

## **Financial Decentralization in Indian Federal System**

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### **ABSTRACT**

Decentralization means devolving powers and responsibilities to the local institutions from the central or higher authority, and empowers the local body in terms of decision making on administration, functional and financial matter. It is true that some autonomy has been enjoyed by urban local bodies in India even in pre Independence period, but the real decentralization has started by the Seventy Fourth Constitutional Amendment Act, 1992. The Constitution of India ordains that India is a Union of States. The Constitution, in its 7th schedule, assigns the powers and functions of the centre and states. Moreover, the Constitution of India specifies the taxes to be divided between the central and state governments. It does not specify the types of taxes ULBs should have, but on the other hand the powers for determining the revenue base of ULBs rests with the state governments. The latter is perfectly at liberty either to add or subtract from the list of taxes that have been at a given moment transferred to the local government. The Indian federal structure bound the centre to leave issues of their empowerment and operationalisation to the discretion of the state governments. The paper argues that the changes made by the constitutional amendment are more 'political' than 'financial'.

**Key Words :** Decentralization, Constitutional Amendment Act, Urban Local Bodies, Revenue

### **INTRODUCTION**

The democratic political system in India is the outcome of two contradictory political forces such as- British colonial rule and Indian nationalism. These were the two political forces, which have created the values, ideology, legitimacy, etc., for setting up of a new political system. After ending of the colonialism through nationalism, the monarchical and colonial centric governance was replaced by citizen centric governance and established fully fledged democratic state. To promote the citizen centric governance, the democratic political system in the post- independent period ensures a written constitution, the right to equal vote for all citizens, multi- party system, periodic elections, citizens' participation in decision making and planning for the overall socio-economic development which is the base of transparent, accountable and responsive governance. But there was a constraint of centralization with single party domination, Planning Commission and bureaucracy up to the period 1990.

It is observed that the last two decades of the twentieth century witnessed a significant rise in the scope of local democracy throughout the developing world, with increasing devolution of political, financial and administrative authority to local bodies. Along with privatization and deregulation, this

shift represents a substantial reduction in the authority of national governments over economic policy. The phenomenon is geographically widespread, occurring simultaneously in Latin America, Africa, Asia and Eastern Europe. The earliest changes were initiated in the 1970's, picked up momentum in the 1980's, and accelerated after 1990.

It is argued that in 1990 with the collapse of first socialist experiment in Soviet Union and East Europe proved that highly centralized political system, whether it is socialism or democracy, will not sustain for long. Rajni Kuthari viewed that centralized power not only was incapable of providing stability to the government, it might well give rise to religious, ethnic and minority upsurges. Further, centralized power is harmful to democratic values and approaches to solving problems.<sup>1</sup> The most important factor for tendency of decentralization in India was mainly from participatory upsurge of the different communities. Under these circumstances, the effort for decentralization of democracy was started in early 1990s through 73rd and 74th Amendments of the Constitution to provide legal mandatory status for local level institutions. Decentralization has become an instrument to ensure efficient, speedy and realistic decision making administration. Moreover, decentralization allows greater representation for various political, religious, caste, gender and tribal groups in development of decision making that could lead to greater equity in the allocation of public resources and investment. A decentralized government structure can facilitate the exchange of information about local needs and channel of political demands from the local community to national level policy makers.

### **Decentralisation in India :**

Municipal administration in India has a fairly long history.<sup>2</sup> Some form of municipal authority appears to have been in existence during the period of the Indus Valley civilisation. A more comprehensive initiative towards this end was adopted during the British period. The charter of

