Version
A:Serial Correlation	CHI-SQ(1)= 3.4153	F(1, 46)= 3.1058
B:Functional Form	CHI-SQ(1)= .0200	F(1, 46)= .0170
C:Normality	CHI-SQ(2)= 33.9355	Not applicable
D:Heteroscedasticity	CHI-SQ(1)= .0506	F(1, 52)= .0488

A:Lagrange multiplier test of residual serial correlation
B:Ramsey's RESET test using the square of the fitted values
C:Based on a test of skewness and kurtosis of residuals
D:Based on the regression of squared residuals on squared fitted values

Note :

F2 is Per capita Expenditure on Public Health
F3 is Per capita Expenditure on Public Safety
F4 is Per capita Expenditure on Public Works

TAB is Per capita Own Resources
TC is Per capita Shared Taxes
TH is Population Growth from 1981 to 1991 (Per cent)

Ordinary Least Squares Estimation
For sample Municipalities in **Assam**

Dependent variable is TD (Per capita Grants)
21 observations used for estimation from 1 to 21

Regressor	Coefficient	Standard Error	T-Ratio
CON	6.3164	6.0555	1.0431
F2	.0500	.1686	.2967
F3	.2254	.2054	1.0974
F4	-.0957	.2154	-.4441
TAB	.0292	.0985	.2966
TC	-.2000	.2403	-.8324
TH	-.1136	1.3795	-.0823

R-Squared	.2767	F-statistic F(6, 14)	.8925
R-Bar-Squared	-.0333	S.E. of Regression	6.3082
Residual Sum of Squares	557.0998	Mean of Dependent Variable	6.8324
S.D. of Dependent Variable	6.2056	Maximum of Log-likelihood	-64.2190
DW-statistic	1.5757		

Diagnostic Tests

Test Statistics	LM Version	F Version
A:Serial Correlation	CHI-SQ(1)= 1.1574	F(1, 13)= .7583
B:Functional Form	CHI-SQ(1)= .9181	F(1, 13)= .5943
C:Normality	CHI-SQ(2)= 8.7086	Not applicable
D:Heteroscedasticity	CHI-SQ(1)= .7276	F(1, 19)= .6820

A:Lagrange multiplier test of residual serial correlation
B:Ramsey's RESET test using the square of the fitted values
C:Based on a test of skewness and kurtosis of residuals
D:Based on the regression of squared residuals on squared fitted values

Note :

F2 is Per capita Expenditure on Public Health
F3 is Per capita Expenditure on Public Safety
F4 is Per capita Expenditure on Public Works

TAB is Per capita Own Resources
TC is Per capita Shared Taxes
TH is Population Growth from 1981 to 1991 (Per cent)

Ordinary Least Squares Estimation
For sample Municipalities in **Kerala**

Dependent variable is TD (Per capita Grants)
58 observations used for estimation from 1 to 58

Regressor	Coefficient	Standard Error	T-Ratio
CON	14.2103	4.9180	2.8894
F2	.1608	.1006	1.5987
F3	.1667	.2215	.7527
F4	-.1240	.0653	-1.8974
TAB	-.0284	.0270	-1.0520
TC	-.1229	.1550	-.7929
TH	-1.9574	2.4875	-.7869

R-Squared	.1533	F-statistic F(6, 51)	1.5390
R-Bar-Squared	.0537	S.E. of Regression	8.9506
Residual Sum of Squares	4085.7	Mean of Dependent Variable	10.4252
S.D. of Dependent Variable	9.2009	Maximum of Log-likelihood	-205.6880
DW-statistic	1.7080		

Diagnostic Tests

Test Statistics	LM Version	F Version
A:Serial Correlation	CHI-SQ(1)= 1.0733	F(1, 50)= .9427
B:Functional Form	CHI-SQ(1)= 1.8129	F(1, 50)= 1.6132
C:Normality	CHI-SQ(2)= 44.1528	Not applicable
D:Heteroscedasticity	CHI-SQ(1)= 1.2791	F(1, 56)= 1.2628

A:Lagrange multiplier test of residual serial correlation
B:Ramsey's RESET test using the square of the fitted values
C:Based on a test of skewness and kurtosis of residuals
D:Based on the regression of squared residuals on squared fitted values

Note :

F2 is Per capita Expenditure on Public Health
F3 is Per capita Expenditure on Public Safety
F4 is Per capita Expenditure on Public Works

TAB is Per capita Own Resources
TC is Per capita Shared Taxes
TH is Population Growth from 1981 to 1991 (Per cent)

Ordinary Least Squares Estimation
For sample Municipalities in **Maharashtra**

Dependent variable is TD (Per capita Grants)
31 observations used for estimation from 1 to 31

Regressor	Coefficient	Standard Error	T-Ratio
CON	133.7960	25.0508	5.3410
F2	-.0170	.1643	-.1035
F3	.1740	.6173	.2818
F4	.0335	.2027	.1655
TAB	-.0245	.0810	-.3028
TC	-3.0648	2.7703	-1.1063
TH	-6.4433	2.8618	-2.2515

