

Fiscal federalism and decline of the third tier in India: A case for sharing of the new GST

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Abstract

Background/Objectives: Increasing number of development agencies and economists are emphasizing on the merits of decentralization. In this context, this study examines the state of fiscal decentralization to sub-national governments in India. It highlights the incomplete process of fiscal decentralization to the urban local bodies in India and suggests reforms for the same.

Methods/Statistical Analysis: This study measures the extent of fiscal decentralization in India using various quantitative indicators as suggested by the International Monetary Fund, such as: share of sub national government in the revenues and expenditures of higher levels of government, sub national expenditures as a % of Gross Domestic Product, sub national revenues as a % of Gross Domestic Product, and share of own revenue and devolved resources in sub national government's total revenue.

Findings: The main findings here suggest that India is a highly decentralized nation in terms of fiscal decentralization to State Governments, however, that is not the case when it comes to the urban local governments. Urban local bodies are neither able to raise adequate revenues from their 'own' sources, nor are they devolved much resources by the Centre and State Governments. A review of the Indian municipal finance system reveals that Indian municipalities lie in doldrums. There is an urgent need to relook into their finance system and carry out reforms. Given the limitations faced by the third level of government in raising revenue from 'own' sources, this paper presents a strong case to share the new Goods and Services Tax with them.

Improvements/Applications: It is expected that the GST Council and the concerned policy makers take the reform suggested into serious consideration so that cities can also get a share in the buoyancy created by them.

Keywords: Fiscal Decentralization, Urban Local Bodies, Goods and Services Tax, Municipalities, Municipal Finance, Own Revenues

1. Introduction

The world is undergoing an extraordinary phase of change in recorded history. Globalization is being embraced across nations at an accelerating pace. Developing nations are opening up their markets to foreign companies, encouraging foreign trade and liberalizing economies. With liberalization of economies, new technology is spreading, and several employment opportunities are being created. The aspirations of companies are increasing and they are now aiming for global leadership. Increasing globalization has also been accompanied with a revolution in the information and communication technology industry. The rise of ICT industry has become inter-changeable with globalization with the arrival of digital technologies and their inherent capabilities for quicker proliferation. Innovations in ICT are amalgamating different parts of the world like never before. Economies are increasingly being based on network and are becoming service-dominated.

The revolution in ICT has changed the way we live our lives. It has increased the magnitude of interconnectedness in almost every sphere of social existence. Internet and social media have integrated regional economies, cultures, and societies through communication, transportation, and trade. Information is now flowing freely and new ideas are being widely accepted.

The internet has made the geographic distance shrink. Distance is not what it used to be earlier and has become irrelevant. Businesses are expanding beyond their domestic boundaries after the arrival of internet, and all this is happening with almost zero transmission or information cost. This development has made developing nations enjoy new freedom and get access to any kind of information without any difficulty. As an innovation, internet has had an earth-shrinking potential. It is in-fact the most powerful driver of innovation in the world.

The role played by ICT in the socio-economic development is being recognized by governments worldwide. The ICT revolution is creating high quality employment opportunities, improving quality of life and creating international competitiveness. It is reducing the costs of shipping goods and communicating knowledge across the world. It is also offering developing countries an opportunity to compete with advanced economies and transform into high value-added information economies [1]. With the world becoming more and more globalized, the ICT industry revolutionizing, and economies becoming service oriented, urban areas are coming to light as the centers of domestic and foreign investment, economic activities, and business process outsourcing [2].

Globalization and new technologies are attracting people to big cities, increasing concentration in urban regions. The count of urban residents is increasing across the globe. More than 55% of the total world population lives in cities today, increasing from 41% in 1985 [3]. Rising migration has made the policy makers question if our cities are fit enough to support this level of development. Most of the developing cities have bad air, bad water, improper infrastructure, crowded slums, awful congestion, and poor housing conditions. Municipalities in India have limited own revenues sources and very less authority to make decisions. Insufficient revenue generation makes them fall short of fulfilling their expenditure commitments, leading to poor service delivery. These characteristics of the ULBs carry implications for the federal structure of governance and cannot be ignored. Unless the resource-raising abilities of the ULBs are not enhanced, cities will be under fiscal stress, and their ability to contribute to development and serve as drivers of growth will be restricted. This paper reviews the financial condition of municipalities in India and draws attention towards feeble condition of finances. It tries to address the most critical issues faced by ULBs- that of revenue generation and expenditure management, and suggests restructuring the local government finance system to facilitate the advent of cities that are competitive, and can efficiently cater to the requirements of basic civic amenities and infrastructure.

