

## **Lecture II**

### **Reorienting public finance with reference to local governments**

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#### **Abstract**

*This lecture develops the argument that Western public finance theories need significant modification to make them relevant to fit in with the decentralisation reform packages that 73rd 74th Amendments made in the Constitution of India and the institutions they have provided for. Some relevant suggestions to reconstruct public finance of India with its local finance components and make it a viable and organic part of Indian fiscal federalism is presented in this paper.*

**Keywords:** *Market-preserving federalism, own source revenue, fiscal illusion, hard budget, union fiancé commission, state finance commission*

#### **4.0. Received theories of fiscal federalism and the 73<sup>rd</sup>/74<sup>th</sup> constitutional amendments**

In the last lecture we have covered a large ground. We have tried to define public finance from a wide spectrum. We have noted how the leading text books as well as the FGT and SGT have failed to walk beyond the market preserving federalism. I opened the doors of a new pathway of working public finance as tool for building a new social democracy. To be sure, Thomas Piketty's works on capital and inequality provided the motivation.

First I shall try to give a brief critique of the western theories of fiscal federalism with special reference to the new dispensation of Indian local governments in India.

The normative theory of fiscal federalism with a small beginning in the 1950s has grown in size and substance and has considerable bearing on policy choices of several advanced countries of the world. Some indicative salience with focus on local governments are discussed. The issue of local finance was brought to theoretical literature prominently by Charles Tiebout (1956) as I have told you in the previous lecture. His model widely called 'voting-with-the feet' theory formulated under severe restrictive assumptions envisages the possibility of a consumer 'to shop' around and choose a jurisdiction where the burden of taxes and benefits of services obtained could be matched<sup>1</sup>. To be sure, it was the well known tripartite classification of public sector responsibility by Musgrave (1959) viz., stabilization, distribution and allocation that provided the earliest guidelines for the sharing of functions among the various levels of government. In the decentralized system, allocative efficiency and welfare gains are enhanced because residents in different jurisdictions could choose the mix of public local goods and taxes that best conforms to their preferences [Smoke (200):6]. A vast volume of literature on fiscal federalism has been built starting with Musgrave and indicatively by Tiebout three years earlier. No one can miss the contributions of Oates beginning with his 'decentralisation theorem' (1972) which argues for a geographical area that internalizes the benefits and costs of a public good including precisely the set of individuals who consume them. It is asserted that welfare is maximized if each local government provides the Pareto-efficient output for its constituency [Oates (1972):35-38]. The ideal Pareto-efficient jurisdiction of Oates cannot be achieved in practice even in developed countries, not to speak of poor countries and backward jurisdictions where many citizens simply cannot even pay taxes or user charges. Imagine a world where fiddling a Nero cannot be disturbed while Rome is burning or specifically the affluent rich of the world who cannot make sacrifices (e.g., taxation) while people die of malnutrition and hunger. Following Qian and Weingast (1997) Oates (2005) distinguishes between the first generation theory of fiscal federalism and the emerging second generation theory of fiscal federalism. I have already noted this in the first lecture.

The first generation theory (FGT) of public economics comprises what Oates (2005) calls the Arrow-Musgrave-Samuelson (AMS) perspective which has been formalized by him in his 'decentralised theorem'.

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<sup>1</sup> The literature on the merits and demerits of Tiebout model also with empirical support are ably summarized in King (1984). Wallace Oates who pointed out that this model 'involves a set of assumptions so patently unrealistic as to verge on the outrageous' [See Oates (1981):93], years later affirms that it played "a major role in the literature in local public finance"[Oates (2005):354].

The FGT "envisioned a setting in which governments at different levels provided efficient levels of outputs of public goods for those goods whose spatial patterns of benefits were encompassed by the geographical scope of their jurisdictions. Such an outcome was called a 'perfect mapping'(or "fiscal equivalence" to use Mancur Olson's (1969) terminology) [Oates (2005):351].

Of course FGT assigned a major role to the central government in establishing an equitable distribution of income and high level of stabilization. In FGT the assignments of functions and taxes were built largely on the Musgravian model, but it also addressed the issue of transfers including the equalizing potential of grants in the theory and practice of fiscal federalism.

The so-called second generation theory of fiscal federalism (SGT) although very wide-ranging is quint-essentially only a refined elaboration of the first. It tries to strongly lay the foundations of a market preserving federalism. It seems the presumption is that strong markets contribute to the viability of the fiscal federal structure [See Wildasin (2004)]. There is a strong emphasis on hard-budget constraints for local governments. The pervasive phenomenon of local governments going to central governments for fiscal reliefs and bailouts are strongly discouraged in a well-functioning federalism. Can we follow this in contemporary India? The answer is a big no.

