

CHAPTER IV

Federal Finance and local-self government in India

1. INTRODUCTION

- 1.1. Before making an attempt to assess the needs of local bodies and grapple with the issues relating to local finances, it would be quite relevant to analyse such issues in their correct perspective of theory and practice of federal finance, and also against the background of development of local-self government in the country.
- 1.2. It is difficult to define the term federation which means different things to different people in different countries. But the most acceptable definition of federation may be that it is a system of government in which there is division of powers and functions between federal government and several regional governments, each of which in its own sphere is coordinate with the others and each of which acts directly on the people through its administrative machinery.

2. The Theoretical base of federation

- 2.1. It was the theoretical framework of the neo-classical economists that had justified the creation of multi-level governments in a country, on the ground that such a system of government would provide optimum level of goods and services at each territorial level, in accordance with the needs and aspirations of the people. Fiscal federalism is a necessary adjunct of the concept of multi-level government in a federal set-up. Since in a federation, there are several levels of government functioning in their respective jurisdictions, there is the need for creating such an optimum institutional arrangement which combines the advantages of decentralisation as well as economies of scale, associated with centralised form of government. Such an arrangement has to undergo revision from time to time, depending upon the experience of running the federation, changing relationships between different layers of government, reflecting changes in social, political and economic conditions in the country.

- 2.2. Much earlier to the enunciation of principles of federal finance by the economists, the political scientists and philosophers had put forth the view that multi-level governments were necessary to protect and promote cultural and linguistic diversities in a country. The theory and practice of multi-level governments and the corresponding ideas relating to fiscal federalism were very simple in the beginning when economic and social life was simple, and the governments were not called upon to undertake many functions. But with the development of means of communication and transport and with the advent of industrialisation, when economic and social life became very complex, causing multiplication in the functions of the government, not only the theory and practice of federal finance but also inter-governmental relationships have become complex. These developments have created problems which sometime defy solution, causing disequilibrium between functions and finances of different layers of government, sometimes leading to fissiparous tendencies, threatening the very fabric of federalism.
- 2.3. In a federation, there are different layers of governments to perform definite functions assigned to them. How many territorial levels of government should be there in a country for the purpose of administration and planning? No cut-and-dried answer can be given to this question. It all depends upon factors like the size of the country, its population, its geography, its history, its social and economic characteristics and its administrative set-up. Certainly tiny states like the Vatican city, Monaco and San Marino, can not have more than one level of central government. But a country of India's size and dimensions, with large geographical variations, varied social and cultural attainments, demands federal set-up, with large devolution of powers and functions and finances, to lower territorial levels of governments.

3. Decentralization - The essence of federation

- 3.1. Decentralisation is the essence of federalism, having a system of multi-level government and multi-level planning. Decentralisation does not mean breaking the

bulk, but devolving powers, functions, authority and finances to different territorial levels of government. To give a concrete shape to the concept of decentralisation in a federal set-up, decentralisation has to be based on sound practices which have to be evolved, and necessary attitudinal changes which have to be brought about among bureaucracy, as the process moves along. At every level in the system of multi-level government, there has to be involvement of the people, endowed with a degree of autonomy in decision-making, relating to functions assigned to that level, within the framework of the Constitution that created the federation. No system of federal government envisages complete autonomy. Different territorial governments are not independent entities but integral parts of the whole system. The determination of relationships between different parts of the system and with the system as a whole, constitutes a major problem confronting every federation. There has to be a proper balance between centralisation and decentralisation in every federation. Excessive centralisation in a federal set-up may ultimately bring about disintegration and collapse of federation. History is replete with such examples. The process of centralisation and centralised planning in a number of socialist economies of East Europe and Soviet Union, could not cope with the requirements of decentralised development, regional needs and aspirations, but accentuated regional disparities, creating distortions and contradictions, ultimately leading to the collapse of the system and disintegration of federations.

4. Principles of division of functions and finances

- 4.1. All forms of federations are based on compromises, and inter-governmental relations between them are the result of give and take, because in the ultimate analysis, both the federal government and the constituent units have to collect taxes from the same body of tax-payers. Fiscal federalism applies cost-benefit analysis to allocate governmental functions to different territorial levels. Accordingly, that level of government which provides public services at the least cost may be entrusted such functions, and public services where supply does not involve economies of scale, should be decentralised. Such a division of functions ensures economic efficiency in the provision of public

goods, accountability of money spent and fiscal autonomy of lower level governments. Wherever such clear-cut demarcations are not possible and wherever benefits accrue beyond the jurisdiction of local governments, resulting in spill over of benefits and costs, the federation has to work out a system of transfer of resources from the higher to lower levels of government.