This study is divided into six sections. Section 2 provides the fiscal federal framework of India and highlights the significance of the third level of government in it. Section 3 analyses the extent of fiscal decentralization to sub-national governments in India. Various quantitative indicators are used to measure fiscal decentralization in Indian federalism. Section 4 discusses the key issues faced by the ULBs in India. Section 5 provides directions for reforms in the context of the new system of Goods and Services Tax subsuming some important municipal taxes. Section 6 concludes.

2. Fiscal federal framework of India: role of the third tier

India is a representative republic with a federated form of government make-up. Just like any other developing country, India is on the cutting edge of globalization. Prior to the LPG (Liberalization, Privatization, and Globalization) Reforms, India had a Central Government, State Governments in each of its states, and a dash of local self-governments in its urban and rural areas. India had a two tiered structure of Government until 1992. The State Governments did not nurture the local governments, and didn't devolve adequate powers and finances. As a result, they were not fully federated and had no constitutional status. In this regard, amendments (73rd and 74th) were made to the Constitution in 1993, and rural and urban local bodies were added as third set of government in India's federal structure. Integration of ULBs into the existing fiscal architecture of the nation created an environment for grounding competitive governance and deepened federalism. The governance circle got complete, with each layer of Government performing a level of function for which it is most appropriately suited.

The Indian Constitution has demarcated the expenditure and revenue powers clearly for all its levels of government. It has put out the areas of responsibility and sources of revenue for the Union and State government. Article 246 schedules seven of the constitution has specified the fiscal, executive, and legislative domains of the Union and State governments in terms of three lists, namely-Union List, State List, and Concurrent List. All matters important to the nation are assigned to the Union List.

The Union List covers functions such as atomic energy, defense, foreign affairs, insurance, organization of the High Courts and Supreme Court, railways, national highways, major ports, elections to the State Legislatures and Parliament, airways, foreign loans, trade and commerce with foreign countries, inter-state trade and commerce, banking, stock exchanges and future markets, census, etc. The State List includes public health and sanitation, public order, elections to local bodies, police, prison, local government, hospitals and dispensaries, irrigation and canals, roads other than highways, agriculture, fisheries, water supplies, land, markets and fairs etc. The Concurrent List includes criminal law and procedure, transfer of property, contracts, bankruptcy and insolvency, trusts, administration of justice, civil procedure, forests, industrial and commercial monopolies, social insurance, social security, education, factories, economic and social planning, electricity, welfare of labor, trade and commerce in certain goods, etc. Given the strategic position of ULBs in the hierarchy of Government setup in delivering services, they have been assigned several important functions by the Constitution (74thAA). Schedule Twelve of the Constitution, Article 243W assigns eighteen functions to the ULBs, such as- planning for social and economic development, slum improvement and urban forestry, urban poverty alleviation, provision of basic services and infrastructure, urban planning and regulation of land use, etc.

