APPROACH TO THE FINANCES OF MUNICIPALITIES: A REPORT TO THE 14th FINANCE COMMISSION

Working Group of State Urban Development Secretaries on Issues before the 14th Finance Commission

Ministry of Urban Development and
National Institute of Urban Affairs New Delhi

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1 INTRODUCTION

1.1 Vide Office Memorandum of 15 November, 2013[1], the Ministry of Urban Development (Government of India) constituted a Working Group of State Urban Development Secretaries and entrusted it with the task of examining the following issues considered relevant for the 14th Finance Commission's mandate as contained in Article 280(3)(c) of the Constitution of India –

i. The issue of condionalities;

ii. Differential approach for different size classes of urban local bodies;

iii. The issue of service level benchmarks;

iv. Criteria for allocation of grants-in-aid, including norms for assessment of needs and resources; and

v. Linkages between Articles 243 Y and 280(3)(c) of the Constitution.

1.2 The Working Group consisted of the Principal Secretaries (Urban Development) of the states of Haryana, Himachal Pradesh, Jammu and Kashmir, Karnataka, Madhya Pradesh, Mizoram, and Rajasthan, and Dr. Ashok Singhvi, Joint Secretary, Ministry of Urban Development (Government of India). Professor Om Prakash Mathur, Distinguished Professor of Urban Economics, National Institute of

[1] See Annex 1

Urban Affairs, New Delhi served as the Chairperson/Convenor of the Working Group.

1.3 The Working Group held two meetings. In the first meeting held on 7 January 2013, the Group discussed its mandate and decided to ask the state governments to–

i. Update the data on the finances of municipalities to the year 2011-12 using the base information that was compiled by the Report of the 13th Finance Commission;

ii. State their position on the terms of reference as set out for the Working Group of State Urban Development Secretaries[2];

iii. Provides copies of the reports of the State Finance Commissions (SFCs); and

iv. Present any other information which in their view, may be useful for examining the issues relevant for the 14th Finance Commission[3].

The second meeting took place on 30 August 2013 to deliberate on the draft report prepared for consideration of the Ministry of Urban Development. While preparing the draft report, the Chairperson/Convenor reviewed the following in order to come to grips with (i) the state of the finances of municipalities, and (ii)

See Annex 2.

Communications sent by the Ministry of Urban Development may be seen as Annex 3. The states that responded to the Ministry's communications included Arunachal Pradesh, Chattisgarh, Gujarat, Haryana, Himachal Pradesh, Jammu and Kashmir, Mizoram, Nagaland, Rajasthan, Uttar Pradesh and West Bengal. Arunachal Pradesh, Chattisgarh, Haryana, Mizoram, and Uttar Pradesh provided the 2011- 12 data on the finances of municipalities. In addition, three urban land bodies (ULBs) of Bihar also provided their finance data.

the approaches employed by the SFCs and FCs in making their recommendations and their effects on the finances of municipalities.

i .Reports of the 11th, 12th, and 13th Finance Commissions, with particular reference to the recommendations pertaining to the urban local bodies (ULBs) as also the premises underlying them;

ii. Research studies on the finances of municipalities that had been commissioned by the successive Finance Commissions (FCs);

iii. Reports of the State Finance Commissions (SFCs) with a view to identifying (a) the approaches employed by them for estimating the vertical and horizontal fiscal gaps, and (b) the criteria used for allocating the recommended grants-in-aid to ULBs of different population size-groups;

iv. Memoranda submitted by the Ministry of Urban Development to the 12th and 13th Finance Commissions; and

v. International literature on the subject, especially as it pertained to the various forms of intergovernmental transfers and grant- in-aid systems, their contexts and impact on local government finance.

1.4In addition, the Chairperson/Convenor requested the World Bank to provide the services of an expert specializing in the implementation of the intergovernmental finance systems; accordingly, the Bank provided the expert services of Mr. Blane Lewis for a period of two weeks.

1.5Reviews of the reports of the FCs and SFCs and the research studies showed that –

i. the level of aggregate municipal spending in India was abysmally low – Rs. 1,513 per capita in 2007-08. The Finance Commission's share (2007/08) was less than 2 percent of the total municipal spending;

ii. there were no estimates of the gap between what the urban local bodies (ULBs) raised from their own tax and non-tax instruments and the amount needed to deliver municipal services such as water supply, sewerage, solid waste collection and management, city and town-level roads, and street lighting at some basic minimum levels. The SFC reports did not shed much insight into the methodologies used for estimating such gaps. For this reason, successive Finance Commissions have resorted to recommending “ad-hoc amounts” which, by any yardstick, cannot be considered adequate in relation to the massive requirements of the ULBs;

iii. No mechanism has as yet – two decades have elapsed since the adoption of the 74th Amendment - been evolved that would enable the Finance Commissions (FCs) to base their recommendations on the reports of the SFCs;

iv. There is no continuity in the recommendations of the Finance Commissions (FCs); as a result, the effective tenure of a recommendation is five years even when there may be value in continuing with that recommendation; and

v. Significant variation exists in the approaches employed by the SFCs in respect of (a) assessing the financial requirements of the ULBs, (b) determining the revenue-sharing arrangements, and (c) fixing the criteria for allocating the grants-in-aid to ULBs of different demographic, economic and social compositions.

1.6 These facts have been taken into account in the preparation of this report.

1.7 The report recognizes that the insertion of (3)(c) into Article 280 of the Constitution and incorporation of Article 243Y requiringthe states to constitute the SFCs on a quinquennial basis owe to the 74thConstitutional amendment whose primary goal is to empower urban local bodies (ULBs). The Working Group considers this goal as of paramount, if not ofover-riding, importance. It is thus compelling that the recommendations which the 14h Finance Commission may make on Article 280(3)(c) contribute to the strengthening of the goals and objectives enshrined in the 74th Amendment. Article 280(3)(c) has no independent raison *d’etre.*

Article 280(3)(c) has no independent raison d'etre. It owes itself to the 74th Constitutional amendment whose primary goal is to empower urban local bodies (ULBs).

1.8 The report also recognizes that the urban local bodies (ULBs) are the principal catalysts for guiding urbanization. Urbanization in India is just evolving and its full potential will begin to unfold in another decade or so when India's urban population will hit the 500 million mark. The efficiency with which the ULBs will undertake and carry out their functions particularly in respect of their responsibilities towards delivering services and governing their jurisdictions will determine whether India can accomplish its macroeconomic growth and poverty reduction goals and objectives. This fact has been especially noted and recognized in the preparation of this report. Fiscal empowerment of ULBs when seen from this perspective is no larger a matter of choice, it is a necessity.

Fiscal empowerment of the ULBs when seen in the context of the urbanization trends that India is faced with is no longer a matter of choice, it is a necessity.

1.9 The report is in five sections. Section 2 presents a brief overview of the finances of ULBs, highlighting issues that appear important for consideration by the 14th Finance Commission. It is followed in Section 3 by a review of the SFC reports of selected states, focusing on the methods for estimating the financial requirements of the ULBs and the criteria for addressing the horizontal inequities, acknowledging that the interface between the SFCs and FCs may be difficult in the short-to-medium term. Section 4 looks at the recommendations of the successive FCs, especially the 13th Finance Commission which has posted an important point of departure by recommending a share of the divisible pool for the ULBs and introduced aperformance-linked grant. Section 5 draws attention to the challenges of decentralization and urbanization and how these impinge on the finances of the ULBs. Section 6 provides a framework of suggestions for the 14th Finance Commission to consider in responding to its mandate embodied in Article 280(3)(c).

2 THE FINANCES OF MUNICIPALITES KEY CHARACTERISTICS

Municipal Finances in India have historically been in an unsatisfactory state[4]. The post-1992 period has not been able to make any difference to the finances of ULBs, notwithstanding the introduction of institutional changes embodied in Articles 243Y and 280(3)(c). This position stands substantiated by the municipal finance data collected and compiled by the 13th Finance Commission. Presented in Table 1 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[5]. 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 revenue and capital expenditures.

A closer examination of this summary position in combination with other data collected and compiled by the 13th Finance Commission, the HPEC Report on Indian Urban Infrastructure and Services, and an ADB-sponsored study footnoted here, shows that –

4 See Government of India. Report of the Local Finance Enquiry Committee. 1951.

5 Data pertaining to the finances of municipalities are drawn from the Website of the 13th Finance Commission and Ministry of Finance. In addition, this section makes use of the Report on Indian Infrastructure and Services, prepared by a High-Powered Expert Committee headed by Dr. Isher Ahluwalia, and a report titled as India Municipal Finance Study available at ADB website:http://www.adb.org/projects/documents/municipal-finance-matters-india-municipal-finance-study-tacr. The 13th Finance Commission data on the finances of municipalities relate to the period 2002-03 to 2007- 08.

Table 1: The Finances of Municipalities, All States

Finances	2002-03 Amount Rs. crore	2002-03 Per Capita Rs	2007-08 Amount Rs. crore	2007-08 Per Capita Rs	CAGR %
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 and 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 (GDP) (India)[6]	22,61,415	21,415	43,20,892	37,969	13.83
Own tax as % of GDP	0.39		0.35		
Own revenue as a % of GDP	0.59		0.54		
Municipal expenditure as % of GDP	0.96		1.09		

Note: Gross Domestic Product at factor cost (current prices).
Source: The 13th Finance Commission.

i.The level of aggregate municipal spending on services,regulatory functions that the urban local bodies (ULBs) are

[6]Local government expenditures as a percent of GDP in several federal OECD countries (2007) are as under:

Country	% of GDP
Australia	2.3
Austria	7.4
Belgium	6.9
Canada	7.2
Germany	7.2
Spain	6.4
Switzerland	9.7

Source: International Monetary Fund.
Government Finance Statistics. 2008.

responsible for and establishment 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 that must be incurred for delivering and maintaining services at some basic minimum levels. While there are no nationally-accepted expenditure norms for municipal services, 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. Even if the HPEC norms are assumed to be long term goals, the gap in spending is far too large to be ignored.[7]

ii. 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

[7]The HPEC's per capita operations and expenditure norms for municipal services are as under:

Water supply	Rs.501
Sewerage	Rs. 286
Solid Waste Management	Rs. 155
Urban Roads	Rs. 397
Storm Water Drainage	Rs. 53
Street Lighting	Rs. 8
Total	Rs. 1,401

These are annual costs at 2009-10 prices. The adjusted costs for 2007- 08 to which Table 1 refers to are Rs. 1,261 per annum, which exclude expenditure on establishment, wages, and costs of implementing regulatory and enforcement functions that the municipalities perform.

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. Also, studies suggest that while state municipal budgets enumerate close to 50 different kinds of revenue instruments, most of them are either not in use or have near zero level of productivity. Many of them are obsolete, with no relevance to the socio-economic realties and the changing economy of cities.

iii.Municipal role in making use of land-based instruments is limited, with the development authorities appropriating much of the gains from the levy of such instruments.

iv.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 5.3percent of ULBs revenues. 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.

