

C H A P T E R - I

: THEORY OF LOCAL FINANCE :

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C H A P T E R - I

THEORY OF LOCAL FINANCE

1.1 INTRODUCTION:

Economics is a social science dealing with covering human beings. It studies human-behaviour. There are different aspects of human behaviour, which are studied in different social sciences i.e. Social, Political, Ethical, Psychological, Economic etc. Economics studies economic behaviour of human beings, therefore, it is called social science. The subject matter of economics is economic behaviour and economic activities of human-beings, society, government and nation. Economics has a vast scope because it is concerned with every economic activity of human beings. Economics is a social science having many branches of study, for example, Economics of Agriculture, Economics of Industry, Economics of Money and Banking, Economics of Public Finance etc. Economics of Public Finance is one of the important branches of economics. The present study is concerned with " Local Finance " which is one of the aspects of the study of Economics of Public Finance.

1.2 MEANING OF PUBLIC FINANCE:

The term " Public Finance " refers to finances - monetary resources of the public authorities or the government bodies at all levels - Central, State or Local. Public Finance

is a study of the finances of the government. Public Finance is a compound word, which is composed of 'public' and 'finance'. In 'Public Finance' the word 'public' is used to denote government or the State. The government may be Central Government, State Government or Local Government. The word 'finance' is necessarily connected with money. However, the word finance is used in the widest sense. The finances of government refers to raising and spending of financial resources. Thus, economics of Public Finance studies systematically and scientifically the operations of public revenue and public expenditures. Therefore, it will be appropriate to say that, public finance is an investigation into the nature and principles of State expenditure and State revenue. F.Shirras defines Public Finance as the study of the principles underlying the spending and raising of funds by public authorities.

In brief, public finance is the science of income and expenditure of the government. It deals with the financial operations of the government to attain pre-determined socio-economic objectives. We find the modern definitions of public finance in the writings of R.A.Musgrave, J.M.Keynes, Galbraith, A.P.Lerner and others.

The government performs various functions to attain predetermined socio-economic objectives by providing public goods and utility services. Therefore, the government requires

revenue. The sources of revenue available to the government are taxation, fees and fines, non-tax revenues, surplus of public sector undertakings, borrowings internal and external and deficit financing.

The functions to be performed by the government depend upon the objectives of growth and development that the government desires to achieve in a country. In the case of under developed countries adopting a mixed economy pattern, the functions that the government have to perform in a democratic political framework and under planning are multiple and envisage huge expenditure outlays. However, on the basis of resources available the government decides how much and to what extent different activities are to be performed. The government also have to decide how much to spend on different activities to achieve pre-determined objectives.

// The history of the origin of state shows that in early stages the functions and the role of government was very limited. It had to maintain internal peace, law and order and protect the community from external aggression. It means, it had to perform only police state functions. It was a police state. But, now, the role of a government is changing. It plays a vital role in every type of economy of the country. Therefore, the functions to be performed by the government are also changing. The scope of functions to be performed by

the government are also changing. The scope of functions to be performed by the government has been enlarged. Now-a-days, the main and the important objectives of the government has become the objectives of social welfare maximisation. The government have to do activities concerned with economic, social and political aspects. The functions of the government are extended to the fields of development, employment, infrastructure facilities, public health and hygiene, social security schemes etc. The government has concentrated its activities on promoting economic development and maximising welfare.

In 1936, J.M.Keynes wrote the famous book entitled " General Theory of Employment, Interest and Money ", in which he, for the first time, wrote that, there should be increase of government interference in the economic activities to take the economy, which is at a stage of under full employment, towards full employment potential. The government should perform functions related to economic activities besides its police functions. He stated in this book, it is the fiscal policy which would increase national income, generate employment and maintain it at high levels, and bring about stability. Therefore, government of the developed as well as under developed countries should interfere in the economic activities to increase national income, generate high level of employment and to promote social welfare. That is why,

the role and the functions of the government have been expanded considerably. The performance of these functions envisages rising government expenditure, which calls in for a greater degree of resource mobilisation by the government.

