

Concept of Fiscal Capacity of Municipal Governments: Issues and Remedial Measures for Revenue Augmentation

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ABSTRACT

Globally, the role of local governments is very important in ensuring access to goods and basic services even to the marginal citizens. In India also, all the local governments, both rural and municipal, numbering about 267,428, are supposed to perform such activities. They are empowered with the constitutional status as third-tier governments in its federal structure. The 73rd and 74th Amendment Acts (CAA) to the Constitution were passed in 1992, according to which respective states were mandated to assign functional responsibilities to them as per the indicative lists in the Constitution in their jurisdictions. The CAA mandated the states to constitute their State Finance Commissions after every five years. In their recommendations they were mandated inter alia to determine on the taxes, duties, tolls and fees which may be assigned to, or appropriated to the local governments. The state legislatures were free to accept, reject or modify the recommendations. This has led to an array of non-uniformity not only at inter-state level but also at intra-state level. The issue remains that how effectively the local governments manage to exploit optimally their fiscal capacity. For this, they have to understand how to rationalise different components of it, namely, sources of revenues and capacity building of their administrators. The suggestions have come from various commissions, committees and study reports of national and international levels.

Keywords: *Area-based system; Central Finance Commission (CFC), State Finance Commission (SFC); Constitutional Amendment Act (CAA).*

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INTRODUCTION

Globally, the role of local governments at grassroots level is very important in ensuring access to essential goods and basic services, including for the most marginalised communities and citizens. Many of the United Nations Sustainable Development Goals have targets that are directly or indirectly related to the responsibilities of local actors, observed UNICEF (2019).¹ It is also a fact noticed by several committees and commissions that the local governments all over the world remain in fiscal stress as their fiscal autonomy is very limited. On the other hand, the expectations of the citizens to provide local public goods and services in terms of quantity and quality increase with the passage of time and technology. As these governments remain fiscally stressed and dependent for fiscal devolutions, it is important to understand how their fiscal capacity may be improved so that they may augment their own resources to discharge their responsibilities. If local governments are financially strong, this would help in relaxing the States fiscally too. With this clear understanding, they may rationalise, as and when required, different elements of fiscal capacity depending on the local conditions. No general formula can be prescribed. Nevertheless, principles of governance and sources of revenues would be helpful in this decision-making.

SYSTEM OF LOCAL GOVERNANCE IN INDIA

India is a federal republic with three tiers of governments: Union (Central), State (Sub-national level) and Local (Sub-state level). The Constitution of India 1952 provides a clear mandate for democratic decentralisation through the Directive Principles of State Policy.² Organisation of village panchayats implies to local governments *per se* in India referring to governmental jurisdictions at the sub-state level. The 73rd and 74th Constitutional Amendment Acts 1992 (CAA) gave recognition and protection to local governments and in addition each state has its own local government legislations. The local governments are of two types: (i) The powers of rural localities have been formalised under the *Panchayati Raj Institutions* (PRIs) system (Panchayats),³ under the 73rd CAA while (ii) Urban Local Bodies (ULBs) covered in the 74th CAA have *Nagar Palika* system (Municipalities).⁴ They derive their actual powers from their State Governments. The Central Government can only guide the States in this matter. However, despite the constitutional mandate, the growth of local governments in the country has been uneven, halting and slow as observed by SARC (India 2007) but still brought a better system compared to pre-1992 period. Nevertheless, in the history of local governance in India, the CAA 1992 was the watershed event. In 2017, there were 2,67,428 number of grassroots

level local governments. The States, where their number is less, are trying to convert some of the eligible panchayats into municipalities like Jharkhand to boost the process of urbanisation to qualify for receipt of more funds for urban causes.

NUMBER OF LOCAL GOVERNMENTS IN INDIA IN 2017

<i>Details</i>	<i>Number</i>
Total number of local governments	2,67,428
Out of which	
1. Rural	2,62,771
i. <i>Zilla Parishads</i> at the district level	632
ii. <i>Panchayat Samitis</i> at the block level	6,672
iii. <i>Gram Panchayats</i> at the village level	2,55,466
2. Urban	4,657

Size of Municipal Sector

It is interesting to observe that the size of the municipal fiscal sector in India, which is very small compared to the one in many developed and developing countries and in relation to the public services that the municipalities are mandated to deliver as noted by the Reserve Bank of India.⁵ Further, the total municipal revenue in India accounts for about 0.75 per cent of the country's GDP as against a figure of 4.5 per cent for Poland, five per cent for Brazil and six per cent for South Africa. In terms of both revenue and expenditure, the municipalities account for little above two per cent of the combined revenue and expenditure of Central Government, State Governments and local governments. This is in contrast to the situation in advanced countries, where these governments normally account for 20-35 per cent of the total Government expenditure and the principle of 'subsidiarity' is regarded as a cornerstone of fiscal federalism. Recent data on municipal finances reveal that the total revenue of municipalities is growing at a lower rate compared to the growth of combined Central and State Government revenues. This is reflected in a further decline in the existing marginal presence of local public finance in the overall fiscal structure of India.

Functional Domain

The Constitution of India provides indicative functional domain to the third-tier local governments as per CAA 1992. Two Schedules are related for this purpose: Schedule XI for panchayats and Schedule XII for municipalities. The Schedule XII under Article 243G indicates

18 functions which may be assigned to municipalities, and which have been classified into categories as per the XI-FC.

- (i) **Core Functions:** Roads and bridges; Water supply for domestic, industrial and commercial purposes; Public health, sanitation conservancy and solid waste management; Burial and burial grounds, cremations, cremation grounds and electric crematorium; Public amenities including street lighting, parking lots, bus stops and public conveniences.
- (ii) **Developmental functions:** Urban planning including town planning; Regulation of land use and construction of buildings; Planning of economic and social development; Fire services; Urban forestry, protection of the environment and promotion of ecological aspects; Vital statistics including registration of births and deaths; Regulation of slaughter houses and tanneries.
- (iii) **Welfare Functions:** Safeguarding the interests of weaker sections of society, including the handicapped and mentally retarded; Slum improvement and upgradation; Urban poverty alleviation; Provision of urban amenities and facilities such as parks, gardens, playgrounds; Promotion of cultural, educational and aesthetic aspects; Cattle ponds, prevention of cruelty to animals.
- (iv) **Agency Functions:** Protection of the environment and promotion of ecological aspects; Safeguarding the interests of weaker sections of society, including the handicapped and the mentally retarded; Urban poverty alleviation; Promotion of cultural, education and aesthetic aspects; Primary Education; Primary Health Care.

Sources of Financing

The sources of finance to discharge these responsibilities broadly are:

- (i) The own tax and own non-tax sources;
- (ii) Inter-governmental fiscal transfers from their States Governments and Central Government as per statutory provisions accepted State Finance Commissions (SFCs) and Central Finance Commissions (FCs) recommendations and also non-statutory provisions, which may be declared grants by the Governments from time-to-time as per exigencies; and
- (iii) Borrowings, if permitted.

Since the CAA 1992 does not empower them with any defined own sources of finances, they are dependent at the rationality of their respective States. Strengthening of these municipal governments in terms of their fiscal capacity is critical in discharging their mandated responsibilities. It may require rationalisation in it depending on the changing situations.

Local Governance and Fiscal Capacity

Local Governance

The local governance is dependent on a few principles as highlighted by SARC.⁶ Different components of financing which are critical in deciding the revenue-raising policies are as under since all governance processes are about fulfilling the citizens' aspirations and needs, whatever be the structure of governance. They are the following: (a) Principle of subsidiarity, (b) Principle of democratic decentralisation, (c) Devolution in real terms, (d) Convergence, (e) Citizen centricity. (For details, please see Annex-1). There is a direct relation between good governance and efficient outcomes by the Governments.

The autonomy given to any Government by the Constitution or the higher-level Government is extremely important for their functioning. The municipal governments with lower degree of autonomy would have an impact on their performance. In the sound governance of municipal governments, this comes in their way. The autonomy enjoyed by municipal corporations is maximum among their counterparts. This gradually or steeply goes down below them. It has been experienced that mostly the State Governments do not have confidence in their capabilities or their capacity to govern and thus for example, borrowing by them is very much restricted. This is also the case in empowering them to levy more taxes and also expenditure management. The capability of these governments exposes when it comes on implementation and handling of high-tech projects, like implementation of GIS-based system of property assessment and other expenditure projects. It results in depending on outsourced consultants. Even collection of revenues is an issue for them. For example, since the Jharkhand State had adopted IT-based - Property Tax Management System by ensuring real-time availability of information. For the management of this complex system, Government of Jharkhand adopted the PPP mode through appointment of three Tax Collection Agencies (TCAs) and one Project Management Unit (PMU) for better resource management of municipal finance in the State in 2017 for property tax, water user charge and trade license. The TCAs had to maintain online database also. The role of the PMU was as an advisory

to the Government based on the best practices and strategies across India and global experiences; support in making governance robust; effective monitoring of revenue collection and administration process; to bridge gap between the municipality/Citizen and the government structure.