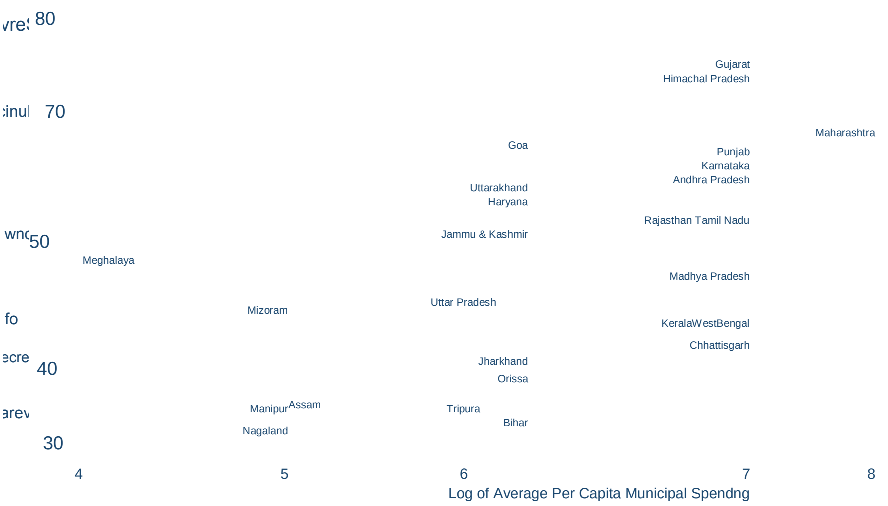
Table 2: Relative Shares of the Different Government Tiers
in Local Government Revenues (%)

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

v. The scale of under spending, referred to in point (i) above, is phenomenally large. There are no studies in India that have estimated the cost of under spending on productivity and the quality of life. An exercise to estimate the elasticity of household access to municipal services with respect to municipal spending – using the 2002-03 to 2007-08 data – show a clear positive relationship between access and spending (not causation). Regressions suggest that both municipal spending and GSDP are significantly associated with service access[8]. The estimate for the municipal spending coefficient implies that a 1 percent increase in capital spending is associated with a 2 percent increase in household access to services[9].

Graph 1: Access to Services and Municipal Spending, 2003-2008



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9

Access to services is estimated as a percent of the population that has access to water, wastewater, and sanitation services. The un-weighted average across the three types of services is employed where the average has been computed across 2002/03 – 2007/08 so as to be comparable with municipal spending data. Service access data is taken from the two censuses 2001 and 2011, and the data for the mid-years has been interpolated.

The nature and quality of data suggest caution with regard to this optimistic outcome. Nevertheless, increasing capital spending is important for improving access to basic services.

vi. The special-category states, Himachal Pradesh, Jammu and Kashmir, and Uttarakhand, and the 8 North-eastern states stand at a disadvantage in matters of both revenue generation and spending levels vis-à-vis other states. The2007-08 position in respect of the finances of urban local bodies of special category states are shown in the following table:

Table 3: Per Capita Own Revenues and Municipal Revenue Expenditure, 2007-08

Special category states	Own revenue (Rs.)	Revenue expenditure (Rs.)
Himachal Pradesh	595	1,198
Jammu & Kashmir	87	452
Uttarakhand	116	330
Arunachal Pradesh	-	-
Assam	143	205
Manipur	50	139
Meghalaya	150	147
Mizoram	-	-
Nagaland	294	195
Tripura	145	232
Sikkim	-	-
Average, All India	757	915

Source: The 13th Finance Commission

vii. 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 mobilisation 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.

Municipalities in India are not bound by any performance standards either in respect of revenue-raising or delivery of services. The economy- wide costs of the absence of any form of performance standards are phenomenally large.

viii. 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. The importance of "own revenues" in the financial structure of municipalities has declined. It is not only that their share has dipped, their growth rates vis-à-vis other revenue constituents have also declined. Fiscal inertia dominates in explaining municipal revenues and spending outcomes. Last year's own-source revenues and spending explain to a large extent the current year's position[10]. 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.

[10] This report does not give the data for the 5-year period 2002-03 to 2007-08. This is, however, available on the site.

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ix. The post-2007 period is marked by substantial investments in municipal infrastructure under the Jawaharlal Nehru National Urban Renewal Mission (JNNURM), a flagship Mission of the Ministry of Urban Development (Government of India). The JNNURM, being a reform-linked grant facility for cities to access the central government funds *inter-alia* aims at improving the performance of property taxes and user charges. The effect of JNNURM on yields from property tax and user charges is not yet known. It is disappointing that the state governments have not been able to provide the post-2007municipal finance data for the use of this Working Group.

3 THE STATE FINANCE COMMISSIONS

The Constitution (seventy-fourth) Amendment 1992 provides for the setting up of a State Finance Commission (SFC), once in five years, to review the financial position of the municipalities and make recommendations as to the principles which should govern –

i. the distribution between the states and the municipalities of the net proceeds of the taxes, duties, tolls and fees leviable by the state,

ii. the determination of the taxes, duties, tolls, and fees which may be assigned to, or appropriated, by the municipalities;

iii. the grants-in-aid to the municipalities from the Consolidated Fund of the State;

iv. the measures needed to improve the financial position of the municipalities; and

v. any other matter in the interest of sound finance of the municipalities.

3.2 Following the amendment, several states viz Andhra Pradesh, Haryana, Himachal Pradesh, Karnataka, Kerala, Maharashtra, Manipur, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh, and West Bengal took the initiative of constituting the first State Finance Commission (SFC) in 1994. Since then, the process of setting up the SFCs has been in motion, although the regimen of establishing the SFCs "at the expiration of every fifth year" as provided under the

Constitution has not been maintained. Currently, in several states, four SFCs have been set up in succession.

3.3 For the purposes of this report, two issues are of direct relevance. One relates to the link between Articles 243(Y) and 280(3)(c), as mandated in the Ministry of Urban Development Office Memorandum of 15 November 2012. As is commonly known, the Finance Commissions (FCs) which are set up under Article 280 have not been able to make use of the reports of the SFCs (constituted under Article 243 I and Y) for reasons that are outlined later in this section, raising a vital question whether there is any way that could bring about an effective interface between the SFCs and FCs. The 74th Constitutional amendment attaches value and significance to the link between the SFCs and FCs; how should that be brought about even if the link so brought about may not be the most optional? The second issue is concerned with the substantive value of the reports of the SFCs, referring to –

i. the alternative ways in which the SFCs have assessed the fiscal gap (vertical imbalance), i.e., the gap between the amount that the municipalities are able to raise with their own revenue raising instruments and what they need in order to deliver services and meet out their functional obligations;

ii. the criteria that they have used to address issues of horizontal imbalance and inequities; and

iii. the incentive structures (if any) that the SFCs have introduced to improve the functioning of the ULBs, particularly in the spheres of revenue generation and expenditure management.

This report addresses these issues.

Link between Articles 243(Y) and 280(3)(c)

3.4 As stated above, none of the FCs have been able to base their recommendations on the basis of the reports of the SFCs, attributing the inability to use them to-

i. the non-availability of the reports of the SFCs;

ii. the non-conformity of the time period for which the SFC reports are prepared with the time period for which the FCs have made recommendations; and

iii. the inability of SFCs to provide in their reports a clear idea of the powers, authority and responsibility actually entrusted to the urban local bodies (ULBs) and to indicate the principles for devolving revenue-raising powers to them as well as sharing of revenues with them.

The 13th Finance Commission has added that –

i. The reports of SFCs are hampered by lack of data;

ii. there is poor ownership of SFC reports by state governments;

iii. the SFCs have no incentive to produce a comprehensive report; and

iv. there is lack of interest in the states to accept the recommendations of SFCs and place the Action Taken Reports (ATRs) before the state legislatures in a timely manner. According to the 13th Finance Commission, this fact is a further disincentive for SFCs to produce good quality reports. The facts as compiled by the successive FCs also indicate that the SFCs take anywhere between 2-4years for completing their reports and the state governments take 6-12 months for formulating the Action Taken Reports (ATRs).

3.5 Successive Finance Commission (FCs) have raised several other issues concerning the composition and working of the SFCs. The 11th Finance Commission, for instance, has pointed out that in several states, "serving government officers are appointed as chairpersons and members of the SFCs" which put "limitation on the ability of the SFC to act as an autonomous body to make recommendations in a free and independent manner". The 12th Finance Commission has observed that in order that a proper approach similar to the one that is followed by the Finance Commission (FC) is followed by the SFC (i.e., a normative approach for assessing municipal revenues and expenditure rather than using forecasts based on historical trends), "it is necessary that the states constitute SFCs with people of eminence and competence, instead of viewing the formation of SFCs as a mere constitutional formality"[11].

3.6 In sum, the non-availability of SFCs reports and the inability of the FCs to make use of them has remained a major drawback in implementing the provisions embodied in the 74th Constitutional amendment. The important point to note is that FCs recommendations are cast independent of the approach(s) and directions laid down in the reports of the SFCs.

3.7The Working Group has considered this issue and examined how best the purpose underlying the link between the SFCs and FCs is best achieved. The vision of the 74th Amendment, it needs to be reiterated, was that the two sets of the Commissions – one at the state level to make an assessment of the finances of ULBs and to formulate its recommendations with recognition to their financial position, and the second at the level of the central government to "supplement" the SFCs approach, will produce a fiscal framework that would meet the requirements of the ULBs. It has not happened.

11 The 13th Finance Commission has proposed that the state governments should prescribe through on Act the qualifications of persons eligible for appointment as members of the SFCs. Several states have enacted legislations in this respect.

No link exists between the two. What alternatives exist or are possible?

3.8 Several suggestions have been made in this respect; for this Working Group, four sequential steps appear essential if a FC is to make use of the reports of the SFCs:

i. Establishment of a SFC, 24 months in advance of the Constitution of a FC;

ii. Preparation of the report by the SFC within 18 months from the date of its establishment; further, it should make recommendations for the same period for which the FC is expected to do;

iii. Preparation of the ATR on the SFC report, within six month of its submission; and

iv. Submission of the SFC Report together with the ATR to the FC at the time of its constitution.

3.9 Prime facia, such a schedule appears difficult to enforce, more so, when 28 states are to undertake such on exercise.

3.10Two suggestions are offered here:

i. Create a permanent SFC Unit in each State, to be funded by the FC initially for a period of 10 years, and mandate it to (a) regularly collect the finance data of all ULBs in the state in a prescribed manner, (b) estimate the revenue potential at various levels of efficiency, and (c) forecast revenues and expenditures – using various assumptions. This will provide a basis not only for the SFCs but also for the FC to undertake relevant exercises, necessary for the FC to formulate its recommendations; and

ii. Provide for a formal consultative mechanism between the FC and SFCs, with the object of formulating an approach to the finances of municipalities[12].