We shall now try to explain why these theories cannot be accepted without modifications in the context of the local governance system envisaged in the two CAs. One, the theories did not evolve out of the practical needs of this country. The so-called costless out-migration of 'consumers' in search of their preferred public-goods package or voting by feet as Tiebout puts it cannot be imagined for rural India tied to land. Many go out for work to the neighbouring affluent regions only to return home. The tragic picture of migrant workers with their families from Delhi moving back to their homes (say in Uttarpradesh or Bihar) at the sudden lockdown announcement in March 2020 by the central government an illustrative case to counter the fallacy of the Western theories that postulate that households can move around in search of local jurisdictions that internalize the costs of taxes and benefits of public services. . Two, these theories of federalism are market preserving. Treating government as a Leviathan [for e.g. Brennan and Buchanan(1980)] and proposing decentralisation only as a counter to correct the evils of market failures cannot be easily accepted in a social state seeking to fight poverty and want an inclusive welfare state. Governments that intervene only

to contain market failures alone cannot work effectively to ensure redistribution, social justice and common good.

Three, the vast fiscal federalism literature does not recognize the institution of panchayats, the reform for which the entire 73rd Constitutional Amendment was designed in India<sup>2</sup>. Not only that, local governments in the received literature do not have such functions as 'planning for economic development and social justice'[Article 243G] or mandated to conserve natural resources, do spatial planning, prepare development plans and so on [Article 243ZD]. Given the historical and political context of Indian decentralisation the fiscal federalism approach that roots its theoretical premises entirely on market mechanism cannot appreciate the expenditure and organizational responsibilities of Indian local governments. The Left Democratic Front (LDF) government imbibing the significance of the CAs launched the famous people's plan campaign and took to a 'big bang' approach devolving 35-40% of investible resources to the local governments. A series of reforms were successfully launched to show that the two Amendments were a feasible and relevant project.

Four, as I have said two basic questions 'who should do what' and 'who should tax where and what?' have influenced the evolution of the fiscal federal literature, as well as policy options in most federal countries [Oates(1972); Musgrave(1983); King(1984); Bird(2000); Shah(1994); Litvacketal (1998); Bahl and Linn(1992), among others]. One of the serious weaknesses of fiscal federalism in India is that these questions were never asked, not even at the time of the Constitutional Assembly debates. The time of 73rd/74th CAs was another historic occasion to raise these questions and go for a meaningful functional mapping.. No one raised them and the price for that is seen reflected in the confusion and policy inaction that followed [several papers of Oommen (2004; 2005; 2022 among others) tried to bring these issues into scholarly attentions].

Five, it is important to recognize that the micro economic theory of consumer choice is inapplicable to the social and fiscal realities of Indian federalism. The formal theory based on a demand-driven consumer choice [FGT in general] is inapplicable to India. India's rural local governments with their three-tier system (PRIs) cannot fit into a model that would internalize costs and benefits as already noted. It is important also to stress that the role of local governments in the Indian democratic context is related to the developmental concept of the citizen in a wider community than the instrumental concept of the consumer whose voting is

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<sup>2</sup> Anwar Shah (1994) treated India as a two tier federation although the 73rd amendment was passed in 1992.

an expression of self-interest. (Mulgan (1997); Council of Europe(1995)]. The concept of consumer choice is also not in sympathy with the concept of citizen's participatory rights as exemplified in the institution of gram sabha where all citizens meet to discuss their development problems and priorities, the reservation of seats for women and backward classes and many others.

Six, it will be difficult to follow the hard budget discipline in the local government context in India. Even so, it is useful to note what an expert on budgets observes:

"Without budget constraints on local politicians, a decision to delegate more authority to sub-national governments in expenditure set incentives for local budgets to draw on the common national tax base to capitalize on it politically in the local political arena without bearing the costs of public expenditure and debt. One way to solve such common resource problems would consist in installing local level budget constraints". [Von Daniels(2016):45].

Indeed there is an important need to promote own source mobilization in India certainly to thwart the fiscal illusion among sub-national level politicians.

## **5.0. Union finance commissions and the third tier**

Federal financial relations in the country have evolved through political, institutional, financial and functional changes. A major watershed in this evolutionary process as we have pointed out already is the 73rd and 74th Amendments to the Constitution that ushered in "a third tier in the federal structure"[FC-10, p.4]. We shall focus on union finance commission vis-a-vis the local governments. It is organized under three broad heads: UFC and the constitutional mandate; approach of UFCs and UFC and fiscal balance.

