Decentralization: Issues and the Way Forward

(With Special Reference to Urban Local Bodies in India)

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1. Introduction

India has always been a union with a centripetal bias. Our constitution makers advisedly wanted it to be so for in their thinking, this was the way to ensure the unity and integrity of India as a fledgling newly born democracy. We have now somewhat matured as a democratic nation and ideas such as co-operative federalism and decentralization are in currency. In fact, whereas cooperative federalism has been in vogue fairly recently, decentralization was formally enshrined in the 73rd and 74th Constitutional Amendments more than three decades ago. Unfortunately, decentralization has been much talked about but seldom invited in. Here, we strongly argue for true decentralization, especially in the context of badly managed cities. *This is important, given that India is urbanizing and consequently urban spaces are assuming a pole position as far as driving the agenda of economic growth and development*. In other words, given that urban spaces are engines of growth and development, it is essential that these urban spaces be managed well as locations which provide liveability and livelihoods.

2. What is Decentralization?

Decentralization comprises of three essential components or aspects. These are decongestion, delegation and devolution. As the problem of management of an economy or city (say) becomes large and complex one or more of the aforesaid tactics are used. To get rid of the clutter and also because of lack of data clarity at the top level decongestion or delegation is resorted to. The first requires that modular break-up of the problem is possible whereas the second is an agency transfer where the problem as a whole is tackled as directed but at a smaller scale. The essential feature here is that there is very little autonomy of action and there is an unmistakable paternal element. *The third element decentralization viz., of devolution is crucial because it refers to untied resource transfer with the accompanying expenditure autonomy*. This presumes a sense of responsibility and capability on the part of the lower level of the organization (here government). This also implicitly assumes that the lower level agency is privy to the felt needs of the community at the local level of government and hence in such matters is able to position itself better than the higher level government.

True decentralization hence must comprise of all the three elements mentioned above most crucial being devolution. Having said this it must be remembered that not everything (task/ job) should be decentralized. The decentralization theorem states that in order to reap the benefit, one must decentralize to the extent that is warranted by the subsidiarity principle. And that is a lot, to be sure. Yet the application of decentralization has been only in the nature of lip service, naturally the outcome has been messy. Let us turn to the several things that must happen if we want to improve the situation.

3. The legacy overhang & 3Fs

The desired principle of 'power to the people', given by Lord Rippon and Mahatma Gandhi has been around in Indian thinking at least where rural communities were concerned with increasing urbanization it is but natural that this principle is extended to urban areas. Indeed, many states of India have had their own administrative arrangements for managing their cities and towns. With the differences in their design the common feature of all such entities was that they were essentially seen as 'creatures of the state' with little or no autonomous power, there by taking away from the essence of decentralization. Historically, the States naturally had an overpowering say in their functioning. With the passage of 73rd and 74th constitutional amendments India decisively emerged as a 2+ federal nation. Unfortunately, since this could not be done on a clean slate for many if not most of the States, the legacy overhang that the States suffered from came in the way of whole hearted implementation of the spirit of the constitutional amendments.

An essential concomitant of decentralization is neatly summed up in '3Fs'. These stand for functions, finances and functionaries. It is clear that functions to performed by any government needs to be laid out clearly so that it lays down the *raison d'etre* of the government's existence. Once this agency is created however, there is a need to have adequate financial resources to carry out these functions, and further there is a need of agents or functionaries who will do the job of delivering on these functions.

The functions are clearly contained in the 12th Schedule of the Constitution and in most cases the transfer of functions by the States to the ULBs has indeed taken place to a reasonable extent. In case of functionaries there is the issue that many times they are sent to the ULBs on deputation from the line departments. They therefore do not necessarily have a stake in the functions of ULBs nor is there a serious accountability since their CRs are written remotely at the ministries. Lack of any HR policy of course means that even fresh appointees are not assured to have requisite capacity to perform their assigned job.

The situation is worse when it comes to the availability financial resources with the ULBs to perform the assigned functions. This leads to the case of unfunded mandates. It is argued many times that it is better to hand over revenue handles to the ULBs rather than granting them financial resources. Sensible as it may sound there is little substance to this argument. *Historically, and in most cases, all the tax handles that theoretically could be classified as local taxes are firmly usurped by the State governments. In any case, in the post GST world all of them have been subsumed under GST*. Indeed, the only tax that is substantial and available with the ULBs is the property tax. Whilst much is talked about required reforms in this arena, it is well to remember that experience around the world shows that property taxes typically are able to finance only around 25-30% of the total expenditures of the cities. It is true that Non-Tax revenues have a potential that could be exploited to some extent. Given the state of political economy in the local governments, in our opinion, whereas some slack can be made up by brave effort of 'getting the prices right' and pricing the public utility services properly through optimal user charges, this alone cannot get us home. The inescapable fact of the matter is that whereas cities are drivers on economic growth the way our tax system is set up, there is no way they can be self-sustaining let alone be surplus entities. The only way is to have a scheme whereby adequate and predictable inter-governmental resource transfer takes place so that the ULBs are empowered. *The good news is that given the tax buoyancies, due to growth impulses from the cities, enjoyed by the higher level governments, they should be able to look at these transfers in the nature of pragmatic investments rather than merely as aid.* Fortunately, there are at least four ways in which this can be accomplished.