Substance of the SFC Reports: Assessing the fiscal gaps

3.11 The second issue relates to the methodologies employed by the SFCs for estimating the financial needs of municipalities and revenue-account gaps. It needs to be recognized that estimating the financial needs of the ULBs requires at the minimum –

i. An account or description of the "spending responsibilities" of the ULBs, in respect of services such as water supply, sewerage, drainage, solid waste and the like;

ii. The physical and expenditure norms for service provision;

iii. The tax and non-tax jurisdiction of the ULBs;

iv. The current level of efficiency in revenue generation;

v. Assumptions with respect to the likely changes in the functional domain and the revenue-raising powers that may take place in the five years, i.e., the tenure of recommendations of the SFCs; and

vi. Assumptions regarding the proportions of expenditure between establishment and operations and maintenance.

[12] The Government of Chattisgarh have proposed that the Finance Commission (FC) should convene a workshop of all State Finance Commissions (SCs) to evolve an approach to the issues concerned with the finances of the ULBs. The 13th Finance Commission held a meeting with selected SFC Chairpersons. However, such meetings can be made more productive by setting an agenda that aims at formulating an integrated approach to the finances of municipalities.

3.12 An examination of the reports of the SFCs suggests that the methodologies they apply for estimating revenues and expenditures fall into four categories –

i. Extending the past trends of revenues and expenditure into the future;

ii. Applying a pre-determined growth rate for estimating the expenditures and using the past trends for estimating the revenues;

iii. "Entitlement" of services as the basis for estimating the ULBs financial requirements; and

iv. Normative assessment of ULB expenditures[13] and application of past trends in respect of revenue receipts.

3.13The methodologies so used suffer from several deficiencies-

i. Undue reliance on past trends – implicitly suggesting a Business- as-Usual scenario, a kind of fiscal inertia that shows in the growth pattern of own source revenues. Such an approach has meant perpetuation and, in several instances, worsening of the financial position of the ULBs. Gaps, wherever noted, are said to become larger under this approach;

ii. No fresh insights on how revenues should be projected or planned;

iii. Few SFCs have attempted to estimate the cost advantages and disadvantages that ULBs have in delivering and managing services, consequently, these are not reflected in determining the

[13] Several SFCs made use of the Zakaria Committee norms for estimating the financial requirements of the ULBs.

criteria for allocating the recommended amounts to the ULBs. In other words, criteria used are largely neutral to the cost advantages or disadvantages of the ULBs; (proxied in such criteria as scheduled caste, scheduled tribes, slum population etc.); and

iv. No standardized norms for assessing the expenditure requirements of the ULBs are used for purposes of estimating the fiscal gaps-this is despite a clear methodology recommended by the 12th Finance Commission for gap estimation.

Substance -- Revenue sharing and grants-in-aid

3.14 An important contribution of the SFCs lies in the sphere of the mode of revenue-sharing between the state governments and the ULBs. Reviews of the reports indicate three methods of revenue sharing having been used -

i. Fixed sums or amount of transfers to the ULBs; (now given up)

ii. Sharing of the net proceeds of individual taxes; and

iii. Sharing of the pool of state government revenues.

3.15 The most important innovation that several SFCs have brought in is the "sharing of the pool of state government revenues with the ULBs, with the object of giving to the ULBs, the buoyancy of the state government revenues". What is important to be noted here that the pool of `state government resources', is defined variously to comprise (a) state tax and non-tax revenues, (b) non-loan gross own tax revenues minus the collection charges, (c) tax revenues minus the collection expenditure, (d) net own tax revenue minus taxes such as entertainment taxes. The shares for the ULBs show huge variations between states. Annex attached with this section shows the extent of variations. Looked at in a comparative framework, the variations in the recommendations of the SFCs are far too large and the rationales for variations not easily comprehensible. Part of the variation stems from the facts that (a) references to the functional profile of the ULBs which are central to assessing the financial requirements are fuzzy, and (b) the definitions of the divisible pool are unclear.

Substance -- Horizontal distribution of state government grants- in-aid

3.16 An important task of the SFCs is to allocate the recommended sums between ULBs which vary in population size, density, economic and social composition of population, topography and terrain and other factors. These factors have an important bearing on the cost of delivering basic services. To what extent do these variables enter into the calculations of the SFCs? What weightages are assigned to these variables. This part of the SFC reports is instructive in that while population is universally applied as a factor in the criteria for allocation, many SFCs have constructed indexes to measure the status of infrastructure – the infrastructure index, deprivation index, and remoteness index. In addition, the SFCs have attempted to include variables that provide weightage to efficiency (tax effort) and equity under which factors such as slum population, the extent of scheduled caste/schedule tribe population have been included.

Table 4: Devolution to ULBs

First, Second, Third, and Fourth State Finance Commissions

State	First	Second	Third	Fourth
Andhra Pradesh	39.24 % state tax and non-tax Urban share:30 per cent			
Assam	2 % of state tax for local bodies, both rural and urban.(the share of urban local bodies has not been specified).			

Additional 10.39 share over and above the existing devolution urban share 35 per cent

3.5 % of state tax (the share of ULB and RLB is on the basis of 1991 population)

- -

25% of non loan gross own tax revenue minus collection expenditure of GOA (the share of ULBs and RLBs is the basis of population 2001 and density 2001 with a weightage of 80% and 20% respectively.

14% of the net proceeds of all State taxes and duties, other than Entry tax, Entertainment tax, and Electricity Duty from the divisible pool for2011-12. The divisible pool net of incentive fund and special purpose grant was apportioned between the PRIs and the ULBs in the ratio of 80:20.

State	First	Second	Third	Fourth
Bihar	-	-	Up to 3% of state's tax revenue minus collection expenditure to be devolved to PRIs and ULBs.	4th SFC of Bihar has recommended 7.5% of state's tax revenue minus collection expenditure for a period of 2010-15. 70% for PRIs and 30% for ULBs.
Chattisgarh	-			
Gujarat	Grants under the head of SFC grant to be distributed under four minor heads-(i) Entertainment tax/entertainment tax on cable/dish tv etc., (ii) professional tax, (iii) basic per capita grant and pay and allowance grant, and (iv) grant for creation of municipal finance development fund for ULBs			

Followed recommendations of 2nd SFC of Madhya Pradesh.

31.15 percent of state gross revenue to be transferred to ULBs and RLBs.

First SFC recommendations for a period of 2005-10. 8.287% of state's net own tax revenue -

to be distributed among PRIs and ULBs based on 2001 population. (6.628% for PRIs and 1.659% for ULBs)

- -

State	First	Second	Third	Fourth
Haryana	(a) 20% of vehicle taxes	(a) 50 % of net income from entertainment tax		
	(b) 50% of net income from entertainment & show tax	(b) show tax be reimposed at 10% and entire proceeds to ULB's		
	© 10 % of royalty on minor minerals	(c) 20% of net proceeds from vehicle tax -50 % on the basis of population		

4% of state's net own tax revenue for a period of 2006-07 to 2010-11. The shares of PRIS and ULBs are 65%and 35% respectively. -

(d) Tax on electricity consumption within municipal limits be raised from one paise per unit to 5 paise per unit

Himachal Pradesh	An amount equal to Rs 12.2 crore as grants in lieu to octroi for 1996-97.rising to Rs 1.79 billion in 2000-01 and centrally sponsored grants to accrue to municipalities.	

and balance 50% on road length and their maintenance cost.

(d)Surcharge or tax on electricity at 5 paise per unit

(e)10% of the annual income from royalty on minor minerals

(f)35% of net proceeds from Local Area Development tax(LADT) be devolved to municipalities

An amount equal to 19.66 crore as developmental grant for the year 2002-03 with a 10 % markup to neutralise inflation , rising to Rs 28.79 crore by 2006-07 as annual CSS grant to municipalities.

Karnataka	5.4 % of the total Net Loan Gross own revenue(ULB Share)	8 percent of Non Loan Gross own revenue receipts(NLGORR). (ULB share)

1.41 percent of state tax and non-tax to be devolved to ULBs from 2008-09 to 2010-12 -

-33% of Net Own Revenue receipts of State should be distributed to PRIs and ULBs in the ratio of 70:30. Besides that SFC also recommended a new pattern ofdevolution-Global protection Provision.

State	First	Second	Third	Fourth
Kerala	1 % of state revenues(excluding from certain sources) transferred to local bodies as non-statutory non plan grants distributed between the rural and urban local bodies in proportion to their population.			
Madhya Pradesh	8.67 % of the tax and non-tax revenues to the state government.			
Maharashtra	25 % to 100% of entertainment taxes collected from municipalities of different grades,25 % of vehicle taxes and 10 % of profession taxes.			
Plan grants : Not less than one-third of the annual size of the state Plan Maintenance Grant: Five and a half percent of the annual tax revenue of the state General purpose Grants: Three and a half percent of state own revenue as general purpose grant in lieu of assigned taxes, shared taxes and statutory and non-statutory grants in aid.	Funds equal to one third are to be given to local self governments from the total resources assessed for financing the annual plan. Twenty five percent of the total state revenue of which a) Maintenance Grant: Five and a half percent of the annual tax revenue of the state; b)General purpose Grants: Three and a half percent of state own revenue as general purpose grant in lieu of assigned taxes, shared taxes and statutory and non-statutory grants in aid. c) for expanding and expanding services and institutions transferred to LSG	To rectify the vertical imbalance, the IV SFC envisaged a vertical transfer system with few components – General purpose fund Maintenance Fund Development Fund (i) GPF fixed at 3.5 of State's own tax revenue of (+2) time. (ii) Maintenance fund fo the assets was recommenced to be 5.5% of SOTR (iii) An allocation o 25% of the proposed – size in 2011-12 and thereafter increase it in relation to the plan size.		
1.07 % of own state net revenue.	1 % of own state net revenue.	-		
8 per cent of taxes, tolls ,duties and fees	-	-		
Manipur	Maintenance grant equal to			

	Rs 8.83 million to accrue to municipalities in1996-97. (The amount varies in subsequent years.)		
10 % of state own taxes including share in central taxes 45 % of the share is reserved for district council. The shares for ULB:PRI =20.62:34.38		-	-
Orissa	Sharing of Entry tax with ULBs after the abolition of Octroi. A share of surcharge on entertainment tax and motor vehicle tax (10% of gross collections) to be transferred to ULBs.		

10% of average of state's gross own tax revenue from1999-2000 to 2001-02. The share of Rural and Urban is 80:20.

15% of average of state's gross tax revenue for a period of 2010-15. The share of Rural and Urban is 75:25.		-

State	First	Second	Third	Fourth
Punjab	20 % of net proceeds of five taxes- stamp duty, motor vehicle tax, electricity duty, entertainment tax and cinematography shows- to be transferred to municipalities.	4 percent of total net proceeds of state taxes. The rural Urban share is 67.5:32.5	4 % of net proceeds of all state taxes. Rural:urban=66:34	-
Rajasthan	2.18 % of net proceeds of state taxes. (The division of these proportions between rural and urban should be in ratio of3.4:1.)			