In terms of revenue authority, the Constitution vests important powers in fiscal matters to the Centre and gives it a comparative advantage in raising revenues from the most buoyant tax sources like income tax, excise, corporation tax, customs etc. The States are also assigned tax instruments like tax on agricultural income, general sales tax, state excise duty, stamp duties and registration fees, etc that generate decent amount of revenue to fund their expenditure requirements. The urban local governments, however, are not assigned any commensurate revenue sources. No Municipal Finance List has been assigned to them. Their own revenue base is extremely narrow and consists of few taxes like property tax, octroi, toll tax, advertisement tax, tax on animals, vacant land tax, taxes on carts and carriages, taxes on consumption and sale of electricity, and. Among these few revenue sources also, only property tax is productive and buoyant. Octroi, which was once the most buoyant revenue source for the ULBs has also been abolished, leaving ULBs cash-strapped. The ULBs fall short of funds to meet the increasing needs of basic services and infrastructure in cities. The Indian Constitution, recognizing this deficit has provided for mechanisms to transferring funds to the urban local bodies under Article 280 3(c) and Article 243(Y) via channels of- Central Finance Commission and State Finance Commission. However, even these mechanisms have not been successful in reviving the municipal sector. The municipal finance system needs an urgent restructuring for the municipalities to gain strength, independence, and sustenance. In this light, this paper recommends reforms needed to strengthen Indian municipal finance, hence designing a brand new fiscal architecture for India.

3. Measuring the extent of fiscal decentralization in India

Many governments, specialists, agencies, and economists consider fiscal decentralization an important tool of boosting economic growth [4-6]. Decentralization basically involves shifting of power away from central government, towards sub national governments. Analysts find inherent merit in decentralization and consider decentralization to be integral to human wellbeing. As per policy makers, fiscal decentralization helps in improving governance, enabling efficient allocation of resources, accelerating economic growth, empowering weaker sections of society, and reducing poverty.

In India, the constitutional arrangements have led to an in-built bias in favor of the Union, and huge vertical imbalances in the responsibilities and resources at the sub-national level. The problem is considerably confounded by the multi-layered character of the federation that has failed to follow the principle of subsidiary while guiding the division of expenditure responsibilities and revenue assignments, and the extant multiple channels of transfer arrangements that have diverse objectives to serve. India, as a federal nation, is considerably decentralized when the Centre-to-State setup is considered, however the nation is extremely centralized in terms of decentralization to the third tier.

Fiscal decentralization can be observed in a nation both-quantitatively and qualitatively. Qualitatively, it is measured by observing the extent to which sub national governments in a nation have autonomy in deciding their tax base and rates, how much discretion sub national governments have over their expenditures and revenues, or how much control they have over their own revenues.

This study tries to measure fiscal decentralization quantitatively using various indicators as suggested by the Indian Monetary Fund. The various indicators used in this paper to capture fiscal decentralization are: share of States/local government in the revenues of Centre, share of States/local government in the expenditures of Centre, share of expenditure of State/local government in the nation's Gross Domestic Product, share of revenue of State/local government in the nation's GDP, share of own revenue component in total revenue of the State/local government, and the share of devolved funds in total revenue of the State/local government. This paper calculates all these ratios for India to evaluate the degree to which the nation is decentralized fiscally.

3.1. Fiscal decentralization to states

The trend in fiscal decentralization to States has been rising over the years, implying increasing shift of authority (in terms of raising revenue and spending) away from Centre- towards States. Table 1 presents a complete picture of fiscal decentralization to States in India since 1990-91. Rising share of state governments in combined revenue receipts, combined expenditure receipts, and GDP indicates the increasing importance of states in India's public finance system. The share of their expenditure, revenue, and tax revenue has increased from 13.87% of GDP, 10.71% of GDP, and 7.62% of GDP in 1990-91 to 18.01% of GDP, 15.02% of GDP, and 10.82% of GDP in 2016-17. An important feature to be noticed is the asymmetry in expenditure and revenue decentralization in Indian fiscal federalism. Although the States are increasingly being decentralized both expenditures and revenues, the pace of expenditure decentralization clearly outpaces revenue decentralization.