On the issue of competency of these governments, in an interview on August 13, 2020 at the Indian Institute of Management Ahmedabad (IIM-A), N.K. Singh, the Chairman of XV-FC also expressed his views that “We have no option but to empower the panchayats and make them more responsible. Also, for that matter, the municipal governments.” He further opined, “The issue of empowering the third-tier of the Government, the urban and rural local governments, is exceedingly important, and unless that is done a lot of India’s growth potential will not be tapped.” To quote again, “There is a sense of hesitation among these to use the property tax, hesitation to come up with credible development scheme. So, we need to overcome that. These are the classic questions – what conditions, more conditions, no conditions, routing of money directly through State Government, other intermediaries, monitoring of accounts. All these are constant challenges we have to counter and we do not have a satisfactory answer to these.”

On the issue of mechanism of flow of funds from the Central Government to these third-tier governments, he added, “This is one of the very big issues we are grappling with... So, how should the money go to the panchayats? Should it go directly from the finance commission to the State panchayats or routed through State Governments. If they are not routed through the State Governments, then they (States) say they did not route through us, they gave it directly to panchayats, so we do not have any control over that. If they are routed through the State Governments, sometimes the conditions and control are such that because of their non-fulfillment of those criteria, the funds are not received by panchayats.”

Fiscal Capacity

The clear understanding of the concept of fiscal capacity helps in revenue augmentation of the local governments. Often iteration of rationalisation may be required for improvement from time-to-time if desired results are not coming forth. Fiscal capacity may be defined as the ability of the government to extract revenues to provide public goods and carry out its other functions, given an administrative, fiscal accounting structure (Kaldor, 1963). It may be referred to as tax capacity, extractive capacity or the power to tax, as taxes are a main source of public revenues. Though tax revenue is essential to fiscal

capacity but other sources of revenue include grants and natural resources. Besides, fiscal capacity is the Government's investment in its organisation - including monitoring, administration, and compliance through such things as training tax officials and running the revenue service efficiently (Besley et al, 2012). Thus, the main components of fiscal capacity are:

- (i) **Local taxes:** A local tax may be defined as "A tax levied and collected by a State/ province and or municipality. Local taxes are collected in order to fund local government services, but they are also often used to pay coupons and principals on municipal bonds. Local taxes sometimes come in the form of income or sales, but the largest example of a local tax is property tax.⁷ Also, "A local tax is an assessment by a state, county, or municipality to fund public services ranging from education to garbage collection and sewer maintenance. Local taxes come in many forms, from property taxes and payroll taxes to sales taxes and licensing fees. They can vary widely from one jurisdiction to the next."⁸ A local tax can be defined as one where the local authority determines the tax revenue by setting the tax rate and/or defining the tax base, and retains the resulting proceeds of the tax for its own purposes. These are internationally applicable definitions. In India, range of local taxes is: land-based property taxes; vacant land tax; betterment tax; advertisement tax; entertainment tax; professions tax; automotive tax, etc.
- (ii) **Local non-taxes:** As a corollary, the non-tax revenue or non-tax receipts are government revenue not generated from taxes. For example - bond issues and profits State-owned companies. The list of local non-taxes is quite long but the most important receipts under this head are interest receipts and dividends and profits received from public sector companies, others are income from assigned productive local assets; service charges; share in royalties from mining; compensation to municipal governments for the civic services; parking fees; tolls; municipal bonds, etc. (For details of principles of local taxes and local non-taxes, see Annex-2).
- (iii) **Investment on Government Organisation:** The investment of the Government training of its officials including law makers would have an impact in monitoring, administration, and compliance through such things as training tax inspectors and running the revenue service efficiently.

ISSUES TO BE ADDRESSED REGARDING FISCAL CAPACITY

Mismatch of Resources and Responsibilities

“The Eleventh Central Finance Commission of India (XI-FC), 2000” and *“The Second Administrative Reforms Commission, Sixth Report Local Governance: An Inspiring Journey into the Future (SARC), 2007”* *inter alia* are the two key reports which have observed in details the recent (post-CAA) issues of municipal governments. It may be appreciated that their observations, remarks, suggestions and recommendations are based on long-drawn discussions with State Governments, submissions from the concerned ministries of the Government of India, departments, organisations, lectures, seminars, etc. Besides there is plethora of published literature nationally and internationally. They take account of the experiences of other countries with this type of governmental entities in a federal system. General view that emerges is that the finances of the third-tier governmental entities form an important element of the larger fiscal scenario of the country, not in quantitative terms, as the panchayats and the municipalities are now the Constitutionally Local Governments engaged in providing a variety of civic amenities and infrastructure. The CAA has assigned enormous responsibilities to them including the preparation of plans for economic development that require technical competency and social justice. To perform these tasks, the municipal governments have to be financially sound with commensurate amount of powers for raising resources. However, while the Constitution has specified and listed the expenditure responsibilities, it does not provide a clear regime of taxes and revenue sources of municipal governments. The expenditure liability of a municipal government depends on the service cost, service norms and population parameters, applied to all categories of services. Revenues raised depend on the size of revenue base, extent of access to the base, the rates and the collection efficiency. The fiscal gap can be redressed in the following broad ways as suggested by Bahl & Linn (1992):⁹

- a. Reducing responsibilities,
- b. Scaling down service norms,
- c. Cutting costs and unnecessary expenditures,
- d. Enhancing power to raise revenues,
- e. Increasing transfers from higher levels of Government, and
- f. Stepping up local effort to raise revenues.

It has been observed by various commissions and committees that the own resources of municipal governments are meagre though they are required more, as per the relevant statutes, to deliver a number of core services to their constituents. In addition, they have been assigned numerous agency functions by Central and State Governments resulting in their heavy dependency on devolution from higher-level Governments.

The Ministry of Urban Development has noted that internal resources provide only for less than half the total expenditure of municipal governments. Octroi has been abolished in all but one State without a viable substitute being put in place as buoyant as it was. The cash availability to the municipal government was a great boon in their daily functioning. The compensation to the municipal governments in lieu of octroi abolition is far from meeting their needs. Local governments have been unable to exploit the next important tax, namely, property tax as a major source of revenue. The ministry also pointed out that the aggregate resource requirement of municipalities for fulfilling all their functions is significantly larger.

The international experience shows that the range of resources available to municipalities in federal countries such as the United States, Canada, Brazil, China, etc., is very broad compared to that in India. 'Own' taxes and user charges of these entities in India is grossly inadequate to meet their expenditure needs. Inability of States to assign a buoyant tax to them in the place of octroi has seriously affected municipal fiscal autonomy. Besides, elaborate State Government controls on the municipal authority to levy taxes and user charges, to set rates, grant exemptions, borrow funds, etc. and on the design, quantum and timing of inter-Governmental transfers are constraining ability of the municipalities in mobilising resources (RBI).¹⁰

Issues Related to Fiscal Capacity

The resulting mismatch between own sources and assigned responsibilities with increasing expectations of the citizens of the municipal governments can be solved by facilitating them to augment their own revenues. This would increase the level of their autonomy and less dependence on the higher-level Governments. It can be done first by identifying the issues of fiscal capacity and then removing them one by one or *en block*.

Main issues related to fiscal capacity are that the local taxes are least income-buoyant compared to their higher-level counterparts. Among all the local taxes, major tax is property tax(es).¹¹ Property tax has been a most dependable own source of tax revenue at local level all over the

world. Its share in total own source revenues remains highest (since abolition of levy of octroi¹²). While increasing the tax coverage and improving collection efficiency are immediate, compelling objectives of reform of the property tax system also require improved valuation and rationalisation of the structure of tax rates.

The XI-FC has identified certain problems that have prevented the municipal governments to exploit their full potential. Such problems are not merely confined to the proximity factor, namely, the municipal governments being too close to the people to be effective tax collectors. In most States, the tax rates have not been revised periodically and there is no standard mechanism for determination of property tax rates and their revision. Indeed, West Bengal has experimented with the institution of Central Valuation Authority and some other States have initiated reforms in the system of property taxation with provisions for self-assessment, mandatory periodic revision, dispensing with the demand notice for the tax and putting the onus on property owners for timely tax payment, etc. Most States have accorded a variety of tax concessions/ exemptions leading to revenue loss to the municipal governments. Arrears of taxes are allowed to accumulate either due to sheer inefficiency or due to delay in assessments and in appeals. Yet another major impediment to the growth of revenue from the property tax has been the rent control laws. The Rent Control Act which was passed by the Indian Government in 1948 has been detrimental in suppressing the rental values of the properties due to non-revision of rents for long times. It resulted in stunted base of the property tax and thereby not improving the buoyancy of this taxation.¹³

Another issue was taxation of Central Government properties due to the immunity provided by the Parliament as the Article 285(1) of the Constitution prescribes that the property of the Union shall, save insofar as Parliament may by law otherwise provide, be exempt from all taxes imposed by a State or by any authority within a State. The XI-FC, another Constitutional body, had also highlighted the issue relating to taxation and levy of service charges of these properties by the municipal governments. Against this, the view was that the municipal governments should be permitted to tax the properties of the Central Government also, like any other property, for supplementing their resources and that necessary amendments to the Constitution be made for the purpose.

