Ministry of Urban Development

Memorandum to the

Fourteenth Finance Commission

January 2014

Index

Tables

Annexures

1. India's Urbanization

1. 1. India is urbanizing. The Census 2011 results place India’s urban population at 377.1 million, having risen from 286 million in 2001.

Table-1: India’s Urban Population

Year	Population (million)	Net population increase (million)	Level of urbanization %
1961	78.9	-	17.96
1971	109.1	30.2	19.90
1981	159.5	50.4	23.40
1991	217.6	58.1	25.71
2001	286.1	68.5	27.81
2011	377.1	91.0	31.16

1.2. The expanding size of Indian cities will happen in many cases through a process of peripheral expansion, with smaller municipalities and large villages surrounding the core city becoming part of the large metropolitan area. In the coming decades, the urban sector will play a critical role in the structural transformation of the Indian economy and in sustaining the high rates of economic growth. It is being argued that India’s economic growth momentum cannot be sustained if urbanization is not actively facilitated. Cities will have to become the engines of national development.

1.3. A correlation analysis between the level of urbanization and per capita GSDP of Indian States has indicated a high degree of positive relation between the two (See **Annexure-1**). The same trend is valid for the countries too- the more urbanized countries have higher levels of income and growth. However, public investment, reflected in the budgetary support, is much higher in respect of non-urban areas as compared to the urban areas. While there are numerous major programmes by way of Central Sector Schemes and Schemes providing Additional Central Assistance to the State Plans for the rural areas, for the urban areas, there is but one- the Jawaharlal Nehru National Urban Renewal Mission (JNNURM). As a result, the states are generally reluctant to notify the growing number of Census Town as Statutory Towns (See **Table-2 below**). This is impeding the natural growth of the country and its economy at the aggregate level, while at the local level, it is leading to haphazard growth of the peri-urban areas.

1.4. Growth of Census Towns

There is massive increase in the number of census towns (CTs) during 2001-2011. New CTs increased from just 1362 in 2001 to 3894 in 2011. The number of new CTs increased dramatically in the states of Kerala, Tamil Nadu, Uttar Pradesh and Maharashtra. While State-wise details are presented in **Annexure-2**, a summary position is indicated in **Table-2** below. While there is large inter-state variation in number of new CTs, in the overall, the number of statutory towns increased by only 242, whereas that of the non- statutory towns, by 2532, which is a very significant situation. The share of urban population in these new CTs is still being governed under the rural administrative framework, despite very different demographic and economic characteristics. This may adversely affect their future growth. There is an urgent need to acknowledge the growth of these new CTs and governed by the formal urban system. Since these units are different from other rural areas by their economic characteristics and have the potential for future growth, proper governance arrangements would be crucial.

Table-2: Urbanisation Trends

	2001	2011	Change
States & UTs	35	35	No change
Districts	593	640	47
No. of Town*	5161	7935	2774
No. of Statutory Towns	3799	4041	242
No. of Non-Statutory Census Towns	1362	3894	2532
Urban Population (in Million)	286	377	32%
Total Population (in Million)	1029	1210	18%
Urban Population as % of Total Population	27.8%	31.2%	

* Total of Statutory Towns and Census Towns.

1.5. It is, therefore, imperative that the governments at the Centre and the States need to consciously encourage and facilitate urbanization. Accordingly, it is suggested that the Finance Commission should recommend appropriate fiscal incentives to encourage States to notify the Census Towns as Statutory Towns. For instance, a lump sum grant of Rs. 10 crore, for development of Municipal Office Building and Town Hall and annual grant of Rs. 1 crore towards staff and maintenance of civic services may be provided for the 5 year period, with the understanding that the State Government would, during these 5 years, make suitable arrangements for subsequent maintenance of the staff and civic services. The State Finance Commissions also need to be suitably advised by the 14th FC in the matter.

2. The State of Service Delivery

2.1. Cities and towns of India are visibly deficient in the quality of services they provide, even to the existing population. The challenge of urbanization in India is to ensure service delivery at the enhanced minimum standards that are necessary when planning ahead. The public services such as drinking water, sewerage, solid waste management, roads, and street lights must be accessible to one and at the same time, they must meet the service norms as set out by the Ministry of Urban Development in 2008 to ensure the contribution of cities to economic growth.