Table 1. Fiscal decentralization to states in India

Selected Indicators		1990-91	2000-01	2010-11	2014-15	2015-16 (RE)	2016-17 (BE)
Total Revenues (as a % of GDP)	Union	9.38	8.85	10.07	8.76	8.90	9.07
	States	10.71	10.19	11.98	12.52	14.41	15.02
	Combined (Union+States)	16.94	16.07	19.89	18.55	21.03	22.21
Tax Revenue (as a % of GDP)	Union	9.82	8.66	10.19	9.98	10.76	10.83
	States	7.62	7.75	9.02	9.11	10.59	10.82
	Combined (Union+States)	14.96	14.02	16.34	16.36	17.57	17.82
Total Expenditure (as a % of GDP)	Union	17.21	14.38	15.26	13.20	13.42	12.99
	States	13.87	14.09	14.01	15.07	18.06	18.01
	Combined (Union+States)	26.65	25.36	27.05	25.61	29.30	29.11
State's Share in Combined Revenues	Tax Revenue	50.93	55.24	55.19	55.71	60.26	60.73
	Non-Tax Revenue	44.86	40.82	23.78	36.40	32.44	33.82
	Total Revenue	63.21	63.37	60.21	67.52	68.52	67.63
State's Share in Combined Expenditures	Revenue Expenditure	55.19	56.03	51.33	58.76	61.48	60.88
	Capital Expenditure	44.54	56.96	53.67	60.79	63.75	67.19
	Total Expenditure	52.05	55.09	51.53	58.86	61.66	61.88
Composition of Total revenues of States	Own Tax Revenue	48.04	52.74	53.65	54.03	51.67	50.65
	Shared Central Taxes	22.37	20.38	21.19	18.28	22.06	21.59
	Grants-in-Aid	19.73	16.88	18.17	21.07	20.07	20.90

Source: Indian public finance statistics, 2016-17

Table 1 reveals that the rise in state's share in the combined expenditure of Centre and States (from 52.05% in 1990-91 to 61.88% in 2016-17) is higher than the rise in state's share in the combined revenues of the Centre and States (from 63.21% in 1990-91 to 67.63% in 2016-17). State's share in the combined tax revenues of the Centre and States has also increased from 50.93% in 1990-91 to 60.73% in 2016-17, indicating a rise in tax decentralization at the State level. These trends clearly express the increasing trend of fiscal decentralization from Centre to States.

3.2. Fiscal decentralization to urban local bodies

Indian ULBs are one of the weakest ULBs in the world in terms of fiscal capacity. They lack autonomy, have a poor resource base, low capacity to mobilize their own revenues, depend highly on the Centre and States for funds, and suffer from internal inefficiencies in managing their finances. Their revenue base is inflexible, narrow, and lacks buoyancy. They have not yet received the necessary momentum and are financially dependent on the upper tiers of Government for sustenance. The municipal finance system is an important part of India's public finance system; however the finances of the municipalities are in such a dismal state that they till date don't hold a position in the nation's aggregate public finance picture. This is a matter of serious concern, as urbanization is increasing, and so is the contribution of urban areas to economic growth.

The Constitution of India, in regards to the weak state of municipal finances, has taken several strategic initiatives in the last two decades. It gave a constitutional status to the municipal bodies through 74th Constitutional Amendment Act and provided them with a constitutional framework to redesign intergovernmental transfer mechanism and improve the fiscal relationship among the three tiers of Government. Article 243Y was inserted into the Constitution (74rd AA), making it compulsory for every State to constitute a SFC every five years, and review the fiscal condition of the municipalities under them. An amendment was made to the Article 280 and clause 3 was inserted into it, making it compulsory for the CFC to devolve funds to the States every five years, recommend measures to augment their Consolidated Fund, and supplement the resources of the ULBs on the basis of the suggestions made by the SFCs. In spite of these interventions, unfortunately, the finances of urban local governments are deteriorating.

Indian ULBs are far behind the various developing and developed countries in terms of decentralization of both expenditure and revenue. Although, the urban local bodies have been growing, their share in the nations GDP, combined expenditure of the States and Centre, and combined revenue of the States and Centre is still very low, and has in-fact been declining over time. The relative importance of municipal sector has been revealed in Table 2. Municipal expenditure had a share of mere 1% in the nation's GDP; the ratio was 1.09% in 2007-08 (Table 2). In contrast, the local expenditure-GDP ratio in 2016 in some of the OECD nations was- 6.99% for Belgium, 7.63% for Germany, 7.65% for Austria, 10.94% for France, 10.05% for United Kingdom, 13.60% for Italy, 21.93% for Finland, 24.79% for Sweden, and 34% for Denmark [7]. The share of municipal expenditure in the combined expenditure of State and Centre also fell from 2.11% in 2007-08 to 1.79% in 2012-13 (Table 2). In comparison, local governments in OECD countries had following shares in their general government expenditure in 2016- 64.97% in Denmark, 50.62% in Sweden, 40.36% in Finland, 31.31% in Poland, and 33.18% in Norway [7].