2.25 % of state own net tax revenue.(2.20 % as share and .05 % percent as incentive amount for raising resources and 15 % of net proceeds from entertainment tax (the division between rural and urban is in the ratio of RLB:ULB= 76.6:23.4

3.5 % of state own net tax revenue.(3 % as share and .5 % percent as incentive amount for raising resources and 100 % of net proceeds from entertainment tax (the division between rural and urban is in the ratio of RLB:ULB= 75.7:24.3

-

Tamil Nadu

8 % of the state 's net tax revenue in 1997-98; gradually increasing in successive years to 9%, 10% and 11%, reaching 12% in 2001-02. The Division of this amount between the rural and urban would be 60% and 40% respectively.

Uttaranchal

11 % of state revenue.

Rural: Urban share is 42.23:57.77

8 % of the state own tax revenue net of entertainment tax for two years 2002-04gradually increasing to 9 for2004-06 and to 10 % for2006-07. Shares of PRI and ULB are in ratio of 58:42.

10 % of state own revenue excluding interest receipts.
Dividend & profits, royalties from minerals and sale proceeds from forest produce. Rural and urban share is 77.69:22.31

10 % of the state own tax revenue net

-

of entertainment tax for a period of 2008-12. Shares of PRI and ULB are in ratio of 58:42.

10.5% of State's own tax revenue to be distributed equally between he ULBs and PRIs in the ratio of 50:50 -

Uttar Pradesh	7 % of net proceeds of the state 's total tax revenue.
West Bengal	16 % of net proceeds of all taxes collected by the state. These proceeds should be divided between urban and rural based on population.

12.5 % of state taxes excluding entertainment tax and land revenue. The distribution between rural and urban is 5% and 7.5% respectively.

16 % of net proceeds of state taxes. The devolution is based on the district population.

22.5 % of state taxes excluding entertainment tax and land revenue. The distribution between rural and urban is 15% and 7.5% respectively. -

5 % of state's own net tax revenue to be distributed among PRIs and ULBs in ratio of 76% and 24% respectively. -

4 THE FINANCE COMMISSIONS (FCs) AND THE FINANCE OF MUNICIPALITES

Until the insertion of sub-article (3)(c) into Article 280 of the Constitution in 1992, the Finance Commissions did not separately consider the financial requirements of the ULBs, nor did they make any separate financial allocations or awards for them. The requirements of ULBs formed a part of the state governments financial memoranda; similarly, the financial awards for states included the requirements of ULBs as well.

4.2 Insertion of 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"[14]. This Article recognizes that own resources of the ULBs combined with the state-level transfers and grants-in-aid that may be recommended by 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. 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.

[14] Effective from 1 June 1993.

Insertion of 3(c) into Article 280 recognizes that (i) urban local bodies (ULBs) are not just the responsibility of state governments – the central government has an important stake in financing their activities, and (ii) urban local bodies (ULBs) have a claim in the divisible pool of the central government resources with many of their functions enumerated in Schedule 12 having been drawn from the Concurrent List of the Constitution.

4.3Successive 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[15]. Their approaches need to be seen in three parts: (i) adequacy of the amounts recommended for ULBs by the Finance Commissions and the underlying reasonings; (ii) the conditions, if any, attached with the recommended amounts, and (iii) the criteria of allocation of the recommended amounts to States.

4.4 The grants for municipalities as recommended by the three FCs are shown in the following table:

15 The 10th Finance Commission recommended an amount of Rs. 1000 crore for the ULBs for a period of 5 years (1995-2000).

Table 5: Recommended Grants-in-aid for Municipalities

Commission	Basic Grant (Rs. Crore)	Earmarked or performance linked (Rs. Crore)	As a % of the divisible pool (PRIs and 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

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"[16]. 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[17].

Adequacy of the grants-in-aid

4.5 The issue is: are the FC grants-in-aid adequate in bridging the vertical fiscal gap of municipalities? Determining the adequacy of the grants-in-aid requires an estimate of the gap between what the municipalities need to deliver services at some standard levels and what they are able to generate after accounting for the shared revenues and grants-in-aid as recommended by the SFCs. It

16 The divisible pool of the central government is the net tax revenue that is obtained by deducting the cost of collection, cesses and surcharges and taxes of UTs from the gross tax revenue.

17 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.

presupposes that the gap so worked out are based on some normative considerations and these normative considerations are broadly comparable across states in order that the FCs are able to apply a uniform set of criteria for assessing their requirements.

4.6 None of this has, however, been possible from the databases contained in the reports of the FCs or of the SFCs. Prima facie, and in comparison with the norms used by the HPEC, 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 1.93 percent (PRIs and ULBs) of the divisible pool which, in combination with the performance grant, amounts to Rs. 23,110 crore for a period of five years for the ULBs. It is a quantum jump over the amount recommended by the 12th Finance Commission, and forms about 4.6 percent of the projected municipal revenues for the year 2012-13 (Annex 4). However, even with 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. Most municipalities have a huge backlog of basic infrastructure; under spending by municipalities as estimated on the basis of the expenditure norms (operations and maintenance) available in the HPEC report is phenomenally large. Also the entire exercise of estimating the gaps is compounded by the fact that ULBs in several states are expected to adhere to a “balanced budget”, making it difficult to assess the state of the finances of municipalities.

The issue of conditionalities

4.7 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. There is enough literature that weighs the advantages of untied versus tied grants-in-aid; this report, however, does not enter into a discussion of this aspect except to say that conditions are a normal feature of the grants-in-aid system in much of the developing world. Indeed, 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. A recent study showed that the local governments globally are dependent on transfers and grants-in-aid to the extent of 42 percent of their revenues (average) which rises to over 60 percent in a large number of countries[18]. 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. Forming a part of good governance agenda, these are intended to strengthen the results-based accountability for service delivery outcomes[19].

4.8 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 11th FC mandated that the recommended grants should be earmarked for operations and maintenance of functions such as primary education, health, drinking water, street lighting and sanitation, and

(b) maintenance of data bases and accounts. It also suggested that grants should NOT be used for salaries and wages. The 12th FC required that 50 percent of the grants should be earmarked for solid waste management through public-private partnership.

18 Om Prakash Mathur. 2012. Intergovernmental Transfers in Local Government Finance. A Report to the UN-Habitat. Nairobi.

19 See Anwar Shah. 2010. Sponsoring a Race to the Top: The Case for Results-Based Intergovernmental Finance for Merit Good. World Bank Policy Research Working Paper No. 5172. Washington D.C.; and United Nations Capital Development Fund. 2011.Performance-Based Grant System: Concept and International Experience. New York.

4.9 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.

4.10 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 is reported that 12 states have been able to access the performance grant on a regular basis[20].

4.11Although 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 -

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

[20]The Ministry of Urban Development monitors the performance grant.

consequences taking place to ensure local governments access minimum level of funding, regardless of their performance;

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.

4.12 For purposes of this report, two performance grants which are of considerable importance have been looked at to ascertain if these grants are making the expected impact. These are (i) putting in place (gradually) standards for delivery of four essential services, viz., water supply, sewerage, storm water drainage, and solid waste management and (ii) putting in place a Property Tax Board. The genesis of the condition on standards for service delivery lies in the “”Benchmarks” set by the Ministry of Urban Development. The 13th Finance Commission has placed implementation of the Benchmarks as one of the nine conditions. The need for a Property Tax Board owes itself to the very successful examples of such Boards in the various Provinces of Canada.

4.13 The Benchmarks in respect of the four services require all municipalities in the States to provide information on the (i) current status of the service, and (ii) the target for the next year. The 13th FC requires this information to be filed for all municipalities separately, on an annual basis in order to gain eligibility for the performance grant (along with the other 8 conditions). The performance details in respect of the two services for two ULBs (names deleted) are as under:

Table 6: Performance Grant for Putting in Place Standards for Service Delivery: Water Supply

Benchmarks	Benchmarks	ULBs 1		ULBs 2	
		Current	Target	Current	Target
Coverage of water supply connections %	100	82	86	71.5	75
Per capita supply of water lpcd	135	120	125	98.15	105
Extent of metering %	100	121	25	62.08	65
Extent of non-revenues water %	20	39	37	53.32	50
Continuity of water supply (hours)	24	10	10.30	1.15	1.15
Quality of water supplied %	100	100	100	100	100
Efficiency in redressel of customer complaints %	80	100	100	100	100
Cost recovery in water supply services %	100	18	24	120	100
Efficiency in collection of water supply charges %	90	71	76	70.13	75

Source: Ministry of Urban Development. Information supplied by the ULBs.

Table 7: Performance Grants for Putting in Place Standards for Service Delivery: Solid Waste Management

Benchmarks	Benchmarks	ULBs 1		ULBs 2	
		Current	Target	Current	Target
Household level coverage of this service	100%	5%	15%	84.16	88
Efficiency of collection of municipal solid waste	100%	60	70	74.42	78
Extent of segregation of municipal waste	100%	0	0	14	20
Extent of municipal solid waste recovered	80%	0	0	84.08	85
Extent of scientific disposal of municipal solid waste	100%	0	0	0	0
Efficiency in redressel of customer complaints	80%	75	80	11.52	15
Extent of cost recovery in SWM	100%	0	0	93.41	95
Efficiency in collection of SWM charges	90%	0	20	80.8	85

Source: Ministry of Urban Development. Information supplied by the ULBs

4.14 It is important to note that the ULBs are required to file the information on the current level of the service and on the target for the following year. The progress or achievement of the target is not mandatory. The data of the two ULBs in respect of the above are contained in the two tables to show the irrelevance of "Benchmark" as one of the nine conditions as also of the limited value of this information for any purpose. The use of decimal point in recording the extent of metering or of non-revenue water shows the lack of understanding by the State how current levels or the targets are to be recorded. Prime facie, there is no value addition of this condition in terms of either enhancing revenues, or revenue productivity or revenue administration. Such conditions, the Working Group holds the position, need not be considered by the 14th Finance Commission. There are other ways of securing this information if that is needed[21].

4.15 On the other hand, the FC's conditionality upon states to constitute a Property Tax Board merits serious attention, particularly in the light of the fact that property tax is the main tax instrument with the ULBs for raising revenues and that this tax remains grossly untapped and unused. Studies done for the 13th Finance Commission show that the untapped potential of property taxes is close to 70 percent, without reassessing property values. A well-administrated property tax is a pre-requisite for strong municipal fiscal base. The purpose of a Property Tax Board, as stated in the Report of the 13th Finance Commission, is to "assist all municipalities and municipal corporations in the state to put in place an independent and transparent procedure for assessing property tax. The Board, according to the 13th FC –

[21] The Working Group 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.

i. shall or cause to enumerate all properties within the jurisdiction of the municipalities and corporations;

ii. shall review the existing property tax system and make suggestions for a suitable basis for assessment and valuation of properties; and

iii. shall make recommendations on modalities for periodic revisions

4.16 The 13th Finance Commission has recommended that the Board should be staffed and equipped in such a manner as to be able to make recommendations relating to at least 25 percent of the aggregate number of estimated properties across all municipal corporations and municipalities in the state by 31 March 2015. Passage of the relevant legislation or issue of the necessary executive instructions by the state government for creation of the Property Tax Board as well as publication of the work plan by the Board in the state government gazette demonstrates compliance with this condition.

