

## A CRITICAL ANALYSIS OF THE CONSTITUTIONAL PROVISIONS GOVERNING FISCAL FEDERALISM IN INDIA WITH REFERENCE TO LOCAL GOVERNMENTS

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### ABSTRACT

The enactment of the 73rd and 74th Constitutional Amendments in 1992 was heralded as a silent revolution, promising to transform India's democratic landscape by constitutionally entrenching a third tier of governance. Decades later, the promise of empowered local self-government remains largely unfulfilled, primarily due to a persistent and critical fiscal deficit. This research paper undertakes a critical legal and political-economic analysis of the constitutional architecture governing the financial relationship between the Union, States and Local Governments. It argues that the amendments, while revolutionary in intent, created a system of "guided" or "dependent fiscal federalism." The framework, meticulously designed through Articles 280, 282, 243H, 243I, 243X and 243Y, establishes a hierarchical, conditional and discretionary model of fiscal devolution that systematically undermines the autonomy of Panchayati Raj Institutions (PRIs) and Urban Local Bodies (ULBs). By dissecting the mechanisms of central finance commission recommendations, grants-in-aid and the delegated taxation powers, this paper demonstrates how the constitutional design inherently reinforces the hegemony of State governments and perpetuates local fiscal infantilization.

**KEYWORDS:** Fiscal Federalism, 73rd and 74th Amendments, Local Government Finance, Article 280, State Finance Commissions, Grants-in-Aid etc.

### 1. INTRODUCTION

India's federal structure is often described as *quasi-federal*, with a strong central government and constitutionally recognized state governments (Rao & Singh, 2005; Basu et al., 2015). Local governments – rural panchayats and urban municipalities – were accorded constitutional status much later, through the 73rd and 74th Amendments in 1992. These amendments aimed to invigorate grassroots democracy and decentralize governance, including the devolution of financial powers to local bodies. The financial relationship between the Union (central government) and local governments is governed by a complex set of constitutional provisions, statutes and administrative practices, encompassing aspects of revenue sharing, grants-in-aid and local taxation powers (Oates, 1999; Rao & Bird, 2010; Finance Commission, 2020). This relationship lies at the intersection of constitutional law, administrative law and public finance. It raises critical questions about fiscal federalism, the autonomy of local bodies and the efficacy of decentralization in India's democracy (Pandey, 2023).

The British introduced local self-government institutions (like municipal boards and district boards) with limited taxation powers in the late 19th and early 20th centuries. These bodies functioned under tight colonial control and had very restricted revenue sources. After Independence in 1947, India's Constitution initially did not grant robust autonomy or guaranteed revenues to local governments. The subject of "local government" was placed in the State List (Entry 5, List II, Seventh Schedule), making it a domain of state legislatures. At the national level, the importance of village panchayats was acknowledged only in a Directive Principle of State Policy – Article 40 of the Constitution – which urged the State "to take steps to organize village panchayats and endow them with such powers and authority as may be necessary to enable them to function as units of self-government". Article 40 was non-judicial and thus

depended on the political will of states. In the Constituent Assembly, there was debate on the role of local bodies; while Mahatma Gandhi advocated *gram swaraj* (village self-rule), Dr. B.R. Ambedkar was skeptical, concerned that empowering village panchayats might entrench local social hierarchies (Singh H., 1994). Ultimately, no enforceable right or structure for local government made it into the original Constitution beyond the DPSP (Ambedkar's caution perhaps contributing to the decision to leave panchayat empowerment to the states). The early decades saw local bodies operating under state laws (such as various Panchayat Acts and Municipal Acts), often subject to dissolution and with meager finances (Basu, 2015).

During the 1950s-1980s, multiple committees – e.g. the Balwantrao Mehta Committee (1957), which led to the introduction of Panchayati Raj in some states and the Ashok Mehta Committee (1978) – recommended greater devolution to local governments, including financial devolution (Mathew, 1994). Despite some reformist state-level legislation, local governments largely remained administratively and financially weak. States were neither constitutionally compelled to share adequate revenue with local bodies nor to ensure their financial stability. A telling indicator of this period's approach is Article 277 of the Constitution, a transitional provision allowing local authorities to continue levying certain taxes that they were charging before the Constitution, until altered by law. The Supreme Court in *Town Municipal Committee, Amravati v. Ramchandra* (1964) interpreted Article 277 strictly, holding that it only permits continuation of pre-Constitution taxes actively levied and does not allow municipalities to impose new taxes or increase rates beyond what existed pre-1950 without fresh legislation. This judgment reinforced that local bodies have no inherent taxing power beyond what state law authorizes, underscoring the constitutional scheme of state control over local fiscal powers (Town Municipal Committee, *Amravati v. Ramchandra*, 1964, as summarized in CaseMine (Chimote case, 1964)). The early judicial stance thus maintained the primacy of the states (or Parliament in some cases) in matters of local taxation, ensuring continuity but not expansion of local fiscal authority (CaseMine Commentary, 1964).