Table 2. Expenditure decentralization to the ULBs

Time Period	ULB Expenditure(in ₹Crore)	Share of ULB Expenditure in the Country's GDP	Share of ULB Expenditure in the Combined Expenditure of States and Centre
1998-1999	12035	0.75%	2.21%
1999-2000	14452	0.82%	2.36%
2000-2001	15743	0.83%	2.34%
2001-2002	15914	0.76%	2.15%
2002-2003	21630	0.92%	2.13%
2007-2008	47026	1.09%	2.11%
2012-2013	92027	1.00%	1.79%

Source: 1) Reports of Finance Commission
2) Handbook of Statistics on Indian Economy
3) Economic Survey of various years, Gol

Decentralization in terms of revenue is all-the-more glaring at ULB level in India. Table 3 shows that the share of the total revenues of the urban local governments in the nation's GDP and the combined revenues of the State and Centre in 2012-13 was just 1.03% and 3.62%. The tax revenues of the municipalities had a share of 0.33% in the GDP in 2012-13, falling from 0.40% in 2007-08 [8]. In comparison, the municipal tax revenue-GDP ratio in 2016 in selected OECD countries was- 4.3% in Poland, 3.2% in Germany, 1.3% in Austria, 1.6% in UK, 3.5% in US, 6.2% in Norway, 6.5% in Italy, 10.2% in Finland, and 12.5% in Denmark [9].

Table 3. Revenue decentralization to the ULBs

Time Period	ULB Revenue (in ₹Crore)	Share of ULB Revenue in the Country's GDP	Share of ULB Revenue in the Combined Revenue of States and Centre
1998-1999	11515	0.69%	2.51%
1999-2000	13173	0.71%	2.43%
2000-2001	14581	0.73%	2.44%
2001-2002	15149	0.70%	2.33%
2002-2003	20920	0.93%	2.95%
2007-2008	49351	1.08%	3.92%
2012-2013	96640	1.03%	3.62%

Source: 1: Handbook of Statistics on Indian Economy

2: Reports of Finance Commission

3: Economic Surveys of various years

Table 2 and 3 together reveal that India's municipal sector is extremely small in size. Urban local governments in India barely account for 2-3% of the combined revenue and expenditure of the States and Centre. Their position is extremely in contrast to the developed countries where fiscal federalism is based on the principle of 'subsidiary' [10].

Table 4 highlights the macro level dismal picture of municipal finances in India in detail. It reveals that the factors responsible for the dismal condition of municipal finances are- insufficient generation of internal revenues, increasing demand for spending on basic infrastructure and services, and ad-hoc nature of transfers and grants-in-aid. Municipal revenues stood at 1.03% of GDP in 2012-13, falling from 1.08% in 2007-08. "Own revenues" had a share of 51.6% in the total municipal revenues in 2012-13; reducing from 55.7% in 2007-08. "Own tax revenues" had a share of 32% in the total municipal revenues in 2012-13, declining from 37.2% in 2007-08. The most buoyant tax with the municipalities- property tax has also been declining, from 0.18% of GDP in 2007-08 to 0.16% of GDP in 2012-13.