### **5.1. UFC and the constitutional mandate**

The 73rd/74th Constitutional Amendments (CAs) added Part IX and Part IXA to the Indian Constitution which introduced sweeping institutional reforms in democratic decentralisation. Panchayats and municipalities which were but appendages of rural and urban departments have been accorded a constitutional status with mandates to deliver economic development and social justice at the bottom level of governance. Although not a part of the Part IX and Part IXA, it is significant that section 280(3)(bb) and 3(c) were added as part of the decentralisation reforms. They are:

- (bb) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats in the State on the basis of the recommendations made by the Finance Commission of the State; and
- (c) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State;

These clauses which have invariably found a place in the ToR of UFCs since FC-11 do not seem to be adequately appreciated by the academic community as well as by the professionals and policy makers of India. Some clarification seems to be in order. One implication in the UFC's task of augmenting resources of local governments (LGs) is the question for what? [See Oommen (1998)]. Provision of certain basic services ensuring every citizen a minimum comparable quality of elementary capabilities in health, education, drinking water, shelter etc., and infrastructure at the local level has been a longstanding need of India. More than 60 years of planning and the paradigm shift to market-mediated growth under the new regime have not succeeded in ensuring this in any visible manner. The two clauses may be seen in this larger context.

Two, given the fact that the decentralisation reform process is an integrated project the two clauses have to be read along with the other complementary clauses such as 243I and 243Y, 243G and 243W along with 243ZD. Articles 243I and 243Y establishing state finance commission (SFC) use almost the same language as the UFC. Evidently the Constitution treats the LG on par with the state when it comes to sharing of financial resources and rectifying vertical and horizontal imbalances. It follows also that articles 243G and 243W mandating LGs to deliver 'economic development and social justice' and Article 243ZD to constitute a district planning committee (DPC) to facilitate 'spatial planning' and draw up bottom-up district planning are to be treated as integrated efforts. UFC and SFC complement each other in promoting territorial equity by facilitating the process of local planning and provisioning of core services. While it is for the UFC to ensure interstate horizontal equity in the allocation of local grants among the states, SFC has to carry the process forward in promoting intra-state equity by designing relevant sub-state level transfer arrangements among panchayats and municipalities within a state.

Third, some UFCs, considered the constitutional wording 'on the basis of the recommendations made by the Finance Commission of the state', unnecessary and restrictive.

FC-XI wanted to abolish these words and others have recommended to modify them to 'after taking into consideration the recommendations' of SFC. While this modification may be relevant, no one can deny the fact that here the constitution is underscoring the organic link in Indian fiscal federalism. Unfortunately UFCs have not taken the clause seriously as pertinent. They generally berate SFC reports. Some have even made sweeping statements like 'sketchy'[FC-12), 'patchy'[FC-13] and the like without any substantiation. It is easy to summarily dispose of but probably difficult to study in-depth. I think it is the bounden responsibility of a UFC to oversee from a national perspective how the existing and emerging transfer arrangements serve the constitutional mandate of decentralised democracy and equitable fiscal balance within the framework of Indian fiscal federalism.

## **5.2. Approach of UFCs - A critique**

To study the process of fiscal decentralisation in India, it is important to critically review the approach of the UFCs since the two CAs were enacted. Although the constitution used the term local government, all the UFCs preferred to use the term local bodies, FC-15 is probably an exception.

All the UFCs implicitly or explicitly used a framework for their recommendations with reference to local government. FC-13, FC-14 and FC-15 were more explicit in their approach. While there is broad agreement on several issues there are significant differences as well. Continuity and relevant changes should be the hallmark of any reform process and this is pertinently so in regard to decentralisation reforms which do not have many political champions to take them forward.

Although FC-10 had no direct mandate with regard to LGs, they understood the gravity of the reforms envisaged and acted *suomoto* and made direct transfers. FC-10 were of the view that the transfer of functions listed in the schedules XI and XII would also involve simultaneous transfers of functionaries and funds and therefore do not entail any extra financial commitment. That this will happen simultaneously and easily is an implausible assumption especially in the context of India's bureaucratic and highly centralized administrative set up. Several legislative hurdles also remained to be negotiated. Even so, FC-10 felt the need for supplementary resources in the transition process. It is important to note that while all the UFCs appreciated the significance of the heralding of the third tier in the Indian federal polity and sought to push the process of decentralisation reforms, there are significant difference in the priorities, strategies and policies recommended.

The five UFCs do not seem to have used SFC reports as a source of guidance in formulating their recommendations. But to dismiss them as 'sketchy', 'patchy' or sub-standard cannot be a truly professional approach. By now nearly 90 reports have been submitted, (ideally it should be over 150). Naturally they cannot be uniform in their approaches, although they cannot stray beyond the tasks assigned to them as per Articles 243I and 243Y. In the rest of this section we shall consider just two aspects (1) conditionalities and performance requirements and (2) accounts and audits in some details. This will be followed by raising certain general issues.