The watershed moment for local government in India came in the early 1990s. Responding to decades of uneven local governance and the recognition that development required grassroots empowerment, the Union Parliament enacted the 73rd Amendment (for rural panchayats) and 74th Amendment (for urban municipalities), which came into force in 1993. These amendments added Part IX (Panchayats) and Part IXA (Municipalities) to the Constitution, fundamentally altering the status of local governments. Crucially, they introduced specific provisions for the financial empowerment of local bodies. This included Articles 243H and 243X, which enable state legislatures to confer taxation powers on panchayats and municipalities respectively and Articles 243-I and 243-Y, which mandate the creation of State Finance Commissions (SFCs) to periodically review and recommend the distribution of financial resources between states and local bodies. In addition, the Eleventh Schedule (for panchayats) and Twelfth Schedule (for municipalities) were appended, listing subjects (29 for panchayats and 18 for municipalities) that could be devolved to local bodies along with finances (Mathew, 1994; Mathew, 1995; Basu, 2015).

The Statement of Objects and Reasons of these amendment bills explicitly acknowledged that local bodies had become “weak and ineffective” due to failures in holding regular elections, prolonged supersessions and inadequate devolution of powers and finances. The amendments sought to remedy these by constitutionalizing regular elections and by “ensuring timely elections in the case of supersession”, as well as by strengthening the fiscal capacity of local governments.

Constitutionally, this marked a shift towards *fiscal decentralization*: local councils now had a firmer legal basis to claim a share in governance and development finances. However, it is important to note that the constitutional design still kept local bodies under the aegis of state governments – the Union did not deal with them directly except through overall frameworks and finance commission recommendations. Local governments were not elevated to a third tier of federalism on par with Union and States, but they were now protected institutions of self-government with constitutionally defined features (Sonkar&Ojha, 2024). The Supreme Court observed that post-1993, the panchayats and municipalities are “institutions of self-government” with constitutional recognition, though the actual devolution of powers and finances is largely mediated by state legislation (*Bhanumati v. State of U.P.*, 2010, noted in Sonkar&Ojha, 2024). In the 30 years since these amendments, progress in financial decentralization has been mixed. Initially, many states were slow or reluctant to implement the new provisions in letter and spirit. By design, the Constitution left it to state legislatures to *empower* local bodies – for instance, Article 243H says a state “*may by law*” authorize Panchayats to levy taxes, rather than directly conferring such powers. In many states, this translated into only partial devolution. Nonetheless, a new institutional structure emerged: most states established SFCs and enacted laws listing taxes local bodies could levy or receive (such as property tax, profession tax, entertainment tax, fees, etc.). The significance of these changes is underscored by contemporary analysis which notes that financial empowerment of local bodies is not just a local issue but integral to India’s fiscal federalism (Isaac & Heller, 2003; Heller et al., 2007). Over time, there has been a gradual increase in grants and transfers to local bodies, yet local governments still account for a relatively small fraction of public expenditure and revenue in India – a point often highlighted in public finance studies that compare India’s decentralization with other federal nations (Oommen, 2010; World Bank, 2011).

## 2. CONSTITUTIONAL FRAMEWORK FOR CENTRE-LOCAL FINANCIAL RELATIONS

**a) Division of Taxation Powers:** The Seventh Schedule of the Constitution demarcates subjects for legislation between the Union and States, including taxation powers. Local governments are not directly assigned entries in the Seventh Schedule; rather, they derive taxing authority from state legislation. Key taxation entries relevant to local finance include: Entry 49 of the State List (taxes on lands and buildings – typically property tax), Entry 52 of State List (taxes on entry of goods into a local area for consumption, formerly octroi), Entry 56 of State List (taxes on professions, trades, callings – “profession tax”), among others. States may levy these taxes and often delegate them to local bodies or share the proceeds (Oates, 1999; Rao& Singh, 2005). Under the new Part IX and IXA, the Constitution explicitly empowers states to legislate on local taxation: Article 243H for panchayats and Article 243X for municipalities. Article 243H(a) authorizes state legislatures to enable panchayats to “levy, collect and appropriate” specified taxes, duties, tolls and fees and Article 243H(b) to provide for assigning to panchayats various taxes collected by the state government. Similarly, Article 243X gives municipalities the power, via state law, to impose taxes and also receive assigned revenues and grants. These provisions were meant to “*impart certainty, continuity and strength*” to local finances. As the Union Minister moving the 73rd Amendment Bill argued, “*unless the Panchayats are provided with adequate financial strength, it will be impossible for them to grow in stature*”. Thus, the

Constitution now mandates that states *consider* devolving adequate taxing powers to local bodies.