4.17At the time of preparing this report, 12 states are reported to have constituted Property Tax Board. Perusal of the notifications indicate that states such as Karnataka and Maharashtra have set up the Boards, specified their functions that are comparable with those proposed in the report of the 13th Finance Commission, and broadened their functional portfolio to include, in the case of Karnataka, the following –

i. enumerate, or cause to enumerate, all class of properties and rates prevailing in zones or areas in the municipality in the state and develop a data-base;

ii. review the property tax system and suggest a suitable basis for capital valuation of properties or the annual taxable value;

iii. design and formulate transparent procedures for determination of capital valuation of properties or annual taxable value;

iv. recommend tax rates for different classes of building or area or zones of the municipalities;

v. recommend modalities for the periodic revision of the assessed values;

vi. assist municipalities in determining the rates of any zone, area of any class of building; and

vii. ensure transparency in capital valuation process or annual taxable value and facilitate disclosure of the same for a fair comparison.

4.18 It is also relevant to refer to the Maharashtra Act XIV of 2011 (an Act to establish the Maharashtra Municipal Property Tax Board) which lays down the following functions for the proposed Board.

i. To do audit of the assessment done by the Commissioner of a Municipal Corporation or as the case may be, the Chief Officer of a Municipal Council for levying the property tax on various categories of properties and to revise the assessment, if found necessary, and to recommend action against concerned persons if it is found that mis-valuation is done with malafide intention or arbitrariness.

ii. On a joint reference made by the Commissioner of a Municipal Corporation or the Chief Officer of a Municipal Council, as the cases may be and any property tax payer, to tender advice or to determine the terms of compromise in case of a dispute between the property tax payer and the Commissioner of a Municipal Corporation or as the case may be, the Chief Officer of a Municipal Council, where both the parties want to amicably settle their dispute which may or not be pending before any

Court of law, for which the Board may charge fees as decided by the Board with the approval of the State Government.

4.19 Such good cases hold promise for other states. The Working Group suggests that a reward/incentive system for states who bring in innovations for institutionalizing a robust property tax system be established.

Criteria for allocation

4.20 Setting criteria for the allocation of the recommended grant- in-aid to states is a major task of the Finance Commission. Successive Finance Commissions have used a mix of criteria which have included population and area, and a set of criteria that indicates the ranking of states on the basis of per capita income (higher the per capita income, lower is the allocation) and revenue effort (higher the revenue effort, higher is the allocation)[22]. In addition, the 11th and 13th FCs used an index of decentralization (or a variant thereof), evidently to signal that the FCs had a responsibility towards deepening decentralization.

4.21Table 8 gives the criteria (together with the weights) for the allocation of the FCs grants-in-aid to states. These have been closely examined with a view to see if these represent the changing demographics and socio-economic urban environment. Consultations have also been held with the state governments who have made the following suggestions for inclusion in the allocative criteria:

(i) Rates of urban population growth, these being an indicator of the population pressures on municipal services;

[22]The FCs have been sensitive to both equity goals (per capita income) and efficiency (revenue effort) considerations in allocating the grants- in-aid for municipalities.

(ii) Levels of urban poverty and incidence of slum-population; and

(iii) Decentralization at the level of the ULBs, it being the core of the 74th Constitutional amendment.

These have been examined and recommendations thereon are contained in the next section. In addition, the Working Group has specifically noted the growing hiatus between “urban” and “municipal”. The Census of India 2011 showed that only 242 new municipal towns were added during 2001-2011; in comparison, the numbers of Census towns rose phenomenally.

Table 8: Criteria for the allocation of the Finance Commissions (FCs) Grants-in aid

11th FC		12th FC		13th FC	
Criteria	Weight(%)	Criteria	Weight(%)	Criteria	Weight (%)
Population	40	Population	40	Population	50
Geographical area	10	Geographical area	10	Area	10
Distance from highest per capita income	20	Distance from highest per capita income	20	Distance from highest per capita sectoral income	20
Index of decentralization	20	Index of deprivation	10	Index of devolution	15
Revenue effort	10	Revenue effort	20	Revenue effort	
		of which (a) with respect to own revenue of states	10	FC local body grants utilisation index	5
		of which (b) with respect to GSDP	10		
	100		100		100
The EFC had selected the following 10 parameters for the purpose of arriving at the index of decentralization: - (i) enactment/amendment of the state panchayats/municipal legislation; (ii) intervention/restriction in the functioning of the local bodies; (iii) assignment of functions to the local bodies by state legislation; (iv) actual transfer of functions to these bodies by way of rules, notification and orders; (v) assignment of power of taxation to the local bodies; (vi) extent of exercise of taxation powers; (vii) constitution of the SFCs and the extent of action taken on their reports; (viii) action taken on the major recommendations of the SFC; (ix) elections to the local bodies; and (x) constitution of the district planning committees as per the letter and spirit of article 243ZD.		Index of deprivation - Intra - State disparities on the basis of data relating to certain minimum needs of the population. Drinking water and sanitation are the two core services performed by the local bodies. State wise census 2001 data is used regarding the (i) number of households fetching water from a distance (over 100 meters in urban areas), (ii) households with no latrines within the house premises, and (iii) households with no drainage facilities for flow of waste water. These have been used to construct the index of deprivation. The formula used is D.I.= 0.5x+0.25(y+z), where DI - Deprivation Index; x - %age of households fetching water from distance; y - % age of households without latrines; z - %age Households without drainage; 0.5 - Standard Deviation was allowed so as to enable the least-deprived state to also get a share (least deprived State based on 2001 census)		Index of devolution derived from the finance accounts for all years 2005-06, 2006-07, and 2007-08. The amount devolved to local bodies in the finance accounts have been aggregated across the following heads - for ULBs sub heads 191, 192, and 193 under applicable major heads in the non-plan category, and for other assistance to all local bodies under the head 3604 in the non-plan category. The transfer so determined was divided by the states non-plan revenue expenditure for the three years and state-wise percentages obtained which were then weighted by the respective 2001 populations to obtain the state-wise devolution index.	

Source: Reports of the Finance Commissions

5 THE CHALLENGES OF DECENTRALIZATION AND URBANIZATION

Decentralization Challenge

Decentralization is a global movement. As a part of this movement which continues to gain momentum, a large number of countries have reallocated the functional and fiscal powers between the different tiers of government, with the general goal of strengthening the local governments. The following table gives examples of a sample of countries that have either amended the Constitution or enacted legislations with the specific objective of mainstreaming local governments.

Table 9: Local governments in a decentralized framework

Argentina The Federal Fiscal Fact, 2000 providing for co-participation of the different tiers of government in sharing tax revenues.

Brazil The 1988 Constitution, recognizing municipalities as constitutional bodies and assigning them with major responsibilities.

Chile The 1998 Organic Law for Municipalities, giving municipalities exclusive jurisdiction in limited spheres.

Hungary Law 65 of 1990 on Local Self-Government that defines the assignment of expenditure and revenue responsibilities

India The Constitution (seventy-fourth) Amendment Act 1992, provides constitutional recognition to municipalities, and lays down an illustrative list of functions combined with an institutional arrangement for revenue assignment.

Indonesia Law No. 22 of 1999 regarding Regional Governments and Law No. 25 of 1999, concerning the fiscal balance between the Central government and the Regions

Kenya The Local Authorities Transfer Fund Act. 1998, aimed at improving the management of local authorities and delivery of services.

Mexico The 1999 Constitutional amendment, recognizing local government as an essential element of government.

Philippines The Local Government Code, 1991, provides a framework for devolution and lays down the powers and responsibilities of local government units.

Poland Law on Local Authorities. 1990.

Russia Law on the Rights of Local Self-Government 1992, recognizes local self- governance

South Africa Constitution of the Republic of South Africa, 1996 and Intergovernmental Fiscal Relation Act, 1997

Thailand The Decentralization and Process Act, 1999

Uganda The Local Government Act, 1997

5.2 The 74th 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 12th Schedule. The Amendment forsees the ULBs to be performing the functions listed in the 12th Schedule of the Constitution. Although it is an illustrative list, it has triggered two changes offar-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 thegrants-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". The 74th 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 12th 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 decentralized functions[23].

[23]This fact indicates the macro-economic role for cities in the country.

The 74th Amendment envisions 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 requirements of the 12th schedule functions.

5.3Few municipalities have thus far taken on the 12th Schedule responsibilities. Apart from the oft-repeated argument that ULBs have no capacity[24], 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 states Municipal Acts, their effective transfer to municipalities has not taken place.

5.4The 74th Amendment is an important step for empowering municipal governments. The statement of Objects and Reasons of the 74th Amendment (Gazette of India September 16, 1991) stated that "in many states, local bodies have become weak and ineffective on account of a variety of reasons, including the failure to hold regular election, 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 an a firm footing the relationship between the state government and urban local bodies with respect to (a) the functions and taxation powers,

(b) arrangement for revenue sharing -".

[24] It is a vicious circle argument and provides no clue as to how it may be done.

5.5 Given the primacy of the relationship between the state and ULBs with respect to the functions and fiscal powers, it is important that the 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 of financing them. 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.

The Challenge of Urbanization

5.6 The Census 2011 results place India's urban population at 377.1 million, having risen from 286 million in 2001. The Census decade 2001-11 registered an annual exponential growth of 2.74%; it translates itself into an annual addition of approximately 10 million persons to its urban population. One of the most formidable challenges that India faces today is to make provision for such basic municipal services as water supply, sewerage and solid waste system, street lighting, and city-wide roads for its fast growing urban population. The financial and fiscal implications of urbanization are phenomenally large (Rs. 39 lakh crore)[25]. 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.

25 See for details, HPEC Report on Indian Infrastructure and Services and McKinsey Global Institute's India's urban awakening: Building inclusive cities, sustaining economic growth, which estimates an investment of US 1.2 trillion in urban infrastructure over a 20-year period to give urban citizens a basic level of services.

Table 10: 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

5.7 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 is 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 12th Plan growth and other development objectives.

The Phenomenon of Census Towns

5.8An important feature of the 2011 Census is the extraordinary rise in the number of "Census towns". The Census 2011, for instance, shows that during 2001-2011, 2,774 settlements acquired the urban status as defined by the Census. Of these settlements, only 242 settlements were given the statutory status of municipality by the respective state governments; the balance of 2532 settlement gained the urban status, without being assigned the statutory status on the ground that they receive significantly larger financial flows from the programmes and schemes of the Ministry of Rural Development and Ministry of Panchayats.

5.9The net result is that India has a large unique and anomalous situation where as many as 3894 settlements are urban according to the Census of India but are treated as "rural" by the respective state governments. They hold 14.5 percent of the country's total urban population. For the reason that the Census towns are not municipal, the 14th Finance Commission will ordinarily NOT make any grants-in-aid for them under Article 280(3)(c). At the same time, these are places that have the potential of becoming "slums" if their growth and development is not regulated and governed by regulations and by-laws generally applicable to cities and towns.