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1. Kuthari, Rajni (1996); "Issues in Decentralized Governance", in Abdul Aziz and David Arnold (eds.), *Decentralized Governance in Asian Countries*, New Delhi, Sage Publications.
  2. The idea of village level functional units of self-government was not new to India. They have an ancient tradition. The western civilization model of the Greek polis, in fact has closer affinity to Indian Panchayats and similar other institutions in the eastern world including in Persia and Ethiopia than with its contemporary western world. However, because of the long intervening period of domination by external forces the idea was lost and found resurgence ironically through the eyes of the British power. It reveals that the concept of local government is not new to our country and there is mention of community assemblies in the vedic texts. Around 600 B.C., the territory north of the river Ganga comprising modern day north Bihar and eastern U.P. was under the suzerainty of small republics called 'Janapad'. In these Janapadas, the affairs of the state were conducted by an assembly consisting of local chieftains. In the post Mauryan times as well, there existed republics of Malavas and the Kshudrakas where decisions were taken by 'Sabhas'. The Greek Ambassador Magasthenes, who visited the court of Chandragupta Maurya in 303 B.C. described the city council which governed Pataliputra. Similar participatory structures also existed in south India. In the Chola kingdoms, the village council, together with its sub-committees and wards, played an important part in administration, arbitrated disputes and managed social affairs. They were also responsible for revenue collection, assessing individual contribution and negotiating the collective assessment with the king's representative. They had virtual ownership of village wasteland, with right of sale, and they were active in irrigation, road building and related work. Their transactions, recorded on the walls of village temples, show a vigorous community life and are a permanent memorial of the best practices in early Indian polity.

James II in 1687 empowered the establishment of municipal corporations by the East India Company. By 1726, mayor's courts were established in the presidency towns of Madras, Bombay and Calcutta. The decentralisation initiative – devolving powers, functional responsibilities and authorities to urban local bodies in India virtually started with the 74th Constitution Amendment Act (CAA) 1992. Starting from the Royal Commission on Decentralisation in 1906, a number of commissions and committees have been appointed both by the central government and various state governments for examining various issues relating to municipal affairs. However, decentralisation through the Constitutional Amendment Act is considered a watershed development in urban policy initiatives in India. This is because, for the first time in the history of urban governance, municipal bodies were provided the constitutional status of the third tier of government. It is, however, well known that local bodies in India are confronted with poor finances, over-controlled local governance and a multiplicity of agencies, often with overlapping functional and geographical jurisdictions.

### **State of Finances :**

An organisation needs finances to fulfil the objectives it has chalked out for itself. As local government carries the word 'government', it must be clothed with authority to levy and collect taxes just like any other level of government. But a vital distinction exists between local government and a higher level of government. The former is non- sovereign and the power of taxation that it enjoys is by no means an original one and derived from the Constitution itself. It is empowered to levy only such taxes as have been approved by the state government. The latter is perfectly at liberty either to add or subtract from the list of taxes that have been at a given moment transferred to the local government.

After independence efforts were made by various committees and commissions in providing more and more financial and functional powers to the local government institution but nothing concrete was actually done till 1992. The constitution (73rd) Amendment Act, 1992 on Panchayat and the constitution (74th) Amendment Act, 1992 on Municipalities are a mile stone development in the history of independent India. In fact, these two constitutional amendments aim at transforming the panchayats and Municipalities into strong and viable unit of "self government" and bringing them into the main stream of the country's social economic development.

It is believed that the Seventy Fourth Constitutional Amendment Act is a milestone to strengthen the decentralized urban governance, but it is very important to mention here that local level institution is a subject under state law.<sup>3</sup> Thus, for instance, governance of urban areas was directly within the jurisdiction of the state government. Based on the issues that have emerged after the Seventy Fourth Constitutional Amendment, it can be said that now there is political decentralization but there are insufficient administrative and fiscal decentralization. By and large, such decentralization remains confined to ensure reservation of seats,<sup>4</sup> setting up of State Election Commission to conduct regular elections,<sup>5</sup> constituting State Finance Commission for periodically devolution of funds and

3. Entry 5 of State List under the 7th Schedule of the Constitution provides that 'Local government, that is to say, the constitution and powers of municipal corporations, improvement trusts, district boards, mining settlement authorities and other local authorities for the purpose of local self- government or village administration'.
4. Provision has been made to induct Women and Dalits into the portals of governance.
5. Regular conduct of election to these institutions means to stabilize the system as in the case of the National Parliament and the State Legislatures.

by prohibiting supersession and suspension, the said Constitutional Amendment Act has created new 'political platform' only.