The real potential of property taxes lies in correctly assessing the property values and in choosing an appropriate rate structure. An appropriate strategy includes the following elements:

- Broadening the tax base by instituting a Geographic Information System (GIS) technique for mapping properties in

all municipal governments with the system of self-assessment. In this form, it is simple-looking but is a technology-oriented system with the introduction of area-based system of property assessment.

- Improving collection efficiency, identifying tax evasion and delinquency and enforcing penal clauses are other areas of reforms. The municipal governments depend not only for its introduction but also for its hand-holding on contracted consultants. It is necessary to use minimum resources in the collection of taxes. These functions of the tax administration comprise the following separable component activities, namely, taxpayers' education and services; collection of information; collation of information; dissemination of information; storage and retrieval of information; verification (appraisal/assessment of information); collection of taxes; taxpayers grievances redressal system; and accountability.

Second major issue is related to the revenues from non-taxes which remain fluctuating on year-to-year basis. So, they cannot be relied upon for planning purposes. Further, the cost recovery policy from the investment in local service-oriented projects is also not based on technical soundness. Again, the rate schedules are archaic, sometimes decades old. Their revisions become difficult due to political resistance and lack of political will. (See Annex-2 for details).

These mentioned and other (not covered) issues result in creating a grey fiscal area causing the deficiency of funds for the municipal governments. Hence, the lack of adequate available funds, implies least autonomy at local level and the municipal governments are reluctant to take on projects that require financial outlay. They are often unable to finance even the most basic administrative needs such as timely payment of salary and wages to their staffs, bills to the contractors, etc. Municipal governments also suffer from structural deficiencies, i.e. no adequate secretarial support and lower levels lacking of technical knowledge which restricted the aggregation of bottom up planning. These issues affect the performance in resource-raising activities of the municipal governments.

Issue of Rationalisation of Fiscal Capacity

The process of rationalisation is to organise the system into a logically coherent system. It is a continuous process with the demands and need of the time. Now in the globally pandemic situation, all the Governments at all levels are facing unprecedented situation. Even

post-pndemic situation would likely to be sub-normal. Under this new emerging situation how the fiscal capacity which is the ability of the Government to extract revenues to provide public goods and carry out its other functions, is to be re-looked. It may be referred to as the power to taxes since they are the own main sources of public revenues. In addition to the amount of public revenue, fiscal capacity is its investment in “State structures – including monitoring, administration, and compliance through such things as training tax inspectors and running the revenue service efficiently.”¹⁴

Role of the Finance Commissions

Central Finance Commissions (CFC)

The role of Central Finance Commission¹⁵ is limited to guide all the State Governments on the issues of the municipal governments since the inclusion of the CAA 1992 in the Constitution of India. But as per constitutional provisions the Central Government has no right to intervene directly in their affairs as they are the sub-State entities. However, though it was not in the mandated Terms of References of the X-FC, but for the first time *suo moto*, it recommended for making grants to the States for panchayats of Rs 80,000 as well as for the municipalities of Rs 20,000 during the four-year period commencing from April 1, 1996. These grants were to be treated as part of the Plan of the State Governments, earmarked to be transferred to municipal governments. But no measures were taken for revenue augmentation.

Subsequently, formally the XI-FC was mandated through the Amendment of Article 280 of the Constitution of India requiring paragraphs 3(c) and 3(d) of the President’s Order, to take into consideration:

- a. the commission shall take into account the recommendations of the State Finance Commissions; and
- b. where the State Finance Commissions have not been constituted as yet, or have not submitted their report giving recommendations, the Commission will make its own assessment about the manner and extent of augmentation of Consolidated Fund of the State to supplement the resources of the Panchayats and Municipalities in the State. While making such assessment, the Commission:
 - (i) shall take into account the provisions required to be made for the emoluments and terminal benefits of the employees of local bodies including those of teachers;

- (ii) shall take into account the existing powers of the Panchayats and Municipalities to raise financial resources including those by way of raising additional taxes by the Panchayats and Municipalities; and
- (iii) the powers, authority and responsibility transferred to Panchayats and Municipalities under Article 243 G and 243 W of the constitution read with Schedules Eleven and Twelve.”

Further, regarding the XI-FC only the paragraph 6 of the President’s Order states that where the SFCs have not been constituted as yet, or have not submitted their reports giving recommendations, it should make own assessment in the matter, keeping in view the provisions required to be made for the emoluments and terminal benefits of the employees of the municipal governments including teachers; the existing powers of these governments to raise financial resources; and the powers, authority and responsibility transferred to them under Articles 243G and 243W read with the XI and XII Schedules of the Constitution regarding suggestive functional domain of the Panchayats and Municipalities. All of them have been of the opinion that certainly there is a need to streamline revenue administration in the States in order to improve own resources of municipal governments.

The dominant view was that:

- a. there may be a case to augment the consolidated fund of the States through additional grants from the Centre keeping in view the special circumstances of the States, which may justify such assistance; and
- b. certain recommendations of the SFCs for augmenting the revenues of the State may require decision making by the Central Government as they may have Centre-State and/or inter-State ramifications. The Centre can act in respect of matters such as:
 - (i) Revision of the rates of taxes/duties wherever the proceeds of such taxes/duties are to be appropriated by or assigned to the State; the Stamp Duty and duties of excise on medicinal and toilet preparations under Article 268 and the Central Sales Tax under Article 269 fall in this category;
 - (ii) Revision of rates for certain categories of non-tax revenues, which are determined by the Central Government, such

as the royalty from minerals wherever a part of such revenues have been recommended to be shared with the municipal governments;

- (iii) Issues concerning Central Public Sector Undertakings (CPSUs), railways, etc. including the property and other local taxes payable by them, return of land in their possession in excess of requirement, etc.; and
- (iv) Upward revision of ceiling on profession tax requiring a constitutional amendment.

These are but an illustrative list of issues which do require the Central Government intervention and where the decisions of the Central Government would influence the flows into the consolidated fund of a State. Measures that a FC may choose to recommend on these and other issues of a similar nature after taking into account the views of the SFCs would, therefore, be a substantial fulfillment of its constitutional mandate.

State Finance Commissions

The observations and recommendations of the FCs or other national level Commissions and Committees on such subjects are of general nature. They have limitations to address the local issues at State-level. To relax this constraint, the Constitution of India prescribed, unlike the Terms of Reference of the FCs which are stated for each of their incarnations afresh, the Terms of Reference of the State Finance Commission (SFC) are constitutionally prescribed under Articles 243(I) for panchayats and 243(Y) for municipalities (though both are similar), under which all the States of the country are mandated to constitute the SFC of their State by its Governor.

1. The Finance Commission constituted under 243(Y) shall also review the financial position of the municipalities and make recommendations to the Governor as to –
 - (a) the principles which should govern –
 - (i) the distribution between the State and the municipalities of the net proceeds of the taxes, duties, tolls and fees leviable by the State, which may be divided between them under this Part and the allocation between the Municipalities at all levels of their respective shares of such proceeds;
 - (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;
 - (b) the measures needed to improve the financial position of the municipalities;
 - (c) any other matter referred to the Finance Commission by the Governor in the interests of sound finance of the municipalities.
2. The Governor shall cause every recommendation made by the Commission under this article together with an explanatory memorandum as to the action taken thereon to be laid before the Legislature of the State.

As the CAA is silent on the list of range of taxes or non-taxes in the Constitution like Union, State and Concurrent List, the devolution of financial resources to these governments has been ensured through five-yearly periodic constitution of the SFCs that are required to make recommendations on the sharing and assignment of various taxes, duties, tolls, fees, etc., and on the grants-in-aid to these governments from the Consolidated Funds of the States. These provisions are closely related to Articles 243G and 243W (related to their functional domain) of the Constitution which require that the State legislature may, by law, entrust these governments with such powers, functions and responsibilities so as to enable them to function as institutions of self-government.