Table 4. Municipal finances in India, all states

Sources of Revenue	2007-08		2012-13	
	Total (in ₹Crore)	As a % of the Total Revenues of the Municipalities	Total (₹Crore)	As a % of the Total Revenues of the Municipalities
Total Own Revenue Source	27,501	55.70	49,913	51.60
Own Tax Revenue	18,366	37.20	30,912	32.00
Own Non-Tax Revenue	9,134	18.50	19,002	19.70
GOI Transfers	3,515	7.10	5,387	5.60
Central Finance Commission Transfers	986	2.00	3,760	3.90
State Assignment/Devolution	9,342	18.90	18,537	19.20
State Grant in Aid	6,653	13.50	14,809	15.30
Others	1,355	2.70	4,234	4.40
Total Revenues	49,351	100	96,640	100
Total Expenditure	47,026	100	92,027	100
GDP at Factor Cost in Current Prices	45,82,086		93,88,876	
Own Taxes as a % of the country's GDP	0.40		0.33	
Own Revenues as a % of the country's GDP	0.60		0.53	
Property Tax as a % of the country's GDP	0.18		0.16	
GOI/Central Finance Commission Transfers as a % of the country's GDP	0.10		0.10	
State Government/State Finance Commission Transfers as % of the country's GDP	0.35		0.36	
Municipal Revenue as % of the country's GDP	1.08		1.03	
Municipal Expenditure as % of the country's GDP	1.09		1.00	

Source: Asia Development Bank - India Municipal Finance Study, February 2013 by NIPFP – Delhi, Administrative Staff College of India (2014)

The share of non-tax own revenues in the total municipal revenues, however increased marginally from 18.50% in 2007-08 to 19.70% in 2012-13. In sum, it can be seen that all the key municipal fiscal autonomy ratios like own revenues-GDP, property tax-GDP, own taxes-GDP have been declining. The main issue faced by the municipalities is the non-buoyancy and non-vitality of the own revenue component in their revenue base. Continuous declining share of own tax revenues in both GDP, and the total municipal revenues reflect that the municipalities are at a high risk of maintaining their fiscal identity in the fiscal federal set-up of India.

The Centre and State, recognizing the failure of municipalities in generating revenues to meet their expenditure requirements, have been trying to meet a large part of this gap through intergovernmental transfers; however the increase has been marginal. Central transfers didn't increase as a % of GDP during the period 2007-2012, and the share was constant at 0.10% in both the years (Table 4). State transfers showed a marginal increase as a % of GDP from 0.35% in 2007-08 to 0.36% in 2012-13 (Table 4). The data conclusively indicates that the overall devolution of funds to municipal governments is growing, however the pace at which it is growing is extremely slow.

All measures of fiscal decentralization to urban local bodies suggest that the nation has moved backwards in carrying out the objectives illustrated in the 74th CAA, and the decentralization agenda as envisioned under the 74th CAA is at a standstill. Even after years of the 74th CAA, the type of decentralization observed at the urban local body level is highly constricted.

4. Key issues

Cities are the engines of growth. In order to continue being the drivers of economic growth, cities need to be able to provide basic infrastructure and civic services to its residents. In India, the financing requirements to provide basic services and infrastructure to all its urban residents are enormous. India would need to spend ₹9.74 million crores on its cities by 2030, with ₹5.31 million crores required for capital expenditure [11]. It would need ₹3.92 million crore for urban infrastructure investment over the period 2012-31. [12] If operation and maintenance costs are added, the figure would increase to ₹5.92 million crore [12]. With an exception of a small number of cities, capital spending for civic infrastructure is grossly deficient.

While the financing requirements are huge, the finances of ULBs in India are in a sorry state. Sadly enough, Indian municipalities do not have either any adequate or appropriate means to raise their "own" revenue, making them highly dependent on the higher levels of government for transfers. They also have limited financial autonomy as the States set tax rates, grant exemptions, determine transfers to municipalities, and also the conditions of their access to market sources. They have also not exploited the option of borrowing as a source of revenue. The State governments practice control over their borrowing powers and decides the rate at which they can borrow. A major chunk of the transfers seem to be tied, project specific and non-discretionary; limiting the abilities of the ULB stomach resources to locally felt needs, and defeating the purpose of the 74th CAA. In other words, the expected benefits of improved fiscal devolution through the CFCs and SFCs have not yet been realized.

