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.

Workpage

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.