- 4.2. The general experience is that when functions and resources are divided between different layers of government, the more elastic and productive sources of revenue with nation-wide base, tend to be allocated to the national government and less elastic with immobile and localised base to the lower layers of government. Such a division results in vertical fiscal imbalances between expenditure needs and own-revenue of the local governments.
- 4.3. Despite evolving a scheme of division of functions and finances, there are bound to be tax and expenditure over-lapping which require coordination and harmonisation of expenditure and taxation policies of different layers of governments. Every federation has to face this problem and also frequent encroachments of the higher level government in the legitimate domain of lower level governments. For example, a large number of centrally sponsored programmes in India, numbering more than 250, particularly in such areas which legitimately belong to the domain of local governments, do not find any theoretical support but tantamounts to encroachment of the Union government in the legitimate domain of state governments and local bodies. Such conflicts are bound to arise in every federation and have to be resolved through dialogue, mutual understanding and interaction.

5. Principles of Federal Finance

- 5.1. In every federation, different layers of government should have considerable freedom and initiative to raise and manage their resources, but some degree of control and regulation by higher levels become necessary to ensure coordination between different bodies and also to promote sound financial management. Division of functions leads to division of resources. Local bodies are generally allocated three sources of revenue: (i)

Independent sources of revenue - tax and non-tax. (ii) Sharing of specific taxes and other revenues raised by higher levels of governments. (iii) Grants-in-aid. In the absence of independent sources of revenue, local bodies would become the spending departments of the central and state governments. In the allocation of sources of revenue to local bodies, it is necessary to see that the base is local and their collection does not involve an elaborate machinery. Resources allocated to different units in a federation must be adequate to meet needs and should be capable of expansion with growing needs. There has to be a balance between direct and indirect taxes, to promote equity in taxation. Prof. B.P. Adarkar has laid down three essential tests of a good federal finance set-up. (i) Independence and responsibility, (ii) Adequacy and elasticity, and (iii) Administrative economy. But no cut-and-dried method can solve the problem of fiscal incoherence which all federations have to face.

- 5.2. Tax revenue sharing is the most important element of inter-governmental fiscal relations. This issue has three major dimensions: tax assignment between the federal and sub-national governments, vertical tax sharing between the federal and sub-national governments, and horizontal redistribution of shared tax revenue among the sub-national governments.

6. THE PROBLEMS OF TAX SHARING

- 6.1. Tax revenue sharing between the federal and sub-national governments is basically geared towards correcting the vertical imbalances generated by revenue and expenditure assignments. Tax sharing is not common among developed countries, except Germany and Switzerland. However, examples of sharing revenue from certain selected taxes include countries like Argentina, Brazil, Hungary, India and Russia. In Columbia, there is a statutory provision for sharing all revenues in fixed proportions. To rectify imbalances, there is a provision in the Indian Constitution for the appointment of the Central Finance Commission by the President of India after every five years, to recommend devolution of resources from the central Government to the states. Similar provisions have been made in some other federations. So far, under the Constitution, the Union Government in India has been sharing revenue from union excise duties and income tax with the state governments on the recommendation of the central Finance Commission. Under such a system of

sharing selective taxes, experience shows that the central government has the propensity to rely more on non-shareable taxes, like customs and corporate income tax, for raising additional resources, thereby tending to distort the tax structure.

- 6.2. The X Finance Commission had recommended a change in the existing constitutional arrangement of devolution of share in central taxes to the states. Instead of sharing revenue from income tax and excise duty, the Commission recommended that 29% of the gross tax revenue of the central government, inclusive of additional excise duties in lieu of sales tax, could be fixed as states share in central taxes and this should be reviewed after every 15 years. This change needed constitutional amendment.
- 6.3. The Government of India has accepted the recommendation of the X Finance Commission, to switch over to the concept of fixing states share in entire tax revenue as a certain percent of net tax proceeds but not gross, as recommended by the Commission. Accordingly Article 270 of the Constitution has been amended to give effect to the decision of the Government of India. The Government has not accepted the other recommendation of the Commission of reviewing this percentage share after 15 years. On the other hand, it would be a subject of review by the Finance Commission after every five years.
- 6.4. The XI Finance Commission, in accordance with the constitutional amendment, has recommended that share of the states be fixed at 28% of the net proceeds of all shareable union taxes and duties for each of the 5 years, commencing from April 1st, 2000.