Typically, village panchayats have been given more substantial tax handles (e.g. property tax in rural areas, house tax, taxes on markets, water fees), whereas higher-tier panchayats (block, district) have fewer independent taxes and often rely on shared revenues. Urban local bodies usually levy property tax, advertise tax, entertainment tax (in some states, until GST subsumed some of these) and user charges. One consistent issue has been the low yield and under-utilization of these local taxes. For instance, property tax – the mainstay of municipal finance worldwide – remains inelastic in India due to inefficient assessment and collection; practices like basing assessment on outdated annual rental values and pervasive undervaluation have kept revenues low (Alok, 2006, as cited in Finance Commission study). Even after reforms in some cities (e.g. shifting to unit area valuation), collection efficiency challenges persist. As a result, own source revenues of Indian local governments form only a small fraction of their expenditures. A study of panchayats found that on average their *own revenues* (from taxes and fees they impose) contribute merely about 6-7% of total panchayat expenditures – the rest coming from inter-governmental transfers. Similarly, for municipalities, data compiled by the 13th Finance Commission showed that in 2007-08, all municipalities in India raised on average only ₹757 per capita in own revenue, which was just about half of their total per capita expenditure (₹1,513). The gap had to be filled by devolution from states, grants-in-aid and transfers from the Union (Rao & Bird, 2010; Finance Commission, 2020).

**b) State Finance Commissions (SFCs) – Articles 243-I and 243-Y:** Perhaps the most innovative feature of the 73rd/74th Amendments in fiscal terms is the creation of SFCs in each state. Article 243-I requires the Governor of each state, every five years, to constitute a Finance Commission to review the financial position of panchayats and recommend principles for: (a) the distribution between the state and panchayats of the net proceeds of taxes, duties, tolls and fees leviable by the state and the allocation among panchayats at different levels; (b) determination of taxes, duties, etc. which may be assigned to panchayats; (c) grants-in-aid to panchayats from the state's Consolidated Fund. Article 243-Y similarly mandates a Finance Commission for allocation of resources to municipalities. The SFCs were envisaged as the cornerstone of fiscal federalism at the sub-state level – analogous to the Union Finance Commission but within each state – to ensure an objective, rule-based devolution of funds to local governments (Mathew, 1995; Basu, 2015). In principle, SFCs usher in a *constitutional duty* upon states to share revenue with local bodies and to evaluate their needs scientifically (George Mathew, as quoted in Pandey, 2023). Indeed, the constitution of SFCs is considered “one of the most important provisions” of the 73rd/74th Amendments, meant to facilitate decentralization of financial power.

Many state governments have defaulted on their obligations: commissions have been constituted late or not at all, reports have been delayed and recommendations often ignored. By 2023 (three decades since the amendments), most states should have set up their 6th SFC (covering 2021-26), but “only nine states have constituted 6th SFC, of which only two are active” (Standing Committee Report as cited in Pandey, 2023). Several states were still on their 3rd or 4th SFC, well behind schedule. Some (Arunachal, for example) had constituted only two SFCs in 30 years. The 15th Finance Commission in 2020 bluntly noted that “*most State Governments did not constitute [SFCs] in time and did not give due importance to strengthening this critical constitutional mechanism*” (15th Finance Commission Report, 2020, as quoted in Sharma, 2024). The Supreme Court has not yet directly compelled states to form SFCs (unlike its



intervention in local elections, discussed later), but there has been at least one instance of public interest litigation – a lawyer in Andhra Pradesh filed a PIL in the High Court to prod the state to constitute its overdue 5th SFC, resulting in the commission being finally set up in 2023 (Reddy's PIL, 2022; see Pandey, 2023).

Common issues plaguing SFCs include lack of reliable data on local finances, inadequate staff and expertise and political reluctance to cede resources to local bodies (Garg, 2025). The “non-availability of data” and poor infrastructure support are documented problems that “*hamper the quality of SFC work in many states*” (Chakraborty, 2022, in Pandey, 2023). Furthermore, there is often a failure by state governments to lay the SFC report with an Action Taken Report (ATR) before the state legislature, as constitutionally required, effectively undermining transparency and follow-up. While Articles 243-I/Y created a potentially powerful instrument for channeling funds to local governments, the lethargy and apathy of state authorities have severely limited its effectiveness (Finance Commission, 2020; Sahu et al., 2024).

**c) Union Finance Commission and Revenue Sharing (Articles 280 & 280(3)):** At the apex of India's inter-governmental fiscal structure is the Union Finance Commission (UFC), established under Article 280. The UFC, appointed every five years, recommends how the Union's divisible pool of taxes should be shared between the Union and the States (vertical devolution) and among States (horizontal distribution) and other fiscal matters. After 1992, the UFC's mandate was expanded. Article 280(3)(bb) and (c) (inserted by the amendments) require the UFC to also recommend measures “needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats (bb) and Municipalities (c) in the State on the basis of the recommendations made by the Finance Commission of the State.” In essence, the national Finance Commission must take into account the SFCs' recommendations and propose how the Union government can bolster the states' finances for local bodies. This is a constitutional recognition that fiscal federalism in India has three tiers – although direct financial transfers from Centre to local are not contemplated, the Centre is to play a supporting role by financially enabling the states to fund local bodies.

