approach to state-municipal fiscal relations

options and perspectives

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New Delhi

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Foreword

Since the adoption of the *Constitution (seventy-fourth) Amendment Act, 1992*, the National Institute of Public Finance and Policy (NIPFP) has maintained a keen interest in the development of state-local fiscal relations. During the years 1994-1997, the NIPFP served as the nodal agency for the first finance commission of states, and organised together with the National Institute of Urban Affairs (NIUA), National Institute of Rural Development (NIRD), and the Lal Bahadur Shastri National Academy of Administration (LBSNAA), a series of workshops and consultations for the members of the first finance commission of states, the state governments and the academia to discuss possible approaches to the different provisions of the *Constitution (seventy-fourth) Amendment Act.* On behalf of the Planning Commission, the NIPFP undertook studies on the finances of municipalities, primarily to understand how the financial position of municipalities might be assessed. In 1999, it conducted for the Eleventh Finance Commission (EFC), a study on the ***Options for Closing the Revenue Gap of Municipalities***.

This study entitled, ***Approach to State-Municipal Fiscal Relations: Options and Perspectives*** is yet another attempt on the part of the NIPFP, to provide some perspectives on approaches to the emerging state-municipal fiscal relations in India. Supported by the Financial Institutions Reforms and Expansion (FIRE) and prepared by Om Prakash Mathur, HDFC Chair in Housing and Urban Economics at the NIPFP, it attempts to map out the steps for addressing the mandate embodied in Articles 243 Y and 280 (3) (c) of the Constitution.

The interpretations and position taken in the study are those of the author, and do not purport to represent the views of the other staff members of NIPFP or members of the Governing Council.

Ashok Lahiri
DIRECTOR

July, 2001

Highlights

Clarity in the division of functional responsibilities between levels of government is an essential condition for any reform in the structure of urban service delivery.

♦

Finance follows function. The appropriate structure of local finance–the mix of taxes, user charges, and transfers – depends first and foremost, on the functions that are assigned to municipal governments.

♦

The first rule of local finance should be, wherever possible, charge.

♦

Local taxes are, in principle, an appropriate means of financing services whose benefits are localised but can not be confined to individual consumers.

♦

Taxation at the local level should be commonly viewed as a form of benefit tax or user charge for services provided at the local level.

♦

Property tax constitutes a suitable tax from which to finance the provision of pure, local public goods.

♦

The nature of many of the local services makes them ideally suited for market type pricing regimes. Services such as water, garbage collection, public library, and public recreation can be subjected to pricing. Failure to use a proper pricing system suggests that goals other than efficiency dominate local decision-making.

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Underpricing of a service results in its over consumption.

♦

Flexibility to charge their constituents for the costs of the services they consume is an important principle in improving the financial viability of local governments.

♦

Meeting the revenue gap via transfers requires a proper determination of the difference between expenditure needs and revenue-raising capacity.

♦

A key measure to reform the intergovernmental transfers is to reduce the uncertainty and adhocism that now accompanies intergovernmental financial flows.

♦

Transfers based on the size of the actual gap are inappropriate as these encourage municipal governments to overstate expenditures and reduce efforts to fully use their tax powers and authority.

♦

For a fiscal package to be productive and adequate for meeting the expenditure needs of municipalities, certain conditions must be met. Of these, some degree of autonomy for municipalities, a minimum level of fiscal performance on the part of municipalities, and predictability in transfers are central.

State Share of Municipalities: Tenth Finance Commission Award

State	%
Andhra Pradesh	7.4
Arunachal Pradesh	Neg.
Assam	1.4
Bihar	6.7
Gujarat	6.7
Haryana	1.7
Himachal Pradesh	0.2
Jammu and Kashmir	1.2
Karnataka	7.0
Kerala	2.5
Madhra Pradesh	6.2
Maharashtra	13.3
Manipur	0.2
Meghalaya	0.1
Mizoram	Neg.
Nagaland	0.1
Orissa	1.9
Punjab	3.1
Rajasthan	4.3
Sikkim	0.1
Tamil Nadu	11.6
Tripura	0.1
Uttar Pradesh	12.1
West Bengal	12.0
Total	100.0

Source: Report of the Tenth Finance Commission. 1996.

Overview

Following the incorporation of Part IX A on Municipalities, i.e., the Constitution (seventy-fourth) Amendment Act, 1992 and amendment of Article 280 to insert (3)(c) into the Constitution of India, three sets of recommendations have been advanced to improve the finances of municipalities, and reorder the state-municipal fiscal relations. First: the Tenth Finance Commission (TFC) recommended for the period 1996–2000, a grant of Rs. 10,000 million for municipalities, and proposed that it be allocated to states on the basis of the 1971 ratio of the inter-state slum to urban population. Second: the finance commission of states (SFCs), set up in accordance with the terms laid down in Article 243 Y of the Constitution, reviewed the financial position of municipalities and made a series of recommendations on the devolution of state resources for municipalities. Third: the Eleventh Finance Commission (EFC) which submitted its report in June 2000 recommended a grant of Rs. 20,000 million for municipalities for a period of five years, beginning with 2000/01.

The Tenth Finance Commission (TFC) stipulated that the grant of Rs. 10,000 million was conditional upon the provision by municipalities of a matching contribution and was useable for properly identified projects. The devolution package as recommended by the finance commission of states consisted of transfer of resources to municipalities by way of (a) sharing of a pool of state resources, (b) sharing of specific state taxes, and (c) a system of grants-in-aid. The recommended composition of the pool comprised in the case of Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal, the net proceeds of state taxes, while in the case of Andhra Pradesh and Madhya Pradesh, it comprised both the tax and non-tax revenues. The Assam Finance Commission defined the pool in terms of the tax revenues of the state, while the Karnataka Finance Commission recommended the pool to consist of the non-loan gross own receipts. Most finance commissions of states set out comprehensive procedures for the allocation of devolved funds among municipalities.

Recommended Share of Municipalities in State Resource Pool: SFCs Award

State	%
Net proceeds of state taxes	
Rajasthan*	21.8
Tamil Nadu*	8.0
Uttar Pradesh*	7.0
West Bengal*	16.0
Tax and non tax revenues	
Andhra Pradesh*	39.2
Madhya Pradesh*	8.7
Tax revenues	
Assam*	2.0
Non-loan gross own revenue	
Karnataka	5.4

* Inclusive of the share of Panchayats. Finance Commission of other states have recommended sharing of specific taxes or awarded a fixed amount for municipalities.

Source: Report of the SFCs, 1995-1999.

State Share of Municipalities: Eleventh Finance Commission Award

State	%
Andhra Pradesh	8.2
Arunachal Pradesh	Neg.
Assam	1.1
Bihar	4.7
Goa	0.2
Gujarat	6.6
Haryana	1.8
Himachal Pradesh	0.2
Jammu and Kashmir	0.8
Karnataka	6.2
Kerala	3.8
Madhra Pradesh	7.8
Maharashtra	15.8
Manipur	0.2
Meghalaya	0.1
Mizoram	0.2
Nagaland	Neg.
Orissa	2.0
Punjab	2.7
Rajasthan	5.0
Sikkim	Neg.
Tamil Nadu	9.7
Tripura	0.2
Uttar Pradesh	12.6
West Bengal	9.9
Total	100.0

Source: Report of the Eleventh Finance Commission. June 2000.

In addition to the devolution package, the first SFCs made wide-ranging recommendations for stepping up resource mobilisation by the municipalities. These included reform of property taxation and better and fuller use of user charges, fees and fines component. The first SFCs suggested greater autonomy for municipalities in matters relating to the fixation of tax rates, charges and fees, and recommended that appropriate mechanisms be put in place for data collection and maintenance, particularly data relating to the finances of municipalities. The SFCs envisioned that the transfer of functions enumerated in schedule twelve of the Constitution would involve concomitant transfer of staff and resources to municipalities, and should, therefore, not entail any additional financial burden on the state governments.

The recommended grant of Rs. 20,000 million by the EFC is meant to supplement the funds that would normally flow from the state governments to municipalities during the period 2000-2005. It would also supplement the amounts that may accrue to municipalities as a result of the implementation of the recommendations of the finance commission of states. This grant is dedicated to improving the maintenance of civic services such as primary education, primary health care, safe drinking water, street lighting, sanitation, maintenance of cremation and burial grounds, public conveniences and other common property resources, and is not expected to be used for payment of wages and salaries. The grant includes a sum of Rs. 29.4 million for the creation of data bases relating to the finances of municipalities and such sum as may be needed by municipalities for a proper upkeep and maintenance of their accounts and audit.

The Eleventh Finance Commission (EFC) has established a comprehensive framework for the allocation of grant to states for municipalities. The framework consists of a set of multiple criteria, with each criterion assigned with a weight.

The principle underlying the framework is that apart from the size - represented by population and geographical area - which is a major determinant of the financial requirement of municipalities and which consequently commands a larger weight, grant should be allocated on the basis of a set of complementary criteria of efficiency, measured by the revenue-raising effort of municipalities, and equity, represented by

Framework for the allocation of Grant

Criteria	Weight
Urban population, 1991	40%
Urban geographical area 1991	10%
Revenue effort of Municipalities	10%
Distance from the highest average per capita non-agricultural gross state domestic product (GSDP)	20%
Index of decentralisation	20%

Source: Report of the Eleventh Finance Commission. June 2000

Index of Decentralisation

- Enactment of state municipal legislation in conformity with the Constitution (seventy-fourth) Amendment Act, 1992
- Intervention/restriction in the functioning of municipalities
- De-jure assignment of functions to municipalities vis-a-vis the twelfth schedule of the Constitution of India
- De-facto assignment of functions to municipalities by way of rules, notifications, and orders of state government
- De-jure assignment of taxation powers to municipalities
- Exercise of taxation powers by municipalities
- Constitution of the finance commission of states and submission of action taken reports
- Action taken on the major recommendations of the finance commission of states
- Election to the municipalities
- Constitution of district planning committees

Source: Report of the Eleventh Finance Commission. June 2000.

the distance of the state's average per capita non-agricultural gross domestic product from the highest average per capita non-agricultural GSDP. The former is meant to serve as an incentive for municipalities to boost their revenue effort, while the latter provides funds for the fiscally-disadvantaged municipalities. An important criterion that commands a 20% weight in the grant allocation relates to decentralisation as envisioned in the Constitution (seventy-fourth) Amendment Act, 1992. An index of decentralisation has been proposed by the EFC for measuring decentralisation.

Recognizing that the financial requirements of municipalities are phenomenal and can not be met by the grant component alone, the EFC has suggested a string of measures for the augmentation of the consolidated fund of the states which, in turn, could supplement the resources of municipalities as also for strengthening of their revenue base. Measures for augmenting the consolidated fund include levy of land taxes by states, surcharge/cess on state taxes which could devolve on local bodies, and fuller use of profession tax as provided for under Article 276 of the Constitution. Similar proposals have been advanced for improving local resource mobilisation and include reform of property taxation, substitution of octroi by a tax which is buoyant, and fixation of user charges which are able to cover full operations and maintenance cost.

The proposed financial frameworks for municipalities are the result of the incorporation of Part IX A on Municipalities and amendment of Article 280 to insert (3)(c) into the Constitution of India. Until the incorporation of these amendments, the state-municipal fiscal relations were an exclusive concern of the state governments. Drawing strength from Article 246 and the state list in the seventh schedule of the Constitution under which the subject of local government formed a part of the state list, the state governments determined the expenditure responsibilities and fiscal powers and authority of municipalities, and defined the degree of autonomy within which they could function. Discussions on how to improve the financial viability of municipalities or streamline the flow of funds to them, or carry out reform of municipal taxes took place within the parameters of state control over municipalities.

