

# 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.<sup>10</sup> 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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<sup>10</sup>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***

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***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 cruelty to animals.*

***Development functions***

- *Urban planning including town planning.*
- *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.*

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*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.<sup>11</sup>

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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<sup>11</sup>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<sup>12</sup>, 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”<sup>13</sup>. 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.

<sup>12</sup>Not all advertisement taxes fall within the jurisdiction of municipalities.

<sup>13</sup>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.<sup>14</sup>”

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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<sup>14</sup>Report of the Eleventh Finance Commission. June 2000.

**Revenue Deficit of States as a  
Percentage of GSDP**

State	Year	
	1998-1999	1999-2000
<b>High income</b>		
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
<b>Middle income</b>		
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
<b>Low income</b>		
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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