2.2. While there are no nationally-accepted expenditure norms for municipal services, and it would be extremely helpful if the 14th FC could prescribe one, a comparison of the current levels of spending (appropriately adjusted to identify the operations and maintenance component) with the operations and maintenance expenditure norms used by the High-Powered Expert Committee (HPEC) suggest that ULBs in India spend about 27-28 percent of what they need for efficient delivery and management of services. This single fact speaks of the extremely poor conditions of services in India's cities and towns.

3. Finances of the Municipalities

3.1. Municipal Finances in India have historically been in an unsatisfactory state and this position stands substantiated by the municipal finance data collected and compiled by the 13th Finance Commission. Presented in **Table 3** below, it shows that the annual per capita aggregate revenues of municipalities amounted to Rs. 1,430 in 2007-08. In comparison, the aggregate expenditures were assessed at Rs. 1,513. The revenues consisted of the revenues raised by municipalities, devolution, assignments, and grants-in-aid from the state governments, central government transfers, and the Finance

Commission grants. The expenditures included on the revenue and capital accounts.

Table-3: The Finances of Municipalities, All States

Finances	2002-03		2007-08		CAGR
	Amount Rs. crore	Per Capita Rs.	Amount Rs. crore	Per Capita Rs.	%
Revenue Income					
Own tax revenue	8,838.13	311	15,277.72	492	11.57
Own non-tax revenue	4,441.84	156	8,243.66	265	13.16
Total own revenue	13,279.97	466	23,521.38	757	12.11
Assignment & Devolution	3,657.06	128	9,171.11	295	20.19
Grants-in-aid	2,259.76	79	5,676.25	183	20.23
Others	1,137.52	40	2,818.32	91	19.90
Transfers from the Central Government	308.86	11	2,372.97	76	50.35
Finance Commission Transfers	276.53	10	869.02	28	25.74
Total revenue income	20,919.69	733	44,429.05	1430	16.26
Expenditure					
Revenue expenditure	15,691.46	550	28,431.45	915	12.62
Capital expenditure	5,938.28	208	18,594.08	598	25.64
Total expenditure	21,629.74	758	47,025.53	1,513	16.80
Gross domestic product (India)	22,61,415	21,415	43,20,892	37,969	13.83

Note: Gross Domestic Product at factor cost (current prices).

Source: The 13th Finance Commission.

3.2. Further analysis of the finances of ULBs underscores the fact that between 2002-03 and 2007-08, the own revenue component of municipal revenues witnessed no sign of vitality or buoyancy, as a proportion of the gross domestic product (GDP), own tax yields dipped from 0.39 percent in 2002-03 to 0.35 percent in 2007-08, and the own revenue component from 0.59 percent to 0.54 percent. What is important to note is that the tax domain of municipal revenues has not registered any change – even the first principle that local governments should have access to tax instruments that have little or no inter-jurisdictional implications has not been adhered to.

3.3. The level of aggregate municipal spending on service delivery and regulatory functions etc. is abysmally low. This level - an annual expenditure of Rs. 1,513 per capita (Rs. 915 per capita of revenue expenditure and Rs. 598 per capita of capital expenditure) – is far below the minimum level.

3.4. Urban local governments in India are among the weakest in the world both in terms of capacity to raise resources and financial autonomy. While transfers from state governments and the Government of India have increased in recent years, the tax bases of ULBs are narrow and inflexible and lack buoyancy, and they have also not been able to levy rational user charges for the services they deliver. There are clear trends towards increasing central and state government transfers and grants-in-aid. In 2007-08, the share of state government transfers constituted 33 percent of the revenues of the ULBs; the central government transfers formed 5.3 percent of ULBs revenues (**Table-4**). Globally, there is evidence to show that transfers yield the desired results under conditions where ULBs tap their own resources optimally. Transfers, when used for neutralizing the inefficiencies of the internal functioning of the ULBs, lead to a zero-sum game.

Table-4: Relative Shares of the Different Government Tiers in Local Government Revenues (%)

Government Tier	2002-03	2007-08
Municipalities	63.5	53.0
State Governments	28.3	33.4
Central government	1.5	5.3
Finance Commission	1.3	1.9
Others	5.4	6.4
Total	100.0	100.0

Source: The 13th Finance Commission.