The Constitution (seventy-fourth) Amendment Act, 1992 and Article 280(3)(c) have, however, altered the erstwhile fiscal arrangement between

The "Why" of the amendments of the Constitution as embodied in the 'Statement of Objects and Reasons' published in the Gazette of India (September 16, 1991) is that in many states, local bodies have become weak and ineffective on account of a variety of reasons, including the failure to hold regular elections, prolonged supersession and inadequate devolution of powers and functions. As a result, urban local bodies are not able to perform effectively as vibrant democratic units of self-government. Having regard to these inadequacies, it is considered necessary that provisions relating to urban local bodies are incorporated in the Constitution particularly for (i) putting on a firmer footing the relationship between the state government and urban local bodies with respect to (a) the functions and taxation powers, and (b) arrangements for revenue sharing, (ii) ensuring regular conduct of election, (iii) ensuring timely elections in the case of supersession, and (iv) providing adequate representation for the weaker sections like scheduled castes, scheduled tribes and women.

the states and municipalities. Under the new fiscal arrangement, every state government is required to constitute, once in five years, a finance commission, and entrust it with the task of reviewing the financial position of municipalities and making recommendations as to the principles that should govern-

- the distribution between the state and the municipalities of the net proceeds of the taxes, duties, tolls and fees leviable by the state;
- the determination of the taxes, duties, tolls and fees that may be assigned to, or appropriated by, the municipalities; and
- the grants-in-aid to municipalities from the consolidated fund of the state.

The new fiscal arrangement has simultaneously effected a major change in the scope of the tasks of the central finance commission which, until the insertion of (3)(c) into Article 280, was confined to the distribution of divisible taxes between the Union and the states and of grants-in-aid to states under Article 275 of the Constitution. The new arrangement requires the central finance commission to suggest measures needed to augment the consolidated fund of a state to supplement the resources of the municipalities on the basis of the recommendations made by the finance commission of states. If the report of the Eleventh Finance Commission (EFC) is any indication, then the state-municipal, indeed, the entire range of state-local relations are poised for a major break from the earlier practices.

Apart from serving the larger purpose of strengthening the forces of decentralisation in the country, these amendments imply that-

- the erstwhile system of assigning tax powers and authority to municipalities and sharing the state resources with municipalities was inadequate to meeting the financial requirement of municipalities;
- as municipalities under the provision of Article 243 W/twelfth schedule acquire additional expenditure responsibilities, several of which have interjurisdictional implications, a new fiscal system may have to be put in place; and

Literature on fiscal federation has grown enormously in the wake of increasing importance of local governments in the developing and transitional economies. A number of countries have enacted legislations aimed at strengthening local governments, important among these being-

Albania 1992	Law 7572 on the Organisation and Operation of Local Government
Bangladesh	The Pourashava (Municipalities) Ordinance, 1977
Bulgaria 1991	Law on Local Self-Government and Local Administration
Hungary	Law 65 of 1990 on Local Self-Government.
Republic of Korea	The Local Antonomy Act, 1988.
Philippines	The Local Government Code 1991
Sri Lanka	The Thirteenth Amendment to the Constitution

- an institution outside of the governmental framework may be able to better assess the financial requirement of municipalities, and devise an appropriate fiscal package for them.

At the center of the Constitutional and other statutory changes lies the new institution of the finance commission of states. The finance commission of states have crucial responsibilities, not only those defined under Article 243 Y but also those that are related to Article 280 (3)(c) of the Constitution. Under these provisions, the SFCs are expected to-

- undertake a review of the finances of municipalities;
- estimate the future financial requirements of municipalities;
- design a package of (a) taxes, duties, tolls and fees that may be assigned to municipalities, (b) taxes, duties, tolls and fees that may be shared between the state and the municipalities, and (c) grants-in-aid that may be extended to municipalities out of the consolidated fund of the state, which is able to meet the financial requirement of municipalities; and
- suggest measures for the strengthening of the finances of municipalities.

In what alternative ways can these tasks be addressed? What are the key steps that are crucial for understanding the emerging state-municipal fiscal relations? What are the pre-requisites for determining the structure and mechanism for financing the expenditure responsibilities of municipalities? This paper entitled, ***Approach to State-Municipal Fiscal Relations: Options and Perspectives***, is concerned with these questions. It does not suggest which taxes, duties, tolls and fees should be assigned to municipalities and which of these should be shared or what measures should be taken for strengthening the finances of municipalities; rather, it attempts to lay out the steps that are crucial for reviewing the financial position of municipalities, estimating their future financial requirements, and determining the principles for. revenue assignment and revenue-sharing relevant for this tier of government.

The paper draws on the lessons learnt from the experiences of the

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first finance commission of states and the Eleventh Finance Commission. It draws on the vast and growing literature on fiscal federalism. The paper has taken into account the very useful comments made on an earlier draft of the paper presented at a workshop organised by the National Institute of Urban Affairs (NIUA) in June 2000, as also the comments received from the Financial Institutions Reform and Expansion Project (FIRE). The paper recognizes that there is no fiscal system that can take into account the financial requirements of over 4,600 municipalities of different sizes and grades or deal with their financial problems. Yet, there are steps which are central to addressing the state-municipal fiscal relations as envisioned in the Constitution (seventy-fourth) Amendment Act, 1992, and Article 280 (3)(c). The purpose of the paper is to map out the steps, provide a rationale for them, and provide alternative ways of approaching the Constitutional mandate.

Number and Population of Cities and Towns, 1991

Class	Number	Population (million)	% variation 1981-91
All Classes	4,615	215.8	36.8
>100,000	322	122.3	47.3
50,000-100,000	421	28.8	30.5
20,000-50,000	1,161	35.3	31.3
10,000-20,000	1,451	21.1	19.3
5,000-10,000	971	7.4	6.6
<5,000	289	0.9	-14.1

Source: Census of India 1991, Series 1 -India, Part II A (ii) - A Series. Table A-4 statement 5, pp.34

The Macro Framework of Municipalities

It is a general and undisputed proposition of law that a municipal corporation possesses and can exercise the following powers, and no others: first, those granted in express words; second, those necessarily or fairly implied in or incidental to the powers expressly granted; and third, those essential to the accomplishment of the declared objects and purposes of the corporation - not simply convenient but indispensable.

—Dillon's Rule

(John F. Dillon. 1911. Commentaries on the Law of Municipal Corporations. Boston. MA. Little, Brown and Co.)

The macro framework of municipalities, i.e., the framework within which the municipalities in India function and carry out their activities, has always been diverse and complex, shaped by years of deliberations on state-local distribution of functional assignments, tax bases, criteria for revenue-sharing and grants-in-aid, and responsibilities for service delivery systems. For one thing, municipalities in India which have a long history - the first municipal corporation[1] was formed in Madras in 1687, are characterised by extreme diversity. First, the population size of municipalities differs. Cities with 12-13 million persons and towns with less than 10,000 persons have one or the other form of municipal government. In 1991, there were 18 urban settlements with a population of over one million, and another 304 settlements which had a population ranging between 100,000 and one million. The other end was represented by 1260 settlements which had a population of less than 10,000 persons.

Second, cities and towns have grown at highly variable rates over the

[1]Notwithstanding the constitution of a municipal corporation in Madras in 1687, municipal administration is said to have begun in the country with the passing of the Regulating Act of 1773 and the Charter Act of 1793. Lord Mayor's resolution of 1870 brought in a measure of self-government at the local level. But it is Lord Ripon's resolution of 1882 that laid the foundation of local and municipal self-government in India.

Population size, growth rates and civic status of municipalities are an important factor in determining their financial requirements.

Expenditure responsibilities of municipalities are large and varied. For the reason that each state government has its own legislation governing the municipalities, municipal government roles, responsibilities, and functions differ in several respects between states.

decades - some having experienced a growth rate of over 9 per cent annually and others registering an annual growth of less than 1 per cent. During the census decade of 1981-91, 856 settlements acquired the urban status for the first time; however, 93 settlements lost their urban status. Thirdly, urban settlements in India have a complex set of civic status.[2] Thus, it is common for urban settlements to have a status of a corporation, a municipality, nagar panchayat, town committee, and the like. A likely implication of this feature is that the functions and consequently the financial requirements may differ between a local body with the civic status of a nagar panchayat, and another which may be a town committee, a municipality or a corporation.

Fiscal relations between the 28 states and over 4,600 municipalities in India are diverse and complex, with much of it rooted in the Constitution itself, which lays down neither an expenditure jurisdiction nor a fiscal domain for municipalities. These are defined by state governments, and coded in state laws. The state governments, out of the powers and responsibilities enumerated in the seventh schedule assign certain functions and duties to municipalities which historically have consisted of public health and sanitation, communications, i.e., roads, bridges etc. not specified in list I, water subject to the provisions of Entry 56 of list I, markets and fairs, libraries, museums and other similar institutions, and burial and cremation grounds. The main services with which the municipalities are associated and which are generally, though not uniformly, performed by them, are water supply, sewerage and drainage, conservancy and sanitation, street lighting, and municipal roads. In addition, the municipalities are vested with a large number of regulatory functions. The Constitution (seventy-fourth) Amendment Act, 1992, while laying down the procedures for the constitution of municipalities and providing for certain safeguards against their arbitrary suspension or dissolution, has not changed the structure of fiscal federalism in the country. The legislature of a state continues to enjoy absolute powers to endow the municipalities with such authority as it considers necessary 'to enable them to function as institutions of self-government'. This arrangement implies concurrency of functions between states and

[2]The Census of India, 1991 lists out as many as 38 kinds of civic status for urban local bodies in India. See. Paper 2 of 1991: Provisional Population Totals. pp. 170. A fuller implementation of the Constitution (seventy-fourth) Amendment Act, 1992 will result in three grades of urban local bodies, namely, corporation, municipality, and nagar panchayat.

Much of the theoretical discussion on state-local relations proceeds on the assumption that clear lines can be drawn between what is or should be local, what is or should be state, and what is or should be federal. In practice, this is not necessarily the case.

—E. Blaine Liner

A Decade of Devolution: Perspectives of State-local Relations municipalities. It implies that the municipalities do not possess what are referred to as general competency powers permitting them to take actions not explicitly prohibited or assigned elsewhere; they possess the legally delegated powers and functions, under the doctrine of ***ultra vires*** that limit local choice and diversity. They are to take ***nothing from the general sovereignty except what is expressly granted.***[3] The functional domain of municipalities has also witnessed periodic shifts and changes, on account of the withdrawal of functions from municipalities or entrusting them with such responsibilities as poverty alleviation. These features have a direct impact on the volume and structure of municipal finances.

The state governments determine the fiscal options of municipal governments. The state laws specify the taxes that the municipalities can levy and collect; like in the case of functional responsibilities, the state governments, out of the tax powers listed in the seventh schedule, devolve certain tax powers to municipalities, which typically have included taxes on lands and buildings, taxes on the entry of goods into a local area for consumption, use or sale therein; taxes on animals and boats; tolls; taxes on professions, trades, callings, and employments; and taxes on entertainment. Significant inter-state variations are witnessed here. Taxes on the entry of goods, which are among the most buoyant and elastic of the local taxes, are currently levied in Gujarat, Maharashtra, Manipur, Orissa, and Punjab. The inclusion or exclusion of this tax has an overwhelmingly large impact on the revenue base of municipalities. Similarly, there are inter-state differences in respect of taxes on entertainment, and taxes on professions, trades, callings, and employment. These tax objects are less mobile, not easily exportable, and thus fit into the model that says that the choice of tax instruments should conform to the rule that each jurisdiction pays for its own benefits.

In its totality, municipalities in India would seem to fall into three groups, with each group presenting a different order of financial requirements–

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[3]The rule known as the Dillon's rule was not accepted by all the judges. However, the Supreme Court of the US upheld it and opined that the relationship between state and local governments was not contractual in nature (thereby implying equality) but was one of a superior (the creator) and the inferior (the created). For further discussion, see Advisory Commission on Intergovernmental Relations. State and Local Roles in the Federal System. Washington D.C. 1982.

Differences in tax jurisdiction, the degree of control exercised by state governments in terms of the fixation of tax base, tax rates, and tax exemptions, and the efficiency with which taxes are administered and enforced, directly impact on the revenue base of municipalities.

State control over local bodies is a universal phenomenon. States place conditions on local governments, often imposing requirements on their performance for various reasons. First: the service may be of such importance statewide that its quality and quantity can not be left to the total discretion of local governments. Second: if the provision of the service is considered essential by the legislature or the courts, it must be uniform across the municipalities. Third: state mandates may be necessary in order to achieve a desirable social and economic goal determined by the legislature. Finally, state governments may require municipal governments to perform a function previously performed at the state level in order to increase responsiveness to citizen needs.

- those which have a comparatively large functional and an equally large fiscal domain. Gujarat and Maharashtra are examples of this typology;

- those which have a larger fiscal domain but a narrow functional jurisdiction. Rajasthan and Manipur are a typical example of this group; and

- those that have a comparatively larger functional jurisdiction, but a narrower fiscal base.