5.10 The Working Group is of the view that this fact should be specifically acknowledged by the Finance Commission and addressed via the Articles 280(3)(c) and 280(3)(bb), keeping in view that the growth of Census towns must be "regulated". Two suggestions are offered here: (i) all Census towns be subjected to the levy of property taxes at rates applicable to municipalities falling within a distance of 25 Kms, and (ii) the development of all Census towns be subjected to the building by-laws as applicable to municipalities falling within a distance of 25 kms.

6 APPROACH TO ADDRESSING ARTICLE 280(3)(c)

Key concerns and challenges: A summing up

The 14th Finance Commission constituted on 2 January 2013 will give its recommendations covering a period of five years commencing on 1 April 2015, among other matters, on the measures needed to augment the Consolidated Fund of the State to supplement the resources of the Municipalities. If past practices are any indication, the 14th Finance Commission will also rely on its own assessment of the finances of municipalities as well as the studies it may commission to get an update on the financial position of municipalities.

6.2 Whichever way the mandate of the 14th Finance Commission may be looked at, it will involve the Commission making recommendations on the following –

i. the quantum of the grants-in-aid;

ii .the aims and purposes that may govern the grants-in-aid;

iii .the nature of the grants-in-aid i.e., whether it is untied or tied to any of the aims and purposes; and

iv. the criteria for allocation of the grants-in-aid

v. the shares of each state in the grants-in-aid.

vi. the mode of releasing the grants-in-aid

6.3 This report addresses the above, taking into account the assessment of the financial position of municipalities – briefly presented in Section 2 and other factors that impinge on their finances, also referred to in the preceding sections. It has considered the alternative approaches put forward by the SFCs and FCs and examined the international practices in this respect. It is necessary to once again reiterate that the assessment of the financial position of municipalities relates to the period 2002-03 to 2007-08which stands dated. The period following 2007-08 has seen major investments in municipal infrastructure which, together with the JNNURM reforms, would have impacted the financial position of municipalities. This position is not available[26]. Attention has on several occasions been drawn to creating a proper data base of the financial position of municipalities but no concrete action has yet been taken. The 11th Finance Commission even set aside a small amount for the ULBs to create a municipal financial data base; it was neither put to effective use nor was this recommendation taken forward by the 12th Finance Commission. Absence of municipal finance data remains one of the serious limitations of this report.

The 11th Finance Commission set aside a small amount (Rs. 2.93 crore) for municipalities to create a data base on their finances. It was neither put to effective use by the municipalities nor was this recommendation taken forward by the 12th or 13th FCs. Absence of municipal finance data

[26] Transfers to states under the JNNURM since 2007-08 have amounted to Rs. 24,994.62 crore, with the year-wise transfers being as under:

2008-09Rs. 6,247.98 crore (Budgeted)
2009-10Rs. 6,124.02 crore (Actual)
2010-11Rs. 5,284.84 crore (Actual)
2011-12Rs. 7,337.78 crore (Actual)

Source: Notes on Demands for Grants. Ministry of Finance.

remains one of the serious limitations in trying to come to grips with the fiscal health of municipalities.

6.4 A few concerns and challenges emerging from the analysis contained in this report may be recapitulated here:

i. Distressingly low level of spending on municipal infrastructure and services. As this report points out the annual municipal spending on maintaining services is just about 27-28 percent of the HPEC norms. This level of spending is grossly inadequate and has to be raised in order to provide basic levels of services to urban citizens and for reasons that are linked to larger objectives of growth, productivity, and quality of life.

ii. Own source revenues of ULBs appear to have reached a plateau. Between 2002-03and 2007-08, own source revenues as a proportion of GDP dipped from 0.59 to 0.54 percent. Also, as stated in Section 2, a single-tax dominated municipal system can hardly be expected to meet the growing infrastructure needs propelled by the forces of urbanization and decentralization. Transfers, therefore, have a larger role to play in financing municipal services. Transfers need not be seen, as is common, as a symbol of dependency. However, for transfers to play an effective role, it is important that the large scale inefficiencies that characterize the own source revenue component are eliminated. Transfers do not function where local governments operate sub-optimally in matters of revenue raising. They work best when own revenues are robust and efficient.

iii. Recommendations of the SFCs in respect of revenue-sharing, transfers, and grants-in-aid, when seen on a comparable scale, are not comprehensible. As shown earlier, the definition of what constitutes a divisible pool varies sharply as between states, the proportions of the share of municipalities range between 1 percent to 10 percent, raising various kinds of questions with respect to the functional jurisdiction, fiscal powers, and the efficiency of the operations of the ULBs etc. While each SFC enjoys under the Constitution flexibility in determining its approach to municipal finance, some form of standardization appears necessary for providing a link between 243 Y and 280(3)(c).

iv. Special category states including the Northeastern states are at a disadvantage in matters of decentralization and the finances of municipalities. They are at early stages of urbanization and decentralization, and face a challenge that is both new and unprecedented.

v. Decentralization agenda as envisioned under the 74th Constitutional amendment is at a standstill. Measured in terms of (a) the own-tax revenues as a percent of GSDP, and (b) municipal expenditure as a percent of GSDP, decentralization is at an incipient stage when compared with other countries. The 13th Finance Commission arguing for decentralization, observed that "more needs to be done to put in place a strong incentive mechanism aimed at persuading state governments to decentralize further".

vi. Urbanization in India, as this report shows, is beginning to unfold itself in different ways. Firstly, the pace of urbanization has accelerated at an annual exponential rate of 2.74 percent (2001-2011), marking a reversal of the trends observed in the previous two census decades. Secondly, the metropolitan cities (> 1 million population) have increased in numbers, with their population share in urban population having risen to 42.6 percent in 2011. Moreover, most such cities have expanded centrifugally, incorporating small towns, census towns, and villages. Thirdly, census towns have risen both in numbers and population, creating a hiatus between what is municipal and what is urban. As this report has indicated, these census towns have the potential of becoming slums and unplanned settlements, if the pattern of their growth is not "regulated" according to planning norms and protocols. The 14th Finance Commission has a vital role in ensuring that these do not become financial liabilities for the future.

Census towns have seen during 2001- 2011 a phenomenal rise both in numbers and population These towns have the potential of becoming slums and unplanned settlements, if the pattern of their growth is not regulated according to planning norms and protocols. The 14th FC has a vital role in ensuring that Census towns do not become financial liabilities for the future.

6.5Approach to Article 280(3)(c)

i. Increase the quantum of grants-in-aid for municipalities. This report provides details of the quantum of grants-in-aid recommended by the 11th, 12th, and 13thFinance Commissions. The 13th Finance Commission recommended 1.93 percent of the divisible pool of central resources, broken into (a) basic grant of Rs. 15,110 crore, and (b) Rs. 8,000 crore performance linked grant for the period2010-2015. On an annual basis, it forms roughly about 4.6 percent of the projected municipal revenues for 2012-13. Although it represents a significant jump over the FC grant in 2007-08 when it amounted to less than 2 percent of the municipal revenues, it is necessary for the Finance

Commission to begin to move towards "bridging the expenditure gap", using the HPEC operations and maintenance expenditure norms, and shed in this process what has been one of the weaknesses in the FC reports, i.e., of being ad-hoc in determining the quantum of the grants-in-aid.

The HPEC Report on Indian Urban Infrastructure and Services provides the norms for operations and maintenance expenditure for six municipal services[27]. The HPEC has made use of the benchmarks set by the Ministry of Urban Development in developing the expenditure norms. The Working Group also notes that the HPEC norms are norms that are developed with the use of field-level cost data of services. It, therefore, suggests that the 14th Finance Commission makes use of these norms as a reference for estimating the financial requirements and determining the quantum of grants-in-aid for the ULBs.

The table below provides estimates of municipal expenditure that needs to be incurred for the delivery of municipal services at normative levels. The estimates are based on (i) the adjusted per capita operations and maintenance expenditure, and (ii) the estimated urban population from 2015 to 2020, the years for which for the years the 14th Finance Commission will make its recommendations[28].

[27]The six municipal services are water supply, sewerage, solid waste management, urban roads, storm water drains, and street lighting. O & M expenditures have been adjusted to reflect the total revenue account municipal expenditure.

[28]Zakaria Committee expenditure norms for municipal services are now outdated.

Table 11: Estimates of municipal expenditure requirements (excluding capital expenditure)

Years	Urban Population (000)	Total Expenditure (Rs. Crore)
2015-16	395253	184583
2016-17	402732	188076
2017-18	410224	191575
2018-19	417713	195072
2019-20	425182	198560
2020-21	432615	202031

ii. Grants-in-aid for long-term institutional strengthening

a. Creation of a SFC Cell, manned with technical staff, with a clear mandate to collect, sift, and compile such information on the finances of municipalities as would enable not just the SFCs but also the Finance Commissions to estimate the vertical fiscal gap of municipalities. The 14th Finance Commission may support the creation of such a cell and finance it for an initial period of ten years.

b. Further strengthening of the Property Tax Board and enabling them play the role that the 13th FC envisaged for them. The evidence of strengthening the Board for release of grants-in-aid should be a GIS based property count and a register of assessed values of the GIS covered properties; and

c. Support creation of a strong municipal data system, the evidence of it being an publication of an annual finance account of municipalities[29].

[29] At the very minimum, all municipalities should publish annually the finance data in the following categories. On the revenue side, it should comprise (a) own tax revenues, (b)non-tax revenues, (c) SFC grants, (d) other grants from states, (e) Finance Commission assistance, and (f) central government transfers. On the expenditure side, it should comprise (a) revenue expenditure, and (b) capital expenditure.

Box 1 - USA: The Fiscally Standardized Cities (FiSC) database

Comparing the finances of the largest US cities is critical for policy- makers, researchers, and others interested in local public finance. The concept of fiscally standardized cities (FiSCs) was developed to make these comparisons possible. While the US Census Bureau provides data on finances for individual local governments, responsibility for providing local public services is often divided among multiple governments, including the municipal (city) government and the overlying country governments, independent school districts, and special districts. The construction of FiSCs involves adding up revenues and expenditures for the city government and an appropriate share of revenues and expenditures from overlying countries, school districts, and special districts. Thus, FiSCs provide a full practice of revenues raised from city residents and businesses on their behalf, whether done by the city government or separate overlying governments. The FiSCs database includes comprehensive data on revenues, expenditures, debt, and assets for 112 of the nation's largest central cities.

Lincoln Institute of Land Policy

Explanation of Fiscally Standardized Cities, 2013

iii. Additional grants-in-aid for special category States: provide a supplementary grant to North-eastern States and other special category states who stand at a disadvantage in that the cost of providing services is far greater in these states compared to others. They are also at a disadvantage in revenue generation.

iv. Special measures for bridging the hiatus between `municipal' and `urban'. The Working Group recommends levy of property taxes in Census towns at rates applicable to municipalities falling within a radius of 25 kms or at rates that may be set by the Property Tax Board. It further recommends extension of planning norms to all Census towns so as to control their haphazard and unplanned growth of such towns in order to become eligible for FC grants under Article 280(3)(bb).

v. Criteria for allocation of grants-in-aid

Previous section of this report has argued in favour of overhauling the criteria for allocation of grants-in-aid for municipalities. The Working Group suggests the following three criteria –

(i) Municipal population, 2011: Table in Annex 9 gives the population of municipal towns which at 358.3 million is 85.4 percent of the total urban population (2011 Census).