The approaches, relating to performance requirements associated with grants are important because they are useful in ensuring continuity as well as change. Giving untied grants is generally viewed as democratic and encouraging autonomy. But the multi-structured third tier, with 3.2 million elected representatives to man nearly 2.5 lakh local governments and with no experience in governance and financial management grants should be with guidance and hand holding. Looking back one can say that the mechanism of award of grants by UFC was governed by conditionalities with varying degrees of emphasis. Absolute untied grants have been next to nil. That grant amounts should not be used for salaries and wages was a recommendation from FC-10 onwards and certainly unassailable. FC-11 and FC-12 recommended grants but with some stipulations regarding the expenditure of the funds. FC-11 stipulated that the first charge on the grants should be maintenance of accounts and audit, followed by the development of a financial database. The remaining amounts were to be utilised for maintenance of core services of primary education, primary healthcare, safe drinking water, street lighting and sanitation including drainage and scavenging facilities, maintenance of cremation and burial grounds, public conveniences and other common property resources. By and large grants were untied, barring the stipulation prohibiting the payment of salaries and wages. The grants were to be distributed between rural and urban local governments, on the principles recommended by the respective SFCs.

FC-12 stipulated that panchayats should use the grants to improve service delivery relating to water supply and sanitation. In towns with a population of over a lakh, 50 per cent of the grant was to be earmarked for solid waste management schemes in public-private-partnership (PPP) mode. The urban and rural local governments were also expected to give high priority to expenditure for the creation of database on LG finances and maintenance of accounts through the use of modern technology and management systems. All the subsequent Finance Commissions systematically followed the practice of earmarking of funds for specific



purposes. The choice of services differed slightly with rural and urban local governments. For example out of the total grants earmarked for PRIs by FC-15, 60 per cent is earmarked for national priorities like drinking water supply and rain water harvesting and sanitation, while 40 per cent is virtually untied at the discretion of PRIs for improving basic services. For urban LGs the same 60:40 ratio is recommended with a slightly modified earmarking of services.

A real watershed in the UFC approach to performance requirements is the recommendations of FC-13 which were avowedly meant to persuade the state governments, many of them proven laggards, to carry forward the process of decentralisation. A solid 34.6 per cent of the total grants were earmarked for performance-based grants. FC-13 stipulated six conditions for panchayats, nine for municipalities and four for the special areas excluded from Part IX and Part IXA of the Constitution. By and large the recommended conditions include a wide range of package relating to budgeting, auditing, property tax, ombudsman etc., All these when implemented could serve as instruments for strengthening local governance and democracy in India, of course if the subsequent commissions also carry forward the reforms. This is important for sustaining change.

FC-14 and FC-15 carried forward the performance grant idea but with reduced allocations and easy conditionalities. In order to be eligible for performance grants, the FC-14 wanted LGs to show an increase in OSR (Own Source Revenue) and submit audited accounts. Municipalities, in addition, had to publish the service level benchmarks relating to basic services each year. The procedure of disbursement and the quantum of incentives were left to be determined by the concerned state government. Over and above these, the MoPR stipulated some more conditions such as the completion of the Gram Panchayat Development Plan as part of the Mission Antyodaya project launched in 2017-18<sup>3</sup>.

FC-15 also stipulated eligibility conditions for receiving grants. They are (a) that all local governments must have web-based availability of annual accounts for the previous year and audited accounts for the year before previous and (b) for urban LGs an additional condition is the notification of minimum floor rates of property taxes by the relevant state followed by improvement in the collection of property taxes in tandem with the growth rate of state's own GSDP. These eligibility conditions are really performance inducing and could be considered

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<sup>3</sup> On this, see Oommen (2022)

as a response to the long-standing problems of accounting and audit. Apart from this, direct performance grants are confined to select areas of the urban local governments. This comprises mostly what is called Million-plus cities challenge Fund (MCF) and is linked to the performance of these cities in improving the air quality and meeting the service level bench marks for urban drinking water supply, sanitation and solid waste management.

### **Account, audit and financial reporting**

While still on the performance-based issues it is important to note that both the PRIs and ULGs need to be significantly incentivized and a judicious mixing of reward and punishment strategy of transfers have to be followed by every state to improve the financial reporting system at the local government level. That public money should be spent with wisdom, faithfulness and efficiency is a prime tenet of accountability in any good governance. All the finance commissions beginning with FC-11 have taken up this issue only with partial success an issue that needed complete remedial action and sustained monitoring. The entry-level condition of FC-15 for being eligible for any grant assumes significance in this context. But this is only the first step. Unless the accounting, budgeting and auditing arrangements are properly streamlined the future of local government and democratic decentralisation is likely to be in jeopardy.