The importance of the SFCs in the scheme of fiscal decentralisation is that besides arbitrating on the claims to resources by the State Government and the municipal governments, their recommendations would impart greater stability and predictability to the transfer mechanism. Besides, the recommendations on fiscal issues, they suggest measures to improve administration, etc. but the irony is that in most cases the concerned State legislature approves the Action Taken Report (ATR), in general by slashing the recommendations of the SFC and with delays. The local governments suffer in all the cases. In a glaring example, the Government of NCR Delhi did not place on the floor of the House the report of IV-DSFC for discussions and by that time the next V-DSFC was constituted. The manner of treatment of the SFC recommendations are not comparable with the FCs, which are more or less a binding to the Central Government for acceptance. But in the case of SFCs there is no guideline. As a result, the local governments suffer heavily.

REMEDIAL MEASURES TO ADDRESS FISCAL CAPACITY ISSUES

The Amendment of Article 280 of the Constitution of India required the XI-FC onwards to suggest “measures needed to augment the consolidated fund of the States to supplement the resources of local governments on the basis of the recommendations of the SFCs”. All of them have been of the conclusion that certainly there is a need to streamline revenue administration in the States in order to improve own resources of municipal governments. The SFCs recommended measures for improvement of revenue augmentations of State finances as well as of municipal governments.

The issues of fiscal capacity impacting the revenue mobilisation through the own sources by the municipal governments cannot be handled by them alone. This can be done by all levels of Governments, since there are various areas of improvement to target.

The objective of improvement in fiscal capacity of the municipal governments is to empower them to make them less dependent on the upper-level Governments for fiscal devolution. It may be recognised that revenue-sharing in tax receipts are their right because the tax base is common to all the Governments. The grants they receive are due to externality issue in providing certain local public goods and services. If some of such essential goods and services cannot be provided by the municipal governments of their own to a certain level and range, they receive grants for upgradation as recommended by respective SFC of the State and even the FCs.

The FC-wise recommendations from XI-FC to XV-FC related measures for revenue augmentation at municipal level are provided in Annex-3.

By Central Government

- The State Governments should incentivise revenue collection by municipal governments through methods such as mandating some or all local taxes as obligatory at non-zero rates of levy; by deducting deemed own revenue collection from transfer entitlements of municipal governments or through a system of matching grants.
- With regard to property tax payable by the Central Government, the Hon’ble Supreme Court on November 19, 2009 has held that ‘charges will be paid at 75 per cent, 50 per cent and 33 per cent respectively of the assessed taxable value

of such property tax leviable on private owners, depending upon whether Union of India or its department is utilising the full services, or partial services or nil services' which is as per the executive orders of the Ministry of Finance. Based on the above judgment, the Ministry of Urban Development has sent advisories to all States and Ministries in the Central Government to take necessary action as per the judgement.

- The issue of rent control takes care if the system of property valuation is done on area-based system. Hence, the Government of India and the State Governments should issue executive instructions that all their respective departments must pay appropriate service charges to local bodies.
- The ceiling of Rs. 2,500 of profession tax was fixed in 1988 and needed to be suitably enhanced. Parliament should be empowered to fix this ceiling without going in for a Constitutional amendment every time. It was recommended that Article 276(2) of the Constitution may be amended to increase the limits on the imposition of professions tax by States to Rs. 12,000 per annum.
- A 'local finance list' may be considered with suitable amendments to the Union List, State List and Concurrent List to limit, not curtail, the discretion of the State Governments to assign taxing power to their respective municipal governments, similar to their functional domain. The municipal governments should be made more autonomous and responsible in raising their own revenues through local taxes as per their needs. Nevertheless, the autonomy of the States should remain to assign responsibilities to different types of municipal governments as per their relative competency and capability in their jurisdictions.

By State Governments

There are various steps to be taken by each State Government for their municipal governments. These measures are based on the recommendations of the XI-FC to XV-FC reports. It is assumed some of them might have been taken care by the SFCs and implemented by some of them.

It is of paramount importance that municipal governments should be able to raise required revenue to meet their current level of revenue expenditure as far as possible. However, the extent to which they can do

so, depends on the powers delegated to them under the State legislation and the rules, notifications and orders issued by the respective State Governments, besides their own will to do so. The efforts made in this direction by the States and the municipal governments would get reflected in higher revenue mobilisation by these governments from their own sources and should be accorded some weight in the principles of devolution. It may be remarked that the States with low per capita SDP will continue to have problems in raising revenue at the State-level as well as at the level of the municipal governments and would, therefore, require additional support.

1. The State Governments should incentivise revenue collection by municipal governments through methods such as mandating some or all local taxes as obligatory at non-zero rates of levy; by deducting deemed own revenue collection from transfer entitlements of municipal governments or through a system of matching grants.
2. The Government of India and the State Governments should issue executive instructions that all their respective departments pay appropriate service charges to municipal governments.
3. Given the increasing income of State Governments from royalties, they should share a portion of this income with those municipal governments in whose jurisdiction such income arises.

Local Taxes

There is a need for improving the revenue mobilisation by the municipal governments themselves. There are two major local taxes, besides user charges, for consideration of all the States.

- *Land taxes:* However, taxes on land/farm income in some form may be levied to strengthen the resource base of the municipal governments. The rate structure is also suitably fixed with provision for revision of the lease rents. The amounts so collected may be passed on to the municipal governments for improving and strengthening the civic services.
- *Property/ HouseTax:* The existing rules be reviewed and amplified to facilitate the levy of property tax and the granting of exemptions be minimised. The assessment of properties

may be done every four or five years and the municipalities should introduce the system of self-assessment. Action should be taken by the States to share information regarding property tax among the municipalities, State and Union Governments. Notifying the floor or minimum rates of property tax to improve own revenues and timely submission of audited accounts. Further, the West Bengal model may be replicated with the setting up of a Central Valuation Authority by other States too. The property/ house tax legislation should be suitably modified to overcome the impediments being faced by them. Where the property has been let out, the property tax should be made recoverable from the occupier.

- *Taxation of Central Government Properties:* While some local authorities are able to levy and collect user charges on the properties of the Central Government departments/ undertakings, many others are unable to do so. It may also be recognised that to the extent the cost of providing services is recovered by user charges, the burden on the Consolidated Funds of the States to supplement the resources of municipalities would get reduced. All the properties located in urban areas enjoy the benefit of civic services that have a cost. This principle has been recognised in the various instructions issued by the Government of India and, therefore, there is ample justification to formalise and regulate it by law. So, all Government properties, whether they belong to the Central or the State Governments, should be subject to the levy of user charges regulated by a suitable legislation.
- *Vacant Land Tax:* The levy of vacant land tax by peri-urban panchayats be considered. In addition, a part of land conversion charges can be shared by State Governments with municipalities.
- *Betterment Tax:* The States should review the position and prepare a clear framework of rules for the levy of betterment tax.
- *Advertisement Tax:* The States may like to consider steps to empower municipal governments to impose advertisement tax and improve own revenues from this source.
- *Entertainment Tax:* The States may review the structure of entertainment tax and take action to increase its scope to cover more and newer forms of entertainment.

- Octroi/Entry Tax: While there is no case of reintroduction of octroi, but it is a felt need for replacing it with a suitable tax that is buoyant and can be collected by the municipal governments.

Local Non-tax

- Surcharge/Cess on State Taxes: Cess on land-based taxes and other State taxes/ duties may be levied to mobilise resources for augmenting specific civic services and for improving their quality.
- Assigning of Productive Local Assets: The State Governments may take action to assign productive local assets to the municipalities, put in place enabling rules for collection and institute systems so that they may obtain the best returns while leasing or renting common resources.
- Royalties from Mining: Mining puts a burden on the local environment and infrastructure, and, therefore, it is appropriate that some of the income from royalties be shared with the municipal government also in whose jurisdiction the mining is done. This would help the municipal government ameliorate the effects of mining on the local population.
- Municipal Bonds: The municipal governments and States may explore the issuance of municipal bonds as a source of finance with suitable support from the Central Government. The States may allow the larger municipal corporations to directly approach the markets while an intermediary could be set up to assist medium and small municipalities who may not have the capacity to access the markets directly.
- Service charges: Municipalities should rationalise their service charges in a way that they are able to at least recover the operation and maintenance costs from the beneficiaries. The rate structure should be revised regularly to keep pace with inflation and to recover at least, as far as possible, the full operations and maintenance cost of providing these services. Municipal governments should have the power to fix the rate of taxes and user charges for themselves. People would be willing to pay, if they get better services. Hence, a principled cost recovery policy is required to be in place by the State Governments to ensure the accountability of public functionaries.

- Traditionally, costs are generalised in two parts on the basis of time period, i.e. costs in short-run and costs in long-run period. Costs are mainly of the following types:
 1. Total cost,
 2. Average cost and
 3. Marginal cost.