In a federal form of political organisation in a country, we have different layers of government working simultaneously to provide maximum welfare and to undertake economic development in the country. In a federal form of government normally, we have the Central Government at the Centre, the various State Government at the State or regional level and the local governments at the lower end, which are the closest form of government to the people. Local governments are basically of two types - the urban local bodies and the rural local bodies. The constitution of the federal country normally divides the functions and resources between the Centre and State governments and the State governments delegate powers and resources to the local governments. Local government bodies assume significance as they are the closest to the people and their functions affect all aspects of the daily life of the people.

1.3 MEANING OF LOCAL GOVERNMENT:

The role of Local government is today much important in the daily life of citizens. In the real sense, citizens are closely connected with the Local governments. They have

been playing a vital role in the overall development of the local areas. Therefore, it becomes essential to take into account the meaning of Local Government.

The term " Local Government " means the government by freely elected local bodies which are endowed with power, discretion and responsibility to be exercised and discharged by them, without control over their decisions by any other higher authority. Their actions are, however, subject to the supremacy of the national government¹.

Local Government has been defined in various ways, but the simplest definition is, " a government at local level having authority to undertake the power to perform public activities within its territory"².

G.M.Harris in his " Comparative Local Government " has defined local government as " the government by the people themselves through freely elected representatives"³.

B.K.Gokhale in the " The Constitution of India" has defined local government as " the government of a specified locality by the local people through the representatives elected by them"⁴.

1 Harris, G.M., Comparative Local Government, London, 1948, p.9.

2 Bhogle, S.K., Local Government and Administration in India, 1977, p.1.

3 Harris, G.M., Comparative Local Government, 1948, p.12.

4 Gokhale, D.K., The Constitution of India, p.1307-1308.

ESSENTIAL ATTRIBUTES OF LOCAL GOVERNMENT:

Shriram Maheshwari in " Local Government in India " has given essential attributes of the local government as follows:

- 1) Statutory status;
- 2) Power to raise finance by taxation in the area under jurisdiction;
- 3) Participation of local community in decision making in specified subjects and their administration;
- 4) The freedom to act independently of central control;
- 5) Its general purpose in character and not a single purpose in character.

In today's world, a local government is an important and integral part of the national government. It is created by the national and state enactments within a limited jurisdiction. It is that part of the government of a country which deals with the matters concerning the people of a particular locality. The local government performs various different functions to provide civic amenities like water supply, health and medical facilities, street lighting, transport facilities etc., within its determined limited jurisdiction.

DEVELOPMENT OF LOCAL GOVERNMENT IN INDIA:

In India, Local Government is widely known as local self government. Two terms ' Local Government ' and ' Local Self Government ' are used interchangeably. However, the appropriate usage in the context of independent India is ' Local Government '. The term ' Local Government ' and not the term ' Local Self Government ' is used in entry 5th of List-II of the Seventh Schedule of the Indian Constitution. Indian constitution defines local government as, ' 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 government or village administration'⁵. The term Local SelfGovernment originated when the country was under British Administration.

Local Government in India has its roots in pre-historic times. Ancient literature reveals that, the conception of local government was not foreign; but originated in India. Sabha or village assemblies were evolved in the Vedic period also. We find many references regarding the existence of Gram Sabhas in Manusmriti, Jakkas, and Shanti Parwa of Maharashtra. Arthashastra of Kautaliya also refers to village councils responsible for village administration.

5 Entry 5 of list II (State List) of the VII Schedule of Constitution of India.

The beginning of a modern system of local government had been made in 1687, when for the first time a local governing body - a Municipal Corporation was set-up for the city of Madras. Thus the Charter Act of 1793 established Municipal Administration in three Presidency towns of Madras, Calcutta and Bombay.