4. Estimates of the Resource Gap and Investment Requirements

4.1. Most municipalities have a huge backlog of basic infrastructure, underspending by municipalities as estimated on the basis of the expenditure norms (operations and maintenance) available in the HPEC report is phenomenally large. As per the estimation of the High-Powered Expert Committee (HPEC) cited before, the ULBs in India spend about 27-28 percent of what they need for efficient delivery and management of services. Even if the HPEC norms are assumed to be long-term goals, the gap in spending is far too large to be ignored.

4.2. The HPEC has prepared detailed estimates of investment for eight sectors, i.e. water supply, sewerage, solid waste management, storm water drains, urban roads, urban transport, traffic support infrastructure, and street lighting. However, these would not cover the requirements of primary health, primary education, and electricity distribution etc. The capital investment for urban infrastructure over the 20-year period is estimated at Rs 39.2 lakh crore at 2009-10 prices. Recognizing that the focus of policy should be on provision of public services that flow from infrastructure assets and not merely on creating the assets, the Committee has highlighted the importance of operations and maintenance (O&M) for the upkeep of the assets. The O&M requirements for new and old assets are projected at Rs 19.9 lakh crore over the 20-year period. Average annual O&M requirements for new and old assets can be assumed to be Rs 1.0 lakh crore.

4.3. The resource requirement of urban local bodies is huge no matter what methods are adopted for its assessment whether it is based on the City Development Plans (CDPs) submitted by the Mission cities under Jawaharlal Nehru Urban Renewal Mission (JNNURM) or going by the estimates given by the state governments. As per the Memorandum of Ministry of Urban Development submitted to the Thirteenth Finance Commission, the estimate of the resource gap and the requirements of funds by ULBs for core services for the 5 year period commencing from 1st April, 2010 to 2015, was projected to Rs. 1,28,660 crore.

4.4. In order to reach at resource gaps for the period of 2015-20, estimates were needed for the same period from different state governments, unfortunately which could not be obtained. MoUD had set up a Working Group to identify the issues for consideration of the 14th Finance Commission. The Working Group felt disappointed that the state governments could not provide to it the post-2007 municipal finance data for its use.

4.5. The expenditure needs of ULBs will also increase during the period of 2015-20, the following points are worthy of being noted:

- Certain annual rise in the administrative cost is inherent with the increase of public employees’ salaries particularly after the implementation of the recommendations of the Sixth Pay Commission and the impending Seventh. The date of implementation of the recommendations of the Seventh Pay Commission is 1st January 2016. This will have huge impact on establishment & salaries costs of the ULBs.
- Operation and maintenance costs will go up chiefly due to greater investment in the form of local infrastructure particularly for drinking water supply, sanitation and urban transport especially due to capital investments under JNNURM, besides various other programmes of the Central and State Governments.

4.6. Given the state of the finances of the states and municipalities, it is hardly likely that the states and municipalities alone will be able to raise and assign resources for financing this scale and pace of urbanization. What is important to recognize is that irrespective of how provision of urban infrastructure and services is allocated between the different tiers of government, the fiscal implications of urbanization will continue to be phenomenally large.

4.7. Although the mandate of the Finance Commission is to recommend measures for the augmentation of resources of the states for meeting the requirements of municipalities, it is necessary that the municipal role in financing and managing urbanization be kept in the forefront for any recommendations. Municipalities are no longer just the responsibility of states; there is a large macro stake in ensuring that cities and towns are efficient in order to help achieve the Millennium Development Goal objectives

5. Finance Commissions

5.1. Insertion of clause 3(c) into Article 280 mandates the Finance Commission (FC) to make recommendations on “the measures needed to augment the Consolidated Fund of a State to supplement the resources of the municipalities in the State on the basis of the recommendations made by the Finance Commission of the State”[1]. This Article recognises that own resources of the ULBs combined with the state-level transfers and grants-in-aid that follow the recommendations of the SFCs, may not be adequate to meet their financial needs, and the Finance Commission may need to step in to supplement the resources of the state for bridging the gap unmet by the SFCs. As per the Report of 14th Finance Commission Working Group set up by MoUD, "It is an extremely important provision under the Constitution, formally recognizing that (i) ULBs are not just the responsibility of the state governments – the central government has an important stake in financing their activities and (ii) the ULBs have a claim in the divisible pool of the central government resources with several of their functions drawn from the Concurrent list of the Constitution".

5.2. Successive Finance Commissions have made recommendations for improving the finances and functioning of the ULBs - i.e., the 11th Finance Commission making recommendations for the period 2000-05; the 12th Finance Commission recommendations for the period 2005-10, and the 13th Finance Commission making recommendations for the period 2010-15. The grants for municipalities as recommended by the three FCs are shown in **Table-5**:

[1] Effective from 1 June 1993.