The 74th CAA visualized greater autonomy and responsibilities for the elected ULBs; however it failed to grant them proper access to resources. The Act provided municipal bodies the right to exist but upheld the prerogative of state governments to decide their functional and financial domains. The political challenges faced by the ULBs, like the State Governments needing to concede their power and authority to levy taxes are daunting. The local tax base assigned to the municipalities is inferior in nature with inadequate augmentation and internal inefficiencies, stopping the municipalities from leveraging their full potential. As a result, even after the constitutional amendments, municipal bodies have remained marginalized both functionally and financially in the Indian federal structure.

Municipal bodies in India have lost the classical theoretical autonomy of a self-ruling institution. The CFCs and SFCs have failed to strengthen the ULBs. Adequate taxes are not devolved to the ULBs, increasing their financial dependence on the higher-level governments and creating a centralized system. The lack of functional and fiscal devolution to municipal bodies has negatively impacted decentralization objectives in making government more responsive to the requirements of its local residents.

The State governments are determining the fiscal space of the municipalities and are not empowering them with adequate resources or powers to levy existing or new taxes or user charges. The State Government levies and collects the taxes assigned to the municipal bodies and passes on the proceeds to the municipal bodies. Lack of buoyant own revenue sources has made the municipal bodies depend on devolutions of funds from the Centre and State to fund their expenditures. Increasing dependence on grants and its widening nature as a policy instrument to finance the infrastructure deficit in the country has adversely affected the municipal bodies which are often self-satisfied to fund its operational deficit through grant money.

The condition of municipal finances in India is deteriorating over the years and the fiscal gap between the expenditure and revenues is increasing by the day. The power of ULBs to levy taxes has been dwindling over the years, eroding their autonomy. ULBs are facing a lot of resource crunch due to poor delegation of revenue raising powers, improper tax administration, inadequate assignment of tax resources, insufficient user fees, and under-exploitation of the revenues assigned to them. The revenue sources assigned to the ULBs are grossly inadequate to meet their burgeoning needs. Only property tax has proved to be a major contributor to the exchequer of the municipalities, but its share in total municipal revenues has also been declining from 16.53% in 2007-08 to 15.64% in 2012-13 [8]. Octroi, a high yielding and buoyant tax that accounted for 70% of municipal revenues [13] also got abolished in all states except Maharashtra on account of being distortionary. None of the State Governments have assigned an alternate source of revenue to the ULBs. The current resources of ULBs stand nowhere compared to the service level gaps and the infrastructure investments needed to promote growth and accommodate incremental population in cities, including rural-urban migrants.

With octroi abolished and States disbursing 'local' taxes such as profession tax, motor vehicles tax, entertainment tax, duty on transfer of property, and tax on consumption or sale of electricity over time, many ULBs in India have reached a state where they cannot even meet the cost of the most basic civic functions with their 'own' resources. Due to protests by municipal employees not receiving salaries for months, a number of states have provincial zed municipal staffing scheme, and municipal employees are receiving salary and pension from the state government. Ironically, Indian cities are deprived of the buoyancy they create in the economy through their agglomeration externalities. With the advent of the GST, the entire key local taxes of the municipalities such as octroi and entry tax will be subsumed, and cities will be losing the limited access they had to the buoyancy in the urban economy. This will paralyze the municipal finance system further and dry up all the revenues of ULBs. The GST Council has divided the unified revenues from the tax between the Centre and States based on a mutually accepted formula, but it has made no provision to share revenues between states and ULBs, leaving ULBs cash-strapped. With no independent revenue sources and no share in the unified GST revenue, ULBs have become weaker and more dependent on state grants. This has stifled their autonomy and has led to weak urban governance. Urgent reforms are needed to improve the condition of municipal finance.