(ii) Municipal land area, 2011. The 14th Finance Commission may like to obtain this data from the Census of India. It is still not in public domain.

(iii) Index of decentralization at the level of municipalities, 2012-13.

•Own revenue as a % of GSDP, 2012/13
•Municipal expenditure as a % of GSDP, 2012/13

The Working Group strongly advocates use of these criteria in place of the State level indicators, e.g., revenue effort of states or the distance from highest per capita income. The State level indicators have no relevance. Further, the use of the index of decentralization as measured by the own revenues of the ULBs and ULBs expenditure as a proportion of GSDP directly contributes to the goals of the 74th Amendment. The 14th Finance Commission may secure this data from the states. The 2007/08 data in respect of these two indicators is given in Annex 7.

As proposed by a few states, the Working Group considered incorporating the levels of urban poverty and slum population in the states as one of the criteria for allocating the grants-in-aid. However, on the ground that it may send a wrong signal (giving higher allocation to states that have higher poverty or slum incidence with no incentive to reduce poverty or slum incidence), the Group decided not to include it. The Group is of the view that the problem of slums can be better addressed by programmes such as the JNNURM, Rajiv Awas Yojna and the like.

Good Practices

6.7 While the overall position in respect of the finances of municipalities is unsatisfactory, facing numerous challenges, several states and municipalities have taken innovative steps to improve revenue generation. Two such steps – one in Chattisgarh which has put in place a "Chattisgarh Municipal (Establishment of Regulatory Commission) Act, 2011 and second in Karnataka where the state government has created a Municipal Reforms Cell are important citation for the 14th Finance Commission. Boxes below provide the key features of such steps.

Box 2: Chhattisgarh Municipal Revenue (Establishment of Regulatory Commission) Act, 2011

An Act to establish a regulatory commission to safeguard the interest of citizens and to rationalize and regulate user charges and other municipal revenue collections by urban local bodies, and for matters connected therewith or incidental thereto.

Functions of the Commission

The Commission shall discharge the following functions, namely –

(a)Determine and regulate the tariff for various municipal public services like water-supply, sanitation, maintenance of roads and services, issue of various kinds of certificates and/or licenses and/or permits, and operation and maintenance of services likes laughter-houses, kanji houses and all other facilities and services that are entrusted to the urban local bodies under Schedule 12 of the Constitution and/or the Chhattisgarh Municipal Corporation Act, 1956 (No. 23 of 1956) and/or the Chhattisgarh Municipalities Act, 1961 (No. 37 of 1961).

Explanation: The Commission may determine the above tariff separately for separate classes of the ULBs (Urban Local Bodies), and/or separately for ULBs on the basis of location and other factors that influence costs of facilities and services.

(b)Regulate the concession granted by the urban local body in respect of any tariffs, levies, taxes, tolls, rents, duties, fines, penalties and any other receipts.

(c)Specify and/or enforce standards with respect to quality continuity and reliability of service (s) rendered to the public by the urban local bodies.

(d)Regulate the quantum of fines and penalties imposed by the urban local bodies

(e)Determine and regulate the tolls and taxes levied by the urban local bodies.

(f)Facilitate the regime of efficient, transparent, accountable, responsible, financially self-sustainable local self-governance.

(g)Facilitate the regime of e-governance.

(h)Facilitate enforcement of citizens duties and responsibilities.

(i)Adjudicate upon disputes relating to and arising out of tariffs, levies, taxes, tolls, rents, duties, fines, penalties services and facilities involving urban local bodies.

(j)Levy fee for the purposes of this Act.

(k)Discharge such other functions as may belong to it or be assigned to it under this Act.

Box 3: Municipal Reform Cell: Karnataka

Created in 2005, the Municipal Reforms Cell (MRC) has the following functions

(a) To create e-Governance Software Platform for improving the governance of the ULBs.

(b) To create GIS based Property Tax Information system to enhance and augment tax collection and make the ULBs self sustainable.

(c) To bring in web-based modern accounting system in Municipal Governance.

(d)To computerize Birth and Death registration and certification.

(e)To introduce PGR a Citizen friendly complaint registration and tracking system that functions over internet, Phone and Paper form and to track status through complaint ID.

(f)To enable the Citizen's and other city stakeholders to understand the city's problems better and constructively participate in the governance of the ULB.

(g) To create a map linked data base of properties in the ULB

(h) To create an interface for public to retrieve certain useful information.

(i)To ensure availability of data for all the Government departments to use it for further value addition.

(j)To bring transparency into affairs of ULBs and make them more accountable

Municipal Reforms Cell co-ordinates with the project partners, namelye-Government Foundation (Application support organization), Survey of India (Technical Advice Support Agency in GIS implementation), Karnataka Urban Infrastructure Development Finance Corporation (Funding Agency) and Software Technology Parks Of India, Bangalore (for O & M of Data Center).

A state level Municipal Data Center is established within the Municipal Reforms Cell and a centralized database of all the ULBs are being maintained by it. The cell is responsible for the development, implementation and monitoring of the usage of e-Governance tools and applications, Operations and Maintenance of Database of ULBs and the task of providing in house online training for ULB staff, DUDC and DMA officials.

The Working Group believes that similar good practices from other states and municipalities may be reviewed from the standpoint of their possible impact on the finances of municipalities and advocated via an Innovation Fund.

A Final Word

Augmenting the finances of ULBs and improving the finance system are necessarily long term exercises. They need continuity on the one hand and innovation on the other. It is important to point out that the taxes that currently support local governments were designed and implemented in a different time and for a different economy. With a few exceptions, these taxes have not changed since their inception. It is now widely believed that without radical changes, these taxes cannot continue raising sufficient revenue for the 21^{st} Century.

No.N-11025/34/2012 UCD
Government of India
Ministry of Urban Development
UCD/LSG Section

202, C-Wing, Nirman
New Delhi -

Dated 15th Novem

OFFICE MEMORANDUM

Subject: Constitution of a Working Group of State Urban Development Secr examine various issues related to the 14th Central Finance Commis CFC)

In the Consultative Meeting with State Urban Development / Finance Se experts, regarding 14th CFC Matters, held on 29.10.2012 at New Delhi, it has bee to constitute a Working Group of State Urban Development Secretaries to exami issues related to the 14th Central Finance Commission. The composition of th Group is as under:

(i) Prof. O.P.Mathur, National Institute of Urban Affairs, New Delhi – Chairperson & C
(ii) Principal Secretary, Urban Development Department, Govt. of Madhya Pradesh -
(iii) Principal Secretary, Urban Development Department, Govt. of Haryana - Member
(iv) Principal Secretary, Urban Development Department, Govt. of Himachal Pradesh
(v) Principal Secretary, Urban Development Department, Govt. of Jammu & Kashmir
(vi) Principal Secretary, Urban Development Department, Govt. of Karnataka - Memb
(vii) Principal Secretary, Urban Development Department, Govt. of Mizoram – Membe
(viii) Principal Secretary, Urban Development /LSG Department, Govt. of Rajasthan
(ix) Joint Secretary (UD), Ministry of Urban Development, GOI - Member

2. The Chairperson of Working Group may co-opt any other person as Memb Matter Expert of the Group in consultation with the Ministry of Urban Development

Terms of Reference

3. The task of the Working Group of State Urban Development Secretaries inter-alia examine the following issues and arrive at a collective view w.r.t. Memo the 14th Finance Commission:

(i) The issues of conditionalities.
(ii) Differential approach for different size-classes of ULBs, for cities and to
(iii) The issue of service level benchmarks.
(iv) Criteria for allocation of grants-in-aid, including norms for assessm needs and resources.
(v) Linkage between Articles 243Y and 280(3)(c) of the Constitution.

4. The Working Group shall submit its recommendations within 3 months.

5. The tenure of the Working Group would be co-terminus with that of the Finance Commission.

(S.T.Venkata
Under Secretary to the G
Tele

Annex 2

ISSUES FOR CONSIDERATION OF THE 14TH FINANCE COMMISSION

Relating to the finances of ULBs 280(3)(c)

1. Norms for assessment of needs and resources and criteria for allocation ofgrants-in-aid. Establishing norms for assessment of needs and resources is central to making any estimates of the grants-in-aid; as the members of the Working Group are aware, India has had expenditure norms for municipal services (Zakaria Committee norms) and a large number of SFCs used them in estimating the financial requirements of ULBs. These norms have not been revised; at the same time, the SFCs have moved away from these norms on the ground that they are “obsolete”. The Ministry of Urban Development produced “service benchmarks” in 2008; however, these are expressed in physical terms and the money equivalent of these norms has not been worked out by the Ministry. The HPEC has worked out the money equivalent by using the cost of various services from a sample of JNNURM projects.

The State governments may give their views on which expenditure norms should be used for estimating the expenditure requirements of the ULBs.

These exist no norms on resources, i.e., the revenue side. No attempt has been made in the country to fix as to what the ULBs should raise, at the minimum, from the tax objects that are assigned to or devolved on them or from the non-tax component of revenues. For estimating the gap, “actual revenues” raised by them are used. It has led to the persistence of inefficiencies in the functioning of the ULBs.

The State governments may give their views on what norms for revenue raising would be appropriate without this, the entire exercise will continue to be ad-hoc as it has in the past. This is crucial for the SFCs and if the exercise of estimating the gap with norms for expenditure and revenue-raising is done, the 14th Finance Commission will be able to decide what part of the gap left unbridged by the SFCs should be met by them.

Criteria for allocation of the grants-in-aid (i.e., once the gap between needs and resources has been determined) is the next important step for the 14th Finance Commission. Criteria for the allocation of grants-in-aid have changed with the successive Finance Commissions; the redeeming aspect of this is that the two criteria that have been used consistently by all Finance Commissions are urban population and area.

The State government may provide their views – what criteria ought to be used in determining the allocation of grants-in-aid between States? In the Consultative meeting, some participants pointed out that Should States that have a “cost disadvantage” in delivering services a factor in the allocation criteria? In what way should “cost disadvantage” be assessed and factored in? Should criteria such as decentralization be brought in as was done by the XIth Finance Commission?

Issue of conditionalities

Grants-in-aid are commonly used to bridge the gap between what the ULBs need for meeting their mandated responsibilities and what they are able to raise from their tax/non-tax powers (on normative consideration). Grants accrue to the ULBs in two ways: (i) general-purpose, and (ii) specific purpose. The 11th Finance Commission gave a part of the grants for specific purposes such as creating a data base and putting in place an accounting system. The 12th Finance Commission earmarked a part of the grant for solid waste disposal services.