Table-5: Grants-in-aid for Municipalities Recommended by the 11th, 12th & 13th FCs

Commission	Basic Grant (Rs. Crore)	Earmarked or performance linked (Rs. Crore)	As a % of the divisible pool (PRIs & ULBs)	Utilization factor (%)
11th FC	2,000	2.93	0.78	87.6
12th FC	5,000	-	1.24	89.4
13th FC	15,110	8,000	1.93	-

Source: Reports of the Finance Commissions.

5.3. While the 11th and 12th Finance Commissions preferred to recommend a fixed amount of grant, the 13th Finance Commission posted a point of departure by recommending “a percentage of the divisible pool to be given to all states as grant under Article 275 of the Constitution”. The share of municipalities in the pool was 26.8 percent of the total amount, representing the urban share in the total population. Sharing of the divisible pool signals a major step towards establishing the claim of the ULBs in the central divisible pool of resources[2].

5.4. The major issue is: are the Finance Commissions' grants-in-aid adequate in bridging the vertical fiscal gap of municipalities? The grants-in-aid as recommended by the FCs - with **annual grants** ranging from Rs. 400 crore (11th FC), Rs. 1000 crore (12th FC), and Rs. 4622 crore (13th FC) - do not bear any relationship with the fiscal needs of municipalities or with the spending gaps. The 13th Finance Commission has recommended a quantum jump over the amount recommended by the 12th Finance Commission. However, even with

[2] The decision of the 13th Finance Commission to share the divisible pool of resources was in part, guided by the consideration that the proposed introduction of GST may remove some tax instruments traditionally allocated to local bodies. These include entertainment tax, entry tax, and a share in stamp duty. The 13th Finance Commission also took into account the demand of local bodies that they be allowed to benefit from the buoyancy of central taxes.

this jump and an annual estimated increase of about 20 percent in the quantum of state government grants-in-aid, assignments and devolutions, (as observed during 2002-03 to 2007-08), the average operations and maintenance expenditure would run significantly short of the operations and maintenance requirements of municipalities, estimated with HPEC norms.

6. Issues of Conditional Grants

6.1. An important part of the FCs' recommendations relates to the nature of the grants – tied or untied - and the conditions that are imposed on the state and the ULBs for accessing the grants-in-aid. In recent years particularly since the time the global community has begun to advocate the decentralization agenda, transfers and conditional transfers have gained importance and primacy. Transfers are less untied now and there are strong trends towards linking grants with the purposes that are stipulated by the higher tiers of government. Recent years have also witnessed the emergence of performance-linked, output-based transfers.

6.2. Successive FCs have used some part of the recommended grants-in-aid to a specific purpose or to be given only upon complying with performance in specified spheres. The 11^{th} FC mandated that the recommended grants should be earmarked for (a) operations and maintenance of functions such as primary education, health, drinking water, street lighting and sanitation, and (b) maintenance of databases and accounts. The 12^{th} FC required that 50 percent of the grants should be earmarked for solid waste management through public-private partnership.

6.3. A significant point of departure is made by the 13th Finance Commission, which set aside Rs. 8000 crore for allocation to states on the basis of their performance (as distinct from tied grants) in respect of the following:

i. Putting in place a supplement to the budget documents for local bodies, requiring the ULBs to maintain accounts as specified by the 13th Finance Commission;

ii. Putting in place an audit system for all local bodies;

iii. Putting in place a system of independent local body ombudsmen who will look into complaints of corruption and maladministration against the functionaries of local bodies, both elected members and officials, and recommend suitable action;

iv. Putting in place a system to electronically transfer local body grants provided by the 13th FC to the respective ULBs within five days of their receipt from the central government;

v. Prescribing through an Act the qualifications of persons eligible for appointment as members of the SFC consistent with Article 243 I (2) of the Constitution;

vi. Enable local bodies to levy a property tax (including tax on all types of residential and commercial properties);

vii. Putting in place a state-level Property Tax Board which will assist all municipalities and municipal corporations in the state for establishing an independent and transparent procedure for assessing property tax;

viii. Putting in place (gradually) standards for delivery of all essential services (water supply, sewerage, storm water drainage, and solid waste management) provided by all local bodies; and

ix. Putting in place a fire hazard response and mitigation plan in all municipal corporations with a population of over one million (2001 Census) for their respective jurisdictions.