All the three types of costs have different connotations when using for recovery purpose. Economic and political rationale must be the guiding principle.

- There is a lot of scope for improving local finances in India through the levy of user charges and benefit taxes. Mobilising resources through reforms in non-tax sources serves the twin purpose of having a rational non-tax structure and generating greater means to achieve economic growth. Irrational structure of non-tax sources has an adverse economic effect. From the economic point of view, therefore, one has to keep in mind the objective of equity, efficiency and neutrality; especially the impact of these on the economic growth of the economy. To fulfil these objectives, one often tends to adopt an economically rational structure of non-tax sources that may not be palatable politically. A popularly elected Government, therefore, has to adopt a balance between the two. State Government should formalise the system by passing rules and regulations in this regard.
- It is reiterated that improvement of tax capacity should be done by all tiers of the Government by:
 - a. Broadening of tax base,
 - b. Streamlining the tax rates, and
 - c. Increasing capacity and expertise of tax administration.

Governments should focus on improving coverage and collection efficiency through better management.

Steps to Improve the Property Tax System, General Administration, and Specialised Local Cadre

The State must consider to setting up a State Property Tax Board, State Training Institute for local governments for proper implementation of property tax system in the State and capacity building of general

administration. In addition, there is a need for local cadre for proper administration of all local governments in the State.

Setting Up of State Property Tax Board

State Governments must put in place a State-level Property Tax Board, taking clue from the West Bengal who have experimented with the institution of Central Valuation Authority to assist all municipal governments in the State to put in place an independent and transparent procedure for assessing property tax. The Board –

- a. shall, or cause to, enumerate all properties within the jurisdiction of the municipal governments;
- b. shall review the present property tax system and make suggestions for a suitable basis for assessment and valuation of properties; and
- c. shall make recommendations on modalities for periodic revisions.

The findings, suggestions and recommendations of the Board will be communicated to the respective municipal governments for necessary action. The exact model to be adopted is left to the respective State. The suggested Board should have an adequate, capable, and well-equipped, skilled staff, to carry out such onerous task.

Setting Up of the State Training and Research Institute for Local Governments

Strengthening primarily municipal governments and in general all local governments through capacity building and better financial management was identified as a key strategy for urban development in the 11th Five Year Plan. The Plan identifies lack of skilled man power as one of the key concerns and recommends setting up of an apex agency to coordinate the activities of national and State level training institutions. Administrative Reforms Commission has also proposed urban governance capacity building programme in order to address capacity gaps at this level.

It is well understood that capacity building is a big issue among the municipal governments. It has been noticed that there is big difference between first officer and below him/her next one and so on. The municipal governments confront with various issues of general administration, accounting, local fund audit, budget-making, administration of variety of taxes, including technology-based property tax, levying user charges, computation of cost recovery of local services,

expenditure management, use of modern-day digital platform, etc. Above all there is hesitation among their higher-level Governments about their competency to handle these issues and in giving more autonomy to them. But it is observed that it is due to the fact that local administrative structure is ill-trained and not up-to-date with latest developments around them. This results in under-performance by them. This is a key issue of concern in any municipal government. So, an investment in the administrative or bureaucratic fiscal structures would help in improving fiscal capacity of the governments. Therefore, State Governments should appropriately strengthen their local fund audit departments through capacity building.

All State Governments (where there is none) must put in place a State-level Training and Research Institute for Local Governments to train all-level local bureaucracy as well as public representatives with the help of experts in their fields. Its training modules should cover all the areas of operation at all types of municipal governments. These trainings and research should be on periodic basis of refresher type and term courses also. It should arrange public interactions to make them active stakeholder of any policy at local level. This would generate the feeling of ownership among citizens in decision-making too. The Institute should be the centre for policy analysis of the local issues of the State, help in developing database, and render help in decision-making of the Government.

Thus, the objectives of the proposed Training and Research Institute thus may broadly be as follows:

- *Training and Capacity Building:* Training and capacity building activities would include need-based training to the participants in the areas of technical tools, tax policy, tax administration, exposure visits, etc. Imparting specialised training for the officials – fresh and in-service;
- *Research:* The research areas would be as desired by the municipal governments and the State Government on any issue concerning the administration of these governments. The exposure field visits to other municipal governments in the State and outside State may be conducted for the officials under the guidance of the experts of the Institute. It can develop specialised library for the researchers and other users also.
- *Knowledge Sharing:* Disseminating knowledge regarding local issues among the public at large; organising seminars and conferences on current issues related to local issues;

undertaking and promoting research in the areas of taxation, tax administration, public finance, fiscal policy and related areas suited to municipal governments;

- *Maintenance of Database:* The municipal governments are now loaded with lot of data on various items like property tax, cost-recovery estimation, user charges so on and so forth like socio-economic information, so the proposed Institute may be a data centre for them.
- *Other Functions:* Organising workshops, seminars and conferences, and any other *ad hoc* events, as deemed appropriate. This would help in teaching in an atmosphere of encouragement and constructive criticism; providing a forum for interaction between academics and users of academic research and teaching output.

Creation of the State-Level Local Cadre

There is a need for separate Municipal Cadre or Municipal Service at State-level in each State, at least bigger ones. Currently, for the Municipal Corporations, at the level of or equivalent to Commissioner, Additional Commissioner and Joint Commissioners the officers are generally drawn from the Indian Administrative Service cadre and lower officers from State services on secondment basis. There is a need to have independent Municipal Cadre of their own whose officers would carry the legacy of State policies, etc. One of the examples is of Odisha State where The Odisha Municipal Cadre, an independent municipal cadre as per which 3,213 posts is created on the 24th December, 2016 in eight different services to meet the demands of an increasing urban population. The new appointments will be made in health, sanitation and cleanliness, finance and e-governance sectors. An elaborate service rules were designed by the Government.¹⁶

SUMMARY

Globally, the local governments play a pivotal role in ensuring access to goods and basic services to the marginal citizens. In India, too it is possible, where they were empowered as constitutional status of third-tier governments with the passage of 73rd and 74th Constitutional Amendment Acts in 1992 (CAA) to the Constitution of India. All types of local governments numbered 267,428 as in 2017, of which 4,657 only were municipalities. As per the CAA, respective States were mandated to assign functional responsibilities as per the capabilities of the municipal governments from the indicative list of 18 functions in the XII schedule for municipalities. They may also

be loaded with undertaking the agency functions of the higher-level Governments too. On the contrary, the CAA is silent in providing any back-up list of financing by their own sources. In addition to this, the States were mandated to constitute every five year their State Finance Commission (SFC) on the lines of the functioning of the Central Finance Commissions. *Inter alia*, one of their functions was to determine the taxes, duties, tolls and fees which may be assigned to, or appropriated to the municipal governments. It was left at the wisdom of respective SFCs to recommend to the State Government, which in turn get approval of their State legislature to implement the approved recommendations. Since the raised revenues are far less than required to discharge their functions, it creates a fiscal gap to be filled up by devolutions from their upper-level Governments. This gap is estimated by the SFC. It poses an issue of fiscal federalism as the burden of financing falls on the fund starved States. The approved own sources are not the same, this has led to an array of non-uniformity not only on inter-State level but also on intra-State level. Various commissions and committees have highlighted numerous issues being faced by them. The XI-FCs and the Second Administrative Reform Commission (SARC) on Local Governance have made key observations and suggestions related to them, though they have been handicapped with non-availability of reliable data. The reports of the SFCs are not available even after so many years, nearly three decades. The XI-FC to the XV-FCs have tried to study the issues of municipal governments of all the States of the country.

In order to understand their fiscal issues, the municipal governments need to understand and improve the fiscal capacities for rationalisation in the areas of local taxation, local non-taxation, cost recovery policy and capacity building of their administrative cadre. The proper rationalisation would help solve the issue that how effectively the local governments may manage to exploit optimally their fiscal capacity. The suggested measures, *inter alia*, setting of State Property Tax Board and also the State Training and Research Institute for Local Governments along with creation of Municipal cadre would go a long way in improving their fiscal capacity and thus relax the dependence on higher Government. It is a hard fact that these issues can be handled meaningfully by the joint efforts of all levels of Governments with sincerity and political will.

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ANNEX-1

PRINCIPLES OF LOCAL GOVERNANCE

The Second Administrative Reforms Commission (SARC), Sixth Report Local Governance: An Inspiring Journey into the Future (2007) clearly set out the following principles of local governance for guidance.

1. Principle of Subsidiarity: The central idea of the principle of subsidiarity is that citizens as sovereigns and stakeholders in a democracy are not only the final decision-makers but also the consumers of all services provided by the Government. Thus, they delegate upward the rest of the functions which require economies of scale, technological and managerial capacity or collective amenities to the local governments. It implies that functions shall be carried out closest to citizens at the smallest unit of governance possible and delegated upwards only when the local unit cannot perform the task. Application of the subsidiarity principle has three great advantages in practical terms.