The state-municipal fiscal relations are complex, with state laws limiting the autonomy of municipal government in laying down local tax policies, including policies relating to the choice of tax rates or determining who to include or exclude from payment of taxes. States stipulate the purposes for which funds may be spent, fix salaries, and impose limits on the amount of debt, the purpose for which debt may be incurred, procedures for repayment and the like. Absence of autonomy in matters relating to tax rate fixation, or a low discretion coefficient as it is often referred to, is one of the most serious handicaps of municipal governments in managing their finances and spending responsibilities. In many ways, it has meant increasing dependence of municipalities on the state governments.[4]

Unlike the provisions in the Constitution which specifies the taxes that are to be divided between the Union and the states, e.g., Chapter I of Part XII, and the grants that may be extended to the state under Article 275 of the Constitution, no such provision regarding the division of tax revenues between the state governments and municipalities or about the grants exists in the state laws. Nor do the laws specify as to when and under what circumstances should the states make transfers and what should be the nature of those transfers. On account of the absence of provisions in respect of the taxes, duties, and fees that should be shared between the states and municipalities and the purpose and manner in which grants-in-aid should be extended to them, the role of transfers in the finances of municipalities has remained highly tentative. The

[4]State limits on local revenue raising authority is neither new nor only a feature of India's federal structure. In the USA, property tax rate limits began in the last century, originating in Rhode Island in 1870.

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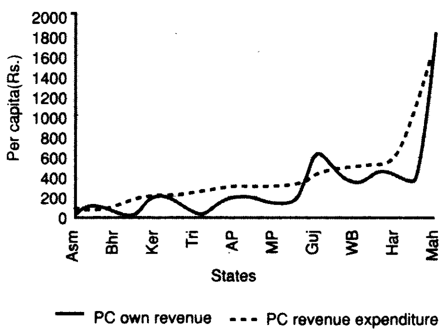
Constitution (seventy-fourth) Amendment Act, 1992, while recognising the crucial role of transfers, makes no specific provision in this respect, leaving the matter to be considered by the finance commission of states, and eventually determined by the state legislatures.

Yet another complex feature of the state-municipal fiscal relations lies in the provision in the state laws that requires the municipalities to balance their budgets and often even maintain a cash balance at the end of a financial year. The Orissa Municipal Act, for instance, lays down that the state government has powers to prescribe a minimum closing balance to be maintained by a municipality. The West Bengal Municipal Act, 1993 provides that the budget estimate of a municipality for a year shall be presented before the Board at a meeting specially convened for the purpose, provided that no deficit shall be shown in the budget estimate so prepared. The municipal corporations in Punjab are required to maintain a cash balance of not less than Rs.100,000 or such higher sum as may be determined. The Uttar Pradesh Municipalities Act provides for maintaining a minimum closing balance as the state government may prescribe. Such a provision suggests that there may, in fact, be no deficit at the end of a financial year, raising the question as to how, under such circumstances, the revenue gap of municipalities could be assessed or supplementary financial requirements estimated. A surplus or a balanced budget does not automatically suggest the need for resources.

The functioning and finances of municipalities are thus to be understood and analysed in a framework which is characterised by (a) asymmetry in their functional and fiscal jurisdiction, (b) absence of appropriate statutory provisions regarding the transfer of funds from the state governments to municipalities, (c) limited autonomy with municipalities in matters of tax rate fixation, staff salaries, and borrowings, and (d) provisions requiring the municipalities to balance their budgets.



Source: A sample survey. NIPFP. 1999.

Appraising the Finances of Municipalities

Appraising the finances of municipalities is central to addressing the mandate embodied in Articles 243 Y and 280(3)(c) of the Constitution. Appraisal shows the fiscal health and performance of municipalities. It shows the level of efficiency of municipalities in managing their finances. It lays the groundwork for estimating the future financial requirements and determining the fiscal jurisdiction of municipalities.

An important objective of appraisal is to assess the revenue gap, i.e., the gap or the difference between the own resources of municipalities and their total revenue expenditure on a common and comparable basis. A revenue gap may arise on account of asymmetry in expenditure and revenue assignments or for reasons of fiscal and cost disabilities among municipalities. A revenue gap may be large or small, depending on what expenditure responsibilities are assigned to municipalities and what resource raising powers they possess. The nature and extent of the gap determines the course of action that could be taken to bring about greater correspondence between the fiscal powers and authority and the expenditure responsibilities of municipalities or, more specifically, to determine the changes that may need to be made in the assignment of taxes, duties, tolls and fees, in revenue-sharing arrangements, the size of the grants-in-aid, or in the expenditure profile of municipalities, in order to close the gap.

Expenditure Appraisal

An appraisal of the finances of municipalities is an extremely complex exercise, involving an estimation of all expenditures incurred by municipalities including the expenditures that are attributable to them as also the committed but yet to be incurred expenditures. These expenditures are the result of the quantity of service used by the population served by a municipality and the average rate of use, on the one hand, and the cost of providing each unit of service which is

Cost of providing a municipal service may differ on account of the differences in the (a) type and standard of service, (b) administrative processes and efficiency with which services are delivered, and (c) cost of service provision.

influenced by the cost of inputs and other costs associated with service provision, on the other. The level of expenditure thus arrived at is indicative of the level of services, even when there may not exist a statistical correspondence between the levels of expenditures and service levels across municipalities. This is a fundamental assumption which underlies any appraisal of the finances of municipalities.[5]

For reasons of the existing accounting systems, most expenditure assessments are able to capture only a part of the expenditures that are attributable to municipalities, and are therefore, incomplete assessments. The municipal budgets and accounts also do not permit an estimation of the cost of services. The purpose of the appraisal is to capture, as accurately as possible, all expenditures attributable to municipalities, and analyse them in a way that it helps to–

- assess the adequacy of expenditure in relation to the established norms and expenditure;
- estimate the cost of providing services, including the cost disabilities with which municipalities may suffer;
- determine the degree of flexibility that a municipality may have in altering the structure of expenditure, specifically the flexibility in changing the relative proportions of the discretionary and the non-discretionary components of expenditure; and

Municipal expenditure consists of–

- direct expenditure incurred by municipalities on establishment, administration, and enforcement of regulations and municipal bye-laws; interest payments; and operations and maintenance of services;
- expenditure attributable to municipalities but incurred or absorbed by state governments, e.g., salaries of selected staff, and pension contribution and terminal benefits;

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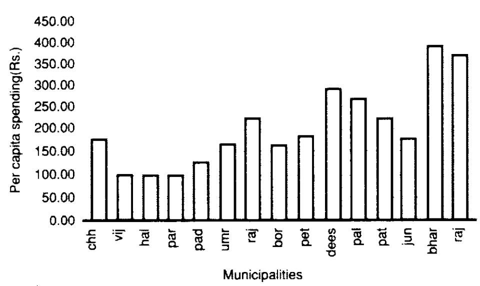
[5]A statistical correspondence may not exist, as on the cost side there are historical costs, and on the revenue side, services are added tot he existing systems. A correspondence may not also exist on account of inefficiencies in operating and maintaining the services.

For the reason that many municipal services are labour intensive and have a high wage component, wages and salaries constitute a major component of municipal expenditure. It accounts for approximately 60-65 percent of total revenue expenditure, and leaves little discretion with municipalities for changing the pattern of expenditure.

Level of spending on core services is uniformly below the established norms and standards, affecting the quality of life in the urban areas.



Source: A Sample Survey. *NIPFP. 1999*

Municipal capacities to raise resources differ on account of the differences in (a) the range and scope of taxes and charges imposed, (b) the rates of taxes and charges, and (c) the fiscal capacity of municipalities.

- expenditure unrelated to municipal functions but incurred by municipalities on behalf of the state governments; and

- outstanding liabilities.

Municipal expenditure can be grouped and examined in different ways:

- ***Grouping 1.*** Expenditure on establishment and administration; interest payments; and operations and maintenance. This grouping shows the relative proportions of the discretionary and non-discretionary constituents of expenditure, and helps in determining the degree of discretion a municipality may be able to exercise in realigning the pattern of expenditure. Wages and salaries and interest payments are the non-discretionary components of municipal expenditure.

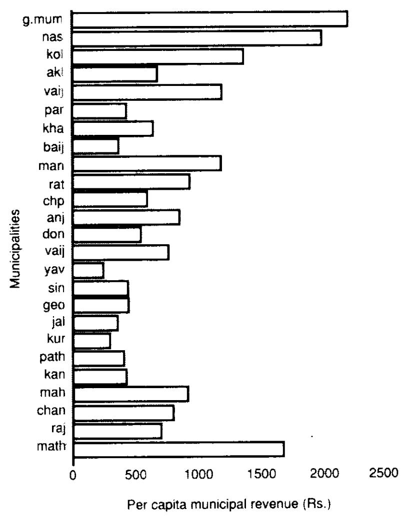
- ***Grouping 2.*** Expenditure on the operation and maintenance of core services such as water supply, sewerage and drainage, conservancy and sanitation, municipal roads, and street lighting vis-a-vis the non-core components of municipal activities.. The Eleventh Finance Commission (EFC) has laid stress on the proper maintenance of such services as primary education, primary health care, safe drinking water, street lighting, sanitation including drainage and scavenging facilities, maintenance of cremation and burial grounds, public conveniences, and other common property resources. Organisation of municipal expenditure data this way helps to assess the adequacy of expenditure on the maintenance of core services as also in ascertaining the unit cost of service provision.

- ***Grouping 3.*** Expenditure on general administration, public health, public works, public instruction, public safety, development and planning, and regulatory functions.

Revenue Appraisal

Parallel with an assessment of expenditure and its long and short run behavior is an analysis of the revenue position of municipalities. It represents the supply side of resources and reflects what the users pay for the services used. Revenue appraisal identifies and accounts for all

Municipal revenue, Maharashtra



Source: A sample survey. NIPFP. 1999.

Own Revenue of Municipality/Own Revenues of States

RE_{Ai} = OR_{Ai} / SOR_{Ai}

RE_{Ai} = Rev. effort of municipality A in the state in year i

OR_{Ai} = Own revenue collection of municipality A in the state in year i

SOR_{Ai} = State's own revenues in year i

i = 1995/96, 1996/97, and 1997/98

Own Revenue of Municipality/State's non-agricultural GSDP

RE_{Ai} = OR_{Ai} / $GSDP_{Ai}$

RE_{Ai} = Rev. effort of municipality A in the state in year i

OR_{Ai} = Own revenue collection of municipality A in the state in year i

$GSDP_{Ai}$ = State's GSDP (excluding primary sector) in year i

i = 1995/96, 1996/97, and 1997/98

revenue account receipts and income, including the income which is due but yet to accrue to them.

Revenue assessment is a process that involves consideration of at least the following:

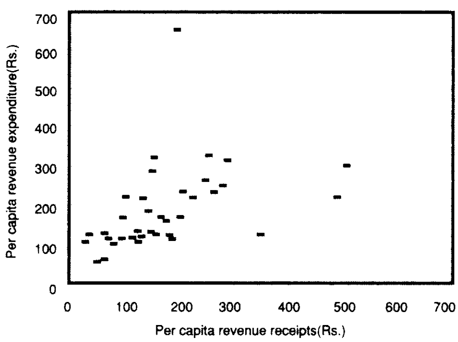
- nature and structure of the municipal revenue base;
- autonomy of municipalities in making use of the revenue base, e.g., determining exemptions, rebates, and rates of taxes, duties, and other levies;
- level of effort and efficiency in revenue generation; and
- extent to which the internally generated resources are able to finance the municipal expenditure, and the degree of municipal dependence on external resources for meeting the expenditure.

Municipal revenues consist of the internally generated resources and resources that are externally provided. The former comprises, on the one hand, taxes on property, octroi where levied, and other minor taxes, and a large mix of charges, fees, rents, levies, and interest earnings. Tax revenues form 50-75 percent of the internally generated resources; the non-tax component, i.e., direct charging for services sold is in its infancy and constitutes one of the weak links in the finances of municipalities. Likewise, fees and rents charged by municipalities bear no relation to the cost incurred by them on different services.