6.4. On the basis of monitoring mechanism set by the 13 FC, the Ministry of Finance has laid down a compliance protocol for accessing the performance grant. This protocol requires that (i) all the nine conditions be complied with before a state can access this grant, and (ii) states must file a compliance report every year. It has been found that the only 8 states could meet this criterion by 31st March 2011, followed by 12 states by 31st March 2012. Only 4 states so far has met these criteria by 31st March 2013 and rest of the states could not submit the necessary certificates and documents in order to get release of 13 FC's performance grant during the year of 2013-14 (as of 1st January, 2014).

6.5. The following are the main observations and issues by which the states are not able to meet the compliance verification mechanism set by the 13th FC:

Supplementary Budget:

- Actuals are not provided and only budget estimates are given for one year. It makes it difficult to know the actual expenditure under certain schemes / heads etc.
- Plan and Non-Plan distinction not provided.
- Many a time, the State Budget Heads and the Supplementary Budget Heads does not match.
- In some cases, the State Urban Development Department (UDD) prepares Supplementary Budget for the Municipalities, which, however,

covers only those grants that are UDD related, while other grants are missed out.

- Confusion in paragraph 10.110 of 13 FC Report, which states on the one side that the details of grants/transfers should be at least up to district level, while on the other hand the details up to the minor heads of 191, 192 and 193 are required, which are meant for municipal corporations, municipalities and nagar panchayats, respectively.

Double entry accounting system:

- State governments are required to produce a certificate saying that the new accounting system has been introduced in all ULBs. In practice, many of the states find it difficult to introduce it in all ULBs especially smaller ULBs with population ranging between 2000 to 50000, owing to lack of staff and technical capabilities. Although the MoUD has advised for outsourcing of this job for a cluster of smaller ULBs etc., but it has been found that the states had difficulties to implement even this suggestion too.
- Compliance verification mechanism requires only a certificate of introduction, even for successive years. Progress/ result of this reform is not feasible to be checked and may result in the compliance only on paper rather than being in actual implementation.
- State Manual in lines of NMAM is also one of the requirements which some states find difficult to prepare or to adopt.

Audit system for ULBs:

- It depends on CAG certificate. Many states have submitted CAG certificates and stating of laying of audit report in State Legislature etc.

- However, ground realties have not been checked so far.
    - According to the C&AG, as per the Constitution provision- *243 Z- "Audit of accounts of Municipalities: The Legislature of a State may, by law, make provisions with respect to the maintenance of accounts by the Municipalities and the auditing of such accounts."*
    - States are free to make legislation for accounts and audit for Local Bodies.
    - DLFA/ Director of Accounts/ similar authority is the primary auditor in most of the States.
    - CAG performs only supplementary role, unitary role of CAG as stops below State level.
    - Issues relating to Finance Commission, as appeared in LB audit reports, are as follows:
        - Delays in release of grants, non-release, interest not credited.
        - Diversion of funds for other purpose or spent on inadmissible items.
        - Unspent grants.
        - Utilisation certificates not provided.
        - Other System lapses- planning, estimates, cash book, asset register, works, technical sanction etc.
        - Non maintenance of database/ accounts, misclassification

Local body Ombudsman:

- The purpose is to make ULBs corruption free.
- However, ground realties are not feasible to be checked.

Prescription of qualification of SFC members:

- The purpose is to make SFC reports technically correct and to obtain useful recommendations from SFCs.
- However, the actual results will only be known after next SFCs' reports.

Property tax without hindrance:

- Haryana and Punjab had to issue relevant Government Orders for levying property tax in order to make a claim for performance grant.
- However, the actual improvements in realization of property tax collection are not feasible to be checked at this stage.
- Merely issuing Government Orders for property tax without hindrance may not make the system effective because it has several other parameters which need to strengthen such as:
    - Deciding on the assessment system and valuation system.
    - Deciding on zones and zonal rates etc.
    - Other formalities of formulation of byelaws etc.

Property Tax Board:

- The Property Tax Boards have been constituted by several states. However, the understanding of the subject and its effective implementation is doubtful.
- Even 13th FC has recommended only coverage of only 25% properties by the end of FC period i.e. 31.3.2015.
- Work Plans submitted by the PT Boards or State Govt. need to be technically checked by the coming Finance Commissions.