- (i) Local decision-making improves efficiency, promotes self-reliance at the local level, encourages competition and nurtures innovation.
- (ii) Democracy is based on three fundamental assumptions: all citizens are equal irrespective of station and birth; the citizen is the ultimate sovereign; and the citizen has the capacity to decide what is in his best interest. Subsidiarity is the concrete expression of these foundations of a democratic society.
- (iii) Once decision-making and its consequences are integrally linked at the local level, people can better appreciate that hard choices need to be made. Such awareness promotes greater responsibility, enlightened citizenship and maturing of democracy.

2. Principle of Democratic Decentralization: While subsidiarity should be the overarching principle in restructuring governance, in practical constitutional terms, it can be applied only through effective decentralization. It is in recognition of this, that the 73rd and 74th CAA were enacted in 1992. While the local government structure and attendant institutions are created by a constitutional mandate, the actual functions to be devolved on local governments are the responsibility of the States. Therefore, effective democratic decentralization from States to local governments should be the cardinal principle of administrative reforms. Such a decentralization should be influenced by four guiding norms.

- (i) There should be a clear link in citizens' minds between their votes and the consequences in terms of the public good it promotes.
- (ii) Decentralization tends to promote fiscal responsibility, provided there is a clear link between resource generation and outcomes in the form of better services.
- (iii) There is considerable asymmetry of power in our society.
- (iv) In centralized structures, citizen participation and ownership are illusory despite national citizen sovereignty. The closer the Government process is to the citizen, the greater the participation, stakes and understanding of the issues.

3. *Devolution in Real Terms:* The principles of subsidiarity and democratic decentralization cannot be operationalised by mere creation of elaborate structures and periodic elections. Devolution, to be real and meaningful, demands that local governments should be effectively empowered to frame regulations, take decisions and enforce their will within their legitimate sphere of action. Such empowerment should be clearly and unambiguously defined by the Constitution and State legislatures. Even legislated empowerment remains illusory unless public servants entrusted with the discharge of responsibilities under the local governments sphere are fully and permanently under local government control, subject to protection of their service conditions. Only then is the responsibility of the local government commensurate with the authority. Finally, fiscal devolution to the local governments must meet two standards: the local government must be able to effectively fulfill its obligation; there must be sufficient room for flexibility through untied resources, to establish priorities, devise new schemes and allocate funds. Equally important, there must be both opportunity and incentive to mobilise local resources through local taxes, cess and user fees, subject to norms of financial propriety and accountability. While devolving funds to local governments, it needs to be ensured that issues of regional equity - inter-State as well intra-State - and minimum entitlement of citizens across the country, the rights guaranteed to citizens under the Constitution and the legitimate expectations of a better life and reasonable opportunity for vertical mobility to all children are similar across the country. Therefore, the devolution package to local governments must go beyond the per capita norms and should take into account certain benchmarks regarding quality of life and services.

Equally important is the building of capacity of local governments

to discharge their functions effectively. Strengthening organizational and management capacity, constant training and human resource development activities, conversion of State agencies into expert manpower pools providing guidance and support on demand, strong federations, pooling of resources, talent and management practices, ability to attract expertise available outside Government to meet the growing need for high quality human resources in public management are some of the crucial challenges in enhancing the capabilities of local governments.

Finally, real empowerment not only demands devolution and capacity building but strategies also need to be evolved to overcome the resistance of the State executives and Governments as the compulsions of real politics often preclude the possibility of any serious measures to enable local governments to function as institutions of self-governance.

4. Convergence: It must be recognized that the citizens' needs and concerns are indivisible. But in large, complex governance structures compartmentalization is inevitable and this fragmentation should yield place to convergence based on even in an otherwise efficient and honest administration, isolated functioning of disparate Government agencies and departments complicates the citizen's life immeasurably. Therefore, convergence must be a key principle in the organization of local governments addressing the following four broad areas of convergence.

- a. The rural-urban divide in the intermediate and district tiers of local governments is a colonial legacy. At the primary level the needs of the rural population and the approaches required to address them are somewhat different from those of urban people. Also, the occupational profile of the population lends itself to rural-urban categorization.
- b. The parastatal bodies function totally independent from the local governments and are directly accountable to the State Government. Thus, the local governments are often divested of their important functions. Such proliferation of parastatals runs counter to the principle of subsidiarity and precludes effective citizens' participation in the management of these services. The citizen is compelled to deal with a multiplicity of authorities to access even the basic amenities and services.
- c. The citizen must be enabled to interact with all service providers through a single window as far as practicable. Increasingly, all over the world, several disparate services

provided by different agencies of Government, are available to citizens under one roof. For instance, the post office is a nodal agency for voter registration and many other services in some countries. In Germany, a local government office is the point of contact in obtaining a passport, though the actual service is provided by the federal Government. Similarly, collection of tariffs, fees and taxes by various service providers can be at a common kiosk and all complaints and suggestions can be received at a common Call Centre.

- d. Empowerment of stakeholders and local governments should be seen as a continuum. Wherever a group of stakeholders can be clearly identified, they should be directly empowered to the extent possible, so that stake-holding and power-wielding are integrally linked. However, stake-holder empowerment should not be seen as antithetical to local government empowerment. Both are part of the same quest for local governance based on subsidiarity. At the same time, the representative local government and the empowered group of stake-holders cannot function in isolation. Just as local government have to function in close coordination, local government and empowered stake-holders' groups should work in concert. The larger functions of support, coordination and policy will be with the local governments, and the actual day-to-day management and service delivery will be the responsibility of stake-holders. This convergence between the empowered stake-holders' groups and local governments should be a key feature of decentralization.

5. Citizen Centricity: The citizen is the heart of a democratic system, therefore, all governance institutions, particularly local governments should be judged by the satisfaction of citizens and the direct empowerment of people.

Representative democracy is a necessary mode of organization in Government. While citizen sovereignty is acknowledged, it is impractical for citizens to participate in decision making in large structures. However, at the local community level, the citizen as stakeholder can directly participate in decision making, relatively easily. A Gram Sabha comprising all the adult residents of a village is a far more legitimate guardian of public interest. Similarly, in urban governance too, we need to create smaller structures for decentralized decision making with people's participation.

The most important form of citizens' participation is a community of clearly identifiable stakeholders in the delivery of a specific public service. For instance, parents sending their children to a public school, farmers receiving irrigation from a common source, producers selling their produce in a market and members of a cooperative are groups of clearly identifiable stakeholders who also need empowerment in consonance with the principle of subsidiarity.

ANNEX-2

CHARACTERISTICS OF LOCAL TAX AND NON-TAXES

Let us discuss little bit more about local taxation and non-taxes two main components of own resource raising powers to help in understanding them clearly to make judgement as to how they are in the local governments.

Principles of assignment of local taxes

A local tax can be defined as one where the local authority determines the tax revenue by setting the tax rate and/or defining the tax base, and retains the resulting proceeds of the tax for its own purposes. Resource mobilization lies at the heart of economic development. Among various means of resource mobilization tax is most closely related to the question of state formation and capacity (UNCTAD, 2009). Known principles and best practices of local public finance point to the following desirable characteristics of a local tax, namely, Immutability, Adequacy, Buoyancy, Stability, Equity, Administrative Ease, Non-exportability, and Visibility.

Using the criteria of equity (consistency of revenue sources with expenditure needs) and efficiency (minimizing resource cost) principles of tax assignment for local governments should be followed:

- (a) Taxes on completely immobile factors of production are best suited for local levels;
- (b) Taxes of lower levels of Government should be cyclically stable; and
- (c) Benefit taxes and user charges are to be used appropriately at all levels.

All land-based and profession taxes are considered suitable for local governments. There is a need to understand a few things on property tax. It is the most important local tax as consistent and dependable source world-wide. The local governments are faced with the problem of assessing the value of several property units at a particular year. The large number of real estate units causes the tax administration to be more complicated, but at the same time it allows the use of mass appraisal. Because of the numerous property units, the appraisal can be based on statistical methods. The mass appraisal focuses on a group of properties and calculates the averages on properties with similar characteristics.

The Unit Area Method (UAM or area-based method) is simple,

arithmetical and transparent. It is based on fixing a base unit area value per square metre of covered space for calculation of property tax. The tax for a particular holding is based on the Annual Rateable Value (ARV) of the holding arrived at by multiplying base Unit Area Value (UAV) assigned to the zone by the covered space of the holding and the Multiplicative Factor Values (MFV) for occupancy, age, structure, construction, location and use of the holding. But for mapping of the properties, the Geographical Information System (GIS) makes it technology-driven. That is why the local governments have to depend on the expert consultants for implementation and hand-holding till the local staff gets trained.