7. Horizontal Re-Distribution

- 7.1. There is the other problem of horizontal redistribution of shared tax gross revenue receipts among the sub-national governments, with a view to reducing regional disparities and tackle specific problems of certain areas. Different countries follow different practices in this regard. In Australia, the system of equalisation aims at ensuring equal ability of the states to provide a standard level of public services at an average level of taxation. In Canada, equalisation transfers to provinces/states, are based on their relative tax capacities and not on the basis of their expenditure needs. While equalisation grants may take care of the problem of horizontal imbalances, a suitable criteria have to be evolved for inter-se

distribution of the divisible pool among the states/local bodies, to reduce horizontal imbalances.

- 7.2. India provides an important case study for horizontal distribution of shared taxes among different states. Every Central Finance Commission has evolved its own criteria for horizontal redistribution of the divisible pool. As far as possible, the gap filling approach has been avoided because it encourages fiscal profligacy. All the Finance Commissions in India have given definite weight to tax effort in their schemes of distribution of devolution, with a view to encouraging resource mobilisation efforts of the state governments. The basic rationale of devolution has to be redistribution. In the words of S. Guhan¹ redistribution is a process of recycling resources from where they accrue to where they might be needed in the transfer process. While being need-based, it should also seek concurrently to improve the “ability” to meet needs. In other words, it should be such as to promote an increase in the size of the cake while slicing it. Judged by international experience, population, distance and tax effort, have figured prominently in the positive list of redistribution criteria, while deficit criterion has figured in the negative list².

8. Recent trends in constitutional developments in India

- 8.1. Initially the governmental levels recognised in the Constitution were two, the Union and the states. But the two constitutional amendments carried out in 1992, have accorded constitutional status to the panchayats and municipalities, although the exact demarcation of their powers and functions is left to the state governments to specify through their respective legislatures.
- 8.2. Indian Constitution has been characterised as “quasi-federal”. In several respects, the unitary elements have clearly over-shadowed the federal attributes with the centre

¹ S. Guhan - Devolution criteria of Finance & Planning Commission: from Gamble to policy - Centre- State budgetary transfers-edited by I.S. Gulati - Oxford University Press, New Delhi - 1987 - Page 283-312.

² S. Gurumurthy - Inter-governmental fiscal relations- three phases of tax sharing-Economic and Political Weekly - September 19, 1998 - Page 2488. (This paper is published in EPW in three instalments in number 35,36 and 37 of August- September 1998)

assuming more dominating role than what even the constitution-makers had visualised³. Although the powers of the Union and the states are enumerated in separate lists in a schedule appended to the Constitution, the “ownership” of powers cannot be said to be clear-cut. There is concurrent list covering fairly wide areas wherein the Union Government is vested with powers to dismiss an elected state government and promulgate central control, through the President rule, on the grounds of break-down of normal constitutional arrangement. The adoption of planning in the country in 1951 and the establishment of the Planning Commission through an administrative order of the Government of India, gave further powers of control over the states by the centre through its strategy of development and planning. The institution of all-India services provides another mechanism for exercising control over the states. The centres, sway over the economy was widened further by public ownership of large industries and nationalisation of major banks in the country. The ambit of central control over state subjects was further extended through a number of centrally sponsored schemes to be implemented by the state and local governments.

- 8.3. While the Constitution clearly recognised the needs for coordination among different levels of government in the matters of governance, and made provision for the creation of a forum for consultation among governments in the shape of Inter-State Council (Article 263), the Council was constituted as late as 1990, despite strong recommendations by high powered commissions - the Administrative Reforms Commission and the Sakaria Commission. The entire gamut of centre-state relations was considered in depth by the Sakaria Commission, but its recommendations are yet to be fully acted upon.
- 8.4. The initiation of economic reforms in 1991 has reduced center's role in controlling the economy and recent changes in the political configuration in the country, have broken the monopoly of the political party that had ruled at the centre and the states in the initial 40 years after independence, and has replaced it by the coalition government at

