



## Effectiveness of the Recommendations of the State Finance Commission – A Case Study Based on Urban Local Bodies in Tamil Nadu

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**Abstract:** *Indian local self-government can be traced to Lord Ripon's resolution of May, 1882. Tamil Nadu was a land of village republics, with community groups undertaking many activities for their area development. Local governments were seen mostly as rivals and so the governments at the Centre delayed the necessary enactments and wherever local governments existed prior to the 74th amendment. Constitution (74th Amendment) Act, 1992 provided for the mandatory establishment of the local bodies by the state governments and has ushered in a new era of urban governance and urban management in India. With more than 300 million urban dwellers in India, the role of the urban local bodies is enormous in dealing with the problems of urbanisation.*

**Index Terms** – Finance Commission; Village Panchayats; Democracy

### I. INTRODUCTION

*"Village Panchayats and the Panchayat Unions constitute the bedrock of Indian democracy and unless we strengthen the Village Panchayats and the Panchayat Unions, our democracy cannot become strong and vibrant. We have to take the knowledge of the world to our people in the rural areas. There is no other way of strengthening our nation."*

-- Perarignar Anna

The British roots of the post-independence Indian local self-government can be traced to Lord Ripon's resolution of May, 1882 which had a subject on the local self-government covering the establishment of local bodies, its structure, functions, finances and powers and the first municipality created during the British era was the Municipal Corporation in Madras (now Chennai) in 1688. It was later that the municipal corporations in Mumbai and Kolkata (erstwhile Bombay and Calcutta respectively) were formed. Lord Mayo's Resolution of 1870 even called for the introduction of an elected President to these municipalities. So Chennai being the capital of Tamilnadu, the latter has a unique position as a pioneer in the field of local self-government.

In a way, in those days, Tamilnadu was a land of village republics, with community groups undertaking many activities for their area development. This tradition reached its peak during the 10th-11th centuries under the reign of Cholas, when Village Councils used to levy taxes, improve community life and administer justice in their limited area. "Kuda Olai Murai" was the process of secret ballot exercised to select members to the Village Councils.<sup>1</sup>

In the post independence era, the first enactment in the context of democratic decentralization was in the State of Tamilnadu namely Madras Village Panchayat Act 1950. Pursuant to the White Paper on the "Reform of Local Administration" in 1957, the Madras Panchayat Act 1958 and Madras District Development Council Act 1958 were enacted.

Hence, Tamilnadu was not only a pioneer in the field of local self governments prior to independence, but also in the post independence era. Even after the 74<sup>th</sup> amendment, Tamilnadu has pioneered in implementing many schemes through early legislations empowering the local governments. Therefore a case study of the Urban Local Bodies in Tamilnadu comprising of 6 municipal corporations, 102 municipalities, 43 intermediate urban centers recently upgraded as municipalities and roughly 565 rural Panchayats called Special Village Panchayats, which are in varying degrees of urbanization going by the occupation and civic needs of the settlements in these Panchayats is apt in this context. In addition, according to the national census, Tamilnadu is above the all India average at 41% compared to 29% in terms of proportion of urban population to total population in the state.

Further it has been widely accepted that the local governments were seen mostly as rivals and so the governments at the Centre delayed the necessary enactments and wherever local governments existed prior to the 74<sup>th</sup> amendment, with less or in many cases no financial empowerment, the success of these local bodies was either nil or minimal in the post independence era. Realising the importance of financial stability, the Chennai (capital of Tamilnadu) Municipal Corporation was the first municipal authority in the

<sup>1</sup> [http://www.tn.gov.in/policynotes/pdf/rural\\_development.pdf](http://www.tn.gov.in/policynotes/pdf/rural_development.pdf)

country to have switched over to double entry accounting system under the aegis of a World Bank funding of urban development even in the late eighties.

So this paper attempts to trace and analyse the achievements Government of Tamilnadu in implementing the recommendations of its State Finance Commissions for strengthening urban local bodies from the context of financial resources based on the 74<sup>th</sup> amendment which initiated the third tier of government bringing finally democracy to the grass root level. It also identifies certain obstacles and makes a few suggestions for mobilising finances which is literally the spine of these urban local bodies. Though various state governments in the past have attempted to introduce the local self-government, it has been a failure, except very few instances, mainly due to the financial instability as these governments totally depended on the state governments for their finances. Even when it was the same party at the helm as the ruling party at the state, still the financial dependence and meager allocation of funds resulted in a farce implementation of the local self-government. If the ruling party of the state and the chairpersons of corporations, municipalities and panchayats were different, the situation was still worse.