5. Need for reforms in the new GST era

As observed, the municipal finance system is in doldrums. It is vital to revamp the municipal structure and tap all existing avenues to facilitate equitable development in cities and promote inclusive economic growth. Extensive reforms are needed in the fiscal federalism framework, assignment of revenues, quantum and timing of intergovernmental transfers to correct the vertical imbalances. The mismatch between revenue and expenditure needs can be corrected only by ensuring that each and every function of ULB has a corresponding financing source. Substantial efforts need to be made to increase the revenues from 'own' sources. There is also an urgent need to redesign the intergovernmental transfers to the municipalities. The sum, design, and frequency of inter-governmental transfers must be objective, transparent, pre-determined and predictable. They must incorporate in-built incentives to promote local resource mobilization so that effective public services can be delivered.

Measures need to be taken to augment the tax base of local bodies to keep the autonomy of ULBs intact. Since municipalities in India do not have access to sales, income, goods and services, value added, excise and business tax bases that keep pace with economic growth, GST can be taken as an opportunity to empower local bodies. The issues of revenue assignment to municipalities need to be revisited in the context of the GST.

In particular, finding alternatives to octroi and entry tax that was adopted by states in place of octroi remains an important issue not resolved so far. This is critical in the GST era under which there will be no possibility for ULBs to levy such taxes. Cities across India need to have one or more taxes that match the revenue potential and buoyancy of octroi. Octroi could be substituted in the form of entry tax if cities are to function as locomotives of growth. Keeping in mind the provisions of the Constitution, the only possibility to have a vibrant alternative to octroi appears to be a city GST rate as part of state GST rate or a statutory share for cities in GST. It is thus important to design a mechanism for the sharing of GST with the urban local governments. In this regard, the GST council needs to come up with a formula, based on which ULBs can get a share of GST, or else, the GST Act would defeat the main purpose of the 73rd and 74th CAA (fighting centralization of powers). Without a formula-based, statutory share in GST which has subsumed many taxes, the conditions of municipalities will continue to be precarious and they will not be able to discharge their role as drivers of structural transformation in process of India's transition to a developed country.

GST provides a golden opportunity to resolve the long-pending issues of non-assignment of a versatile alternative to octroi and other 'local taxes' to ULBs or an appropriate and predictable sharing of some buoyant taxes of higher levels of government with ULBs. To ensure that ULBs have access to the GST base to which cities contribute significantly, we suggest that the GST regime considers compensating municipalities fully for the loss of octroi and other local taxes such as advertisement tax, entry tax, entertainment tax, tax on sale and consumption of electricity, etc. taken over by states over time or subsumed by GST now. The fact that octroi was abolished by States based on a call given by Government of India to create a common market in India – the same objective as that of GST – needs to be fully taken into account by the Centre and States while stabilizing the Goods and Services Tax structure in the future. A city GST rate or statutory, formula-based sharing of State GST with cities based on a clear understanding between the Central Government and the State Governments is desirable. The revenues that could have accrued to ULBs had octroi and entry tax not been abolished or taxes meant for or recommended for local bodies had not been taken over by state governments or subsumed under GST should be taken as the benchmark to arrive at city GST rate or share of cities in GST.

Internationally, ULBs in several multi-tier countries (e.g. Brazil, China and Nigeria) get an access to a city GST rate equal to 25-30% of the State-GST rate. Alternatively, the ULBs in India may have a statutory minimum share in state GST, at 25-30% to compensate them for the huge financial loss they are likely to suffer in the unified tax regime. Further, they may also get an access to the divisible pool of the taxes of the Centre, including central GST through the CFC route based on an amendment to the Constitution. India may perhaps set a road map to achieve a 3% 'transfers to municipalities-GDP' ratio by the time the country reaches 50% urban mark – 1% through central channels and 2% through state routes, including city GST rate within state GST rate or a formula-based share in state GST.

6. Conclusion

Reforms in the municipal sector cannot be viewed in isolation from the broader economic and social policies and the fiscal federalism framework of India. For cities to continue acting as engines of economic growth, it is high time policy makers consider undertaking drastic reforms that would augment and deepen the resource base of the ULBs, and match the increasing demands of basic infrastructure and civic amenities in a better fashion. In this regard, it is extremely important to empower our ULBs with "assured" and "predictable" sources of revenue.

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