4. SFCs, FCs, Bonds & LBFTs: Empowering the ULBs

The first of these ways is clearly laid out in the constitution (73^{rd}&74^{th} Amendments) wherein it is mandated that the State government shall set up a **State Finance Commission** every five years which will then consider the vertical and horizontal imbalances w.r.t. ULBs and PRIs and based on principles recommend the total amount to be devolved and how it is to be distributed between the different local bodies. Clearly, the intention here was to strengthen decentralization and for that purpose the SFCs were meant to mimic the role and function of (Central) Finance Commissions. With the 15^{th} FC in place, *the institution of Finance Commission must truly stand out as one of the most remarkable triumphs that has sustained through all the messiness of a fledgling democracy*. The maturity of the Central Governments and the strong early precedents set up early perhaps has allowed for this. And yet, despite identical constitutional wordings relating to SFCs as in case of FCs, the SFCs have been treated almost farcically in most cases. The recent FCs have tried to nudge, incentive and arm twist the State governments to no avail. This clearly must change and at least some beginning of true devolution via SFCs has to commence.

Recognizing the importance of decentralization and the fact that the local bodies were not being adequately empowered (including for reason of limited ability in terms of fiscal space) the **Finance Commissions** of recent vintage have been called upon to 'augment the consolidated fund of the State' to help local bodies' economic health. Ideally, after the passage of 73^{rd} and 74^{th} Constitutional Amendments the third tier of government ought to be recognized as a full-fledged sub-national government. As such it would appear possible that the federal government should be able to talk with the local government. There is however some constitutional issue that precludes such a thing from happening. *This has meant that the 13^{th} FC has had to use a quasi-devolution formula which preserves some buoyancy in fund flow from the FC to the local bodies*. Unfortunately, the 14^{th} FC has gone back to granting some funds to the local bodies in absolute terms.

The third way is to enable the ULBs to take exposure to financial markets with adequate precautions. This could involve access to muni bonds which is a huge market segment in the USA but largely untapped in India. In the Indian case we have issued Municipal Bonds but they have largely been in the nature of IPOs. This has been due to the underdeveloped secondary bond- market in India. By way of pre-requisites, amongst other things, *rating of ULBs is essential also further encouragement towards creation of secondary bond-markets and certain legal enablement is required, chief amongst these would have to do with* *regulatory framework of Banks especially the Urban Cooperatives.* Alternatively the ULBs could singly or together (forming virtual entities) take exposure or issue bonds. Herein one may follow the example of Pooled Fund Banks in the US with the proviso that whereas the US example leads to cherry picking of just the strongest ULBs, in we will have to take care of not so strong small and medium ULBs by allowing them to virtually form collectives with the stronger ULBs.

The fourth way is to make use of the fact that urban lands typically are highly valued. The trick is to leverage these values and raise resources to finance the urban infrastructure and provisioning of local public good and services. Whereas land is characterized by fixity of supply, the development rights on them are prescribed to them by policy. Such policies can augment the effective land supply but it needs to be done with care. We need to begin with a proper documentation of public lands and then manage them optimally. Once this is done, optimal land management can be achieved thereby leading to additional resources. Further one the facts of putting infrastructure in place is the emergence of positive externality that the persons who own land in relevant areas enjoy. Given that these are in the realm of unearned profits substantial part of this can be fairly taxed away by the State. This leads to a whole host of tools that are referred to as **Land Based Fiscal Tools** (LBFTs). Charging premium and generally charging FSI, as well as property tax, impact fees, development charge are some of the LBFTs that are used in practice. These are ways to use this highly valued resource (viz. land) that can be used to raise resources for urban infrastructure development. There are examples galore of Land Companies as well as use of LBFTs in the world. We must learn from them and implement them in practice in India. Admittedly, land is a State subject as per the Constitution, but the State must pragmatically share the gains with the cities.

5. Way Forward or the necessary steps required:

Thus, given the argument for crucial recognition of decentralization by governments at Central and State levels to foster empowerment of ULBs we sum up some of the essential steps to facilitate the implementation process.

1. Given the importance of cities as drivers of economic growth the governments at higher levels must internalize the importance of decentralization and implement the 73^{rd} and 74^{th} Constitutional Amendments in letter and spirit.

2. Amongst the three elements of decentralization, devolution of adequate untied grants is essential and must be ensured. This will allow the third tier of government to identify the felt needs of the local community and be assured of expenditure autonomy to service these felt needs.

3. Recognize the importance of 3Fs inherent in true decentralization to be made operational, the State government must work towards evolving a proper HR policy in hiring the functionaries and work towards their capacity building. Adequate financial resources must follow so that there are no unfunded mandates. This requires that the vehicle for this viz., the SFCs must be formed properly (with right persons), at the

right time (synchronous with FCs) and their awards should be accepted. Whilst the magnitude of devolution (especially in proportion to agency transfers or tied grants) may be moot, the argument here is that some beginning of proper decentralization/ devolution has to be implemented. In a word they must have the same de facto status as granted to the FCs by the Central Government.

4. The FCs must continue to top up the needed resources by consolidated fund of the States to empower ULBs and PRIs. It is essential to either to pursue constitutional amendment so as to enable a direct talk with the third tier or at the least expand the magnitude of fund flow formulaically so as to reap the benefit of national economic growth induced buoyancy in such a fund flow.

5. Create incentives and encourage ratings for ULBs and build capacity amongst the agency of ULBs and agents that that are hired by a cadre creation or a comprehensive HR policy so as to enable service delivery of local public goods and amenities. Encourage ULBs to take exposure to financial markets by regulatory and legal reforms through issuance of Muni-Bonds as well as taking loans from FIs. Given the developmental mandate and inclusion of small and medium cities and towns, allow them to create virtual entities to take exposure and to issue bonds.

6. Leverage urban land values through Public Land Management Companies and use of Land Based Fiscal Tools (LBFTs) to raise resources that can then be used for financing the much needed urban infrastructure which will service both the livelihoods and liveability needs of the urban citizenry. Give that land is a State subject, it is to be expected that the a high percentage of the revenues raised should be shared by the States with its cities.