³ Dandekar V.M. - Unitary elements in a Federal Constitution - economic and Political Weekly - 7th October, 1987 - reprinted in journal of Indian School of Political economy - Volume 3, July - September 1999.

the centre. There has been the emergence of governments in several states run by regional parties, leading to the demand for greater regional autonomy to the states and vesting of constitutional status to local bodies, consequent upon the enactment of constitutional amendments. All these developments led to the demand for “co-operative federalism” in the country, to guard against the emergence of monopoly at the centre. Cooperative federalism accords primacy to lower tiers of the government in providing public services, and contemplates the most decentralised form of governance. But a change from quasi-federalism to cooperative federalism needs lot of changes - political, legal and constitutional. A Constitution Review Commission has been set up recently by the Govt. of India, to consider different aspects of changes demanded in the Constitution.

- 8.5. The above presentation shows that federation is not just a structure but a process and, therefore, it is more important to activate the forum for interaction than going in only for formal arrangements that divide the powers between the Union and the states and the state and the local bodies. Federalism is poised for acquiring new dimensions, with world economy getting globalised and integrated and the paradigm of desirable arrangements of functions and finances at the sub national levels undergoing changes, old ideas of sovereignty are fast facing obsolescence, as nations agree on their own to abide by internationally accepted conventions and standards.⁴

9. The Principles of Local Taxation

- 9.1. Local bodies which are considered as sine qua non of stable democracy, must have adequate financial resources of their own to meet their expenditure on locally determined functions. Although local inequalities in the standard of services can be set right through the device of differential grants and assigned revenues, the main emphasis should be on stability of local resources and their augmentation. In the devolution

⁴ Bagchi Ameresh -Rethinking Federalism - Overview of current debate with some reflections in Indian Context - Economic and Political Weekly, August 19, 2000

of powers of taxation to local bodies, the Taxation Enquiry Commission (1953) has laid down the following criteria:-

(i) Suitability of a tax. (ii) The capacity to levy and administer the tax equitably and efficiently. (iii) The devolution should be sufficiently prompt, flexible and diversified. The main characteristics of local taxation as suggested by Bird and Wallich⁵ (1993) are the following:

- (i) The tax base should be relatively immobile and allow local authorities some leeway in varying rates without losing most of their tax base.
- (ii) The tax yield should be adequate to meet local needs and sufficiently buoyant over time, that is, it should expand atleast as fast as expenditure.
- (iii) Tax yield should be relatively stable and predictable over time.
- (iv) The tax base should be visible to ensure accountability.
- (v) Tax should be perceived to be reasonably fair by the tax payers.
- (vi) The tax should be relatively easy to administer efficiently and effectively.

In practice, a local tax system having all the above characteristics, is a rare possibility.

10. Recent Trends in Federal Finances

- 10.1. Recent trends in federal finance are, (i) the increasing control of the federal government over the economic activities of the people, as a result of development of means of communications and transportation, growth of large-scale industry and increasing economic integration. (ii) The goal of welfare state and the need for contra-cyclical measures to promote economic stability and create full employment, demand centralisation in decision-making and national policies. (iii) In almost all federations, central resources have grown faster than resources of constituent units, and the central government because of its superior financial position, makes over large sums of money

⁵ Bird R and C Wallich (1993) **Fiscal Decentralisation and Inter-governmental Relations in Transition Economies. Policy Research Framework of Analysis - Paper No. 1122 - World Bank, Washington DC.**

to the units, in terms of devolution of resources, to enable the units to meet their developmental and maintenance needs. (iv) Recent experience shows that federal governments are resorting, by and large, to direct taxes, while units are being assigned mostly indirect taxes, making the budgetary position of the central government more stable as compared to the units.

11. Local finances under the federal set-up in India

- 11.1. In the realm of federations, India is comparatively a new entrant. The present federal set-up in India, is the outcome of a lengthy process of decentralisation that can be traced to the Lord Mayos' scheme of decentralisation in 1887, earlier to which revenues and expenditures in India were completely centralised. Further developments during the British period in the direction of creation of federal set-up are, Lord Ripons' amendments in the earlier scheme and the enactment of Government of India Act of 1912 and 1935 which transferred more powers to the provinces.
- 11.2. The fiscal arrangements under the 1935 Act were, more or less, on federal lines. The New Constitution that we adopted in 1950, embodies the characteristics of a federal constitution. The new constitution includes three lists, viz. Union, State and Concurrent. There is no separate list of taxes for local bodies which would continue to depend on the state legislatures to whatever taxation powers are given from the state list to local bodes. In the absence of clear cut demarcation of taxes between the state governments and local bodies, there have been frequent encroachments by the state governments in the legitimate domain of local bodies.
- 11.3. The Local Finance Enquiry Committee which reported in 1951, after a careful scrutiny of the problem of local finances, recommended that one tax from the Union List (item 89) , namely, terminal tax on goods and passengers carried by railways, sea and air and the following 12 taxes from the state list be reserved for the utilisation by or for local bodies :-
 1. Tax on land and buildings (item 49)