Under British rule in India, the 1870's resolution of Lord Mayo on financial decentralization is visualised as an effort in the development of local government institutions. In 1882, Lord Ripon issued a new resolution on local self government is considered as an important land mark in the evolution of local self government in modern India. According to him, it is an instrument of political and popular education.

After getting independence also, for further development of local government, various different committees have been set-up in India i.e. Local Self Government Ministers Conference (1947), Local Finance Enquiry Committee (1949), Taxation Enquiry Committee (1953), Rural Urban Relationship Committee (1963), Balwantrai Mehta Committee (1956) etc. An effort was made in the Government of India Act of 1935 to develop local self government in India.

1.4 STRUCTURE OF LOCAL GOVERNMENT IN INDIA:

As the present study is concerned with Kolhapur Municipal Corporation, an attempt is made to describe the structure of Local Government in India.

India has not a uniform type of local government like France. But India has adopted a different structure of local government for rural and urban areas. India has taken structure of local government from England.

There are two main types of local government: (1) Local Government for Rural Areas (2) Local Government for Urban areas.

The government for the rural areas in India is called Rural Local Government. Rural local government has three bodies. There is a village Panchayat at the bottom, Zilla Parishad at the top. And in between there is a Panchayat Samiti.

We find the distinction between the structure of rural local government in Maharashtra and that in the nearer state of Karnataka. Maharashtra's Rural local government consists of three bodies - Village Panchayat, Panchayat Samiti and Zilla Parishad.

On the contrary, Karnataka has adopted a different structure of rural local government. The rural local government of Karnataka consists of three bodies i.e. - Mandal Panchayat, Panchayat Samiti and Zilla Parishad. Mandal Panchayat at the bottom is formed by combining village Panchayats of two or three small villages.

The government for the urban areas in India is called urban local government. Urban local government in India has five bodies. These are Municipal Councils, Municipal Corporations, Notified Area Committees, Cantonment Boards and Town Committees. But among these five types, only first two bodies are full fledged representatives of urban local government in India. Out of them, large cities have Municipal Corporations, middle and small size towns have Municipalities and developing towns have notified area committees.

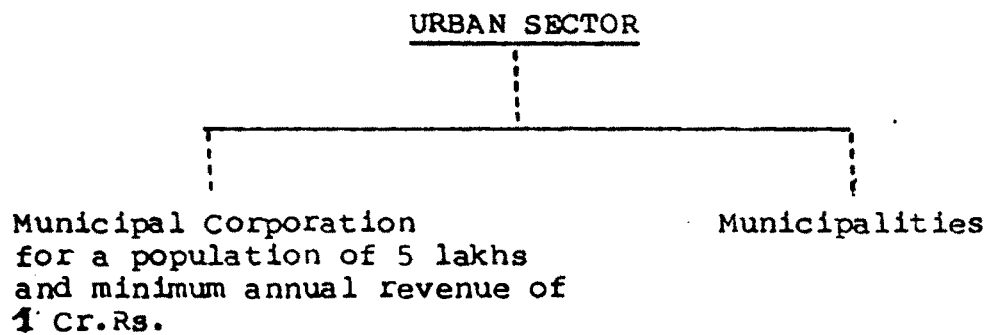
We find the corporation form of urban local government in the large or principal cities in India. Municipal Corporation is created by law and it depends for its existence as well as for its powers upon the State. The peculiarity of Municipal Corporation in India is that, the Statute has distributed powers among three co-ordinating authorities namely - the Corporation or Council, the Commissioner and the Standing Committees. All the Municipal Corporations in India are uniform in this respect.

There are different grades of types (categories) of Municipal Corporations in India. On the basis of different criteria, the Rural Urban Relationship Committee (1966) has classified Municipal Corporations into five categories:-

- a) Special grade Municipal Corporation;
- b) Selection grade Municipal Corporation;
- c) First Class Municipal Corporation;
- d) Second class Municipal Corporation;
- e) Third Class Municipal Corporation.

