

Inaugural address

by

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On behalf of the Twelfth Finance Commission, may I extend to all of you a hearty welcome to this Seminar on Municipal Finances. This seminar is being convened in the context of the tasks entrusted to the Finance Commission.

Like in many other federations, the Local Bodies in India are expected to perform many important functions on the strength of their own tax and non-tax revenues as well as the support they receive from their respective State Governments from time to time. These include such essential services as water supply, drainage, sanitation, street lighting and roads. That there is a considerable gap between the requirement and availability of resources for most local bodies for performing these functions is, perhaps, an unfortunate fact.

Evolution of Local Bodies

The roots of local bodies in India particularly rural local bodies go back to the ancient times. The history of the Urban Local Bodies also could be traced to as early as the Mauryan period and later to the Cholas and Kings of Vijayanagar under whom mature local self governing institutions are believed to have functioned effectively. However, the representative character of the local self-government comprising a democratically elected body enjoying wide powers of administration and taxation to discharge their functions may only be a creation of the British. The need for decentralization and popular involvement in civic functions was, perhaps, first conceived by Lord Mayo, the then Governor General of India in 1870, when he issued a Resolution aimed at strengthening municipal institutions and to ensure supervision and care in the management of funds devoted to education, sanitation, medical relief and public works. In the wake of this Resolution, the elective principle was included in all the municipal laws. However, in their working, the municipalities remained fully dependent on the provincial governments and their officers controlled the working of the committees. A review of this arrangement in 1882 led to the famous Resolution by Lord Ripon, with whose name urban local self government is now associated, that sought to increase the scope of local governments by (a) devolution of more functions and (b) making local government an instrument of political and popular education. The Resolution conceded non-official majorities in all municipalities. The Chairman was to be a non-official too, replacing

the district collector. It placed the management of local functions and services with the municipal committees. It was also laid down that the local bodies would be entrusted with adequate financial resources and frame their own budget. Following this, many provincial governments passed enabling Acts with provision for election, financial resources, etc. The functions handed over to local bodies included: (i) maintenance of roads, street lighting, upkeep of municipal property and buildings; (ii) Public health, vaccination, sanitation, drainage, water supply and measures against epidemics; and (iii) Education. The principal sources of local revenue identified were: (i) Octroi, (ii) Property tax on houses and lands; (iii) Tax on professions and trades; (iv) Road tolls; (v) Taxes on carts and other vehicles; and (vi) Rates and fees for services rendered like conservancy, water supply, markets, etc. However, the results of the Reforms fell short of the high hopes especially after the exit of Lord Ripon. The efforts were resumed in 1919 by the then Viceroy Lord Chelmsford. The Government of India Act 1919 enlarged the sphere of municipal taxation to include (i) Toll; (ii) Land tax and tax on land values; (iii) Tax on buildings; (iv) Tax on vehicles and boats; (v) Tax on menial and domestic servants; (vi) Tax on animals; (vii) Octroi; (viii) Terminal tax; (ix) Tax on trade, professions and callings; (x) Tax on private market; and (xi) Tax on municipal services - water supply, lighting, drainage, public conveniences. It also gave certain other powers to the local bodies intended to make them independent of government control. It is noteworthy that subsequent developments in local finance have not introduced any better scheme of local taxation than this. Following this, every province passed new legislation to reform local administration. However, while the system of elections improved, in their day-to-day functions and services the municipal bodies were faced with several handicaps including raising their own funds.

The Government of India Act, 1935 envisaged a federal constitution. The subject of local self-government was assigned to provinces. In this arrangement, the legal position of municipalities suffered. The civic functions declined because of a resource crunch. Lapses and failure of municipal functions were met with dissolution of municipal committees. Thus, the institution of local self-government failed to grow in the right direction despite the best intentions of the various legislations.

Post independence, the Indian Constitution adopted the model of the Government of India Act, 1935 and assigned the subject of local self-government to the States. The Municipal Acts that followed were, therefore, creations of state legislatures and the lack of uniformity was inevitable. Despite several committees that were appointed from time to time, municipal self-government remained in an undefined state.

The Constitution Seventy-Fourth Amendment Act, 1992 was the culmination of a prolonged debate on the measures required to strengthen the third tier of the government so that it acquires the institutional capability to deal with the problems created by urbanization and urban growth. It was a recognition of the fact that the Local Bodies in many States had become weak and ineffective on account of a variety of reasons including failure to hold regular elections, prolonged supercessions and inadequate devolution of powers and functions. The Act envisages the urban local bodies to function effectively as vibrant democratic units of self-government. It has attempted to put on a firmer footing the relationship between the State Government and Urban Local Bodies with respect to the functions, taxation powers and arrangements for revenue sharing. It also mandates regular conduct of elections and provides for adequate representation for the weaker sections of the society including women in the elected bodies.