The Union Finance Commissions since the Tenth (1995) have provided various grants to local bodies, becoming a significant source of local finance. There has been an evolution in approach: the 10th FC (which overlapped with the constitutional change) recommended modest ad hoc grants (e.g. ₹100 per capita for rural population, ₹1000 crore for urban local bodies) to kick-start support. The 11th FC (2000) was the first fully mandated to tackle this; it set criteria and allocated grants for panchayats and municipalities for 2000–05, albeit acknowledging it had to work with scant SFC inputs. Notably, the 11th FC found several structural problems: as it reported, it “*found itself unable to adopt the SFC reports as the basis*” due to mismatch of timing, unclear division of functions vs. finances and many SFC reports not being available or useful. The 11th FC explicitly recommended amending the Constitution to delete the phrase “on the basis of the recommendations of the Finance Commission of the State” from Article 280(3), given the non-synchronization and delays (Finance Commission, 2000, 2010, 2015, 2020; Mehta et al., 2020). This suggestion was echoed by the National Commission to Review the Working of the Constitution (NCRWC, 2002) and later Finance Commissions also lamented the constraint (Singh, 2008). *No such constitutional amendment has yet been carried out*, but the Union Finance Commissions have adopted practical workarounds – making their own assessments of local needs when SFC inputs were lacking.

Over successive Finance Commissions, the scale of support to local bodies increased and the nature of grants evolved:

- The **12th Finance Commission (2005-10)** recommended grants for local bodies tied to the condition of improvements in accounting and auditing (an incentive for reforms). It also reiterated the need for states to properly constitute and empower SFCs.
- The **13th Finance Commission (2010-15)** marked a significant step by devolving a percentage of the Union divisible pool to local governments *as a matter of right*. It recommended that a portion of central tax revenue (out of the states' share) be earmarked for panchayats and municipalities and introduced performance-based grants – additional funds if local bodies met certain reforms (such as publishing accounts, increasing revenue effort). This was heralded as a “point of departure” in treating local bodies as integral stakeholders of the federation.
- The **14th Finance Commission (2015-20)** significantly enhanced the vertical devolution to states (42% of Union taxes) and within that, greatly increased the allocations to local bodies. It allotted grants to every rural and urban local body in the country, primarily in two streams – basic (“untied”) grants and performance grants – thereby substantially boosting the flow of funds to village panchayats and city municipalities (Finance Commission, 2015). The 14th FC also stressed that states must not reduce their own devolution because of these central grants.
- The **15th Finance Commission (2020-26)** continued the large devolution to local governments, but with some new conditions. It set aside grants for specific sectors: e.g. a substantial portion of grants had to be spent on water and sanitation (tied grants), which sparked debate about local flexibility. The 15th FC also, as noted, imposed a *compliance condition*: after 2024, states that have not constituted SFCs and followed constitutional requirements would stop receiving the local body grants (Finance Commission, 2020). This was effectively using the Centre’s financial leverage to enforce state accountability to the Constitution. By November 2024, this pressure worked – all states except one (Arunachal) had formed the required SFCs, many doing so only when faced with the prospect of losing funds (Sharma, 2024).

Article 275 provides for “grants-in-aid” to states in need and Article 282 allows the Union or a state to make grants for any public purpose, even if outside their legislative competence. Article 282 has traditionally been the basis for centrally sponsored schemes and discretionary grants. Scholars argue that Article 282, read with the new Part IX/IXA, permits the Union to give grants directly to local bodies for public purposes (Singh, 2009). In fact, the 13th Finance Commission’s expert study noted that nothing in Articles 243H, 243X, etc., “*precludes the Union Finance Commission from earmarking a share of central taxes for local governments*”. There is an evolving view that the Union Finance Commission, a constitutional entity, is meant to be “the balance wheel of Indian federalism” even with respect to local governments, in contrast to the erstwhile Planning Commission which was extra-constitutional (Singh, 2009, p.18). The Supreme Court has not directly pronounced on the extent of permissible direct transfers to local bodies by the Centre, but given Article 282 and Finance Commission recommendations approved by Parliament, such transfers (usually via state treasuries) are constitutionally sanctioned as “*public purpose*” expenditures (Finance Commission, 2015, 2020; Sahu et al., 2024).

**d) Grants-in-Aid and Other Fiscal Provisions:** Apart from Finance Commission mechanisms, the Constitution in Part XII provides for grants-in-aid to states (Article 275) which have been used for specific purposes (e.g., up to 10th FC, some grants were for primary education, etc., indirectly benefiting local services). There is also a provision for grants for any public purpose (Article 282) which, as mentioned, legitimizes many central schemes where money is given to local bodies (like the Smart Cities Mission or Swachh Bharat Abhiyan funds to municipalities) albeit typically routed through state or district-level agencies. Another relevant aspect is borrowing powers – local bodies cannot directly borrow from outside or internationally; they borrow under state laws and with state guarantees. The Constitution doesn't explicitly cover local borrowing, but states often impose limits (Rao & Singh, 2005; Rao & Bird, 2010).