Constitution (74th Amendment) Act, 1992 provided for the mandatory establishment of the local bodies by the state governments and has ushered in a new era of urban governance and urban management in India. With more than 300 million urban dwellers in India, the role of the urban local bodies is enormous in dealing with the problems of urbanisation. The role of the planners, investors and the administrators in this regard is an uphill task.

## **ACHIEVEMENTS**

The Seventy third and Seventy fourth Constitution Amendments Acts (1992), heralded a new era, in the chapter of the Local bodies by providing, among other things, the constitution of State Finance Commission in all the states within one year from the commencement of the Constitutional Amendment Act initially and thereafter for every fifth year to review the sources of municipal finance and to recommend steps to support state resources. Thus the Government of Tamilnadu has periodically constituted the State Finance Commission to review the financial position of the urban local bodies and recommended the principles which should govern the devolution of resources, including grant-in-aid from the Consolidated Fund of the State of these bodies.

In exercise of the powers conferred sub-section (1) of section 198 of the Tamilnadu Panchayat Act, 1994 (Tamilnadu Act 21 of 1994) the Governor of Tamilnadu appointed the first State Finance Commission.<sup>2</sup> Accordingly, the Government of Tamilnadu issued two notifications covering Rural and Urban Local bodies in G.O.Ms.No.350.Finance, Dated 23.4.94 and G.O.Ms.No.971, Finance, Dated 6.12.94, constituting the State Finance Commission and specifying the necessary terms of references though it started functioning only with effect from March 1995. Later the Second State Finance Commission was constituted on the 1<sup>st</sup> December 1999 and shall make its report available by 31<sup>st</sup> October 2001 covering the period of five years commencing on 1<sup>st</sup> April 2002.<sup>3</sup> The Government of Tamilnadu constituted the third State Finance Commission<sup>4</sup> to review the financial position of urban and rural local bodies and suggest measures to improve it. The Commission assessed the financial position of each of the local bodies as on March 31, 2005 and submitted its report for the five-year period from April 1, 2007. Before submitting its recommendations on the 30<sup>th</sup> September 2006, the Commission also took into account the resources of the State Government and the various demands placed on it, including the debt-servicing burden of the local bodies and the commitments that the Government made by enacting the Tamil Nadu Fiscal Responsibility Act 2003.

The State Finance Commission's<sup>5</sup> major recommendations implemented from the Financial Year 1997-98<sup>6</sup> to strengthen the financial resources of the urban local bodies by the Government of Tamilnadu are:

- (1) 90% of the Entertainment Tax was assigned to local bodies from 1997-98
- (2) 8 % of the revenue collected from State Taxes other than entertainment Tax was assigned to local bodies from 1997-98 onwards.
- (3) 15% of the amount was allotted to equalisation and incentive fund in the ratio 60:40 between the rural and urban local bodies.
- (4) The balance shall be distributed between rural and urban local bodies in the ratio 55:45
- (5) Rs.99,393 Crores has been allotted to local bodies as Equalisation and Incentive Fund. 40 % of this amount has been assigned to urban local bodies. The ratio of this amount is distributed between the Corporations, Municipalities and Town Panchayats at the ratio 31:31:38 respectively.
- (6) 80% of the incentive fund was distributed between the urban local bodies who have recovered more than 85% of the property tax. The balance 20% was distributed based on the repayment of the loans obtained under IUDP, MUDF and IDSMT.<sup>7</sup>
- (7) Restructuring of the MUDF component of TNUDF to create the first Public-Private partnership experiment for financing urban infrastructure.
- (8) 3.6% of State's tax revenue passed on urban local bodies
- (9) The first major computerisation effort in the country for ULBs functions was done in Tamilnadu through the Grant Fund, set up under the restructured TNUDF – I.
- (10) With assistance from the 'Grant Fund' of TNUDF, the ULBs have been able to avail of non-guaranteed debt to the extent of Rs.17.59 Crores from TNUDF.
- (11) Tamilnadu was the state to introduce a The Common Urban Local Bodies(ULBs) Bill which is a comprehensive legal framework for all ULBs in the State replacing about 8 existing legislations which was analyzed in detail by a committee of elected representatives, employees, general public etc and with modifications was passed by the State legislature in October 1998.