The Seventy Fourth Constitutional Amendment Act did not lay down revenue base for Urban Local Bodies and power to determine the revenue base continue to remain with state government. The Constitution under Article 243X(a) states that a state may by law authorise a Municipality to levy, collect and appropriate such taxes, duties, tolls and fees in accordance with such procedure and subject to such limits. The State government may lay down the procedure and ceiling for the same. Article 243Y has made it mandatory for every state to constitute a State Finance Commission (SFC).<sup>6</sup> The SFC shall review the financial position of the Municipalities and make recommendations regarding distribution of taxes between the States and the Municipalities to the Governor. It is also expected to look into the criteria for grants-in-aid and suggest measures needed to improve the financial position of the Municipalities. But the SFC has to function strictly according to the Terms of reference (ToR) provided to it by the state. Since 'funds required' and the 'functions to be performed' are interrelated, the SFCs could review the existing situation and recommend a functional domain that would serve public interest and also be financially viable. But most of the SFCs did not touch on the subject at all. Revenue powers of Urban Local Bodies of different states throughout the country are often not in consonance. Though, the actual degree of devolution has been left to the discretion of respective state governments, resulting in conspicuous disparities in the extent of decentralization across India.

The constitution of India ordains that India is a Union of States,<sup>7</sup> with residual legislative powers vesting in the central government. The constitution, in its 7th schedule, assigns the powers and functions of the centre and states. The schedule specifies the exclusive powers of the centre in the Union List, exclusive powers of the states in the State List, and those falling under the joint jurisdiction in the Concurrent List. The Constitution of India specifies the taxes to be divided between the central and state governments but it does not specify the revenue base for Urban Local Bodies.<sup>8</sup> The Seventy Fourth Constitutional Amendment Act is not specific about the types of taxes of Urban Local Bodies should have but on the other hand the powers for determining the revenue base of ULBs rests with the state governments. The resource base of Urban Local Bodies typically

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6. Article 243Y (related to ULBs) and Article 243I (related to Panchayats) are the duplication of each other.

7. The Constitution of India, Article 1. The Republic of India described as union and not federation. The Drafting Committee had a purpose in choosing the word 'Union', in preference to 'Federation'. They were of the view that the word 'Union' better expresses the fact that the Union of India is not the outcome of an agreement among the old provinces with the result that it is not open to any State or a group of States to secede from the Union or to vary the boundary of their States on their own free will. Article 1 of the Constitution says that India is a Union of States, and the States and the territories thereof are specified in the First Schedule. None of the constituent units of the Indian Union was sovereign and independent in the sense the American colonies or the Swiss Cantons were before they formed their federal unions. The Constituent Assembly of India, deriving its power from the sovereign people, was unfettered by any previous commitment in evolving a constitutional pattern suitable to the genius and requirements of the Indian people as a whole (*Babulal Parate v. State of Bombay*, AIR 1960 SC 51,55).

8. However, this was not always the position. During the period 1921-37 the local government was endowed with a separate tax-zone. The Government of India 1919, contained a local list of taxes. The Government of India Act, 1935 did not include any local list of taxes, and so, with the inauguration of the Act in 1937 the local government got deprived of the special position in regard to taxation.

consists of their own resources (tax and non-tax revenues), shared revenues, state grants, and loans from state governments and market borrowings.

The constitutional assignment of the tax powers in India follows the principal of separation *i.e.* the tax handles are exclusively assigned either to the centre or to the states. Most of the broad based and the productive tax handles have been assigned to the centre, including income tax, wealth tax from non agricultural sources, corporation tax etc.<sup>9</sup> States taxes include taxes on agricultural income and wealth, tax on the transfer of properties (Stamp duties and registration fees), taxes on motor vehicles, entertainment tax, taxes on professions, trades, callings and employment, property tax. The centre has also been assigned all residual powers of taxation.<sup>10</sup>

Urban Local Bodies face so many constraints in which finance is an important. An organisation needs finances to fulfil the objectives it has chalked out for itself. Urban Local Bodies (ULBs) has a limited scope for decision making in the absence of appropriate financial control mechanism. They are more depended on the grants provided by the central and state governments. As local governments in India do not have the inherent power of taxation. The prior information about expected amount of own fund during a particular period is of great importance for decision making. But large scale dependency on the various level of federal government does not proficient to have prior information about the grant amount and delivery time. Moreover, the financial powers made available to it have suffered reduction over a period of time.<sup>11</sup> Absence of a list for local taxation in the Constitution, encroachment of the state government on areas traditionally earmarked for local government, an inefficient tax administration, and increasing local expenditure in response to both rising costs and rising expectations have made the financial position of local government desperate.<sup>12</sup>