This classification is based on these criteria of: population of the city, income, and minimum per capita income.

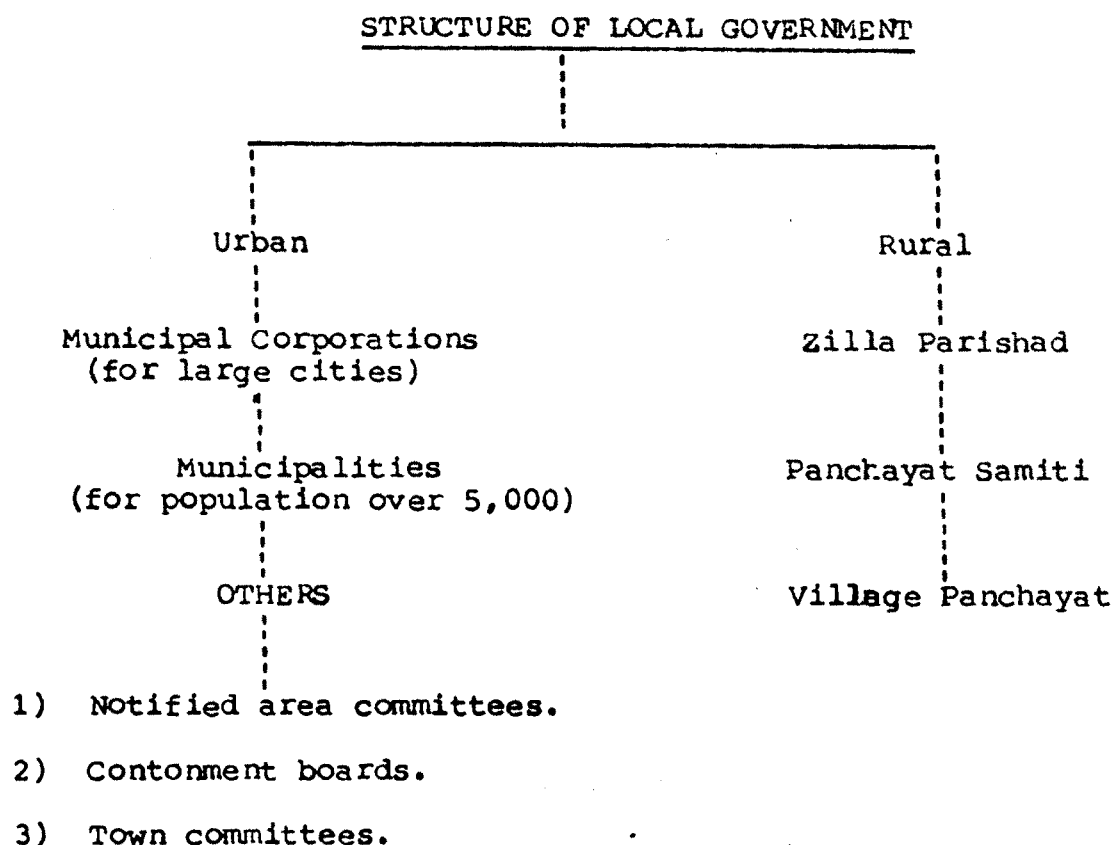
Municipal Corporation's classification into five categories can be shown as follows:



Grade of Municipal Corporations	C R I T E R I A		
	Populations	Income Rs	Minimum P.C.I. Rs
1) Special grade	2,50,000	7,50,000	30
2) Selection grade	1,00,000	2,50,000	20
3) First Class grade	50,000	1,00,000	15
4) Second Class grade	35,000	50,000	10
5) Third Class grade	20,000	35,000	5

(Recommendations of the Rural Urban Relationship Committee 1966.
(Ministry of Health & Family Planning, Govt. of India)

The structure of local government in India can be shown as follows:



As per 1981 census, there were 11 corporations in Maharashtra at Nasik, Amaravati, Kalyan, Aurangabad, Solapur, Bombay, Pune, Kolhapur, Nagpur, Thane and Pimpri-Chinchvad. There were 221 Municipal Councils and 7 Cantonments. Out of 221 Municipal Councils, 22 'A' class Municipal Councils for more than 75, 000 population, 45 'B' class Municipal Councils for population between 30,000 to 75,000 and 154 'C' grade Municipal Councils for less than 30,000 population.