Revenue potential

Revenue potential may be taken as the amount of revenue that could be raised in a given jurisdiction if a normal tax rate is applied to a base that is adjusted to normal exemptions and is subjected to a normal level of administrative effort though its estimation is no easy task. Also, it is dependent on the goal that is to be pursued in reforming the local tax system and the assumptions that necessarily accompany the reform measures. It could be higher or lower depending on the objectives fixed for reforming the local tax system and the constraints imposed. For designing tax reform, it is fundamental to have an understanding of the factors affecting local tax bases and how changes to a tax base will result in a range of fiscal impacts upon different local taxing jurisdictions. The common assumption is that an expanding tax base benefits the existing taxpayers. However, the ultimate impact on taxpayers will vary depending on which tax bases are affected.

Role of tax administration

It is widely accepted for all the taxes that a significant portion of potential tax revenue is not collected because of poor tax administration and high tax evasion. The question is whether the complexity of the tax structure or high tax rates have led to a high incidence of tax evasion, or if lax tax administration by itself has been unable to fulfill the revenue objectives implied by the tax structure. In practice, it is likely that both tax policy and tax administration have mutually affected each other. It is widely recognized that tax policy and tax administrations are intrinsically linked.

Tax collection is merely transfer of resources from the large masses of taxpayers to the Government. It is necessary to use minimum resources in the collection of taxes. These functions of the tax administration comprise the following separable component activities:

Taxpayers education and services; Collection of information; Collation of information; Dissemination of information; Storage and retrieval of information; Verification (appraisal/assessment of information); Collection of taxes; Taxpayers grievances redressal system; and Accountability.

Own non-taxes as user charges and benefit taxes

The Government, also earn some recurring income from own non-tax sources. The number of sources of own non-tax revenue are very large with wide variance in the quantum of collections per source, though the quantum of collection per source is much less compared to tax collections. They include the revenue from the infrastructure services provided by the Government. The Government also collects interest on the loans and funds advanced for various purposes.

When beneficiaries are identifiable and benefits can be measured, user charges are the first best instruments of financing public services. They promote efficiency by providing information on demand to the providers of public service and also ensure that what the public sector supplies is valued (at the margin) by citizens. They act as instruments to ensure the accountability of public functionaries. In the case of 'collective' services where beneficiaries are not identifiable or services are not measurable and levying user charge is not possible, benefit taxes are the appropriate instruments of financing. When clear linkages exist between the taxes levied and the expenditures financed, earmarked benefit taxes constitute indirect user charges or surrogate prices for services. Earmarking then facilitates the rational choice by tax payers. There is a lot of scope for improving local finances in India through the levy user charges and benefit taxes. "Users pay", "Beneficiaries pay" and "Polluters pay" are the cornerstones of local public finance. In fact, non-tax revenues can fluctuate significantly from one year to another. Indeed, their value is correlated with changing economic circumstances and may vary the profits of fines and penalties.

Principles of cost recovery

The principle of cost recovery is applied as charges against these services provided by the Government. Mobilizing resources through reforms in non-tax sources serves the twin purpose of having a rational non-tax structure and generating greater means to achieve economic growth. Irrational structure of non-tax sources has adverse economic effect effects that invalidate growth objectives. From the economic point of view, therefore, one has to keep in mind the objective of equity, efficiency and neutrality; especially the impact of these on the economic

growth of the economy. To fulfil these objectives, one often tends to adopt an economically rational structure of non-tax sources that may not be palatable politically. A popularly elected Government, therefore, has to adopt a balance between the two.

Traditionally, costs are generalized in two parts on the basis of time period, i.e. costs in short-run and costs in long-run period. Costs are mainly of the following types: 1. Total cost, 2. Average cost and 3. Marginal cost. If the costs are recovered by applying these principles keeping in mind the objective of welfare maximization of the Government. All the three types of costs have different connotation when using for recovery purpose. Economic and political rationale must be the guiding principle.

ANNEX-3

RECOMMENDATIONS OF THE UNION FINANCE COMMISSIONS ON FISCAL CAPACITY OF LOCAL GOVERNMENTS

XI-FC was the first FC to make recommendations following measures on additional efforts needed- both at the local and State level for raising the resources to meet the growing requirements of the local governments:

Land taxes: In many States, land revenue has either been abolished or land holdings up to a certain size have been exempted. However, taxes on land/farm income in some form may be levied to strengthen the resource base of the local governments of which the rate structure suitably fixed. In the urban areas, similar measures should be taken for revision of the lease rents. The amounts so collected may be passed on to the local governments for improving and strengthening the civic services.

Surcharge/Cess on State taxes: Cess on land-based taxes and other State taxes/duties may be levied to mobilise resources for augmenting specific civic services and for improving their quality.

Profession tax: Article 276 of the Constitution provides for levy of a tax on professions, trades, callings or employment for the benefit of the State or local governments at a rate not exceeding Rs.2,500 per taxpayer per year. States should levy this tax with a view to supplement the resources of local governments or they should empower the local governments to levy it. The ceiling was fixed in 1988 and needs to be suitably enhanced. Parliament should be empowered to fix this ceiling without going in for a Constitutional amendment every time.

Reforms in local taxes and rates

There is a need for improving the revenue mobilization by the local governments themselves There are two local taxes, besides user charges, for consideration of all the States.

Property/House tax: The West Bengal model may be replicated with the institution of Central Valuation Authority by the other States. The property/ house tax legislation should be suitably modified to overcome the impediments being faced by them. Where the property has been let out, the property tax should be made recoverable from the occupier.

Octroi/Entry tax: While it was not in favour of reintroduction of octroi, but felt a need for replacing it with a suitable tax that is buoyant and can be collected by the local bodies.

User charges: The rate structure should be revised regularly to keep pace with inflation and to recover at least, as far as possible, the full operations and maintenance cost of providing these services. local governments should have the power to fix the rate of taxes and user charges for themselves. That will make for accountability at the margin. People would be willing to pay, if they get better services.

Local governments should be able to raise revenue to meet their current level of revenue expenditure as far as possible. However, the extent to which they can do so, depends on the powers delegated to them under the State legislation and the rules, notifications and orders issued by the respective State Government, besides their own will to do so.

The efforts made in this direction by the States and the local governments would get reflected in higher revenue mobilization by these governments from their own sources and should be accorded some weight in the principles of devolution.

It was awareness that the States with low per capita SDP will continue to have problems in raising revenue at the State level as well as at the level of the local governments and would, therefore, require additional support.

Taxation of Central Government Properties: While some local authorities are able to levy and collect user charges on the properties of the Central Government departments/undertakings, many others are unable to do so. It may also be recognized that to the extent the cost of providing services is recovered by user charges, the burden on the Consolidated Funds of the States to supplement the resources of panchayats and municipalities would get reduced. All the properties located in rural or urban areas enjoy the benefit of civic services that have a cost. This principle has been recognised in the various instructions issued by the Government of India and, therefore, there is ample justification to formalise and regulate it by law. So, all Government properties, whether they belong to the Central or the State Governments, should be subject to the levy of user charges regulated by a suitable legislation.

The XII-FC identified 14 best practices which local governments could usefully adopt, including enhancing taxation powers, levy of user charges, setting up of SFCs in a timely manner and regular maintenance of accounts and audit. It has also suggested that the State Governments should be discouraged from following the recently established trend of abolishing panchayat level taxes like property tax and profession tax, and that towards this end, a significant component of the fiscal discipline

criterion should be related to the State Governments' stance towards enlargement and maintenance of the panchayat tax base.

The Ministry of Urban Development noted that internal resources provide for less than half the total expenditure of local governments. Octroi has been abolished in all but one State without a viable substitute being put in place. Local governments have been unable to exploit property tax as a major source of revenue. The ministry also pointed out that the aggregate resource requirement of municipalities for fulfilling all their functions is significantly larger.

The XIII-FC recommended that the

The State Governments should incentivise revenue collection by local governments through methods such as mandating some or all local taxes as obligatory at non-zero rates of levy; by deducting deemed own revenue collection from transfer entitlements of local governments or through a system of matching grants.

The Government of India and the State Governments should issue executive instructions that all their respective departments pay appropriate service charges to local governments.

Given the increasing income of State Governments from royalties, they should share a portion of this income with those local governments in whose jurisdiction such income arises.

The XIV-FC recommended on

Own local taxes

Property tax: The existing rules be reviewed and amplified to facilitate the levy of property tax and the granting of exemptions be minimized. The assessment of properties may be done every four or five years and the municipalities should introduce the system of self-assessment. Action be taken by the States to share information regarding property tax among the municipalities, State and Union Governments.

Vacant land tax: The levy of vacant land tax by peri-urban panchayats be considered. In addition, a part of land conversion charges can be shared by State Governments with municipalities and panchayats.