Service Level Benchmarks:

- Arbitrariness has been observed in making these benchmarks
- It has to be made for all ULBs.
- The existing benchmarks are obtained based on ULBs rough estimates and Future estimates are based on these benchmarks.
- Cities have achieved these targets or not, is difficult to monitor.
- The progress or achievement of the target is not mandatory which may lead to merely a paper exercise.

Fire hazard plan for million plus cities:

- Many of the states which have million plus cities have made these plans. However, it is not feasible at this stage to check for right implementation.

7. The Key Role of the Fourteenth Finance Commission

7.1. The Fourteenth Finance Commission has a major role to empower the institutions of governance that are closest to the people. The process of fiscal devolution from States to the ULBs is taking place through SFCs. In many States, the reports of third and fourth generation SFCs have been submitted. Assets are being either created or transferred to the ULBs. All of this imposes an administrative cost on the ULBs and draws on scarce resources that they receive from their own sources and from the State. In this connection, fiscal transfers through 14th FC have to play a critical role.

7.2. The memorandum submitted by the MoUD to 13th FC had recommended, "to desist from the approach of *ad hoc* nature and include the ULBs in the arrangement of revenue sharing as the case with the State emanated from the 80th Amendment of the Constitution. Also, the Articles 243X, 243Y, 266, 268, 269, 270, 275, 279 and 280 do not, in any way, preclude the CFC from earmarking a share of central revenues for the ULBs, suggesting that it be given into the Consolidated Fund of a State for the express purpose of supplementing the ULBs fund". It was urged, that local governments should also be considered to get the share from the central divisible pool along with the States. This was to be over and above the fiscal devolution recommended to the States to correct vertical imbalance. Considering the merits of tax sharing, it was recommended that three per cent of the net proceeds of the central taxes could be devolved to the ULBs.

7.3. The 13th FC considered the suggestion of sharing of central revenues with ULBs and provided 1.93 percent (PRIs and ULBs) of the divisible pool of central resources. The share of ULBs in the pool was 26.8 percent of the total amount, representing the urban share in the total population. Merely 0.51 percent (26.8% of 1.93) of the divisible pool was allocated to the ULBs. The 13th FC also divided the share of ULBs in two parts (a) basic grant, and (b) performance linked grant. It has been mentioned above that the performance linked grant has not been absorbed by all the states as per their respective share due to non-compliance of some of the nine conditions.

7.4. It is, therefore, suggested to the Fourteenth Finance Commission to realistically assess the cost of the creation of third tier and compensate it adequately. The MoUD is of opinion that the 14th FC should recommend for suitable arrangements to enable sharing of central divisible pool with Local Bodies. Seemingly, the scheme would have the following merits:

- This will help a great deal in linking the ULBs with the Indian federal structure along with the State and Union government.
- The ULBs will be able to share the aggregate buoyancy of central taxes. This is particularly important when the economy is passing through an inflationary phase.
- The Union, State and local governments would feel the impact of fluctuations in central tax revenues alike.
- The progress of tax reforms will be greatly facilitated if the scope of tax sharing arrangement is enlarged so as to give greater certainty of resource flows to local government and increased flexibility in tax reform and tax reengineering *e.g.* introduction of goods and service tax (GST).

7.5. Such an arrangement will be consistent with the practice adopted in other federations with an institution akin to the Finance Commission. For example; a) 4 per cent of the commonwealth net personal income tax is shared with local governments in Australia, b) local governments are entitled to an 'equitable share' of national revenue in terms of section 214 of the constitution of South Africa, c) In Nigeria, resources are allocated among the three tiers of government, *i.e.*, federal (49%), state (24%), local (20%), other funds and the federal capital territory (7%).

7.6. Considering the merits of tax sharing, the Fourteenth Finance Commission should recommend three per cent of the divisible pool of the Union. In other words, three per cent of the net proceeds of the central taxes could be devolved to the ULBs through the State governments. This would be over and above the share of the State governments from the divisible pool. It is recognised that the 14th FC will be making a detailed analysis of the trend of the central tax revenues and the projections that could also be based on the likely introduction of GST.

8. Other Considerations for the 14th Finance Commission

8.1. Performance based Grants: A key issue to be deliberated upon is as to whether the nine performance based conditions of 13th FC should be continued or only selected conditions of 13th FC should be continued or should not be continued at all or some new conditions to be considered.