<sup>2</sup> Tamilnadu Government Gazette extraordinary Notification No.II (1)/FIN/38(C )/94 dated 23<sup>rd</sup> April 1994, at pages 1-2 of part II section 1 of the, dated the 23<sup>rd</sup> April 1994.

<sup>3</sup> TamilNadu Govt. Gazette Extraordinary Finance Department Notification No.11(1)/FIN/112(a)/99 dated the 1<sup>st</sup> December 1999 published at page 1 of part II –Section 1 of the dated the 2<sup>nd</sup> December 1999.

<sup>4</sup> G.O.Ms.No.573, Finance(FC-IV) Department, dated 1.12.2004. and Finance Department's Notification No:II(1)/Fin/ 77(b) / 2004 published in Tamil Nadu Government Gazette Extraordinary, dated the 2nd December, 2004.

<sup>5</sup> <http://www.tnrajbhavan.gov.in/Events.htm>

<sup>6</sup> Finance department G.O. Ms.No.247 dated 09-10-1997.

<sup>7</sup> [http://www.worldbank.org/urban/mun\\_fin/uifpapers/krishnan.pdf](http://www.worldbank.org/urban/mun_fin/uifpapers/krishnan.pdf)

Some of the important provisions in this Act are:

- Laying down of clear criteria for municipalisation
- Delineating the mandatory and discretionary functions of the local bodies.
- A carpet area based property tax system with provision for self assessment and penalties for delayed payments
- Presentation of urban services to Access capital market for resources
- Transparent Budget to include statements showing cost of service, population groups subsidised and quantum of subsidy.
- Levy of administrative charges for conservancy operations handling encroachments on public land effectively
- Area based penalty on unauthorised building constructions
- Power to levy a water tax, sewerage tax, tax on hoardings etc.
- Mandatory revision of fees / charges once in 3 years
- For the first time the State would undertake a major training program for both officials and non-officials of ULBs.
- TNUDP II has a major ID component which would concentrate on comprehensive training, system improvements like computerisation, lateral entry of professionals, for specified periods of time etc.
- The Tamilnadu Institute of Urban Studies to be restructured to become a state level Training Institute, capable of sustaining the training efforts to be started under TNUDP II.

(12) In order to enable the local governments to have access to funds for financing urban infrastructure projects, the Finance Bill 2000-2001 proposed to accord a tax-free status according to Clause 15 of Section 10 the Income Tax Act to the interest on bonds issued by them. Accordingly, a series of public-private partnerships (PPP) to finance urban infrastructure by accessing the capital market through debt instruments like Municipal Bond have emerged in different cities and towns. For example Ahmedabad Municipal Corporation issued a first historical Municipal Bond in Asia to raise Rs.100 crores from the capital market for part of financing a water supply project.<sup>8</sup>

(13) The Chennai Metropolitan Water Supply and Sewerage Board (CMWSSB) has planned to raise tax-free municipal bonds for urban infrastructure development works in city to benefit Chennai residents. It is also learnt that the Commissioner of Chennai Municipal Corporation in Tamilnadu has also called for a presentation on floating of low interest bonds by the Chennai Corporation. after getting itself credit-rated.<sup>9</sup>

(14) In Tamilnadu a dual control both by the state government and local bodies in some instances has also been successful. After the advent of 74th Amendment Act the regulatory functions relating to Pollution Control (vide S. No. 8 of XII Schedule of the Constitution) fall on urban local body. At present there is dual control by urban local body and Tamilnadu State Pollution Control Board in respect of Municipal Solid Waste (Management and Handling) Rules 1999.

(15) HUDCO and IL&FS acted as the financial intermediaries to channel the funds along with a matching amount of locally raised funds to municipalities or private sector entities to finance selected commercially viable urban infrastructure projects relating to water supply, Sewerage, Solid Waste Management and area development. Projects in many cities including in Tiruppur (Tamil Nadu), Ahmedabad, Pune, etc. provided catalytic in developing new financing techniques which differ from each other and hence serve as alternative models in urban infrastructure financing.