The 13th Finance Commission, however, made an important departure by linking grants-in-aid to “performance” in nine areas. In this case, grants are payable upon reporting “compliance” in the specified nine areas. Moreover, performance is required to be completed in all the nine areas before States become eligible for performance grants.

The State governments may give their views in respect of what conditions should form part of the grant-in-aid system? Should the conditions laid down by the 13th Finance Commission be continued or changed? Two issues are important here:

(i) Continuity in the nature of grants – how important is this aspect? Discontinuing a specific - or a performance-linked grant can be highly de-establishing for ULBs.

(ii) Some broad assessment of the share of general purpose versus conditional/performance grants. What should be the division between them?

Linkage between Article 243(3)(c) and 280(3)(c)

Absence of a link between Article 243(y) and 280(3)(c) has been underlined by every Finance Commission. The past Finance Commissions have had no option but to be “ad-hoc” in the absence of the SFC reports. While a number of suggestions have been made including amendment of the Constitutional provision for linking SFCs with the Finance Commission, no progress has been made.

The State governments may consider this, and give suggestions on the “next or the second best option” in case the SFC reports are unlikely to be available for consideration of the 14th Finance Commission.

The 14th Finance Commission

The 14th Finance Commission has now been constituted. It will invite Memorandum from States. These Memoranda in the past have focused on two aspects:

(i) As estimate of the assistance (grants-in-aid) that should flow from the Finance Commission for ULBs. Because such estimates were not based on normative considerations, the previous Finance Commissions paid no attention to them. The 14thFinance Commission will perhaps do the same, if the States just place an order of demand without any scientific basis. It is thus important that the States pay special attention to this aspect.

(ii) In what ways can be finances of the ULBs and fiscally governance be strengthened? Of late, the Finance Commissions have become sensitive to long- range improvement of the finances of ULBs. It will be important if the States can devote some space to this aspect.

Dr. ASHOK SINGHVI
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सत्यमेव जयते

भारत सरकार
शहरी विकास मंत्रालय
निर्माण भवन
GOVERNMENT OF INDIA
MINISTRY OF URBAN DEVELOPM
NIRMAN BHAWAN
नई दिल्ली-110011, तारीख
New Delhi-110011, Dated the

D.O. No.N-11025/34/2012 U
17th April, 20

To

The Principal Secretaries, Urban Development Department Municipal Administration Department / Local Self Govt. Departme of all States.

Subject: Working Group on issues for the 14th Finance Commission

Dear Sir,

Please refer to my D.O. letters of even number dated 14.1.2013 a 30.1.2013 on the above subject, as well as telephonic messages, requesting y to update the municipal finance data for the year 2011-12 and to complete t questionnaire attached with my D.O. letter of 14.1.2013.

2. You will appreciate that if we approach the 14th Finance Commission f (i) increasing the share of the divisible pool for ULBs, (ii) simplifying t performance grant system, then we need to build stronger case using the late 2011-12 financial profile of the ULBs, rather than the old data of 2007-08.

3. Similarly, Ministry will like to know precisely the grounds on which t existing system of performance grants need to be simplified. Prof. Om Praka Mathur, Convenor of the Working Group holds the view that if a case for a larg share is built on the 2007-08 data on the finances of ULBs, the 14th Finan Commission may not give it the attention that it deserves.. The same for t performance grant.

4. I would, therefore, appreciate if the data on the finances of municipaliti can be updated to the year 2011-12 and the questionnaire completed, a returned to us no later than **30.4.2013**

Thanking you and with regards,

Yours sincere

(Ashok Singhv

Copy to: Prof. Om Prakash Mathur, Distinguished Professor of Urban Economi

Consolidated Urban Local Body Revenues, 2012-13

	Estimated	Percent	Percent
	(Rs. crore)	of Total Rev	of GDP
Revenue			
Own Tax	26,409	25.6	0.32
Own Non Tax	15,300	14.8	0.18
Own Revenue	41,709	40.4	0.50
Capital Grants from Central Government	12,522	12.1	0.15
Transfers from Finance Commission	4,709	4.6	0.06
State Assignment + Devolution Transfers	22,999	22.3	0.28
Grants-in-Aid from State Government	14,258	13.8	0.17
Other Revenue	6,983	6.8	0.08
Total Other Revenue	61,471	59.6	0.74
Total Revenue	103,180	100.0	1.24

Estimated figures for 2012-13 are based on average annual growth rates from 2002-03 to 2007-08 except for Capital Grants from Central government and transfers from Finance Commission, which are taken from the Union Budget.

Annex 5

Grants-in-aid for Municipalities Recommended by the Successive Finance Commission

(Rs. Crore)

States	11th FC	12th FC	13th FC*
Andhra Pradesh	32.931	74.80	383.84
Arunachal Pradesh	0.137	0.60	6.32
Assam	4.308	11.00	50.72
Bihar	18.779	28.40	145.52
Chhattisgarh		17.60	123.44
Goa	0.927	2.40	16.38
Gujarat	26.505	82.80	260.44
Haryana	7.328	18.20	86.92
Himachal Pradesh	0.778	1.60	16.46
Jammu & Kashmir	3.132	7.60	40.86
Jharkhand		19.60	85.16
Karnataka	24.964	64.60	398.38
Kerala	15.049	29.80	145.18
Madhya Pradesh	31.202	72.20	298.86
Maharashtra	63.251	158.20	635.62
Manipur	0.879	1.80	16.34
Meghalaya	0.539	1.60	16.06
Mizoram	0.768	2.00	18.86
Nagaland	0.357	1.20	15.30
Orissa	7.992	20.80	99.22
Punjab	10.945	34.20	125.74
Rajasthan	19.883	44.00	238.86
Sikkim	0.042	0.20	0.54
Tamil Nadu	38.673	114.40	474.40
Tripura	0.803	1.60	11.14
Uttar Pradesh	50.326	103.40	590.56
Uttaranchal		6.80	38.04
West Bengal	39.498	78.60	323.08
Total Per Year	400.00	1000	4622.00
Total For Five years	2000.00	5000.00	23311.00

* Actual values will depend on the divisible pool for the respective years, also on what gets actually released out of the share of the performance grant.

Annex 6

Percent Share of States in the
FCs recommended Grants-in-aid

States	11th FC	12th FC	13th FC
Andhra Pradesh	8.23	7.48	8.30
Arunachal Pradesh	0.03	0.06	0.14
Assam	1.08	1.10	1.10
Bihar	4.70	2.84	3.15
Chhattisgarh		1.76	1.81
Goa	0.23	0.24	0.35
Gujarat	6.63	8.28	5.63
Haryana	1.83	1.82	1.88
Himachal Pradesh	0.20	0.16	0.36
Jammu & Kashmir	0.78	0.76	0.88
Jharkhand		1.96	1.84
Karnataka	6.24	6.46	8.62
Kerala	3.76	2.98	3.14
Madhya Pradesh	7.80	7.22	6.47
Maharashtra	15.81	15.82	13.75
Manipur	0.22	0.18	0.35
Meghalaya	0.14	0.16	0.35
Mizoram	0.19	0.20	0.41
Nagaland	0.09	0.12	0.33
Orissa	2.00	2.08	2.15
Punjab	2.74	3.42	2.72
Rajasthan	4.97	4.40	5.17
Sikkim	0.01	0.02	0.01
Tamil Nadu	9.67	11.44	10.26
Tripura	0.20	0.16	0.24
Uttar Pradesh	12.58	10.34	12.78
Uttaranchal		0.68	0.82
West Bengal	9.87	7.86	6.99
Total	100.00	100.00	100.00

Measuring Decentralization

	Own Tax Revenues as a % of GSDP		Municipal Expenditure as a % of GSDP	
States	2002-03	2007-08	2002-03	2007-08
Andhra Pradesh	0.26	0.32	0.88	1.18
Assam	0.03	0.05	0.14	0.26
Bihar	0.10	0.06	0.20	0.61
Chattisgarh	0.20	0.14	1.21	1.76
Gujarat	0.91	0.60	1.45	1.40
Haryana	0.10	0.05	0.33	0.40
Himachal Pradesh	0.12	-	0.28	-
Jammu & Kashmir	0.01	0.01	0.33	0.61
Jharkhand	0.08	0.09	0.36	0.43
Karnataka	0.40	0.26	1.04	1.49
Kerala	0.18	0.10	0.46	0.46
Madhya Pradesh	0.08	0.09	1.21	1.72
Maharashtra	1.48	1.47	2.52	2.94
Orissa	0.02	0.01	0.34	0.46
Punjab	0.65	0.56	0.83	0.79
Rajasthan	0.03	0.01	0.80	0.71
Tamil Nadu	0.37	0.29	1.42	1.29
Uttar Pradesh	0.10	0.07	0.82	0.54
Uttarakhand	0.06	0.04	0.35	0.29
West Bengal	0.18	0.14	0.67	0.76

Source: 13th Finance Commission, Selected States

Annex 8

Fiscal Importance of Decentralization and Local Governments, 2008

Indicators of decentralization	Countries			
	Developed	Developing	All	India
Expenditure decentralization%	22.6	14.5	17.8	1.09
Revenue decentralization %	16.3	9.4	12.2	0.54
Local governments share in the combined tax revenues of the centre, state, and local governments%	16.2	10.2	12.7	2.5

Sources:(i) IMF Government Finance Statistics. 2008.

(ii)India's figures are calculated from the municipal data as compiled by the 13th Finance Commission

Urban and Municipal Population Totals, 2011

S.No.	States	Urban Population	Municipal Population
1	Andhra Pradesh	282,19,075	241,28,019
2	Arunachal Pradesh	3,17,369	3,13,557
3	Assam	43,98,542	34,29,030
4	Bihar	117,58,016	112,66,945
5	Chhattisgarh	59,37,237	58,01,907
6	Goa	9,06,814	4,38,006
7	Gujarat	257,45,083	239,78,324
8	Haryana	88,42,103	79,14,767
9	Himachal Pradesh	6,88,552	6,70,493
10	Jammu & Kashmir	34,33,242	31,61,065
11	Jharkhand	79,33,061	53,51,345
12	Karnataka	236,25,962	223,99,014
13	Kerala	159,34,926	56,39,582
14	Madhya Pradesh	200,69,405	189,59,289
15	Maharashtra	508,18,259	467,57,988
16	Manipur	8,34,154	6,50,717
17	Meghalaya	5,95,450	3,75,930
18	Mizoram	5,71,771	5,71,771
19	Nagaland	5,70,966	5,05,440
20	Odisha	70,03,656	61,76,141
21	Punjab	103,99,146	97,12,373
22	Rajasthan	170,48,085	158,07,765
23	Sikkim	1,53,578	1,47,695
24	Tamil Nadu	349,17,440	296,95,187
25	Tripura	9,61,453	6,70,902
26	Uttarakhand	30,49,338	25,38,644
27	Uttar Pradesh	444,95,063	409,38,038
28	West Bengal	290,93,002	210,25,200
	Grand Total	3583,20,748	3090,25,134

Source: Primary Census Abstracts. Final Population Totals, 2011.