8.2. Municipalities in India are not bound by any performance standards either in respect of revenue-raising or delivery of services. The result is twofold: (i) they continue to operate at sub-optional levels and hardly ever formulate plans for eliminating inefficiencies in the internal mobilization and management of resources, and (ii) they are hardly ever confronted with a hard budget constraint, rely as they do on intergovernmental transfers. The economy-wide costs of the absence of any form of performance standards are phenomenally large.

8.3. In sum, the existing fiscal system is out of sync with the present day realities; it is burdened with taxes that have no productive value and are obsolete. Property taxes, although vital for the fiscal viability of municipalities, have accumulated a lot of inefficiencies. Other taxes that meet the test of immobility, e.g., land-based taxes, stand appropriated by state-level development authorities. As a result, municipalities in several states are at a high risk in maintaining their fiscal identity as the third tier of government. If own revenues are taken as a measure of decentralization, as the international literature suggests, then, India has moved backwards in implementing the objectives embodied in the 74th Constitutional Amendment Act, 1992.

8.4. Transfers should not be used as an incentives. Transfers, when used for neutralizing the inefficiencies of the internal functioning of the ULBs, lead to a zero-sum game.

8.5. The 14th Finance Commission Working Group set up at NIUA recognizes that the instrument of performance grants is central to improving performance in spheres of revenue augmentation, revenue productivity, and revenue administration. It should be selective, and limited to areas of critical importance, and its compliance should be output-oriented. Too many conditions will dissipate the value of this extremely useful instrument.

8.6. Although the use of performance linked grants is not new, their systematic inclusion as an integral part of the grant allocation process is relatively recent. According to the UNCDF, there are about 15 countries that are currently using "Performance Based Grant System" (PBGS), either on a pilot basis or nationally. Application of PBGS has yielded many lessons and issues, which include the following:

i. Most countries include a "capacity building component" in the PBGS, with a tendency over time to move towards the allocation of capacity building grant to local governments;

ii. The use of minimum conditions has been near universal, thus providing local governments with incentives to demonstrate compliance with indicators that point towards a basic level of absorptive capacity;

iii. A majority of countries include "Performance Measures" for assessing the qualitative differences, with individual local governments scores resulting in differences in their grant allocations; and

iv. Most PBGS have been reinforced over time, with more indicators being introduced and with modifications to budgetary consequences taking place to ensure local governments access minimum level of funding, regardless of their performance.

8.7. The 74th Constitutional Amendment, State Finance Commissions and Articles 243(Y) and 280 (3)(c):

i. The 74^{th} Constitutional amendment on Municipalities, cast in the context of global movement towards decentralization, advocates among others, an expansion of the functional portfolio of the ULBs via the 12^{th} Schedule. The Amendment expects the ULBs to be performing the functions listed in the 12^{th} Schedule of the Constitution. Although it is an illustrative list, it has triggered two changes of far-reaching importance: (i) Article 243 Y requiring the states to set up, at the expiry of the fifth year, a State Finance Commission (SFC) to make recommendations on the taxes, duties, tolls, etc. to be assigned to the ULBs; the taxes etc. that may be shared between the states and the ULBs; and the grants-in-aid for them; and (ii) insertion of (3)(c) into Article 280 requiring the Finance Commission to make recommendations on the "measures needed to augment the Consolidated Fund of a State to supplement the resources of the municipalities in the State on the basis of the recommendations made by the Finance Commission of the State".

ii. The 74^{th} Amendment recognizes that Articles 243(Y) and 280(3)(c) together should be able to develop a financial package for municipalities in ways that it is able to meet the 12^{th} schedule functions. Justification for 280(3)(c) stems from the facts that (i) the SFCs may not be able to fully meet the requirements of the ULBs, and leave a gap to be bridged by the FCs, and (ii) the 12th Schedule consists of several functions that are drawn from the Concurrent List of the Constitution, providing space for the central government to contribute to meeting the cost of such decentralised functions.

iii. Few municipalities have thus far been equipped to discharge the 12th Schedule responsibilities effectively. One reason is that there is no mechanism in place for financing the 12th Schedule functions nor has any attempt been made either by the SFCs or the FCs to develop such a mechanism. While several states have incorporated the 12 schedule functions into the State Municipal Acts, their effective transfer to municipalities has not taken place.

iv. Given the primacy of the relationship between the state and ULBs with respect to the functions and fiscal powers, it is important that the 14th Finance Commission puts in an incentive structure for the States to assign the 12th Schedule functions to the ULBs and for the SFCs to formulate and suggest a mechanism for financing the same. This is central to decentralization, which underlies the 74th Amendment. The Article 280(3)(c) owes itself to the 74th Amendment; it is thus important that the Finance Commission responds to this goal.