A key component of the appraisal lies in assessing the structure and buoyancy of the municipal revenue base. Perceived as inferior in comparison with revenue bases of the higher governmental tiers, and narrow with only a small percentage of population paying for municipal services, the purpose of the appraisal becomes one of measuring the capacity of municipalities to make use of the assigned or devolved revenues. The Eleventh Finance Commission (EFC) has proposed that the own revenue effort of municipalities be measured in relation to (a) own revenues of the state, and (b) non-agricultural gross state domestic product (GSDP). Own revenue collection of municipalities in each state is measured against the own revenue collection of the state for three

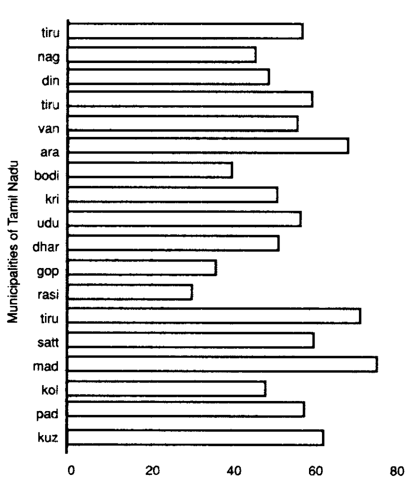
Own resources of municipalities are dismally low. In several states, own resources of municipalities are not able to meet even the wages and salaries component. Own resources are severely constrained on account of the absence of autonomy and poor tax administration.

Per capita municipal income & expenditure, U.P.



Source: A sample survey. NIPFP.
1999

Transfers as a % of municipal revenue



Source: A sample survey. NIPFP.
1999

years, viz, 1995/96, 1996/97 and 1997/98, and the average of these ratios is weighted by the urban population of 1991 to arrive at the share of each state. Similarly, the own revenue collection of municipalities in each state is measured against the state's non-agricultural GSDP for three years, and the average of the ratios is weighted by the urban population of 1991 to arrive at the share of each state. Here, the purpose of the appraisal is to measure the own revenue effort of each municipality in relation to (a) own revenues of the state, and (b) non-agricultural GDP of that state. In addition to measuring revenue generation capacity, appraisal is designed to also measure the efficiency in revenue collection, by examining the ratios of tax assessed, tax demanded, and tax collected.

Appraising Transfers

The externally provided resources constitute a significant component of municipal revenues. Representing in most cases the difference between own resources and revenue account expenditure of municipalities, transfers play an extremely important role in meeting the vertical gap of municipalities. Transfers enable the municipalities to continue to maintain services, or as is often said, make the cities and towns function. Transfers are extensively used for meeting the sector objectives and contributing towards the reduction of fiscal imbalances. Barring transfers of a statutory nature, that is, those which are extended in fulfillment of the requirements of such statutes as the land revenue codes, transfers are perceived by municipalities as entitlements and a legitimate component of their revenues.

Accruing in the form of shared revenues and grants-in-aid, transfers are used for meeting the financial requirements of municipalities which are fiscally handicapped or which have cost disadvantages. They represent an outgo from the consolidated fund of a state and are, therefore, of direct concern to state governments. Often, the proportion of transfers is understated as the state governments directly absorb a part of the expenditure of municipalities, e.g., the salaries of their staff and contribution towards their provident fund, pension and retirement benefits. It is important that such transfers are brought within the scope of the appraisal exercises.

Appraising the role of transfers is crucial in assessing the financial

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position of municipalities. It relates to the—

- purpose of transfers, i.e., whether transfers are extended to meet the vertical gap or designed to compensate the municipalities for actions taken at the level of states, e.g., salary revision or increase in dearness allowance, or pension and terminal allowance adjustments, or called in to compensate for the spillover effects of the fiscal operations of municipalities and the extent to which the transfers are able to meet the purpose or purposes for which these are made;

- basis of transfers, i.e., the basis on which the state governments determine the amount that should be transferred. There exists no clarity whether transfers are determined on the basis of the gap between what the municipalities need and what they are able to raise, or are negotiated between the state and municipalities, or simply determined on the basis of past, historical trends. Additionally, transfers are characterised by unpredictability making it difficult for municipalities to plan out their activities; and

- effect of transfer. It is crucial that the appraisal exercise analyses the effect of the externally-provided funds not only on the purposes for which these funds are advanced, but on the internal revenue generation as well, to ascertain whether such funds have substituted the locally-raised resources, or distorted the state-local fiscal relations in any way.

The extent to which transfers actually impart efficiency and equity is an important aspect of the appraisal exercise. Key variables in this regard are the methods employed for determining the amount to be transferred, criteria used to allocate resources, the conditions attached to the use of transfers, and the manner in which transfers are made to municipalities.

Use of Indicators for Appraising the Finances of Municipalities

The primary objective of appraisal is to realistically capture the financial strengths and weakness of municipalities and use the results for estimating the future financial requirements of municipalities. It means collection of key finance data of municipalities for about five years and putting them together in a manner which can bring out the fiscal strengths and weaknesses of municipalities. An illustrative set of indicators which are

Use of Indicators for Appraisal

Indicators relating to	Years t_1–t_5	Annual average % change
Municipal Expenditure		
Municipal income		
Transfers to municipalities		
Efficiencies in revenue generation and collection		
Efficiency in expenditure		
Others		

useful for appraisal is given below:

- per capita level of revenue expenditure;
- proportion of expenditure on wages and salaries to total municipal expenditure;
- proportion of expenditure on interest payments to total municipal expenditure;
- proportion of expenditure on operations and maintenance to total municipal expenditure;
- expenditure on core services as a proportion of (a) total municipal expenditure, and (b) the norms of expenditure on core services;
- per capita expenditure on core services expressed in physical units, e.g., per 1 km of road; per 100 street lights; per 1000 kg of solid waste; and the like;
- per capita level of revenue receipts and income;
- proportion of own revenues to total municipal revenues;
- proportion of tax revenues to total own revenues;
- revenues from property taxes as a proportion of tax revenues;
- proportion of non-tax revenues to total own revenues;
- proportion of externally-provided, i.e., state resources to the total municipal revenues;
- proportion of shared revenues to the externally-provided resources;
- proportion of grants-in-aid to the externally-provided funds;
- proportion of conditional grants to the total grants-in-aid;

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- cost of collecting taxes and other non-tax charges as a proportion of total own revenues;

- proportion of municipal expenditure covered by own revenues (i.e., vertical gap); and

- own revenues as a proportion of revenue assessed and revenue demanded.

Time series data on the above are crucial for assessing the financial position of municipalities. These alone can indicate whether the finances of municipalities have improved or deteriorated over time, and assist in formulating a strategy for addressing the financial issues confronting the municipalities. A well-designed appraisal is an indispensable exercise in understanding the state-municipal fiscal relations.

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Measuring the Revenue Gap and Level of Underspending

A central task in implementing the provisions of Article 243 Y of the Constitution is to determine the size and nature of the revenue gap of municipalities . Only after the size and nature of the gap is known, can a state government decide upon, and design, its policy in respect of the devolution of funds to municipalities. The size and nature of the revenue gap is a crucial input to developing a package of fiscal and other measures for bridging this gap. An accompanying task that impinges directly on the size of the gap is to measure the adequacy of spending levels of municipalities, particularly on such core services as water supply, sewerage and drainage, solid waste collection, city-wide roads, and street lighting. A revenue gap has relevance only when it is measured in relation to the level of services that a municipal government is able to provide to its citizens.

Revenue Gap

A revenue gap is generally understood in terms of the difference between the own resources of municipalities and their revenue expenditure. However, when the task is to determine the ***future*** financial needs of municipalities, a gap so worked out is of little value. Using such a gap for projecting the financial requirements is also inappropriate as it is usually based on overstated expenditures and understated revenues. For the purpose of determining the future financial needs, it is the difference between the expenditure ***needs*** and revenue-raising ***capacity*** of municipalities that constitutes the revenue gap. Revenue-raising capacity is defined as the amount of money a city could raise at a given tax burden on its citizens. Expenditure need is the amount a city must spend to provide public services of a given quality.

A revenue gap may arise for any of the following reasons:

- **Asymmetry in expenditure and revenue assignment.** A municipality

Same tax base and same tax rate may yield lower or higher revenues on account of differences in the level of economic activity.

Both revenue-raising capacity and expenditure needs are influenced by a city's economic and social structure and by its fiscal institutions. Economic and social factors determine the potential taxable resources in the city and the cost of providing city services, whereas state-determined fiscal institutions determine which taxes a municipality is allowed to employ and the extent of a municipality's responsibilities for providing public services.

—John Yinger and Helen F. Ladd, The Determinants of State Assistance to Central Cities, in National Tax Journal. XLII

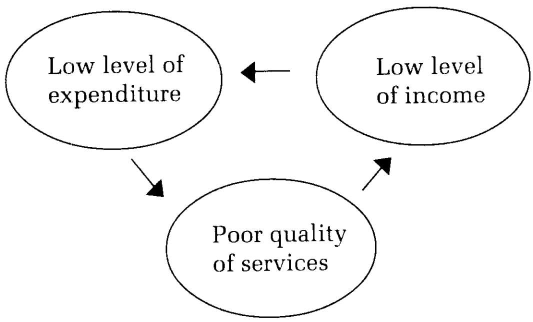
may have a comparative advantage in the provision of a class of goods and services, but may not possess a similar advantage in revenue generation. This asymmetry produces what is commonly known as the vertical fiscal gap or imbalance.

- **Fiscal handicap of municipalities.** Some municipalities have a poor economic base, with the result that even with the same tax powers and authority, they are unable to generate revenues that are sufficient to meet their expenditures. Such differences in the per capita revenue of municipalities of roughly the same size and placed in a somewhat similar socio-economic context result in a gap. This gap has implications for designing a fiscal transfer system which is able to accommodate the highly disparate requirements of municipalities.

- **Variation in the unit cost of providing services across municipalities.** Unit costs may vary on account of such factors as the choice of a municipality on the type and standard of a service as also the differences in the administrative processes and efficiency with which a service may be provided. In addition, these may also vary on account of cost disabilities caused by factors over which municipalities have little control, e.g., high cost of service delivery on account of topography, density patterns, climate, physical shape of a city, and a host of similar factors. A revenue gap resulting from the high cost of service delivery has the same effect as that of fiscal handicap among municipalities.

- **Limited autonomy with municipalities.** One of the reasons why a revenue gap may arise or persist is the absence of autonomy with municipalities to adjust their revenue base in order to meet their revenue account expenditures.

Measuring the revenue gap of municipalities requires some standardisation of expenditure and revenue components. Standardization is necessary in order to ensure comparability of the estimates of gap between municipalities. Such a standardisation is also necessary for purposes of designing a grants or transfer system. The purpose of the exercise should be to capture, on the one hand, the gap caused by the asymmetry in expenditure and revenue-raising authority, and on the other hand, the fiscal disabilities of municipalities caused by factors that are


Low level of
expenditure
Low level
of income
Poor quality
of services

external to them. Estimates of revenue gaps, it should be noted, are neither intended nor designed to find out whether municipalities are spending too much or too little; rather, these are aimed at measuring the fiscal condition of municipalities in relation to each other. Establishing a benchmark is another step for measuring the revenue gap of municipalities in relation to each other.

Some municipalities may show a low level or zero revenue gap. A zero or low level gap does not necessarily mean that such municipalities are efficient or that their fiscal health is satisfactory. Indeed, it may well portray a vicious circle, characterised by poor quality of service, low level of income, and low expenditure levels. Similarly, a large revenue gap may not necessarily mean inefficiencies in the functioning of municipalities.

Revenue gaps, i.e., the difference between revenue expenditure and own revenues can be used in three complementary ways: First: these can be used to determine whether disparities among municipalities are so large as to require the intervention of state governments. Second, the distribution of relative gaps can provide a benchmark against which the existing grants/transfer policy can be evaluated. Third, they can be used as the basis for designing a formula for allocating grants among local governments. Thus, cities and towns in a state could be ranked by their relative need-capacity gaps, and a system of grants designed so as to allocate grants in proportion to the relative gaps of municipalities - relative to a baseline municipality. Alternatively, all municipalities could be given per capita grants with the neediest municipality getting the most and the least needy municipality getting the least. The advantage of this approach is that all municipalities receive some transfers; the disadvantage is that the total amount is thinly spread.

Level of Municipal Underspending

Underspending on the operations and maintenance of services is a common feature among municipalities in India. On an average, municipalities in India spend Rs. 2.04 per capita per day.[6] In several states, the per capita level of spending is less than Rs. 1.00 which, when

[6]These figures are drawn from a survey of 249 municipalities undertaken in 1999 by NIPFP and other research institutions.