The Constitutions Seventy-fourth Amendment Act also envisages devolving to the local bodies, functions relating to preparation of plans for economic development and social justice as well as for implementation of various development schemes. A new Twelfth Schedule has been appended to the Constitution of India which lists out 18 functions including urban planning, regulation of land use, construction of buildings, roads and bridges, water supply and slum improvement that could be performed by the Municipalities. However, the discretion allowed to the State Governments to transfer these functions to the Municipalities is still very large with the result that there is considerable variation in the responsibilities assigned to them in different states.

Status of Urban Problems

The urban population of India has grown at a fast rate in the last few decades. While it was 7 crore persons in 1961, it has now increased to about 29 crore. Urban population projections indicate a more rapid growth and a doubling of the population in the next twenty five years. Its repercussions for the municipal infrastructure can easily be imagined. The rampant growth of slums cannot but have deleterious effects on the environment. It is estimated that at present there is no sanitation available to 52% of urban population while individual toilet facilities are available to only 24% of the population. The sewerage system covers but a very small population. The solid waste management leaves much to be desired. A significant portion of urban waste is allowed to decompose and putrefy on the roadsides and around the houses and factories. Much of it goes into the drains, chocking them and creating health hazards for the people. The performance of urban local bodies in the provision of drinking water, street lighting and other essential services has been no better.

Improvement of the civic services in most Municipalities would require substantial capital investments and maintenance costs. The need to empower the Local Bodies to raise their own resources cannot be over emphasized. The Octroi which was the principal source of tax revenues for the urban local bodies does not exist in many States. It has been replaced by an entry tax or a surcharge on sales tax collected at the State level. While the advantages of centralized collection in terms of efficiency and removal of barriers in the movement of goods are accepted, it is generally agreed that the Local Bodies should be adequately compensated for the loss of this revenue. However, many states complain of lack of buoyancy of the entry tax. The other principal tax of the Local Bodies viz. the property tax needs major reforms. We understand that the Government of India has circulated the guidelines for property tax reforms to States to facilitate action towards area based valuation of property. These would need to be pursued vigorously. Little progress has been reported regarding the levy/enhancement of land taxes. Profession tax levels continue to remain low and have not been assigned to local bodies in many States.

State Finance Commission

The provisions regarding the constitution of the State Finance Commission (SFC) for recommending transfer of resources from the State to the local bodies as well as the requirement that the Finance Commission at the national level should also recommend measures for augmenting the Consolidated Fund of the States to supplement the resources of the Municipalities would need to be seen in this context. 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 LSGs and making recommendations as to the principles that should govern:

- the distribution between the state and the Panchayats and 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 Panchayats and Municipalities; and
- the grants-in-aid to Panchayats and Municipalities from the Consolidated Fund of the State.

Besides, the Finance Commission of the State is also expected to recommend measures needed to improve the financial position of the Panchayats and the Municipalities.

Barring one or two exceptions, all States have now set up the State Finance Commission (SFC) as required under the Constitution. Many of the SFCs have submitted their reports and in many States their recommendations are already under implementation. The importance of the SFCs in the scheme of fiscal decentralization is that besides arbitrating on the claims to resources by the State Government and the local bodies, their recommendations would impart greater stability and predictability to the transfer mechanism. However, the convention established at the national level of accepting the principal recommendations of the Finance Commission without modification is not being followed in the States. Even the accepted recommendations are not always fully implemented citing resource constraints and this defeats the very purpose of constituting the SFCs. On the other hand, the funds transferred for the

implementation of development schemes remain unspent either due to institutional/procedural constraints or diversion to meet other committed expenditure.

Central Finance Commission

The Constitution requires the Finance Commission to recommend measures to augment the Consolidated Fund of the States to supplement the resources of the Local Body on the basis of the recommendations of the SFCs. For both historical and economic reasons, the extent of devolution of functions to the local bodies, their fiscal capacity and expenditure needs vary widely not only across states but even within the states. The lack of uniformity in the approach of the SFCs in terms of the principles laid down for devolution of resources from the state government to the local bodies, the lack of synchronization in the award period of the SFCs and the absence of a rational determination of the gap between normative costs of service delivery and the normative capacity to raise resources from all sources including appropriate user charges in different states makes the task of recommending measures on the basis of the recommendations of the SFC hugely complex. The Eleventh Finance Commission had, in fact, gone to the extent of recommending the deletion of the reference to the SFCs in the relevant clause of the Constitution so that future Commissions did not face similar handicaps. However, our terms of reference clearly require us to consider the issue exactly in accordance with the present constitutional provision.