1.5 ROLE OF LOCAL GOVERNMENT:

Local government is the important form of government with which cities are most closely connected. Like the Central and the State governments, local government has increased activities to do. It plays a vital role in achieving socio-economic objectives. Today, local government is much more important in the daily life of citizens than in that of the State or Central government. Local government tries to solve the problems created in a locality due to communal living. For this, it provides civic amenities like water supply, removal of rubbish, drainage, street lighting, preventing of epidemics, health and medical facilities, education, road construction and repairing. It has become the responsibility of the local government to make living better physically, economically, socially and also culturally for people.

Local government renders valuable services to promote social welfare of the community. Therefore, the ex-president of India, Dr. Radhakrishnan said, -

"... the local bodies must have the sole objectives of promoting the well being of the people ..."6.

Besides economic and developmental role, local government also plays an important role in the politics of

6 Reported in the Hindustan Times, 28th March, 1966.

of the country. It gives an opportunity to the citizens to have free, intelligent and active participation in the government of their local area. It contributes to strengthening of democratic institutions. It gives political education and creates political consciousness. It serves as a thinking ground for politicians in the beginning of their career. It also helps in decentralising political power and promoting democratic values.

Local government by starting educational institutions provides educational facilities. For this, it starts primary schools, high schools, colleges and also public libraries. This has helped in minimising the number of uneducated. It has been creating social consciousness and a sense of co-operation among the people living in the local area. Thus, local government also plays a significant role in the social field.

Local government also makes physical and cultural life of local people better. For this, it constructs play grounds, stadiums, gymnasiums, gardens, public parks, cultural halls etc. This field is also covered by local government.

In cities or urban areas, local government also offers help at the last moment of a person. It

gives "mudi-gate" facility. It provides the vans to carry the dead bodies to mudi-gate and also provides required material for cremation free of cost.

Thus, local government in rural as well as urban areas plays a vital role in different aspects of development. All fields which can be intervened are covered by local government. No single field is left to intervene.

1.6 MEANING OF LOCAL FINANCE:

The term local finance refers to finances of local governmental bodies i.e. Gram Panchayat, Panchayat Samiti, Zilla Parishad, Municipal Councils and Municipal Corporation. Local finance is the branch of public finance which deals with financial aspects of local government. The word 'Local Finance' is a compound word, which is composed of 'Local' and 'Finance'. In Local finance, the branch of public finance, the word 'Local' is used to denote Local Government or the government of a particular locality. And the word 'Finance' is used to denote the raising and spending of public funds.

Thus, 'Local Finance' means the finances of local government. It is the study of how local government raises funds and spends them. In simple words, it is the study of income and expenditure of Local government. Local finance, the branch of public finance, studies the financial operations

of local government. Therefore, it is said that, Local Finance is an investigation into the nature and principles of local bodies revenue and expenditure.

The principle of Local finance is the same that of National finance. The only one principle of public finance, that is the principle of maximum social welfare is applicable to all its branches - National, State and Local finance.

However, some economists distinguish local finance from national finance. According to them, national finance imposes taxes on the basis of principle of ability to pay, while local finance imposes taxes on the basis of benefit principle. In both the cases, the basis of assessment is the same because both the branches of public finance want to attain the same objective, that is to collect the revenue. The confusion has arisen due to the fact that the area of administration in case of local government is a small. Therefore, a tax-payer can see services rendered by local government in returns of taxes paid. But, this is not possible in case of the national finance. Therefore, it is incorrect to distinguish between local finance and national finance.