R-Squared	.2263	F-statistic F(6, 24)	1.1699
R-Bar-Squared	.0329	S.E. of Regression	62.3396
Residual Sum of Squares	93269.4	Mean of Dependent Variable	91.9690
S.D. of Dependent Variable	63.3900	Maximum of Log-likelihood	-168.1306
DW-statistic	2.0607		

Diagnostic Tests

Test Statistics	LM Version	F Version
A:Serial Correlation	CHI-SQ(1)= .2118	F(1, 23)= .1582
B:Functional Form	CHI-SQ(1)= 3.8212	F(1, 23)= 3.2337
C:Normality	CHI-SQ(2)= 3.7123	Not applicable
D:Heteroscedasticity	CHI-SQ(1)= 1.9218	F(1, 29)= 1.9166

A:Lagrange multiplier test of residual serial correlation
B:Ramsey's RESET test using the square of the fitted values
C:Based on a test of skewness and kurtosis of residuals
D:Based on the regression of squared residuals on squared fitted values

Note :

F2 is Per capita Expenditure on Public Health
F3 is Per capita Expenditure on Public Safety
F4 is Per capita Expenditure on Public Works

TAB is Per capita Own Resources
TC is Per capita Shared Taxes
TH is Population Growth from 1981 to 1991 (Per cent)

Ordinary Least Squares Estimation
For sample Municipalities in Punjab

Dependent variable is TD (Per capita Grants)
33 observations used for estimation from 1 to 33

Regressor	Coefficient	Standard Error	T-Ratio
CON	40.9767	8.0317	5.1018
F2	.1475	.1126	1.3095
F3	-.1423	.2671	-.5326
F4	.1625	.0603	2.6922
TAB	-.1370	.0572	-2.3960
TH	.7533	2.1715	.3469

R-Squared	.2708	F-statistic F(5, 27)	2.0052
R-Bar-Squared	.1357	S.E. of Regression	14.9251
Residual Sum of Squares	6014.5	Mean of Dependent Variable	33.9473
S.D. of Dependent Variable	16.0544	Maximum of Log-likelihood	-132.7143
DW-statistic	1.8348		

Diagnostic Tests

Test Statistics	LM Version	F Version
A:Serial Correlation	CHI-SQ(1)= .2304	F(1, 26)= .1828
B:Functional Form	CHI-SQ(1)= 1.0537	F(1, 26)= .8576
C:Normality	CHI-SQ(2)= 33.6050	Not applicable
D:Heteroscedasticity	CHI-SQ(1)= .1863	F(1, 31)= .1760

A:Lagrange multiplier test of residual serial correlation
B:Ramsey's RESET test using the square of the fitted values
C:Based on a test of skewness and kurtosis of residuals
D:Based on the regression of squared residuals on squared fitted values

Note :

F2 is Per capita Expenditure on Public Health
F3 is Per capita Expenditure on Public Safety
F4 is Per capita Expenditure on Public Works

TAB is Per capita Own Resources
TC is Per capita Shared Taxes
TH is Population Growth from 1981 to 1991 (Per cent)

Ordinary Least Squares Estimation

For sample Municipalities in **West Bengal**

Dependent variable is TD (Per capita Grants)

25 observations used for estimation from 1 to 25

Regressor	Coefficient	Standard Error	T-Ratio
CON	10.1058	15.7965	.6397
F2	.3275	.1661	1.9717
F3	-.2126	1.1668	-.1822
F4	.2375	.2403	.9880
TAB	.3379	.2809	1.2028
TC	-.3732	.4067	-.9175
TH	.1648	1.1890	.1386

R-Squared	.5258	F-statistic F(6, 18)	3.3271
R-Bar-Squared	.3678	S.E. of Regression	20.1817
Residual Sum of Squares	7331.4	Mean of Dependent Variable	36.2372
S.D. of Dependent Variable	25.3822	Maximum of Log-likelihood	-106.4865
DW-statistic	2.0112		

Diagnostic Tests

Test Statistics	LM Version	F Version
A:Serial Correlation	CHI-SQ(1)= .0015711	F(1, 17)= .0010684
B:Functional Form	CHI-SQ(1)= .0060356	F(1, 17)= .0041052
C:Normality	CHI-SQ(2)= .0412	Not applicable
D:Heteroscedasticity	CHI-SQ(1)= 1.1572	F(1, 23)= 1.1163

A:Lagrange multiplier test of residual serial correlation
B:Ramsey's RESET test using the square of the fitted values
C:Based on a test of skewness and kurtosis of residuals
D:Based on the regression of squared residuals on squared fitted values

Note :

F2 is Per capita Expenditure on Public Health
F3 is Per capita Expenditure on Public Safety
F4 is Per capita Expenditure on Public Works

TAB is Per capita Own Resources
TC is Per capita Shared Taxes
TH is Population Growth from 1981 to 1991 (Per cent)