The Zakaria Committee Aggregate Expenditure Norms

City size	Per capita operation and maintenance expenditure (Rs)	
	All services	
Lakh	1960/61	1997/98
>20	43.50	698.89
5-20	39.03	627.07
1-5	33.40	536.62
0.5-1	27.62	443.75
0.2-0.5	24.27	389.93
<0.2	21.07	338.52

The Zakaria Committee Expenditure Norms for Core servces

City Size	Per capita operation and maintenance expenditure (Rs)	
Lakh	1960/61	1997/98
>20	28.50	457.89
5-20	27.15	436.20
1-5	24.90	400.05
0.5-1	21.59	346.87
0.2-0.5	19.61	315.06
<0.2	18.72	300.76

Source: Table 7(b.36) and Table VIII (117) of the Zakaria Committee report for 1960/61 norms. The price index (consumer, urban non-manual) is used for adjusting the expenditure to 1997/98

Per Capita Investment Norms as Established by the Planning Commission. 1997/98

Services	Low	High
Water Supply		
Surface system	1066.74	1523.91
Ground system	870.80	1306.21
Sewerage/sanitation		
Water borne system	1523.91	2177.02
Septic tank	870.80	979.66
Pit latrines	522.48	653.10
Solid waste disposal	108.85	174.16
Roads	870.80	1306.21
Street lighting	261.24	261.24

Note: All India Consumer Price Index, urban non-manual (Base 1984/85=100) is used as inflator

Source: Planning Commission, Government of India (1983), Task Forces on Housing and Urban Development (Vol. II), Financing of Urban Development, New Delhi.

considered in the context of the myriad responsibilities that municipalities are required to meet would by any norm or standard, seem to be a gross underspending. Annual expenditure on conservancy and sanitation which is one of the most important duties of municipalities is just about Rs. 12 per capita in Assam, Rs. 40 in Bihar, Rs. 37 in Madhya Pradesh, and Rs. 60 in Tamil Nadu. The prevalence of large deficits on services understates the revenue gap. The gap would be significantly higher, if service levels were to be anywhere close to the norms and standards.

Determining the level of spending is a basic exercise for measuring the revenue gap. Spending levels represent the level of services; higher the level of spending, higher is assumed to be the level of services.[7] Since it is often difficult to compare the service levels, spending levels are used to determine whether or not these are adequate in relation to the prescribed norms and standards.

Norms and standards are crucial factors in determining the adequacy of municipal spending. They provide a benchmark for estimating the deficits in services. These constitute an equally important factor in estimating the financial requirements of municipalities. The purpose underlying the specification of norms and standards is to ensure for citizens a minimum environmental quality; however, fixing norms and standards is a complex exercise as these vary according to the size of city, climate, and density. Factors such as the level of economic activity, income profile, and the capacity of municipalities to provide and maintain services are equally important in fixing norms of expenditure.

Norms and standards relate to:

- ***Service*** standards and norms, e.g., 70 ltrs per capita/day of water supply, X number of street lights per running kilometer, and the like.
- ***Expenditure*** norms, e.g., Rs. 145 per capita for operating and maintaining a water borne system of waste disposal or Rs. 1060 per capita investment for a surface water system.
- ***Staff*** norms, e.g., x number of sanitary workers per 1000 population.

[7] It assumes that spending levels are not unduly affected by inefficiencies in operating services.

Estimating the Level of Underspending

$$US = \sum_{i=1}^{q} (z - y_i) n_i / n \ldots\ldots\ldots(i)$$

$$n = \sum_{i=1}^{q} n_i \ldots\ldots\ldots\ldots\ldots\ldots(ii)$$

where US is the per capita underspending; z refers to the per capita average expenditure of municipalities in a state; y_i is the average per capita expenditure of those municipalities whose expenditure is below the average of all municipalities in a state; n_i (1, 2, - - - q) refers to the population of those municipalities whose expenditure is below the state average; and n is the total population of those municipalities whose expenditure is below the state average.

The Zakaria Committee (1963) established service norms[8] for water supply, sewerage and storm water drainage, and roads, and expenditure norms for these and several other services including street lighting, horticulture operations, medical and health services, education, and general municipal administration. Other agencies such as the Planning Commission, Committee on Plan Projects (COPP), and a few state governments like the Government of Uttar Pradesh have, from time to time, proposed desirable levels of services, norms of investment, as also expenditure norms for operating and maintaining services.

Which norms to use for assessing the level of spending and estimating the financial requirements is a contextual decision. The Zakaria Committee norms are, in the existing context, considered to be excessive and unaffordable. A recent survey showed that only ten out of the 249 municipalities met the expenditure norms established by the Zakaria Committee. The basis of norms suggested by other committees and their country-wide relevance and application has been questioned on other grounds. As an alternative, norms such as the following are possible to be used, whose main purpose is to enhance the level of spending of deficit municipalities to at least the average per capita expenditure of municipalities or the average per capita expenditure of the better-off municipalities.

- Average per capita expenditure of municipalities.
- Average per capita expenditure of the better-off municipalities.
- Average per capita expenditure of municipalities on core services.
- Average per capita expenditure of the better-off municipalities on core services.

An assessment of the level of underspending involves calculation of the distance of the current municipal expenditure from the preferred norms and standards. This methodology is identical to that employed by the Eleventh Finance Commission (EFC) in calculating the distance of a state's per capita non-agricultrual GSDP from the benchmark which in

[8]The report entitled, Augmentation of Financial Resources of Urban Bodies, known as the Zakaria Committee report provides details of how service norms were worked out.

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its case, was the highest per capita GSDP.

These exercises set the stage for estimating the future financial requirement of municipalities and determining the mechanisms of financing them. The future financial requirements are sums of expenditures projected on the basis of assumed rates[9] and the sums that may be needed to scale up the services. The levels to which scaling is to be done are indicated by spending deficits. The mechanisms of financing expenditures include the sums of own revenues of municipalities, projected to rise at assumed rates and the sums that they may need by way of transfers for closing the revenue gap.

[9]Assumed rates can be the past growth rates, or rates of inflation, or any other rate that may be considered appropriate.

...there should be an efficient and equitable balance of resources within and between governmental tiers. Without a relative correspondence between responsibilities and resources among (vertical) and across (horizontal) the various governmental layers, the system may not be sustained. In terms of the vertical dimension, each layer of government should have access to resources roughly equal to its share of the total public sector burden. In its horizontal dimension, this means that governance entities of a given tier should have comparable command of resources and the ability to provide roughly similar service levels. However, the comparative advantage of one tier in the provision of a class of public sector goods may not be matched with a similar advantage in revenue generation. It is thus possible for the revenues and expenditure to be disjoined at the local/municipal levels. A higher level of government may take a larger share of the system's overall resources, and systematically transfer funds to lower levels of government.

Principles for Determining the Fiscal Package for Municipalities

Establishing the principles for determining the fiscal package for municipalities is the core of the mandate contained in Article 243 Y of the Constitution (seventy-fourth) Amendment Act, 1992. In its expanded form, it involves undertaking an examination of the state list of taxes, duties, levies and fees as enumerated in the seventh schedule of the Constitution, and taking a view on–

- Which of the taxes, duties, levies and fees are appropriate to be assigned to, or devolved on, municipalities?;

- Which of the taxes, duties, levies and fees are appropriate for sharing between the state and municipalities? In what proportion should these be shared?;

- What part of the resources constituting the consolidated fund of the state should be given to municipalities as grants-in-aid, and with what conditions, if any?

Underlying the mandate is the concern that the finances of municipalities are in a shambles, and the existing revenue base consisting of the assigned or devolved taxes, shared revenues, and grants-in-aid is far from adequate for meeting the financial requirement of municipalities. The existing arrangement provides no incentive for municipalities to improve their finances and financial performance, or to make use of such other options as privatisation for improving service provision and delivery. The existing revenue jurisdiction of municipalities continues to be guided by the general precept that constraints to local service delivery lie almost wholly in factors that are internal to municipalities, taking no note of the fact that the age old state-local fiscal relations are unable to serve the objectives laid down in the Constitution (seventy-fourth) Amendment Act, 1992, and that for improving local services, it is essential to reassess and reexamine the relationship between these two

...just as it is wrong to withdraw from the individual and to commit to the community at large what private enterprise can accomplish, so it is likewise unjust and a grave disturbance of right order to turn over to a greater society of higher rank functions and services which can be performed by lesser bodies on a lower plane. This is a fundamental principle of social philosophy, unshaken and unchangeable.

Pius XI. Quadragesimo Anno
1931. pp203

There is a virtually no public service which fails to afford some benefits external to the jurisdiction that provides it. The real problem is created by the services in which the ratio of external to internal benefits is very high.

tiers of government.

The Constitution (seventy-fourth) Amendment Act, 1992 is aimed at re-examining the state-local fiscal relations.

Determining the principles of revenue assignment, revenue sharing, and grants-in-aid is not an independent activity. Nor can the principles be formulated in abstract. These depend on the—

- nature of expenditure and functional jurisdiction of municipalities; and

- adequacy of the existing fiscal domain of municipalities and the flexibility with which it can be used.

The Nature of Expenditure Jurisdiction

Defining the expenditure and functional jurisdiction of municipalities is an integral part of a process which looks at the question of dividing expenditure responsibilities between the different tiers of government. According to the prevalent theories of fiscal federalism, expenditure responsibilities whose benefits are confined to local jurisdictions and for which there is a differential scale of preference, should normally be assigned to, and performed by, the local governments. Conversely, expenditures whose benefits extend to a larger jurisdiction and for which preferences are largely uniform, should be assigned to the higher tiers of government.[10] Theories further suggest that it is efficient to place the responsibility for each function with the lowest level of government capable of delivering it efficiently, according to what is known as the principle of subsidiarity.

Public expenditure responsibilities are accordingly allocated between the different tiers of government. Under this arrangement, responsibilities

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[10]In the classical formulation, public sector has three roles, viz, (a) macro stabilisation, (b) income redistribution, and (c) resource allocation. The public economics model assigns the first two of these roles to higher tiers of government. Local governments are considered appropriate units for only the third role. See William Dillinger (1994); Decentralization and Its Implications for Urban Service Delivery. The World Bank.

The Twelfth Schedule of the Constitution of India, Article 243 W

Core Functions

- *Roads and bridges*
- *Water supply for domestic, industrial and commercial purposes.*
- *Public health, sanitation conservancy and solid waste management.*
- *Burial and cremation grounds and electric crematoria.*
- *Public amenities including street lighting, parking lots, bus stops and public conveniences.*

Welfare functions

- *Safeguarding the interests of weaker sections of society, including the handicapped and mentally retarded.*
- *Slum improvement and upgradation.*
- *Urban poverty alleviation.*
- *Provision of urban amenities and facilities such as parks, gardens, playgrounds.*
- *Promotion of cultural, educational and aesthetic aspects.*
- *Cattle ponds; prevention of cruetly to animals.*

Development functions

- *Urban planning including town plzanning.*
- *Regulation of land-use and construction of buildings.*
- *Planing for economic and social development.*
- *Fire services.*
- *Urban forestry, protection of the environment and promotion of ecological aspects.*
- *Vital statistics including registration of births and deaths.*
- *Regulation of slaughter houses and tanneries.*

Note: Classification proposed by the Eleventh Finance Commission, Report of the Eleventh Finance Commission, June 2000.

are classified into:

- local, with negligible spillovers beyond the local levels;

- intermediate or regional, with spillovers from the local to regional levels; and

- national, with significant interregional spillover.[11]

In practice, the major role assigned to municipal governments is to provide goods and services whose benefits are geographically limited - solid waste disposal, primary health, street lighting, public libraries, maintenance of cremation and burial grounds, road maintenance and the like. Municipalities in India have come to acquire these functions and responsibilities as a result of the long process of both political adjustment to the changing social and economic environment as well as the belief that compared with the state governments, municipal capacities to deliver services are inferior. The twelfth schedule attached with the Constitution (seventy-fourth) Amendment Act, 1992 has, however, proposed a larger functional domain than what the municipalities have historically been responsible for; the new functions envisaged for them comprise planning for social and economic development, poverty alleviation, urban planning, regulation of land use, urban forestry and protection of the environment. The benefits of many of these may spillover the municipal boundaries and call for a different kind of financing arrangement than what has so far been on the statutes.