Article 243J (for panchayats) and 243Z (for municipalities) mandate that state laws provide for maintenance and audit of accounts of local bodies. Many states have brought local bodies under the audit of the Comptroller and Auditor General (CAG) or the state's local fund audit department to enforce financial discipline. Regular auditing is now a constitutional expectation, though quality varies. Additionally, Articles 243ZC and 243M carve out exceptions for certain areas (like Scheduled Areas, hill areas, Northeast states) where the general provisions may not fully apply; Parliament enacted the Panchayat (Extension to Scheduled Areas) Act, 1996 (PESA) to extend self-government to tribal areas, including some financial provisions like control over minor forest produce etc., but that is a nuanced area beyond this paper's main scope (Oates, 1999; Sahu et al., 2024).

### 3. ADMINISTRATIVE LAW AND PUBLIC FINANCE PERSPECTIVES ON LOCAL FINANCES

**a) Administrative Control and Bureaucratic Oversight:** Traditionally, even after the 1993 amendments, *bureaucratic control over local finances remains pervasive*. State governments, through the district administration and line departments, often retain control over substantial funds meant for local services. For example, funds from centrally sponsored schemes (e.g., rural employment guarantee, urban infrastructure missions) are frequently routed through state departments or district collectors, who supervise how the money is spent by panchayats or municipalities. In many states, the higher levels of government impose spending guidelines, approve local budgets and can reallocate unused funds. Local bodies often cannot freely hire staff or increase salaries without state approval, impacting how they use their finances (Administrative Reforms Commission, 2007).

There is also the issue of the appointed local bureaucracy – such as panchayat secretaries or municipal commissioners – holding substantial financial authority. As one analysis notes, “*the bureaucracy runs the show at the local government level, both rural and urban*,” often diminishing the role of elected representatives (Sisodia & Chattopadhyay, 2025). This extends to financial matters: a municipal commissioner (an IAS officer) typically has the final word on municipal expenditures and a village panchayat secretary co-signs all panchayat payments, effectively giving the state-controlled bureaucracy veto power over local spending. Such administrative rules, while perhaps instituted to ensure probity, also reflect a trust deficit that constrains local autonomy. From an administrative law viewpoint, this creates a tension between democratic decentralization and bureaucratic accountability mechanisms. Recent judicial decisions have started pushing back against excessive bureaucratic interference – for instance, the Supreme Court in *Rajendra Kondale v. State of Maharashtra* (2023) criticized instances

where local bureaucrats (“babus”) misbehaved with or undermined elected village heads, warning that “*bureaucrats cannot be allowed to frustrate grassroots democracy*” (Surya Kant J.). Although that case was about wrongful removal of a sarpanch, the principle extends to financial decision-making: the *elected* council should have primacy in local governance, with bureaucracy as facilitators, not controllers.

Many states’ municipal and panchayat laws (predating the amendments, but somewhat constrained by them now) allow the state to remove local elected officials or supersede councils on various grounds (often malfeasance or “incompetence”). This has been abused at times for political reasons and when a municipality is under suspension, its financial powers revert to an administrator (often a civil servant). The Supreme Court has upheld that the constitutional scheme, via Articles 243E and 243U, requires any such dissolution to be followed by elections within 6 months, thus limiting how long bureaucrats can control a local body’s finances without an elected council (*KishansinghTomar v. Ahmedabad Municipal Corp*, 2006). In *Kishan Singh Tomar*, the Court made it clear that the five-year tenure of a municipality is fixed and mandatory and elections must be held before the term expires. It even directed state governments to “*provide funds, staff and other assistance*” to State Election Commissions for conducting timely local elections (Kishan Singh Tomar, 2006, Supreme Court). This judicial mandate recognized that logistical or financial excuses (like a state claiming it has no money to hold panchayat elections) are not acceptable to deny democratic continuity at the local level. Significantly, the Court empowered State Election Commissioners to approach High Courts if the government dragged its feet and ultimately the Supreme Court for enforcement. The outcome of such cases is a stronger administrative norm that states must not, by inaction or design, keep local bodies unelected (and hence not in control of their funds) beyond the constitutional timeframe. It implicitly safeguards local financial autonomy by ensuring elected institutions – which have constitutional financial rights – are in place to claim their due transfers (indeed, as noted in a 2025 commentary, some states lost Finance Commission grants due to delayed elections because the grants were contingent on having “duly constituted” local bodies (Ratlam, 1980; Gupta, 2024)).

**b) Audit and Accountability:** Administrative law also covers mechanisms of accountability like audits and anti-corruption measures. Under Articles 243J and 243Z, state laws have largely brought local bodies under formal audit regimes. In many states, the CAG (through State AGs) conducts regular or sample audits of local bodies and reports findings to state legislatures. The importance of sound accounting and audit was emphasized by the Union Finance Commissions by making grants conditional on maintaining accounts (Oates, 1999; Rao & Bird, 2010; Chakraborty, 2019). For example, the 13th FC’s performance grants required states to certify that local bodies had audited accounts and made them public. This push has led to initiatives like the Panchayat Enterprise Suite (e.g. PRIAsoft accounting software) and a recent *AuditOnline* system developed by the Ministry of Panchayati Raj in 2020 to facilitate online auditing of panchayat accounts (AuditOnline, 2020).