(16) Sewerage Project implemented in Alandur (Tamil Nadu), on the basis of public-private partnership in which construction was contract basis and the treatment plants was on BOT basis. The local body through a combination of sewerage tax, sewerage charge, connection charge, general revenues and state government completed the project well.

(17) The recommended grants to states by the Eleventh Central Finance Commission (CFC) for financing local bodies is ten times more than the Tenth Finance Commission recommended amount of Rs.1000 crores which is a positive sign by the Central government.

### **CRITICISM**

Despite the fact that the experience with the 74th Amendment has been successful with so many developmental programmes in progress, needless to say, it has not been a happy one to date due to certain factors:

- (1) Many legislative powers towards urban infrastructure are still vested with the States.
- (2) State governments are still the main resource-raising authority, evident in the usual urban taxes, from stamp duty to entertainment tax.
- (3) The only levy left to the municipalities is property tax. But here, too, the State decides the tax base, rates and modes of assessment.
- (4) Contrary to the federal practices of modern democracies, India fares poorly in its record of devolution to local bodies. Civic government expenditure in India is just 0.6 per cent of national GDP, compared with 5 per cent in Brazil and 6 per cent in South Africa.<sup>10</sup>
- (5) The Central governments have neither considered the Mayors as political heads nor has ever called them for a political discussion of civic issues of national importance.
- (6) In the most critical function of the mission — fund-raising — the local bodies have been left out entirely. Thus, of the projected Rs 1 lakh crore to be raised over the next seven years, the Centre will provide 35 per cent, the States 15 per cent, and the financial institutions the remaining 50 per cent.<sup>11</sup>
- (7) Debt service for the loans taken to pay for salaries and maintenance of civic amenities have become a major item of expenditure
- (8) Although Tamilnadu passed the Confirmity Legislation to the 74th Amendment in 1994, the reform process really started in 1996.
- (9) Centre and State investments have tended to reflect rural infrastructure priorities.<sup>12</sup>

<sup>8</sup><http://www.developmentfunds.org/pubs/Mukesh%20Paper%20on%20Municipal%20Situation%20in%20India.doc>

<sup>9</sup> <http://www.thehindubusinessline.com/2002/12/25/stories/2002122501631700.htm>.

<sup>10</sup> Ashoak Upadhyay, Urban infrastructure: Only devolution will work, Business Line, Tuesday, Mar 21, 2006 <http://www.thehindubusinessline.com/2006/03/21/04hdline.htm>

<sup>11</sup> Ashoak Upadhyay, Urban infrastructure: Only devolution will work, Business Line, Tuesday, Mar 21, 2006 <http://www.thehindubusinessline.com/2006/03/21/04hdline.htm>

<sup>12</sup> <http://www.tnrajbhavan.gov.in/Events.htm>



(10) The Commission (CFC) has recommended grants amounting to Rs. 10,000 crores for local bodies of the country during 2000-2005. Of this, Rs.1600 crores are for the panchayats and Rs.400 crores for the municipalities for each of the five years, starting from the financial year 2000-01. In per capita terms, the amount recommended for the Panchayati Raj Institutions (PRIs) are higher than those for the Urban Local Bodies (ULBs).

(11) The Ministry of Urban Development and Poverty Alleviation has, in its memorandum to us, stated that the urban population that was 26 per cent of the country's total population in 1991, was expected to reach the level of 30 per cent by 2001 and 41 per cent by 2021. The urban centres currently provide over 60 per cent of the GDP, yet they suffer from serious deficiencies in civic services and infrastructure in terms of safe drinking water, sewerage and drainage, solid and Liquid waste management, roads, street lighting etc.<sup>13</sup>

(12) Zakaria Committee (1963), India Infrastructure Report (Rakesh Mohan Committee (1996) and the Ministry of Urban development have always highlighted the serious lacunae in funds allocation for urban development.

**TABLE I - STATUS OF FIRST SFC RECOMMENDATIONS<sup>14</sup>**

	Total	Accepted	Not Accepted	Under Examination	No Orders Passed	Accepted in principle only
Taxation and other issues	195	93	97	2	3	0

**TABLE I - STATUS OF SECOND SFC RECOMMENDATIONS<sup>15</sup>**

	Accepted	Accepted in principle only	Not Accepted	No Orders Passed	Under Examination	Total
Taxation and other issues	93	0	97	3	2	195

Though many of the recommendations have been implemented by the Government of Tamilnadu, the above data highlights the fact that the recommendations that have not been accepted are more than the accepted ones. This trend has to change for better functioning of the urban local bodies.