Most state governments have incorporated the twelfth schedule functions in the laws governing municipalities. However, there is still no clarity whether the twelfth schedule functions have, in fact, been assigned to municipalities and whether the municipalities have begun to discharge them. Absence of clarity in respect of the functional jurisdiction of municipalities has been, and continues to be, a major impediment in the implementation of the Constitution (seventy-fourth) Amendment Act, 1992 and a major constraint in the functioning of the finance commission of states.

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[11]George F. Break. 1982. Intergovernmental Fiscal Relations in the United States.

A level of government should employ those taxes which it can most effectively handle and no others. A level which has no absolute advantage for any tax nevertheless should use the taxes it can handle least badly.

It is by no means always clear who has, so to speak, the ownership of a particular tax source. A local tax might be as one (i) assessed by local governments, (ii) applied at rates decided by local governments, (iii) collected by local governments, or simply one (iv) whose proceeds accrue to local governments. In principle, it is clear that the most important characteristic of a local tax is that the local government has some freedom in determining the tax rate.

Richard Bird. 1998
Designing State-Local Fiscal Transfers for Uttar Pradesh

Clarity in respect of the functional jurisdiction of municipalities is an essential first step in determining the financial requirements of municipalities, and in deciding upon the principles of revenue assignment, revenue-sharing, and intergovernmental transfers. Only after the functions of municipalities are known can any decision be taken on how these can be financed. The structure of financing mechanism, i.e., the mix of taxes, charges, shared revenues, and grants-in-aid, which is appropriate in a given context depends on the functions that are assigned to municipal governments. For instance, tax financing may be appropriate for services which are community based, and whose benefits are localised. On the other hand, charging may be better suited for services which are discrete and whose consumption is possible to be attributable to users. Functions and services whose benefits are expected to flow beyond the municipal boundaries may be more appropriately financed out of transfers.

General Principles for Determining a Fiscal Package

Determining a fiscal package for municipalities is a central task under the Constitution (seventy-fourth) Amendment Act, 1992. The fiscal package is to be designed in such a way that it is adequate for providing and maintaining local services at desirable levels. It is to be so determined as to be sufficient for meeting the future financial requirement of municipalities.

Of the two main constituents of the fiscal package, namely, (a) taxes, duties, levies and fees assigned to municipalities, and (b) transfers, the issue of which taxes, duties, tolls and fees should be assigned to municipalities is a part of the larger question of ***which level of government should tax what.*** Public finance theory has not fully resolved this issue. Perhaps the oldest prescription in fiscal federalism literature is the doctrine of separation of revenue resources – the doctrine that each level of government should employ distinctive revenue instruments, not utilised by the other levels.

Theories of fiscal federalism suggest that the municipal governments should be assigned those taxes that are leviable on bases which are immobile, and those whose burden can not be exported outside the municipal jurisdiction. Taxes which are leviable on bases that are mobile

Taxes imposed at a uniform centrally-determined rate, even if collected by local governments, are not really local, except to the extent the local governments can vary collection efforts. Rather, such levies are conceptually just locally-collected central taxes.

—user charges are not revised periodically and a significant percentage of the demand remains in arrears. The rate structure should be revised regularly to keep pace with inflation and to recover, as far as possible, the full operations and maintenance cost of providing these services. Local bodies should have the power to fix the rate of taxes and user charges for themselves. That will make for accountability at the margin. People would be willing to pay, if they get better services.

Report of the Eleventh Finance Commission, June 2000.

or on bases that are unevenly distributed over space should be assigned to the higher levels of government. Other attributes have come to be associated with local taxes. Thus, literatures suggests that local taxes should have the following attributes:

- Taxes should be difficult to avoid and evade. Property taxes score particularly well here as the basis of the tax is immovable property which is fixed in location.

- Local taxes should be stable, and not prone to severe variability.

- Local taxation should have a clear identity and be perceptible to local taxpayers.

Following these principles, taxes on property, advertisements[12], non-motorised vehicles, entertainment, and selectively taxes on professions, trades, callings and employment have come to form the tax base of municipalities in India. The burden of these taxes is largely localised and absorbed by the citizens of municipalities. Municipalities in selected states have also access to a buoyant but controversial tax on the entry of goods for consumption or sale. Other taxes in the state list do not enter into the municipal domain on the ground that their bases do not fulfil the immobility criterion. Charges, duties, fees and levies of different kinds constitute the non-tax base of municipalities.

For this component of the fiscal package to be adequately productive, certain conditions must be met–

- Autonomy with municipalities in determining the local tax policy, in particular, autonomy in fixing tax rates within a band. According to Richard Bird, "the most important characteristic of a local tax is that the local government has some freedom in determining the tax rate"[13]. He adds: local governments may have large receipts from what appear to be local taxes, but if they can neither set the tax rate nor determine the tax base, it is difficult to see how they can be accountable to their constituents at the margin, as both democracy and efficiency require.

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[12]Not all advertisement taxes fall within the jurisdiction of municipalities.

[13]Richard Bird. 1998. Designing State-Local Fiscal Transfers for Uttar Pradesh. mimeo.

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- Provision for a periodic revision in the base value of taxes or their rates, in order to adjust for price changes.

- A proper alignment of prices, i.e., charges and fees with the cost of delivery of services. A proper linkage between prices and cost is an essential component of the fiscal package of municipalities. Such linkages serve to ration output, in addition to raising resources. Inappropriate linkage of prices with cost e.g., a fixed price for water on the ground that some sections of the population are unable to pay the full price, provides implicit subsidies to high income households.

In practice, none of the conditions are met. The municipal governments do not enjoy the flexibility or autonomy in respect of fixing tax rates, charges and fees. Rateable values of properties are not revised for long periods, notwithstanding the relevant provisions in the statutes. Prices of municipal services bear no relation to the cost that is incurred on their provision and delivery. The result is that this component of the fiscal package remains grossly underused. The observations of the Eleventh Finance Commission (EFC) are relevant in this respect- "It (property tax) has remained beset with a variety of problems that have prevented the local bodies to exploit its potential. Such problems are not merely confined to the proximity factor, namely, the local bodies being too close to the people to be effective tax collectors. In most states, the tax rates have not been revised periodically, and there is no standard mechanism for determination of property tax rates and their revision. Most states have accorded a variety of tax concessions/exemptions leading to revenue loss to the local bodies. Arrears of taxes are allowed to accumulate either due to sheer inefficiency or due to delay in assessments and in appeals.[14]"

It is thus important that the fiscal package for municipalities is determined in such a way that it incorporates provisions in respect of municipal autonomy, powers to revise tax bases and tax rates, and establishment of correct prices for municipal infrastructure and services. Realisation of the potential of fiscal package is conditional upon such provisions.

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[14]Report of the Eleventh Finance Commission. June 2000.

Revenue Deficit of States as a Percentage of GSDP

State	Year	
	1998-1999	1999-2000
High income		
Gujarat	-2.91	-1.26
Haryana	-3.57	-1.24
Maharashtra	-1.90	-3.40
Punjab	-4.65	-2.88
Goa	-3.68	-3.59
Middle income		
Andhra Pradesh	-2.70	-1.40
Karnataka	-1.64	-1.67
Kerala	-3.99	-3.74
Tamil Nadu	-3.48	-2.36
West Bengal	-4.74	-6.48
Low income		
Bihar	-3.69	-4.55
Madhya Pradesh	-3.61	-1.99
Orissa	-7.58	-5.67
Rajasthan	-4.97	-4.91
Uttar Pradesh	-5.92	-4.18

Source: Report of the Eleventh Finance Commission. June, 2000.

Transfers from the state governments form the second constituent of the fiscal package for municipalities. In view of the universal importance of transfers in the financial set-up of local governments and recognising that a gap between the expenditure needs and revenue-raising capacity is a common phenomenon, a set of principles have come to be established on how state government funds should flow to municipalities, for what purposes, and under what conditions. A basic principle that governs intergovernmental transfers is that transfers should be extended to municipalities for meeting the revenue gap which arises on account of a mismatch between their expenditure responsibilities and revenue-raising authority, and which may arise on account of their fiscal disabilities. Transfers are equally justified when municipal governments are entrusted with functions whose benefits spillover to jurisdictions beyond the municipal boundaries. As noted earlier, the twelfth schedule of the Constitution comprises functions, e.g., poverty alleviation, planning for social and economic development, and protection of the environment which may have impacts extending beyond the municipal boundaries. Transfers may be justified for financing and operating activities relating to these functions.

For transfers to be efficient and for municipalities to effectively use them, certain principles need to be followed–

- Transfers must be predictable.
- Transfers must be stable and not subjected to year-to-year fluctuations.
- Transfers must be transparent and based on formulae.

These principles form an important part of the fiscal package, and needs to be so recommended.

Transfers consist of the shared revenues and grants-in-aid. An important issue concerning the shared revenues is how to fix the share of municipalities in the revenues of the state governments. Currently, Line 3604 in the state budgets indicates the amount that is budgeted for local bodies. The state budgets and the accompanying documents do not provide any information on the rationale for arriving at the budgeted amount, or the purposes for which it might be used or the mode of

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transfers. The result is that transfers to municipal and other local governments have continued to be ad-hoc and discretionary, and characterised neither by predictability nor stability.

Following the recommendations of the finance commission of states, this position is beginning to see some changes. In some states, a fixed percentage of the state-level taxes has come to be earmarked for municipalities and other local governments; in others, the state governments have constituted a divisible pool of resources out of which a fixed percentage is earmarked for municipalities. These are positive signals and need to be further reinforced. At the same time, it is necessary to recognise that any decision on the share of municipalities in the state governments revenues is dependent on, firstly, the state's own fiscal position, and secondly the size and nature of the revenue gap. All state governments currently have revenue deficits, ranging between 1.64 and 7.58 percent of GSDP. With the exception of a few municipalities, all municipalities have a large revenue account deficit, which may rise with the assignment of additional responsibilities as envisaged under schedule twelve of the Constitution. The fiscal package is to be necessarily designed within such constraints.

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Guidelines for Collating the Fiscal Package

The primary objective of Article 243 Y of the Constitution (seventy-fourth) Amendment Act, 1992 is to bring about an improvement in the delivery and performance of municipal services. The aim of the fiscal package is to ensure achievement of the objective. In this study, an attempt is made to lay out the steps that are integral to developing such a fiscal package. The steps as outlined in earlier sections comprise:

Review the macro-economic environment within which the municipalities in India operate

- functions, powers, and authority;
- limits and constraints within which the municipalities are permitted to function; and
- degree of autonomy granted to municipalities.

Undertake an appraisal of the finances of municipalities

- changes and shifts in the fiscal health of municipalities, referring to revenue and expenditure growth and performance;
- trends in the volume and nature of transfers; and
- key issues in making fuller use of revenue resources and reordering expenditure priorities.

Estimate the revenue gap of municipalities

- trends in gap between revenue-raising capacity and expenditure needs; and

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- assessment of the level of municipal underspending.

Project the expenditure needs into the future

- assumptions in respect of the expenditure responsibilities;
- norms and standards for services and activities;
- accounting for revenue gaps and level of underspending; and
- needs arising out of the fiscal disabilities of municipalities.

Determine a fiscal package for financing future expenditure needs

- principles for assignment of taxes, duties, tolls and fees;
- principles for revenue-sharing and grants-in-aid;
- degree of access of municipalities to the divisible pool of state resources;
- supplementing the revenue resources with grants-in-aid; and
- pre-conditions for making the fiscal package productive.

Beyond the Fiscal Package

The scope of the Article 243 Y of the Constitution is not limited to determining the constituents of the fiscal package for municipalities. It extends to evolving measures that would improve the financial position of municipalities. It extends to developing strategies that would contribute to the sound finance of municipalities. In many ways, Articles 243 Y (b) and (c) are by far the most important as these permit an examination of the functioning of municipalities with a view to suggest measures that would result in a long term, sustainable improvement in the finances of municipalities. The Constitutional amendment implies that the efficiency of the fiscal package can be significantly enhanced if it is accompanied by supplementary measures for improving the finances of municipalities.

Using the provisions under Article 280(3)(c), the Eleventh Finance Commission (EFC) has proposed that the state governments should review the existing accounting heads under which funds are being transferred to local bodies, and create for each major/sub-major head, three minor heads for the panchayati raj institutions and urban local bodies. It has further suggested that the Comptroller and Auditor General should lay down the formats for the preparation of budgets and keeping of accounts for municipalities.

