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

Workpage

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