There are two major problems with the accounts of local governments in India: (a) the lack of accounts, including audited accounts, on a timely basis and (b) the classification of their accounts to make them amenable to consolidation with Union and State Governments' accounts. Beginning with the pioneering recommendations of the FC-11, efforts were afoot to build a reliable data base on the finances of local governments particularly on the finances of panchayats at the district, state and union government levels which could be accessible on line. This foundational initiative still did not acquire the needed progress to have a viable financial reporting system. FC-11 recommended that the Comptroller and Auditor General (CAG) should be entrusted with the responsibility of exercising control and supervision over the maintenance of accounts and audit of all tiers of rural and urban local governments, and that its audit report should be placed before a committee of the State legislature. FC-12 recommended that the compilation of disaggregated data in the formats suggested by the CAG is necessary for State Finance Commissions to be able to assess the income and expenditure requirements of the local governments. Priority should be given to the creation of a database and maintenance of accounts through the use of modern technology and

management systems. FC-12 has rightly pointed out a proper accounting system has to be put in place at the grassroots level to facilitate realistic assessment of the needs of the panchayats and municipalities for carrying forward the basic civic and developmental functions. Resource gap estimation for core services is central to the process of a fiscal transfer that would encourage equalization which is the hallmark of a successful federation. FC-13 recommended that while the CAG should provide technical guidance and supervision, a major portion of the actual auditing would have to be undertaken by the local fund audit departments. Hence, all State Governments should strengthen their local fund audit departments through both capacity building of existing manpower as well as augmentation of personnel. FC-14 recommended that accounts prepared by the local governments should distinctly capture income from own taxes, assigned taxes, grants from the State Finance Commission grants and grants for any agency functions assigned by the Union and State Governments. In addition, it also recommended that technical guidance and support arrangements by the CAG should be continued and States should facilitate local governments to compile accounts and have them audited in time. The growing practice of following private accountants into the system can only increase the corruption practices at the local level.

On the whole there is not much amiss in saying that the approaches of FCs could have made a more striking impact if only they were consistently carried forward by the states inspired by the overarching spirit of the two decentralisation amendments. The nine guiding principles<sup>4</sup> adumbrated by the FC-15 only affirm this contention. Genuine pursuit of cooperative federalism and the critical role of local governments in providing minimum primary services of standard quality irrespective of the residential location of the citizens in the most participatory manner by all tiers demand a sound principle-based approach.

Five union finance commissions have submitted reports since Part IX and Part IXA were added to the constitution. UFCs have yet to accommodate the third tier and restructure Indian public finance. In fact the ToR of both FC-11 and FC-12 mandated them to review the finances of the union and the states and suggest ways to restructure public finances primarily to restore budgetary balance which has assumed unmanageable dimensions during the first decades of 2000. Adhering strictly to the

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<sup>4</sup> The need to evolve a national training policy to build the capabilities of the 3 million local governments elected representatives conspicuously remains left out. Some UFCs, prominently FC-13 strongly emphasized this.

letter of the ToR, both commissions avoided incorporating the local governments into the picture<sup>5</sup>. But the moot question is how can it be possible to restructure expenditure and revenue sources leaving aside the panchayats and municipalities? Since public finances reflect the collective choices of the people, omission of LGs is a serious act. UFC is the only constitutional body that has to mediate the flow of federal revenues not only to the states but also to the LGs. No restructuring can be done in isolation. To be sure the macro goals and the goals of the subunits have to be examined in an integrated fashion and in an integrated manner.

The omission of the 'restructuring of public finances' without taking the LGs has created the precedent that the third tier is a subordinate or a poor relative of sort. It is impossible to achieve the horizontal equity without addressing the imbalances in the fiscal capacities of the panchayats and municipalities.

That the Article 280 establishing the UFC has been amended along with that of the 73rd/74th amendments to endow it with the great responsibility of linking the LGs into the fiscal federal system is obvious. Given the long-standing neglect and indifferent decentralization reform of the pre-amendment regime, considerable hand holding, incentivisation and punishment presumably should govern the approach of the UFCs. The assumption of FC-10 that the transfer of duties and functions listed in the XIth and XIIth schedules of the constitution would involve concomitant transfers of functionaries and finance was certainly unrealistic as subsequent events demonstrated. The broad principle of continuity and change (underlined by FC-14) is relevant to facilitate progress towards democratic decentralization, local democracy, economic development and social justice and building institutions of local self-government. Although India's failure to make consistent progress in achieving these goals cannot be put on the UFCs, they cannot be entirely absolved from the blame.

Lack of a reliable data base is the basis of a valid financial reporting system. All the FCs beginning with FC-11 have tried to build a reliable data base and tried to incentivize the maintenance of accounts along with proper audits but not yet succeeded. FC-11 provided the abstract of revenue and expenditures of the PRIs and municipalities. Although this was a much needed exercise, the Commission never utilized the data they collected in their analysis

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<sup>5</sup> Though two advisory groups, one for panchayats and another for municipalities were constituted for the FC-11, they never convened a meeting nor consulted them. (I was a member of the panchayat group). This is reflective of the indifference of FC-11 towards LGs.

and discussions. Obviously this was due to the unreliability of the data presented. FC-12 and FC-13 also canvassed fiscal data of panchayats and municipalities. FC-12 also provided the data like FC-11 and even made limited use of the data in assessing the own source revenue of local governments. FC-13 did not use the data they collected but uploaded them in their website. FC-14 and FC-15 abandoned the idea of collecting local government data leave alone analyzing them. Indeed both the commissions were deeply concerned. In the words of FC-15 "For any part of the government using tax payers money availability of accounts (including audited accounts) in the public domain on a timely basis is a primary requirement for good governments"[Report p.175]. The outcome of the eligibility condition imposed by FC-15 is awaited by the people.