These provisions have afforded an opportunity for determining the–

- soundness of the existing system of property taxation;

- appropriateness of the existing system of municipal accounting, i.e., whether it is able to adequately capture the expenditure and receipts of municipalities and the need and relevance for introducing a double entry, accrual based accounting system; and

- feasibility of privatisation of municipal services and activities.

Several states have taken initiatives in these spheres. The Government of India (Ministry of Urban Development) has circulated a set of guidelines for property tax reforms. *Inter-alia*, the guidelines have proposed that a tax on built-up property may be linked to such factors as (a) location, (b) type of construction, (c) use of property, and (d) carpet area of property. The states of Andhra Pradesh, Gujarat, Tamil Nadu and Uttar Pradesh and cities such as Patna have begun to use area-based methods for taxing properties.

In an attempt to improve the municipal accounting system, the Institute of Chartered Accountants of India (ICAI) have published a technical guide on Accounting and Financial Reporting by Urban Local Bodies. Considering that proper financial information and standardized accounting practices are central to undertaking municipal credit ratings, developing commercially viable urban infrastructure projects, and involving the private sector in the delivery of urban services, the Government of Tamil Nadu has introduced a double entry, accrual based accounting system for municipalities.

Using a variety of options such as service contract, management contract, lease, build, operate and transfer (BOT), and concessions, many city governments have begun to engage the private sector in the provision of municipal services. The most prominent of these are solid waste management, management of street lights, public toilets and gardens, operation and maintenance of sewage pumping stations, billing and collection of service charges, and selectively local tax collection. That private sector participation in the delivery of municipal services can help achieve cost savings and improve operational efficiency is borne

Tax Free Municipal Bonds

The insertion of clause (vii) to section 10(15) of the Income Tax Act, 1961 vide the Finance Act, 2000 has laid down procedures for municipalities to issue tax free bonds. Among others, the procedures require the municipalities (and other local authorities) to (a) prepare an investment plan, (b) ensure that the project is financially viable, (c) create an Escrow account for debt servicing of bond proceeds with earmarked revenue, (d) maintain a separate account of the amount raised from the tax free municipal bonds, and (e) obtain an investment grade rating from a RBI approved credit rating agency.

out by experiences from several cities.

Yet another initiative that has an important bearing on the finances of municipalities relates to the issuance of municipal bonds. In 1998, the Ahmedabad Municipal Corporation issued the country's first municipal bond without a state guarantee, signalling an important milestone in local resource raising and mobilization. For cities that face an increasing demand for services, and simultaneously a decline in transfers from state governments, such bonds are an important instrument for tapping the capital market to finance municipal infrastructure. Bonds represent an approach to capital market borrowing by municipal governments that presents a number of benefits over the traditional financing approaches. Recognizing the emerging role of bonds in financing urban infrastructure, the Government of India has inserted a new clause (vii) to section 10(15) of the Income Tax Act, 1961, whereby interest income from bonds issued by local authorities will be exempted from income tax. The use of funds raised from the tax free municipal bonds is restricted to capital investments in urban infrastructure comprising potable water supply; sewerage or sanitation; drainage; solid waste management; roads, bridges and flyovers; and urban transport, if it is a municipal function. The maximum amount of tax free municipal bonds as a percentage of the total project cost (excluding interest during construction) is 33.3 % or Rs. 500 million whichever is lower. The debt-equity ratio of such bonds is not to exceed 3:1.

Incentives are crucial for municipal governments to initiate reform and improve their functioning. The role of incentives has been recognized and underlined by the Eleventh Finance Commission (EFC), which has recommended 20% of the grant amount to be allocated on the basis of the progress achieved by states on decentralisation as visualised in the Constitution (seventy-fourth) Amendment Act, 1992. Setting aside such sums as incentives or creation of dedicated incentive funds are important measures for accelerating the implementation of the different provisions of the Constitution (seventy-fourth) Amendment Act, 1992.

The task of the finance commissions of states is to review the relevance and appropriateness of such initiatives and incorporate them in the reform package for municipalities to enable them improve their functioning and financial viability.

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The Constitution (seventy-fourth) Amendment Act, 1992 on municipalities constitutes a major step towards strengthening of municipal governments, and operationalising the Directive Principles of State Policy. The provisions with respect to their finances are crucial to the strengthening of municipal governments. The manner in which these tasks are carried out, will determine the journey on the road to effective decentralisation.

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Annexure 1

Grants for Municipalities: Recommendations of the Tenth Finance Commission (TFC)

(Rs. million)

State	1995-96	1996-97	1997-98	1998-99	1999-2000	1995-2000
Andhra Pradesh	0.00	184.80	184.80	184.80	184.90	739.40
Arunachal Pradesh	0.00	0.30	0.30	0.30	0.30	1.20
Assam	0.00	35.50	35.50	35.50	35.50	142.00
Bihar	0.00	167.70	167.70	167.80	167.70	670.90
Gujarat	0.00	168.70	168.70	168.60	168.70	674.60
Haryana	0.00	41.50	41.50	41.40	41.40	165.80
Himachal Pradesh	0.00	5.10	5.10	5.10	5.20	20.50
Jammu & Kashmir	0.00	30.20	30.20	30.20	30.30	120.90
Karnataka	0.00	175.40	175.50	175.50	175.50	701.90
Kerala	0.00	63.60	63.60	63.60	63.50	254.30
Madhya Pradesh	0.00	154.40	154.40	154.30	154.30	617.40
Maharashtra	0.00	332.40	332.40	332.30	332.40	1329.50
Manipur	0.00	5.60	5.60	5.60	5.50	22.30
Mehhalaya	0.00	3.70	3.70	3.70	3.60	14.70
Mizoram	0.00	0.90	0.90	1.00	1.00	3.80
Nagaland	0.00	1.40	1.40	1.40	1.40	5.60
Orissa	0.00	47.80	47.80	47.80	47.70	191.10
Punjab	0.00	76.50	76.50	76.50	76.50	306.00
Rajasthan	0.00	108.00	108.00	107.90	107.90	431.80
Sikkim	0.00	1.40	1.40	1.50	1.50	5.80
Tamil Nadu	0.00	288.80	288.80	288.80	288.80	1155.20
Tripura	0.00	2.60	2.60	2.50	2.60	10.30
Uttar Pradesh	0.00	302.90	302.90	303.00	303.00	1211.80
West Bengal	0.00	300.80	300.80	300.80	300.80	1203.20
Total	**0.00**	**2,500.00**	**2,500.00**	**2,500.00**	**2,500.00**	**10,000.00**

Source: The Report of the Tenth Finance Commission

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Annexure 2

Share of Municipalities in State's Resources as Recommended by the first Finance Commission of States

States	Recommended Shares
❑ Andhra Pradesh	39.24% of state tax and non-tax revenue to all local bodies.
❑ Assam	2% of State tax for local bodies, both rural and urban. (The share of urban local bodies has not been specified).
❑ Himachal Pradesh	An amount equal to Rs. 12.2 crore as grants in lieu of octroi for 1996/97, to rise to Rs. 17.9 crore in 2000/01 and CSS grants to accrue to municipalities.
❑ Karnataka	5.4% of the total non-loan gross own revenue receipts for meeting the plan and non-plan requirements.
❑ Kerala	1% of State revenues (excluding from certain sources) be transferred to local bodies as non-statutory non-plan grants distributed between the rural and urban local bodies in proportion to their population.
❑ Madhya Pradesh	8.67% of the tax and non-tax revenues of State government.
❑ Maharashtra	25% to 100% of entertainment taxes collected from municipalities of different grades, 25% of vehicle tax and 10% of profession tax are recommended shares for local bodies.
❑ Manipur	Maintenance grant equal to Rs. 88.3 lakh to accrue to municipalities in 1996/97, which varies in subsequent years.
❑ Orissa	Rs. 179.5 crores is the projected transfer (grant) to urban local bodies between 1998/99 and 2004/05. (The deficit of Rs. 1,378 crores between the estimated income and expenditure and an additional requirement of Rs. 381.48 crore for improvement of core civic services should be met by the Eleventh Finance Commission).
❑ Punjab	20% of the net proceed for five taxes namely, stamp duty, motor vehicle tax, electricity duty, entertainment tax, and cinematograph shows should be trans ferred to municipalities, and the projected gap of Rs. 322 crore should be met by the Central Finance Commission.
❑ Rajasthan	21.8% the net proceeds of State taxes should be devolved on the local bodies; thedivision of these proceeds between rural and urban should be in the ratio of 3.4:1.
❑ Tamil Nadu	8% of the State's net tax revenue should be devolved on to the local bodies in 1997/98; this percentage should gradually increase in successive years to 9%, 10%, 11% and reaching 12% in 2001/02. The division of this amount between rural and urban should be on the basis of population as in the last Census.
❑ Uttar Pradesh	7% of the net proceeds of State's total tax revenue should be transferred to urban local bodies.
❑ West Bengal	16% of the net proceeds of all taxes collected by the State should be transferred to local bodies. Such funds should be released to the Districts. These proceeds should be divided between urban and rural based on population.

Source: Reports of the Finance Commission of States.

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Annexure 3

Grants for Municipalities: Recommendations of the Eleventh Finance Commission (EFC)

State	% share of state in the allocation of grant							Annual Share (Rs. lakh)
	Urban Population	Urban Area	Distance from highest PC/GSDP +0.5 s.d.	Revenue effort in relation to Own revenue of the state	Revenue effort in relation to Non-primary sector GSDP	Index of decentralisation	State's share	Total
	Weight 40%	Weight 10%	Weight 20%	Weight 5%	Weight 5%	Weight 20%		
Andhra Pradesh	8.60	8.09	8.98	7.54	7.32	7.22	8.23	3293.14
Arunachal Pradesh	0.05	0.00	0.05	0.00	0.00	0.01	0.03	13.67
Assam	1.19	1.29	1.08	0.55	0.50	1.00	1.08	430.84
Bihar	5.46	5.85	6.03	1.23	0.92	3.05	4.69	1877.94
Goa	0.23	0.60	0.18	0.03	0.07	0.19	0.23	92.73
Gujarat	6.85	8.03	6.33	6.16	7.13	5.75	6.63	2650.46
Haryana	1.95	1.51	1.64	0.85	1.87	2.18	1.83	732.80
Himachal Pradesh	0.22	0.42	0.03	0.13	0.12	0.24	0.19	77.84
Jammu & Kashmir	0.88	1.37	0.92	0.10	0.07	0.50	0.78	313.16
Karnataka	6.69	6.68	7.05	2.90	4.38	5.61	6.24	2496.39
Kerala	3.69	5.26	3.57	1.87	2.49	4.13	3.76	1504.91
Madhya Pradesh	7.38	12.37	7.90	3.22	4.41	8.25	7.80	3120.22
Maharashtra	14.69	9.74	12.86	29.38	32.67	16.44	15.81	6325.09
Manipur	0.24	0.23	0.28	0.03	0.02	0.20	0.22	87.92
Meghalaya	0.16	0.24	0.14	0.01	0.00	0.09	0.13	53.98
Mizoram	0.15	0.77	0.18	0.00	0.00	0.09	0.19	76.89
Nagaland	0.10	0.23	0.07	0.00	0.00	0.06	0.09	35.72
Orissa	2.04	3.98	1.95	0.55	0.53	1.71	1.99	799.20
Punjab	2.88	2.25	2.63	2.05	4.92	2.42	2.74	1094.53
Rajasthan	4.84	7.61	4.96	1.90	2.03	5.42	4.97	1988.32
Sikkim	0.02	0.00	0.01	0.00	0.00	0.01	0.01	4.16
Tamil Nadu	9.18	9.66	8.91	11.81	12.13	10.27	9.67	3867.34
Tripura	0.20	0.23	0.22	0.05	0.08	0.22	0.20	80.32
Uttar Pradesh	13.28	8.76	14.37	5.83	5.14	14.86	12.58	5032.64
West Bengal	8.99	4.81	9.65	23.80	13.20	10.07	9.87	3949.78
Total	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**40,000.00**

Source:Report of the Eleventh Finance Commission. June 2000.