The judiciary has occasionally been called upon to adjudicate issues of local financial mismanagement. High Courts have entertained cases concerning misappropriation in municipalities, enforcement of audit findings, etc. While these are mostly fact-specific, the overarching principle upheld is that local bodies, though autonomous in spending, are *public authorities* and their funds (often largely public money via grants) are subject to public accountability. The Kerala High Court, for instance, ruled that the refusal of a municipality to



account for expenditure as per CAG's format was untenable, because audit rules under state law (pursuant to Article 243Z) must be followed to uphold financial accountability (Kerala HC, 2018, reported in local media). Thus, administrative law ensures that with autonomy comes accountability – an essential balance in public finance management (Heller et al., 2007; Finance Commission, 2020).

**c) Public Finance Challenges – Revenue, Expenditure and “Unfunded Mandates”:** In theory, the devolution of functions through the Eleventh and Twelfth Schedules should be accompanied by devolution of funds – the maxim “finance follows function” is often invoked. In practice, a serious challenge has been the prevalence of “unfunded mandates” at the local level (Mishra et al., 2021; Mathur, 2024). States have transferred a long list of responsibilities to panchayats and municipalities (ranging from water supply, street lighting and sanitation to libraries and minor irrigation), but not a commensurate share of revenue or fiscal power. This asymmetry between functions and finance leads to chronic resource gaps: local bodies are expected to deliver key services but lack adequate revenue capacity to do so. For example, a municipality might be responsible for maintaining local roads and drains (a function), but if octroi (a major revenue source) is abolished post-GST and property tax rates are capped by state law, it ends up dependent on state grants which may be insufficient or delayed. This imbalance was highlighted in the 2nd Administrative Reforms Commission and by economists like O.P. Mathur, who pointed out that urban local bodies in India typically spend barely 1% of GDP, whereas comparable countries' local governments spend much more – indicating underinvestment in local public goods (ARC Report, 2007; Mathur, 2013).

Moreover, when higher-level grants come, they often come with conditions (tied to specific sectors like sanitation or conditional on performance metrics). While this can ensure funds address national priorities and are used effectively, it can also restrict local discretion. The 15th FC, for instance, earmarked ~60% of its rural local body grants for water and sanitation services. Some critics argue this undermines the spirit of decentralization, effectively treating local governments as implementation arms for central schemes rather than autonomous units that can set their own budget priorities (Berman, 2019; Faguet, 2021). On the other hand, supporters contend that without such earmarking, critical services might remain underfunded given local capacity constraints or political myopia (Mohanty et al., 2007; Mehta et al., 2020).

**d) Efficiency and Equity Considerations:** Public finance theory suggests that local governments are best suited to provide goods and services that have localized benefits and they can do so efficiently if they have adequate fiscal autonomy (Oates' Decentralization Theorem). In India, however, the efficiency gains of decentralization have been limited by resource inadequacy and capacity issues. Many rural panchayats, for instance, lack qualified accountants or technological tools, leading to under-utilization of funds or leakages. The Union and state governments have started capacity-building programs (training, e-governance systems) to address this “absorption capacity” issue, which the 15th FC also flagged (15th FC Report, 2020). On the equity front, there is considerable variation in local fiscal health across and within states. Metropolitan city bodies like Mumbai or Bengaluru generate significant revenues internally (through property taxes, fees, etc.), whereas small towns and village panchayats in poorer regions may generate almost nothing and rely entirely on transfers. The Finance Commissions (both Union and State) employ formulae to distribute funds in an equalizing manner – using criteria like population, area, deprivation index, etc., to ensure weaker local bodies get a larger per capita support (14th FC used population and area; 15th FC added criteria like demographic

performance and sanitation). Still, discrepancies remain. Some state finance commissions have innovated – e.g., Kerala’s SFC recommended a formula linking grants to local revenue effort to incentivize better collections (Kerala 3rd SFC Report, 2005). The 15th FC also recommended states consider incentivizing local revenue mobilization in their distribution (Chakraborty, 2019; Finance Commission, 2020).

**e) Judiciary on Local Finance Issues:** The higher judiciary in India has not frequently been called upon to adjudicate pure questions of local fiscal federalism (unlike Centre-State fiscal disputes which have a richer case law). *Municipal Council, Ratlam v. Vardhichand* (1980) – a landmark Supreme Court case often cited in the context of civic obligations – though decided before the 73rd/74th Amendments, it carries enduring relevance (Bhanumati v. State of U.P., 2010; Basu, 2015). In Ratlam, residents of a town complained about open sewage and filth; the municipality argued it lacked funds to construct proper drains. Justice V.R. Krishna Iyer, delivering the judgment, forcefully rejected paucity of funds as an excuse. He held that a statutory municipal body “cannot run away from its principal duty by pleading financial inability”, declaring that “*decency and dignity are non-negotiable facets of human rights and are the first charge on local self-governing bodies*” (Ratlam, 1980, SCC). This judgment, apart from solving the immediate issue by directing the municipality to find resources (even raise taxes or reallocate funds) to abate the public nuisance, set a broader principle that lack of money does not exonerate a local government from its basic public health obligations. It underscored that if local bodies face resource constraints, the correct response is to seek more funds or improve revenue, not to neglect duties – effectively nudging higher levels of government to assist or empower that local body financially. Ratlam has since been cited for the idea that essential services are an entitlement of citizens and governments must prioritize them in budgets.