Building fiscal data is closely related to the maintenance of a proper accounting system. There has been an unpardonable neglect by all concerned on this. Nearly two decades ago the FC-12 noted. "The absence of data necessary for a rational determination of the gap between the cost of service delivery and the capacity to raise resources makes the task of recommending measures for achieving equalization of services almost impossible. It is, therefore, imperative that high priority should be accorded to creation of data base and maintenance of accounts at the grassroots level"[FC-12, Report Vol.II,p.154]. Unless the LGs of India follow the precedents and practices of budget making practice pursued by the union and state governments India can never enjoy a sound public finance and financial reporting system.

FC-13 approach is ideally the most relevant compared to all others for a variety of reasons. First, they tried to respectfully accommodate the third tier into the fiscal federal polity of India. The transfer to LGs is made a share of the divisible pool of tax revenues a privilege only the states enjoyed. They were convinced that "the traditional theology that funds and functionaries will follow functions" has not worked and could not be expected to work in the future. The FC-13 endeavoured to provide a predictable and buoyant source of revenue to the LGs. This is in line with best international practice. Second, the commission adopted an incentive-based approach in regard to maintain a comprehensive data base and in upto-dating an accounting system. We have already noted how this much-needed reform has not made progress. Third, for the first-time they introduced a comprehensive performance-based grant system to reverse the lagging course of the decentralization process. Unlike their earlier counterparts, they felt that LGs need be regularly empowered to discharge their constitutional obligations. Local government grants only recommended had two components, basic grant

component and performance based components, six for panchayats and nine for urban local governments all important measures to incentivize the states to carry on and make democratic decentralization durable. For example, making devolution to the various tiers a part of the state budget under separate major and minor heads which can prevent needless interference and virement by departments. Four, FC-13 also recognized that several parastatal bodies operate in areas ear-marked for LGs under Schedule XI and XII and emasculate them "both financially and operationally"[FC-13,Report p.171]. No UFC took up this issue, although it continues to persist more vehemently disempowering the local democratic process.

Given the proverbial indifference on the part of the states to carry forward with commitment and dedication the decentralized reform process, the monitorable conditionalities recommended of the FC-13 was a great initiative which ought to have been sustained. The principle of continuity and change which the FC-14 wanted to promote failed to take forward the initiatives of FC-13 to take democratic decentralization process forward. In fact FC-14 increased the basic grant component to gram panchayats to 90 per cent from 65 per cent recommended by the FC-13 while the performance component was reduced to 10 per cent for making available data and audited accounts and for improving own source revenues. For municipalities, the division was on a 80:20 basis.FC-15 did not use the performance component for the panchayats, but used it for incubation of new cities to be administered by the Ministry of Housing and Urban affairs.

An interesting feature of the approach of FC-15 is that they made explicit nine principles that governed their recommendations related to the LGs. (see Appendix 5A). It will be clear to any one that these are not principles or norms pertaining to democratic decentralization, role of local government in fiscal federalism or any other relevant issues. They are at best the areas of emphasis which the commission followed. The emphasis given to the challenges and dynamics of the rapid urbanization well underway is very evident in some of the principles. Given the fact that as far back as the 2011 census 55.3 per cent of the Indian population live in areas with urban-like features, this was a remarkable emphasis, certainly in contrast to the previous commissions.

Two most important salience in the approach of these commissions that need be mentioned are (a) the emphasis on the role of state finance commission and the need to strengthen them to play a more critical role in the fiscal governance at the state-sub-state level and (b) the earmarking of funds for improving the core services at the grass roots level of rural and urban areas. However the progress made leave many things to be desired.

In sum, the constitutional role of organically linking the institution of UFC with the third tier was historical step. What comes out most prominently is the failure of various institutions particularly the intermediate tier of the state to deliberately support to decentralization reform.