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Annexure 4

Methodology adopted by the Eleventh Finance Commission (EFC) for determining the allocation of grant to States for Urban Local Bodies

Criteria	Weight as a % of the total allocation	Specifications of the criteria	Derivation of the share of each State
Urban population	40	1st criterion=State's urban population in the year 1991.	S_{1i}=(0.4)*X*(P_i/P) where S_1=ΣS_{1i} S_{1i}=Share of ith state with first criterion, (i varies from 1 to 25). P_i=Urban population of ith state. P=ΣP_i = Total urban population of the country. S_1=0.10*X=Total allocation based on the first criterion.
Geographical area	10	IInd criterion=State's geographical urban area in the year 1991.	S_{2i}=(0.1)*X*(A_i/A) where S_2= S_{2i}=ΣS_{2i} S_{2i}=Share of ith state with second criterion, (i varies from 1 to 25). A_i=Urban area of ith state. A=ΣA_i=Total urban area of the country. S_2=0.10*X=Total allocation based on the second criterion.
Distance from highest average per capita GSDP (Gross State Domestic Product)	20	IIIrd criterion = Distance from highest average per capita GSDP excluding primary sector. D_i=G'+(0.5)sd-G_i where G_i=$\Sigma(G_{ij}/P_{ij})/3$ and j varies from 1 to 3 i.e. j=95/96, 96/97, 97/98 G=ΣG_i (i varies from 1 to 25) D_i=Distance of the ith state of average per capita GSDP from highest average per capita GSDP. G_i=Average GSDP of the ith State. G_{ij}=Gross domestic product of ith state for jth year. P_{ij}=Urban population of ith state for jth year. G'=Highest average gross domestic product among all the states. G=Average gross domestic product of the country. sd=Standard deviation of G_i's or of G_1, G_2,.....,G_{25}.	S_{3i}=(0.2)*X*D_1*(P_i/P) where S_3=ΣS_{3i} S_{3i}=Share of ith state with third criterion, (i varies from 1 to 25). D_i=Distance of the ith state of average per capita GSDP from highest average per capita GSDP. S_3=0.20*X=Total allocation based on the third criterion.

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Criteria	Weight as a % of the total allocation	Specifications of the criteria	Derivation of the share of each State
Own revenue efforts of municipalities in a state, using state's own revenue as an indicator	5	IVth criterion =Own revenue efforts of municipalities in a state, using state's own revenue as an indicator. $RE_i=\Sigma(MOR_{ij}/SOR_{ij})/3$ and j varies from 1 to 3 i.e. J=95/96, 96/97, 97/98. RE_i=Revenue effort of all municipalities in ith state for the jth year. SOR_{ij}=Own revenue collected by the ith state for the jth year.	$S_{4i}=(0.05)*X*RE_i*(P_i/P)$ where $S_4=\Sigma S_{4i}$ S_{4i}=Share of ith state with fourth criterion, (i varies from 1 to 25). RE_i=Revenue effort of all municipalities in ith state. $S_4=0.05*X$=Total allocation based on the fourth criterion.
Own revenue efforts of municipalities in a state, using gross state domestic product as an indicator	5	Vth criterion=Own revenue efforts of the municipalities in a state, using GSDP as an indicator. $RE'_i=(\Sigma MOR_{ij}/\Sigma GSDP_{ik})/3$ and j varies from 1 to 3 i.e. j=95/96, 96/97, 97/98 and k varies from 1 to 3 i.e. k=94/95, 95/96,96/97. RE'_i=Revenue effort of all municipalities in ith state. MOR_{ij}=Own revenue collected by all municipalities in ith state for the jth year. $GSDP_{ij}$=Gross state domestic product (excluding primary sector) of the ith state for the jth year.	$S_{5i}=(0.05)*X*RE'_i*(P_i/P)$ where $S_5=\Sigma S_{5i}$ S_{5i}=Share of ith state with fifth criterion, (i varies from 1 to 25). RE'_i=Revenue effort of all municipalities in ith state. $S_5=0.05*X$=Total allocation based on the fifth criterion.
Index of decentralisation ❑ Enactment of state municipal legislation in conformity with 74th Amendment. ❑ Intervention/restriction in the functioning of the municipal bodies. ❑ Assignment of functions to municipalities in the state municipal legislation vis-a-vis the twelfth schedule. ❑ Transfer of functions to municipalities by way of rules/ notifications/ orders of state government ❑ Assignment of taxation powers to municipalities as	20	The index has been constructed as follows– ***Step 1:*** marks scored by the states in respect of each of the ten items have been converted on a scale of 1-100. ***Step 2:*** in respect of each indicator, states are grouped into four categories and marks are assigned, as follows: **Group** **Range** **Mks.** A above(A.M.+0.5 sd) 3 B A.M.±0.5 sd 2 C Below A.M.–0.5 sd but above zero 1 D Zero 0 ***Step 3:*** A.M. and sd of the total marks of the various states have been computed and states once again grouped	$A_{6i}= (0.2)*X*M_i*(P_i/P)$ where $S_6 = \Sigma S_{6i}$ S_{6i}= Share of ith state with sixth criterion, (i varies from 1 to 25). $S_6 = (0.2)*X$ = Total allocation based on the sixth criterion.

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Criteria	Weight as a % of the total allocation	Specifications of the criteria	Derivation of the share of each State
per state municipal acts ❏ Levy of taxes by municipalities ❏ Constitution of the State Finance Commissions and submission of Action Taken Reports. ❏ Action taken on the major recommendations of the SFCs. ❏ Elections to municipalities. ❏ Constitution of district planning committees.		into four categories and marks assigned as follows: **Group** **Range** **Mks.** A Above(A.M.+0.5 sd) 4 B A.M.±0.5 sd 3 C Below A.M.–0.5 sd but above zero 2 D Zero 1 ***Step 4:*** The marks so obtained have been used as weights to determine the index of decentralisation.	

S= X= $S_1+S_2+S_3+S_4+S_5+S_6$ where X is the total allocation for urban local bodies, and S is sum of shares in respect of all the six criteria.
A.M = Arithmetic Mean
Sd = Standard deviation

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Annexure 5

Urban Population Estimates, 2001

States	Urban Population (million)	Percent Urban
Andhra Pradesh	20.50	27.08
Arunachal Pradesh	0.22	20.41
Assam	3.39	12.72
Bihar	8.68	10.47
Chhatisgarh	4.18	20.08
Goa	0.67	49.77
Gujarat	18.90	37.35
Haryana	6.11	29.00
Himachal Pradesh	0.59	9.79
Jammu and Kashmir	2.51	24.88
Jharkhand	5.99	22.25
Karnataka	17.92	33.98
Kerala	8.27	25.97
Madhya Pradesh	16.10	26.67
Maharashtra	41.02	42.40
Manipur	0.57	23.88
Meghalaya	0.45	19.63
Mizoram	0.44	49.50
Nagaland	0.35	17.74
Orissa	5.50	14.97
Punjab	8.25	33.95
Rajasthan	13.21	23.38
Sikkim	0.06	11.10
Tamil Nadu	27.24	43.86
Tripura	0.54	17.02
Uttaranchal	2.17	25.59
Uttar Pradesh	34.51	20.78
West Bengal	22.49	28.03
Total	**285.35**	**27.78**

Source: Office of the Registrar General, India. Press Release 20 July, 2001.

In place of 'Total'
read this row as.

'All-India including
Union Territories'

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Annexure 6

Accounting Principles (ICAI)

- The financial statements of urban local bodies (viz. Balance sheet and income and expenditure account) should be prepared on accrual basis, except that modified accrual basis should be followed in accounting for those items of revenue about whose recovery or timings of recovery there is a significant uncertainty. Such items of revenue pertaining to an accounting period should be accounted for as revenue of that period if recovered during the accounting period or within a reasonable period, say, two months of the close of the accounting period. Revenues not recovered during the said period should be accounted for as revenue of the period in which they are recovered.
- Accounting policies should be applied consistently from one financial year to the next. Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change, should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.
- Provision should be made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information. Revenue should not be recognized unless (i) the related performance has been achieved; and (ii) no significant uncertainty exists regarding the amount of the consideration; and (iii) it is not unreasonable to expect ultimate collection.
- The accounting treatment and presentation in the balance sheet and the income and expenditure account of transactions and events should be governed by their substance and not merely by the legal form.
- In determining the accounting treatment and manner of disclosure of an item in the balance sheet and/or the income and expenditure account, due consideration should be given to the materiality of the item.
- Notes to the balance sheet and the income and expenditure account should contain only the explanatory material pertaining to the items in the balance sheet and the income and expenditure account.
- A statement of all significant accounting policies adopted in the preparation and presentation of the balance sheet and the income and expenditure account should be included in the urban local body's balance sheet. Where any of the accounting policies is not in conformity with accounting standards, and the effect of departures from accounting standards is material , the particulars of the departure should be disclosed, together with the reasons therefor and also the financial effect thereof except where such effect is not ascertainable.
- If the information required to be given under any of the items or sub-items in these formats cannot be conveniently included in the balance sheet or the income and expenditure account itself, as the case may be, it can be furnished in a separate Schedule or Schedules to be annexed to and forming part of the balance sheet or the income and expenditure account. This is recommended where items are numerous.
- Accounting policies and explanatory notes should form an integral part of the balance sheet.
- The corresponding amounts for the immediately preceding financial year for all items shown in the balance sheet and income and expenditure account should also be given in the balance sheet or income and expenditure account, as the case may be.
- 'Provision' means any amount written off or retained by way of providing for depreciation, renewals or

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diminution in value of assets, or retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy.

- A cash flow statement should be annexed to the balance sheet showing cash flows during the period covered by the income and expenditure account and during the corresponding previous period.
- Apart from aggregate figures relating to revenues, expenses, assets and liabilities appearing on the face of the income and expenditure account and balance sheet, an urban local body should also present information required herein in respect of each major type of activity undertaken by it (hereinafter referred to as 'segment') if it meets the criteria specified in this behalf.
- Segment information should be provided in respect of an activity if it satisfies any of the following conditions:
  - Its revenue from sales to external and internal customers ('segment revenue') is 10% or more of the total revenue as reported in the income and expenditure account.
  - its expenses ('segment expense') are 10% or more of the total expenses as reported in the income and expenditure account.
  - its assets (segment assets) are 10% or more of the total assets of the urban local body.

  The following information should be disclosed in respect of each reportable segment that meets one or more of the criteria specified above:

  - Segment revenue
  - Segment result
  - Total carrying amount of segment assets
  - Total amount of segment liabilities
  - Total cost incurred during the period to acquire fixed assets.

  A reconciliation between the information disclosed for reported segments and the aggregate information as reported in the financial statements should be presented. For example, segment revenue should be reconciled to the total revenue reported in the profit and loss account.

  For the purpose of the above:

  - Segment revenue is revenue reported in the income and expenditure account that is directly attributable to the segment and the relevant potion of total revenue of the entity that can be allocated on a reasonable basis to the segment. Segment revenue does not include extraordinary items, interest or dividend income and gain on sale of investments.
  - Segment expense is the expense reported in the income and expenditure account that is directly attributable to the segment and the relevant portion of total expense of the entity that can be allocated on a reasonable basis to the segment. Segment expense does not include extraordinary items, interest expense and loss on sale of investments.
  - Segment assets are those operating assets that are employed by a segment in its operating assets that are employed by a segment in its operating activity and that are either directly attributable to the segment or can be allocated to the segment on a reasonable basis. In determining segment assets, related allowances/provisions that are deducted in reporting those assets in the balance sheet should be deducted.
  - Segment liabilities are those operating liabilities that result from the operating activities of a segment and that are either directly attributable to the segment or can be allocated to the segment on a reasonable basis.
  - Segment result is segment revenue less segment expense.

Source: Technical Guide on Accounting and Financial Reporting by Urban Local Bodies, The Institute of Chartered Accountants of India, New Delhi 2000.

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Om Prakash Mathur

ABOUT THE BOOK

Approach to State-Municipal Fiscal Relations: Options and Perspectives attempts to lay out the steps that are crucial for determining taxes, duties, tolls and fees which may be assigned to municipalities and those which may be shared between a state and municipalities, as well as determining the grants-in-aid for municipalities. Designed as a handbook, it recognises that there is no fiscal system that can take into account the financial requirements of over 4600 urban local bodies of different sizes and grades or deal with their financial problems. Yet, it argues, there are exercises which are central to addressing the state-municipal fiscal relations as envisioned in the *Constitution (seventy-fourth) Amendment Act, 1992* and Article 280(3)(c) of the *Constitution of India.*

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