Although, national finance and local finance are two branches of public finance, we cannot fully separate them from each other. The reason is, these are relative terms.

Therefore, Prof. Canon has very rightly pointed out that, the word local is relative in character, from the point of view of an empire, the tax of a country is local, and from the point of view of a country the tax of a provincial government can be termed as local; so the difference between local and national finance is of degree only.

1.7 THEORY OF LOCAL FINANCE:

There are three layers of government i.e. Central, State and Local government. The finance of a local government is called local finance. Local finance is the branch of public finance which studies financial operations of a local government.

From a review of the literature on local bodies, it becomes clear that local finance is a neglected part of public finance. But, the surprising thing is that, its origin is found back to a century. There is also a comparative neglect of local government both in practice and in academic study.

Therefore, U.K. Hicks in " Development from below " says, one of the primary tasks in the study of local finance is to place the local government finance in the perspective of state and national finances and to clearly define their role in national economic development⁷.

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Hicks, U.K., Development From Below, Oxford, 1966, p.8.

An attention towards local government and local finance is not given, because local governments are set-up as an administrative agency of the state government and statutory devolution of functions. Some functions to perform are assigned to them.

There may be two approaches to the local finance:

- 1) Correspondence theory;
- 2) Theory of separating of local finance.

According to first approach, functions and resources of local government must match each other. It means, the financial resources of the local government should be in proportion to functions which local government has to perform. The revenue should be equal to expenditure required to perform assigned functions to the local government.

According to second approach, there should be separation of resources and functions to be performed. The discriminatory treatment should be given to resources and the functions to be performed.

Local government performs various functions as to achieve the determined objectives. Local government cannot perform functions in absence of adequate revenue. Local government can perform functions and render services with adequate revenue only. Therefore, Venkatraman has aptly

remarked, " The building up of social overheads so necessary cannot take place first enough unless the local bodies are entrusted with the responsibility of mopping up resources for the purpose"⁸.

Local governments have no independent and adequate sources of finance, but the state government assigns them some sources of finance. A Local government collects its revenue with the help of tax and non-tax revenue. Sources of revenue assigned to a local government are not adequate. Therefore, there is need of assigning revenue resources especially in a local area to a required extent. The activities of a local government are increasing extensively and intesively, but to that extent revenue is not increasing.

Traditionally, there was a tendency to treat separately the principle of taxation between local and central governments. Selgman holds a view that, revenue raising based on ability principle is much relevant to the central government and benefit principle to local governments. Because the wider the tax base and the wider the geographical operational area, ability principle is more beneficial. On the contrary the smaller the tax base and the narrower the governmental jurisdiction then benefit principle is more relevant. At the same time, local government is a community service

8 Venkataraman K., Local Finance in Perspective, 1965, Asia, p.3.

Unit over a specified area. Hence cost benefit considerations are more proper in local finance. The ability based taxes though useful have only limited role in the local finance system, because it is mainly the beneficial service which forms the major portion of municipal and local activities and the beneficiaries are located in that particular local area. Therefore, the benefit principle must be guiding rule of the local finance.

The benefit principle is very suitable for local units for a number of reasons⁹.

- 1) They are based on property value which is easily derivable;
- 2) They are strictly confined to a local base;
- 3) The accounting is simple;
- 4) The management costs are low.

However, the benefit principle has some deficiencies. Benefit taxation is relatively rigid and inelastic and after a point it tends to be regressive on small property owners. The tax burden may increase along with increase in benefit. It results in falling revenue from taxation. It is at this point that grants and subsidies from State government assume significance.

9 Sinha, K.K., Local Taxation in a Developing Economy, 1968, p.4.

From the foregoing discussions, following principles or maxims of local finance should be considered.