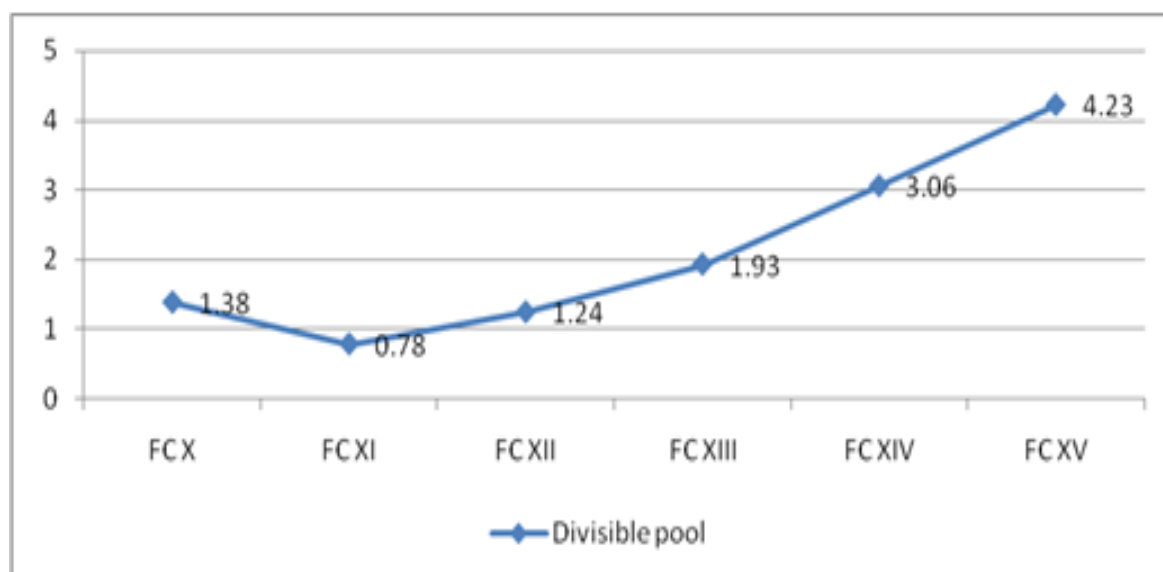
### **5.3. UFC and fiscal balance**

Fiscal balance refers to the issues relating to vertical imbalances in the resources and expenditure responsibilities and horizontal imbalances in terse distribution of the resources among the constituents. The constitutional mandate to support the consolidated fund of a state to supplement the resources of panchayats and municipalities is a task to reduce vertical gaps among the state's on an equitable basis. We address the two issues with reference to LGs under two heads: vertical balance and horizontal balance.

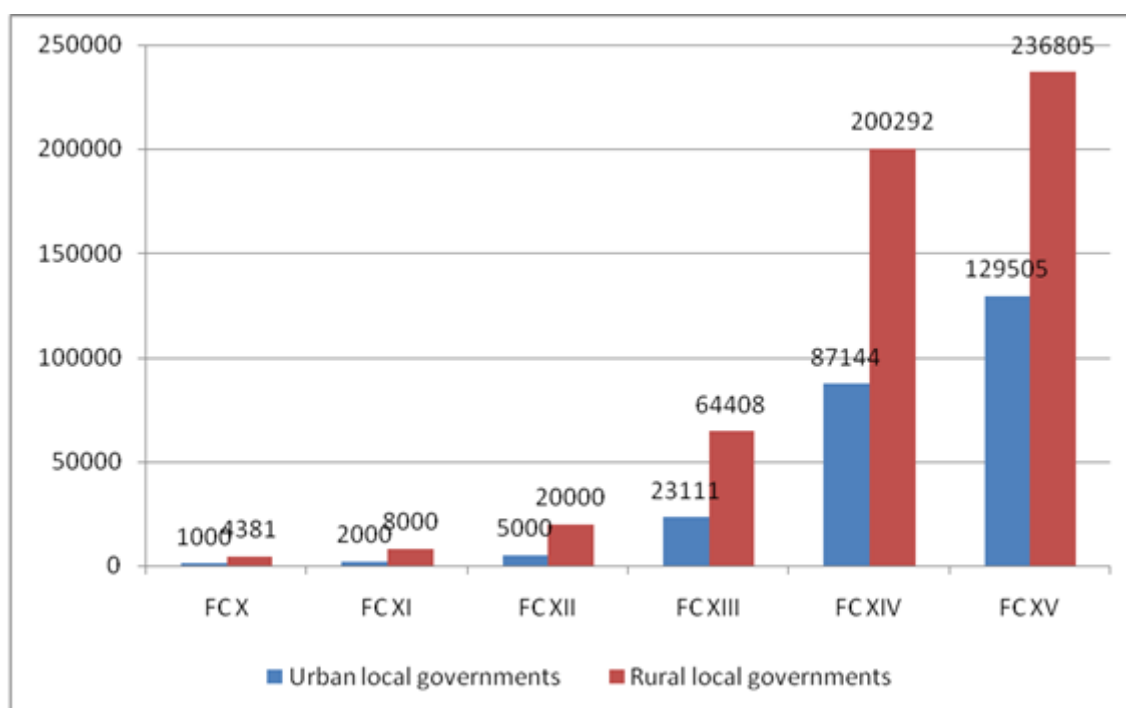
#### **5.3.1. Vertical balance**

Estimating fiscal gap independent of the level of government is very difficult. Quite often the needs revenue gap yawns wide. A study sponsored by the FC-11 estimated that a sum of over Rs.1.42 trillion was required for the maintenance of core services by the rural local bodies, besides a total capital expenditure of the order of Rs.86000 crore. The recommended transfers of FC-11 to rural local bodies work out hardly to 3.5 per cent of the estimated gap. It is probably interesting to compare the situation related to FC-15. A study initiated by the commission came up with an estimated resource gap of Rs.10 trillion crore for gram panchayats and Rs.12.27 crore for municipalities for the period from 2021 to 2025.