A demand has often been made that local government in India should be given a separate list of taxes. In order to ensure definite sources of revenue, the Constitution needs to be suitably amended to include, on the lines of the union and the state list, list of local taxes also. At present, a local government, in respect of its finances, is at the mercy of the state government. Such dependence is sought to be overcome by incorporation in the constitution of a list of taxes for exclusive use of the local government.<sup>13</sup> By earmarking an area of taxes for the exclusive utilization by a local government, the list of local taxes will surely help keep local government unaffected by changing moods of the state government. The local government will get an assured and predictable list of taxes for its use.<sup>14</sup>

Experience shows that functional autonomy becomes a reality only when it is accompanied by

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9. Such tax sharing systems exist in other federations like Australia and Canada.
  10. Entry 97 of Union List. Any other matter not enumerated in List II and List III including any tax not mentioned in either of those Lists.
  11. The terminal tax on goods pulled by railways now vests in the Central government; the central government properties enjoy immunity from local taxation and the tax on professions has the maximum limit of Rs 250.00 imposed by Art. 276 of the Constitution.
  12. Maheswari, S.R. (2000): Local Government in India, Lakshmi Narain Agarwal, Agra, p.329.
  13. Ibid, pp 330-31.
  14. This question was examined in 1951 by the Local Finance Enquiry Committee. The Committee recommended a list of thirteen taxes (Terminal tax on goods or passengers carried by railway, sea or air; tax on lands and buildings; tax on mineral rights; tax on the entry of goods into a local area for consumption, use or sale therein; tax on the consumption on sale of electricity; tax on advertisements other than advertisements

financial independence. State governments, therefore, need to strengthen the autonomous functioning of the Urban Local Bodies through positive measures, and in particular, has to ensure their financial self-reliance. A new list named as Local Lists may be incorporated in the 7th schedule. A subject like municipal finance under local lists may be included in the constitution through amendment to provide assured and sustainable sources of income to the ULBs. This may include property tax, vacant land tax, service charge on central and state properties, trade licensing, building permission fee, development fee, etc., which are already in the local domain. Others in the municipal finance may include motor vehicle tax, surcharge on stamp duty, professional tax, entertainment tax, etc.<sup>15</sup>

There is often a mis-match between functional responsibilities and resource generation capacity of local governments. Therefore, the lower tiers of governance would depend on the higher tier for actual devolution. With the abolition of Octroi by most States, Property Tax is the most important source of revenue for local governments. Property tax<sup>16</sup> reforms like periodic revision, strengthening assessment, levy and collection procedures, improving billing and collection efficiency, elimination of exemptions, provision of penal clauses on illegal constructions, identifying un-assessed and under-assessed properties, etc., should be prioritized by Urban Local Bodies to improve their finances and to mobilize more resources. The Urban Local Bodies need to review their non-tax sources and periodically revise as per service improvements to meet the escalating costs. The user charges should be revised periodically by linking them to service improvements.

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published in the newspapers; tax on goods and passengers carried by road or on inland water-ways; tax on vehicles; tax on animals and boats; tolls; tax on professions, trades, callings and employment; capitation tax; tax on entertainments.) for the exclusive utilization by or for the local government. Again the Taxation Enquiry Commission (1953- 54) also addressed itself to the question of what specific taxes be devolved on local government. It recommended a list of ten taxes (tax on lands and buildings; octroi; tax on vehicles other than those mechanically propelled; tax on animals and boats; tax on professions, trades, callings and employment; tax on advertisements other than those published in newspapers; theatre tax; duty on transfer of property; tax on goods and passengers carried by road or inland water-ways.) to be reserved for a local government.

15. All most all the mentioned taxes are included in the State List.

16. The expression 'property tax' implies a tax on property. Traditionally, it is a tax on immovable and tangible property. It excludes such movable properties as furniture, fixtures, machinery, equipment etc. and such rights as licenses to run a hotel, shop in a cinema theatre.