Before attempting to suggest measures to supplement the resources of the Local Bodies, it is necessary to understand the precise role of the Finance Commission in this regard. The Tenth Finance Commission had expressed the view that such measures to augment the Consolidated Fund of the State need not necessarily involve transfer of resources from the Centre to the States. It had observed that once the SFCs completed their task, the Finance Commission was duty bound to assess and build into the expenditure stream of the States, the funding requirements for supplementing the resources of the Panchayats and Municipalities. The transfer of duties and functions listed in the Eleventh & Twelfth Schedule of the Constitution would also involve concomitant transfers of staff and

resources and, therefore, not entail any extra financial burden. The Eleventh Finance Commission more or less agreed with these views and stated that while assessing the revenue and expenditure of the States, the additional burden falling on the financial resources of the States had already been taken into account and, therefore, no additional provisions were required to be made on this account. The EFC did, however, recommend some grants with a view to reemphasizing the need for maintenance of essential civic services including primary education, primary health, safe drinking water, street lighting, sanitation, public conveniences etc. The EFC had evolved a formula for *inter se* distribution of the grants among the States which included a weightage for the steps taken by the States towards decentralization. This was considered necessary, as many states were slow to follow up on the legislative and the executive measures required to be taken in the wake of the Constitutional Amendment. The EFC also recommended certain measures which if taken by State Government/Local Bodies would enable them to supplement the resources of the Local Bodies.

Conclusion

It is well recognized that local bodies have an important role to play in the democratic process and in meeting the basic requirements of people. The old adage “for every citizen, most government is local government” still holds good. It is also recognized that the financial resources available to the urban local bodies fall short of what is needed by these institutions to fulfill their responsibilities. The role of the Central Finance Commission in this context is one step removed. The primary responsibility rests with the local bodies and the State Governments. The local bodies need to do their best to raise as much resources as possible through the various avenues available to them. At present there is no strong evidence that all municipal authorities have exercised in full the powers given to them to raise revenues. That benefit taxes where there is a direct quid-pro-quo between the taxpayer and the tax authority can be levied more easily has not happened. The States have come to the help of the local bodies in a number of ways. Apart from tax assignments, there has also been revenue sharing as well as untied grants. However, the mode of support from the State Government to the local bodies has varied from one state to another.

The Terms of Reference to the Twelfth Finance Commission as already mentioned require the Commission to suggest measures needed to augment the Consolidated Fund of the State to supplement the resources of the panchayats and municipalities. "Measures" could be interpreted to include not only financial but also legislative and administrative.

In relation to allocation of financial resources by Central Finance Commission to urban local bodies, several approaches are possible. One is to follow the route of the Tenth and Eleventh Finance Commission and provide for an ad hoc grant which will go in some way to augment the resources of the local bodies. Another approach can be to supplement the ad hoc grants with additional resources to fulfill some basic services such as, say, solid waste management in urban areas. This would be an application of the equalization principle that a citizen should be entitled to certain minimum standard of civic services irrespective of where he or she resides. Each local government must be able to provide a comparable level of services at comparable charges and if there are gaps due to the factors beyond the control of the local bodies, the higher levels of government should come to its aid. Even here one must recognize that the role of the Central Finance Commission must be treated as supplementary rather than primary. Nevertheless, an application of the equalization principle to one or two select services based on normative projections of revenue and expenditure is worth considering. However, the financial implications will have to be carefully studied, given the constraints at the State and the Central levels.

A reference must also be made here to the principles which would underline the distribution among states of resources earmarked by the Central Finance Commission. The Eleventh Finance Commission, as indicated earlier, used a formula which included variables such as population with a weight of 40 per cent, index of de-centralisation with a weight of 20 per cent, distance from the highest per capita income with a weight of 20 per cent and revenue effort and geographical area, each with a weight of 10 per cent. The variable, Index of Decentralisation has come in for some criticism. While recognizing that the states which have actively taken forward the process of decentralization must be rewarded, a critical question is: How to measure it? Mere assignment of functions or

even financial or taxation powers may not necessarily reflect the extent of decentralization at the ground level. A search for an appropriate measure becomes necessary, if the incentive through additional funds allocation is to achieve its purpose.

The Finance Commission is keen to play its role to improve the standards of services of the Urban Local Bodies. We look forward to your ideas and suggestions in this regard. I thank you for sparing your time to participate in the Seminar and hope that, by the time of its conclusion tomorrow, there would be a greater clarity regarding the approach that we should take to strengthen the local bodies in the true spirit of the Constitution 74th Amendment Act.