## **SUGGESTIONS**

In the macro-economic policy perspective, the most significant public policy issue during the eighties has been the increasing trend towards privatization. Privatization has emerged as a major policy issue in recent years reflecting a world-wide interest in reducing the role of public sector. Municipal services such as garbage collection and disposal, public transportation, waste water and sewerage treatment, fire protection etc. have been contracted out by many states and local governments in countries like UK, USA, Canada, France and Italy.

Though privatization has started in Tamilnadu, the advantages of privatization in terms of capital infusion, increased revenue in recoveries and coverage of service and most importantly increased efficiency should further enhance the importance of the role of private sector in urban development.

- All the subjects mentioned in the Twelfth Schedule be transferred to ULBs
- ULBs should be given autonomy to fix tax rates and user charges.
- ULBs should privatize municipal services wherever it brings efficiency bodies along with transfer of funds and functionaries.

Article 243I should be amended to enable the States to set up the State Finance Commissions (SFC) at the expiration of every fifth year or earlier, akin to the provision that already exists under article 280 for constituting the Finance Commission. The synchronization of availability of the SFC reports may also be ensured through either a Central legislation or an appropriate provision in the Constitution.<sup>16</sup>

## **Conclusion**

The new economic policies, oriented towards market based economy-led growth objectives, would also entail significant contribution of the urban sector and efforts would be needed to reduce infrastructure bottlenecks and increase urban productivity and employment.

It will require serious efforts at various levels including the level of municipal governments, state governments and central government. All the subjects mentioned in the Twelfth Schedule should be transferred to urban local bodies along with transfer of funds and functionaries. Property tax which is one of the main sources of income for the municipalities should be simplified and rationalized. Exemptions from Property tax should be minimized and central government properties should also pay service charges in lieu of property tax.

Privatization of municipal services is clearly an option to improve service levels in urban areas and attract private capital and management skills in provision and maintenance of urban services.

Constitutionally speaking, there is no bar on them to raise funds throughout the globe. They are eligible to borrow from banks and raise bonds and have not yet capitalized this area of resource mobilization seriously.

Major resources of these urban bodies come from property taxes, profession tax, duty on registration, entertainment tax and monies devolved from taxes collected by the state by means of statutory transfers. The Ministry of Urban Development has a model Municipal Law and has even recommended a State Municipal Regulatory Commission to determine user charges and standards of

<sup>13</sup> Report of the 11<sup>th</sup> Central Finance Commission.

<sup>14</sup> <http://tnsfc.tn.nic.in/recom-index3.htm>

<sup>15</sup> <http://tnsfc.tn.nic.in/recom-index3.htm>

<sup>16</sup> Report of the 11<sup>th</sup> Central Finance Commission.

services and suggest options for private sector participation. More areas of resource generation will have to be worked out by these urban local bodies through better infrastructure and service to the people.

The national Eleventh Finance Commission has also recommended devolution of Rs. 2000 Crores as grant-in-aid from the Central Government to the urban local bodies.

Over the past couple of decades, India and specially Tamilnadu has seen the implementation and framing of efforts to modernise local government and has also revealed in the course of these efforts a commitment to local government that was hitherto a weak link in the Indian system. Nevertheless, it remains a system in transition that has room for further evolution to match its prevalent ground conditions. In addition to the areas to which attention has been drawn, the system also needs adequate quality control monitoring and capacity building mechanisms as well as additional reforms.

An estimate of financial needs for operation and maintenance of core municipal services in urban India made by the national institute of urban affairs indicates that the estimated gap in 1995 worked out to Rs.5987 Crores. It is expected to go up to Rs.12,980 Crores in the year 2000. while the accuracy of these estimates and measures that the state and urban local bodies can adopt to bridge the gap are matters to be discussed and studied by the state finance commissions, we are of the view that a provision of Rs.1000 Crores for the five year period covered by our recommendations will go a long way in enabling the urban local bodies to meet their primary obligations.<sup>17</sup>

Democracy at the third level will be successful only if it is made 'by the finance' and 'of the finance' so that it can be "for the people".



<sup>17</sup> Report of the 10<sup>th</sup> Central Finance commission.