- 1) Canon of Locality: The tax base should be tangible and localised. Immovable property in the form of land and buildings are more suited for local taxation.
- 2) Canon of Simplicity: Both tax compliance and collection costs should be low. Also the administrative proceedings must be simple and direct.
- 3) Canon of Least Effect: The local taxation must have practically no price or any other economic effects.
- 4) Canon of Quid-Proquo: Local taxation should have a large element of net return of benefits to the citizens.

In short, a local tax system that covers the beneficiaries of the area and has a simple administration and assessment code may be considered as good.

1.8 SOURCES OF URBAN LOCAL FINANCE:

Like Central or State governments, local government performs, various different functions to achieve pre-determined objectives. Therefore, local government also requires finance or revenue. In absence of revenue, it cannot perform functions and also cannot achieve pre-determined goals. Therefore, it becomes necessary to take into account the sources of revenue.

The present study is concerned with urban local government, therefore, an attempt is made to narrate sources of urban local finance.

The sources of urban-local finance are as follows:

A) Tax Revenue:

- 1) Property tax,
- 2) Tax on vehicles,
- 3) Tax on animals,
- 4) Tax on trade and callings,
- 5) Octroi,
- 6) Terminal tax,
- 7) Toll tax,
- 8) Entertainment tax,
- 9) Tax on dogs,
- 10) Tax on advertisements,
- 11) Settlement tax,
- 12) Tax on deeds,
- 13) Any other tax.

B) Non-tax Revenue:

- 1) Property and other funds,
- 2) Fees and licenses,
- 3) Grants-in-aid,
- 4) Loans.

A recent enquiry shows that, " the urban local bodies derive about 66 % of their ordinary income from tax revenues, about 21 % from non tax revenues and 13 % from grants-in-aid "¹⁰.

1.9 PROBLEM OF MUNICIPAL FINANCE:

Urban local bodies have been facing the problem of adequate finance. They are unable to collect the required revenue. The revenue of local urban bodies have been falling shorter than their expenditure. They have been facing financial stringency. One of the reasons is, urban population has been growing rapidly. The population of India was 54.60 crores in 1971, 68.51 crores in 1981 and 84.36 crores in 1991; and the population of Maharashtra was 5.04, 6.28, 7.87 crores respectively. The urban population was - 20.2 % in 1971 and in 1980-81 - 27.7 % in India. At the same time in Maharashtra, it was 31.17 % in 1971 and 35.03 % in 1981. In 1981 there were 29 cities having population one lakh or more. This increasing urbanisation has resulted in increased demand for civic amenities like health and medical, water supply, roads, transport facilities, education, cleaning, street lighting etc. This has been increasing expenditure of urban local bodies. Therefore, urban local bodies are in financial crises.

10 Report of the Committee of Ministers constituted by the Central Council of Local Self Government, 1963.

Another reason is that, urban local government could not impose new taxes on the one hand expenditure has been increasing and at the same time on the other hand new sources of tax revenue are not available. Therefore, also revenue has been falling shorter than expenditure.

The grants and loans is one of the sources of urban local finance. But the grants and loans from the State government are insufficient. Therefore, the urban local bodies are facing financial problems. The system of grants and loans should be re-examined and placed on a surer and dependable footing. But it should be noted that, the provision of funds alone is not going to help to solve the financial problems of urban local government. The funds should be utilised properly for that competent staff is of course necessary, but what is equally important is sound budgeting. They need to train their budget officers for this purpose. Similarly a good system of continuous internal and regular external audit, must be immediately introduced ¹¹.

After independence many committees and commissions have studied the problem of Municipal finance and concluded familiar conclusions that, finances of Municipal Corporations are insufficient and are facing financial strinsgency,

11 Avasti, A Municipal Administration in India, 1972, p.8.

suitable measures should be taken to make financially strong. The substance of recommendations has remained the same from Local Financing Enquiry committee 1951 to the Rural Urban Relationship Committee 1966. But no efforts are made to implement the recommendations of these committees.