Betterment tax: The States should review the position and prepare a clear framework of rules for the levy of betterment tax.

Advertisement tax: The States may like to consider steps to empower local governments to impose advertisement tax and improve own revenues from this source.

Entertainment tax: The States review the structure of entertainment tax and take action to increase its scope to cover more and newer forms of entertainment.

Professions tax: Raising the ceiling of professions tax from Rs. 2,500 to Rs. 12,000 per annum. It further recommended that Article 276(2) of the Constitution may be amended to increase the limits on the imposition of professions tax by States. The amendment may also vest the power to impose limits on Parliament with the caveat that the limits should adhere to the Finance Commission's recommendations and the Union Government should prescribe a uniform limit for all States.

Own local own non-tax

Assigning of productive local assets: The State Governments take action to assign productive local assets to the panchayats, put in place enabling rules for collection and institute systems so that they can obtain the best returns while leasing or renting common resources.

Service charges: Municipalities should rationalize their service charges in a way that they are able to at least recover the operation and maintenance costs from the beneficiaries.

Royalties from mining: Mining puts a burden on the local environment and infrastructure, and, therefore, it is appropriate that some of the income from royalties be shared with the local government in whose jurisdiction the mining is done. This would help the local government ameliorate the effects of mining on the local population.

Compensation to local governments for the civic services: The Union and State Governments examine in depth the issue of properly compensating local governments for the civic services provided by them to government properties and take necessary action, including enacting suitable legislation, in this regard.

Municipal bonds: The local governments and States explore the issuance of municipal bonds as a source of finance with suitable support from the Union Government. The States may allow the larger municipal corporations to directly approach the markets while an intermediary could be set up to assist medium and small municipalities who may not have the capacity to access the markets directly.

The XV-FC recommended that in the case of municipalities, they should be differentiated between municipalities by dividing them into two categories:

- Million-Plus urban agglomerations/cities, and
- All other municipalities with less than one million population.

Larger municipalities will have a tendency to grow faster, and grants are to be provided to fifty million-plus municipalities on agglomeration basis, with special emphasis on meeting the challenges of poor air quality, ground water depletion and sanitation. For non-million-plus municipalities, 50 per cent of the funds are untied and the remaining 50 per cent tied, with an equal share for drinking water and sanitation. Though it has not recommended any conditions for municipalities in 2020-21, it recommended two entry level conditions in the subsequent years - notifying the floor or minimum rates of property tax to improve own revenues and timely submission of audited accounts.

The interim report of the XV-FC reiterated that improvement of tax capacity should be done by all tiers of the Government by

- Broadening of tax base,
- Streamlining the tax rates, and
- Increasing capacity and expertise of tax administration.

Governments should focus on improving coverage and collection efficiency through better management.

Endnotes

1. For example, of the 169 SDG targets, 21 per cent can only be implemented with the help of local actors, while an additional 24 per cent should be implemented with the help of local actors. Source: adelphi and Urban Catalyst, Sustainable Development Goals and Habitat III: Opportunities for a successful New Urban Agenda, Cities Alliance Discussion Paper No. 3, Cities Alliance, Brussels, November 2015.
2. Article 40. *Organization of village panchayats*. The State shall take steps to organize village panchayats and endow them with such powers and authority as may be necessary to enable them to function as units of self-government.
3. The PRI system is a three-tier system with elected governments at the Gram Panchayat for each village or group of villages, a Tehsil level council, and a Zilla Panchayat at the district level.
4. Three types of municipal governments are: (1) Municipal Corporation, (2) Municipality, and (3) Notified Area Council or City Council. Among all ULBs, municipal corporations enjoy a greater degree of fiscal autonomy and functions although the specific fiscal and functional powers vary across the States, these local governments have larger populations, a more diversified economic base, and deal with the State Governments directly. On the other hand, municipalities have less autonomy, smaller jurisdictions and have to deal with the State Governments through the Directorate of Municipalities or through the Collector of a district. These local governments are subject to detailed supervisory control and guidance by the State Governments.

5. <https://rbidocs.rbi.org.in/rdocs/Content/PDFs/82508.pdf>
6. The Second Administrative Reforms Commission (ARC), Sixth Report Local Governance: An inspiring Journey into the Future, 2007.
7. <https://financial-dictionary.thefreedictionary.com/Local+taxes>
8. <https://www.investopedia.com/terms/l/localtax.asp>
9. Roy W. Bahl and Johannes F. Linn (1992) in Urban Public Finance in Developing Countries, World Bank has provided some general principles for identifying the revenue sources appropriate to financing particular types of local expenditures:
 - (i) Where the benefits of public services are measurable and accrue to readily identified individuals in a jurisdiction, user charges are the appropriate financing instruments;
 - (ii) Local public services such as administration, traffic control, street lighting and security, which are services to the general public in the sense that identification of beneficiaries and measurement of benefits and costs to individuals is difficult, are most appropriately financed by taxes on local residents;
 - (iii) The cost of services for which significant spillovers to neighbouring jurisdictions occur e.g., health, education and welfare, should be financed by substantial state or national inter-Governmental transfers;
 - (iv) Borrowing is an appropriate source to finance capital outlays on infrastructure services particularly, public utilities and roads.

The above principles may be kept in view when the State Governments consider reforming the assignment of local government revenue sources to match their expenditure requirements arising of their functional domain.
10. <https://rbidocs.rbi.org.in/rdocs/Content/PDFs/82508.pdf>
11. Sometimes this tax is attached with property-related services like sanitation, garbage collection, street light, public water supply, etc. The application of general property tax exclusively or with a family in combination of other service taxes loaded on the same tax base varies among taxing authorities in the country. There is no uniform rule on this.
12. So far, there is no substitute to Octroi duty since its abolition. Grants as compensation in lieu of this is not a complement to this.
13. Rent Control Act: The Rent Control Act was passed by the Indian Government in 1948. This Act was passed so as to regulate the various norms of tenancy and land ownership and to curb the exploitation of either the landlord or the tenant due to rent or occupancy. The following are the various provisions of the act in favour of the landlord and the tenant –

(1) Rights of Landlord Under the Act

Evicting a Tenant – Under the Rent Control Act, the landlord has the right to evict the tenant. The states have individual byelaws. In Punjab and Haryana, a

landlord can evict the tenant on the basis of a personal, bona fide requirement, whereas the same does not happen in the Karnataka byelaws. But playing by ordinary rationale, courts allow for the eviction of the tenants on the landlord's request, keeping into consideration facts and circumstances. The Draft Model Tenancy Act, 2015 shall make matters easier for the landlords.

Temporary Recovery of Possession – In order to make all the necessary repairs, alterations and changes in the property, a landlord has a right to recover temporary possession of the same.

Rent Changes – The Draft Model Tenancy Act is an instrumental legislation. Rent changes are something that usually occurs in accordance with the whims and fancies of the landlord. The rent cannot be unreasonably high or increased suddenly, however, the upper hand remains of the landlord and he can periodically increase the rent of the property.

(2) Rights of Tenant Under the Act

Fair Rent – A landlord cannot unjustifiably increase the rent, however, he can approach the Rent Control Court in order to fix a rent. The rent has to be fair which is usually supposed to be 9 per cent of the value of the building in totality including the cost of construction, the market value of land and amenities being provided. The landlord also does not possess the right to disconnect essential services of electricity and water even due to rental reasons. They can approach the court, however, cannot deprive you to your basic supplies and amenities.

Eviction – In order to evict a tenant the landlord is required to approach the court and cannot unjustifiably evict the tenant. Byelaws play a major role in such a scenario. The Maharashtra byelaws are such that do not allow for the eviction of the tenant if the tenant is willing to acquiesce and agree to the changes in rent and is willing to pay the same. A notice is also to be given ninety days prior to filing a suit. (Courtesy NRI Legal Services <https://www.nrilegalservices.com/rent-control-act-india/>)

14. When investment in these administrative or bureaucratic fiscal structures are specific to the Government's power to extract resources, fiscal capacity is moreover related to a larger concept of state capacity. Finally, given that public goods funded by fiscal capacity include infrastructure development and social insurance, a state's fiscal capacity is essential to its economic growth, development, and state-building. Also, fiscal capacity and tax structure depend immensely on the strength and capabilities of the tax administration itself. Fiscal capacity is key in deciding the fiscal policy of the Government.
15. It is a question whether it should be called 'Central' or 'Union'. Both are used and there is no consistency in its usage, though, it is better 'Union' is as per the Constitution as there is no mention of "Central". However, in common usage it is "Central". The same is true with the usage of "Central Government" or "Union Government".
16. <https://www.lawinsider.com/documents/ak2e3H5vDvv#> municipal-services-or-municipal-cadre