-x-x-x-x-x-

Annexure-1

Urbanization Rate and Per Capita Gross State Domestic Product (PCGSDP)

States	Urbanization level 2011 (per cent)	Rank - Urbanization Level 2011	PCGSDP 2009-10 (Rs.)	Rank -PCGSDP 2009-10
Andhra Pradesh	33.49	13	51,025	15
Arunachal Pradesh	22.67	25	51,405	14
Assam	14.08	29	27,197	28
Bihar	11.30	30	16,715	31
Chhattisgarh	23.24	24	38,059	21
Gujarat	42.58	8	63,961	8
Haryana	34.79	12	50,365	16
Himachal Pradesh	10.04	31	78,781	4
Jammu & Kashmir	27.21	19	30,582	25
Jharkhand	24.05	23	27,132	29
Karnataka	38.57	9	52,097	13
Kerala	47.72	6	59,179	12
Madhya Pradesh	27.63	18	27,250	27
Maharashtra	45.23	7	74,027	6
Manipur	30.21	16	27,332	26
Meghalaya	20.08	27	43,555	19
Mizoram	51.51	4	45,982	17
Nagaland	28.97	17	45,353	18
Odisha	16.68	28	33,226	24
Punjab	37.49	10	60,746	10
Rajasthan	24.89	22	34,042	23
Sikkim	24.97	21	68,731	7
Tamil Nadu	48.45	5	63,547	9
Tripura	26.18	20	35,799	22
Uttar Pradesh	22.28	26	23,395	30
Uttarakhand	30.55	15	59,584	11
West Bengal	31.89	14	41,219	20
A & N islands	35.67	11	74,340	5
Chandigarh	97.25	2	118,136	1
Delhi	97.5	1	116,886	2
Puducherry	68.31	3	88,158	3

- Conclusion: Coefficient of Correlation is **0.804** implying high positive relation.

Annexure-2

Number of Administrative Units and Change in Census Towns during 2001-2011

Sl. No.	India/ State/ Union Territory #	Census 2011			Census 2001	Change in CT during 2001-2011
		Districts	Statutory Towns	Census Towns	Census Towns	
1	**India**	640	4,041	3,894	1362	2,532
2	A & N Islands #	3	1	4	2	2
3	Andhra Pradesh	23	125	228	93	135
4	Arunachal Pradesh	16	26	1	17	-16
5	Assam	27	88	126	45	81
6	Bihar	38	139	60	5	55
7	Chandigarh #	1	1	5	0	5
8	Chhattisgarh	18	168	14	22	-8
9	Dadra & Nagar Haveli #	1	1	5	2	3
10	Daman & Diu #	2	2	6	0	6
11	Goa	2	14	56	30	26
12	Gujarat	26	195	153	74	79
13	Haryana	21	80	74	22	52
14	Himachal Pradesh	12	56	3	1	2
15	Jammu & Kashmir	22	86	36	3	33
16	Jharkhand	24	40	188	108	80
17	Karnataka	30	220	127	44	83
18	Kerala	14	59	461	99	362
19	Lakshadweep #	1	0	6	3	3
20	Madhya Pradesh	50	364	112	55	57
21	Maharashtra	35	256	279	127	152
22	Manipur	9	28	23	5	18
23	Meghalaya	7	10	12	6	6
24	Mizoram	8	23	0	0	0
25	Nagaland	11	19	7	1	6
26	NCT of Delhi #	9	3	110	59	51
27	Orissa	30	107	116	31	85
28	Puducherry #	4	6	4	0	4
29	Punjab	20	143	74	18	56
30	Rajasthan	33	185	112	38	74
31	Sikkim	4	8	1	1	0
32	Tamil Nadu	32	721	376	111	265
33	Tripura	4	16	26	10	16
34	Uttar Pradesh	71	648	267	66	201
35	Uttarakhand	13	74	42	12	30
36	West Bengal	19	129	780	252	528

Source: Census of India 2011 (Provisional).

#: Refers to Union Territory.

* includes un-inhabited villages.