2. Tax on mineral rights subject to limits imposed by the Parliament relating to mineral development (item 50)
 3. Taxes on entry of goods into local areas for consumption, use or sale (item 52)
 4. Tax on consumption or sale of electricity (item 53)
 5. Tax on advertisement other than published in newspapers (item 55)
 6. Tax on goods and passengers carried by rail or inland waterways (item 56)
 7. Taxes on vehicles other than those mechanically propelled (item 57)
 8. Toll tax (item 59)
 9. Tax on animals and boats. (item 58)
 10. Taxes on profession, trade, callings and employment (item 60)
 11. Capitation taxes (item 61)
 12. Tax on entertainment, including amusements (item 62)
- 11.4. The Taxation Enquiry Commission (1953), besides examining the taxation structures of central and the state governments, also made an enquiry into the finances of local bodies and made comprehensive recommendations for improving their finances. The observation of the Commission in the context of local finances is very significant. “The incorporation in the Union list, of the terminal taxes on goods carried by railways, the limitations on account of profession tax leviable on any assessee and the immunity of Union properties from local taxation, has resulted in contraction of the powers of taxation and consequently of the potential resources of local bodies, and the inclusion of only two lists, viz. Union and State, has obliterated the legal distinction between the spheres of taxation of local bodies and state governments which has created new problems in regard to the devising of an adequate and satisfactory system of local taxation and local finance”. The Commission has pointed out the relative inelasticity of local finance in comparison to the state and central finances. Even the 73rd and 74th Constitutional amendments have not considered the issue of demarcating the sources of revenue between the state governments and local bodies.
- 11.5. However, the constitutional amendment Act, 1992, by making a provision for the constitution of State Finance Commission, under Article 243(i) and 243(y) after the expiry of every five years, for recommending devolution of resources from state

government to local bodies, has altered the erstwhile fiscal arrangement between the state government and local bodies and has tried to rectify the imbalance.

- 11.6. The Constitutional Amendment Act gives local bodies a constitutional status, assigns them a number of functions, ensures them stability, provides a suitable framework to function with greater freedom and also makes institutional arrangements for devolution of finances from the state government to local bodies.
- 11.7. It is for the first time that unlike its predecessors, the XI Finance Commission was assigned certain terms of reference relating to local bodies and their finances. The inclusion of certain issues relating to local finances in the TOR of the Commission has added a new dimension to the character of fiscal federalism in India and also demonstrates the fact that the nation as a whole should feel interested in the financial health of local bodies and have a stake in the task of restructuring and strengthening local bodies as units of self-government.

12. Conclusion

- 12.1 A brief and quick account of federal finance and its principles shows that the institutional framework militates against the expansion of local finances, and a striking feature of federal finance in India is the progressive increase in dependence of local bodies on assigned revenue and grants-in-aid. In this respect, it would not be out of place to mention that partly local bodies themselves are responsible for their poor state of affairs. It would be fruitful to examine the extent to which local bodies have exploited their taxation powers given to them by the state legislatures. In most of the cases, they feel reluctant to impose and collect taxes to the maximum extent. The nearer the government to the people, the more reluctant it becomes to impose and realise taxes.
- 12.2. Local governments cannot be allowed unrestricted transfers without an appropriate system of checks and balances. A completely decentralised tax system can distort the allocation of mobile factors of production across localities and stand in the way of

creating domestic common market. With a view to ensuring harmonisation of the tax system, checking fiscal profligacy and reducing distortions in the allocation of resources, it is necessary that the state government retains control of the tax structure of local bodies. But such controls are to be judiciously and objectively used, and their operation should not be vitiated by political considerations. The local self-government will take time to take firm roots. It may not have yielded the desired results. But it must succeed.