*Olga Tellis v. Bombay Municipal Corporation* (1985) – known as the “pavement dwellers” case, where the Supreme Court ruled that the right to livelihood is part of the right to life, it restrained the Mumbai municipal authorities from evicting slum dwellers without alternative arrangements. While primarily a fundamental rights case, it had financial implications: providing alternative shelter or compensation required funds, meaning the state and city had to allocate resources for this purpose. The case is a reminder that local governments, as state actors, can be directed by courts to undertake expenditures to fulfill constitutional rights (even if not explicitly budgeted), further straining their finances or the state’s support. It exemplifies how *judicial enforcement of rights can override fiscal arguments* – Bombay Municipal Corp had argued about the impractical burden of rehousing everyone, but the Court still mandated a scheme. In doing so, courts sometimes effectively reorder public finance priorities in specific contexts.

There have been a few challenges on the limits of local taxation – often dealing with whether a municipality can levy a certain tax or increase a rate. For instance, in one case a municipal body’s bid to impose a new tax by resolution was struck down because the power had not been properly conferred by state law (*Punjab Leather Technology Assn. v. Jalandhar Municipality*, 2004, SC). The Supreme Court held that municipalities must act within the four corners of authority given by state legislation; any tax imposed without such authority is unconstitutional as it violates Article 265 (no tax except by authority of law). This reinforces the principle that local taxation in India is not a right but a delegated power and the delegation must be explicit. Another important case is *Rama Krishna Dalmia v. Justice Tendolkar* (not directly on local finance, but often cited on delegation) – by analogy, it supports that the Legislature can delegate taxing power to local bodies, but the scope of that delegation can be examined by courts if challenged.

The *Amravati Municipal Committee* case (1964) discussed earlier is one of the few Supreme Court expositions on a constitutional article relating to local tax (Article 277) and it clearly demarcated that continuation of pre-1950 local taxes does not mean expansion.

In the case of *State of U.P. v. PradhanSanghKshettraSamiti* (1995), certain definitions and provisions were challenged when the U.P. government had enacted a new Panchayat Raj Act to conform to the amendment. The Supreme Court upheld the state law and, importantly, observed that Part IX of the Constitution is broadly enabling – it sets up a framework for panchayati raj institutions, but the actual functional and financial devolution is to be carried out as per state law within that framework. The Court's tone indicated that it would not interfere lightly in the state's discretion on how much power/funds to devolve so long as the basic constitutional mandates (like forming panchayats, holding elections, constituting SFCs) were met. This essentially deferred to the legislative and executive branches to work out fiscal details, which may explain why few cases reach the courts purely on the question of “how much funds should a panchayat get” – a question seen as political rather than justiciable.

#### 4. CONTEMPORARY CHALLENGES AND WAY FORWARD

Below we critically discuss some of the major contemporary issues:

**a) Strengthening State Finance Commissions:** As detailed earlier, the neglect of SFCs is a chronic problem. Many states view SFC recommendations as advisory at best and political executives are wary of binding themselves to formula-based sharing of revenue with local bodies. The consequence is ad hoc and politicized transfers – some local bodies that have the favor of state-level politicians might get more funds, while others languish. The 15th Finance Commission's conditionality has triggered a positive response by forcing states to constitute SFCs under threat of losing central funds. Constituting a commission is only the first step; ensuring *high-quality output* from SFCs is the real task. This involves appointing qualified experts (not just politicians or bureaucrats nearing retirement), giving SFCs adequate time and data and crucially, cultivating a norm that SFC reports deserve the same respect as UFC reports. There is a case to be made for amending Article 280(3) to remove the rigid “based on SFC” language and instead allow the Union Finance Commission to make independent judgments on local needs when SFC input is absent or inadequate (Finance Commission, 2020; Chakraborty, 2019; Sahu et al., 2024). This, combined with perhaps a statutory requirement that SFCs be constituted by a certain fixed date (with a presumed continuation of previous SFC formula if delayed), could close the gaps. The NCRWC in 2002 recommended that states' compliance with SFC provisions be made a prerequisite for some central assistance (NCRWC Report, 2002) – an idea now partly realized by the 15th FC. Looking forward, the upcoming 16th Finance Commission (constituted in 2023 for 2025-30) is expected to consider drafting a “charter” for SFCs – possibly guidelines or model structures to improve their performance (Chakraborty, 2022; Mishra et al., 2021). The hope is that, over time, SFCs can do for state-local fiscal relations what the UFC does for Centre-state: depoliticize and regularize them (Garg, 2025).