While the recommended amount to gram panchayats works out to over 23 per cent of the estimated gap it is only 10.5 per cent in regard to the municipalities. To be sure the provision of resources for the fast urbanizing India seems to yawn wide.

**Figure 1:** Local government grant as a percent of divisible pool (FC-10 to FC-15)

Source: FC Report XIV and and XV

**Figure 2:** Grants to Local Governments by various Finance commissions disaggregated to Rural and Urban local governments.

Source: As above. Note: FC-15 does not include grants for primary health sector.



Figure 1 and figure 2 show respectively the magnitude and trend of the vertical transfers and their disaggregated into the shares for rural and urban local governments. It is evident from Fig.1 that FC-10, although had no mandate to recommend any transfers to panchayats and municipalities thought it important to do so and devoted 1.38 percent of the divisible pool. Interestingly they were more sensitive to the needs of the local level governments as could be noted from the figure. Real watershed seems to come from the critical transfers by FC-13. All those years panchayats received the larger (see.Fig.2) The impact of urbanization is well recognized by FC-15. The fundamental task of building core basic services like drinking water, sanitation, solid waste management primary health of standard quality to all the residential regions of the country still remains a distant goal.

### 5.3.2. Horizontal balance

The interse distribution of the vertical transfer is crucial because the union can act only via the states. But how much of this should go to "augment" the consolidate4d fund of a state depend on the criteria chosen for the horizontal distribution. Table 5.1 shows the criteria for grants to states.

5.1. Table 7.2: Criteria for Distribution of Grants to States for Local Governments by Finance Commissions

(in per cent)

Criteria	FC-10	FC-11	FC-12		FC-13		FC-14	FC-15
				<i>RLG</i>		<i>ULG</i>		
Population	100	40	40		50		90	90
Census	1971	1971	2001		2001		2011	2011
Geographical Area		10	10		10		10	10
Distance from highest per capita income		20	20	10		20		
Index of decentralisation		20			15			
Index of deprivation			10					
Revenue effort		10	20					
Proportion of scheduled castes/scheduled tribes in population				10		0		
FC local body grants utilisation index					5			

Source: Report of the Fifteenth Finance Commission, Chapter 7, P.173.

It is clear from the table that population and area, the broad need assessment criteria were used by all the commissions FC-10 which had no constitutional mandate relating to local

governments quite understandably used the widely employed criterion of population. FC-14 and FC-15 also carried that preference but with a 90 per cent weightage. Except FC-11 which used an index of decentralization (the variables used showed a poor understanding of the letter and spirit of the two Amendments that heralded the reform process), no commission ventured to employ decentralization for incentivizing the process. That FC-11, FC-12 and FC-13 used the equity criterion of distance from the highest per capita income is equally relevant in all transfers. The index of deprivation which is based on the intra-state disparities in two core services viz., drinking water and sanitation was a prudent criterion. But subsequent commissions abandoned it. The index of utilization of local grant although with a smaller weightage was also important, but only used by FC-13. On the whole one can say that the criteria chosen were not well thought out judged from the specific purpose for which the grant-in-aid was intended by the constitution.

The two lectures were a denovo approach to integrate local government to India's public finance.

## **Appendix A**

### Nine Guiding Principles of the XVth Finance Commission

- I. Relevant ToR and the Constitutional provisions.
- II. Pre-requisite of timely online availability in the public domain of both the accounts of the previous year and audited accounts of the year before the previous year for availing of grants for both rural and urban local bodies.
- III. Pre-requisite of notifying minimum floor on property tax rates by States in order to increase the buoyancy of revenue of urban local bodies.
- IV. Inclusive and uniform approach for all three tiers within rural local bodies, Excluded Areas and cantonment areas.
- V. Inter se rural and urban share of devolution in the context of the evolving urban complexities and challenges.
- VI. Differential needs of urban habitations, including the special needs of emerging large urban areas as "agglomeration economies".
- VII. Air pollution in Million-Plus urban agglomerations.
- VIII. Focus on national priorities related to

- a) strengthening of primary health care and Fifteenth Finance Commission 188 creation of diagnostics infrastructure for management of disease and epidemics at the local level;
  - b) solid waste management;
  - c) provisioning for drinking water and sanitation; and
  - d) promoting and incentivising water recycling, rejuvenation and rainwater harvesting.
- IX. Importance of generation of internal resources like revenues from property taxation and tax on professions.

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