**b) Aligning Functions with Funds (Unfunded Mandates):** The issue of unfunded (or under-funded) mandates remains critical. The 11th and 12th Schedules enumerate functions, but many of these (like primary education, healthcare, etc.) overlap with state functions. Often, states devolved functions in law but not in finance. The result is duplication or neglect. For example, a village panchayat may be responsible for a primary school's maintenance, but the education department controls the teacher salaries and infrastructure budget. The panchayat's role then is

marginal, with token funds. To remedy this, some experts suggest a clearer activity mapping and expenditure assignment: identify which government level is accountable for which sub-components of a service and ensure funds follow accordingly (ASI & World Bank, 2019). “*Activity mapping*” exercises have been done in a few states (Kerala, Karnataka) to delineate what each tier does for each of the 29 matters in Schedule XI. These need to be backed by financial mapping. Another approach is to increase the *own revenue capacity* of local bodies so they can fund more of their expenditure needs autonomously. For instance, reforming property tax (by switching to capital value based assessment, improving coverage and valuation, using GIS, etc.) can significantly increase municipal revenues – some cities like Bengaluru and Hyderabad have seen boosts after such reforms (Jnnurm Reforms Report, 2014). Similarly, many argue for user charges for local utilities to be rationalized (low or no user charges have led to poor service and strain on budgets; higher charges with proper service delivery can improve both finances and quality)(Finance Commission, 2015, 2020; Rao & Bird, 2010).

**c) Over-dependence on Transfers and its Risks:** As of now, a major portion of local funding comes from state and central transfers. This dependency can undermine local accountability – local officials may feel answerable upward (to those who give funds) rather than downward to citizens. It also makes local services vulnerable to higher-level fiscal stress: e.g., if a state government faces a deficit, it might delay releasing funds to municipalities (a common occurrence). In recent years, there have been instances where Finance Commission-recommended grants were not promptly passed on to local bodies by state treasuries, sometimes diverting them for cash management. Such practices, while legally questionable (since FC grants are intended for local bodies), highlight a need for mechanisms to protect local funds. Some economists have proposed that local grants be put in escrow or public financial management systems that bypass state discretion (Kundu, 2019). The 15th FC recommended tying local grants to an online portal monitoring their transfer and usage. Technology may also enable direct benefit transfers to local bodies with transparency, though constitutionally the money still goes via state accounts (because of federal structure). Ensuring timely release of constitutionally-mandated transfers could possibly be enforced through courts if one argues states have a *constitutional duty* under Article 280(3) to abide by the distribution. There hasn’t been a prominent PIL on this yet, possibly because local bodies themselves are not well-organized to litigate and states rarely default blatantly (they delay but eventually pay when pressured).

**d) Capacity Building and Administrative Reforms:** Many rural local bodies do not have professional accountants or financial officers. They rely on junior clerks or secretaries who may not be trained in modern budgeting. Urban local bodies are somewhat better endowed but even there, financial management practices lag behind – leading to under-utilization of budgets, or accumulation of unused balances in some places alongside deficits in others. Strengthening human resources at the local level is essential: hiring or deputing finance and accounts staff, training elected representatives in budget oversight and institutionalizing citizen audit committees or social audit for local expenditures can improve outcomes (Ministry of Panchayati Raj, “Gram Panchayat Development Plan” guidelines, 2018). The judiciary’s stance in *Fouziya Imtiaz Shaikh* (2021) – that State Election Commissions must be truly independent (not manned part-time by a civil servant) – reflects a broader principle that institutions supporting local governance (like SECs, SFCs, District Planning Committees, etc.) need autonomy and capacity. Similarly, if local financial administration (like local treasuries or auditing bodies) is staffed in a partisan or inept way, the intent of devolution is defeated. Reforms like separating



the state cadre of municipal administration, creating an Indian Municipal Service, or a Panchayat Cadre, have been suggested to professionalize local administration (Second ARC, 2007; Mohanty et al., 2007; Mehta et al., 2020).

**e) Urban Finance Pressures and Reforms:** Many cities are struggling with inadequate infrastructure financing. Constitutional provisions allow municipalities to tap capital markets (with state approvals) – and indeed some bigger cities have issued municipal bonds in recent years (Pune, Ahmedabad, etc.). Yet, most municipalities have low creditworthiness due to weak revenue bases and over-reliance on intergovernmental transfers. The 74th Amendment did not explicitly address new-age financing tools, but some states have innovated with public-private partnerships, land-based financing (e.g., land value capture, betterment levies, which are allowed under municipal laws). A contemporary concern is the impact of GST (Goods and Services Tax) on local finances. GST, introduced in 2017, subsumed several taxes that were either collected by local bodies or were significant to them (like octroi/entry tax in many states, as well as a share of entertainment tax). While states were compensated for GST losses (through 2022), local bodies did not have a direct compensation mechanism. States had to make their own arrangements – for example, Maharashtra, where Mumbai and other cities lost octroi (which was 30-40% of Mumbai’s revenue), the state introduced a “Local Body Tax” and later a grant equivalent to octroi collection to those corporations. But this is an executive arrangement, not in the Constitution. The long-term integration of local bodies into the GST framework (perhaps giving them a share of GST or a new local levy) remains unresolved. Some experts argue for a constitutional amendment to formally integrate local governments in revenue sharing of GST, or to allow a small piggyback local tax on GST (Bird & Smart, 2019; Mehta et al., 2020; RBI Report on Municipal Finances, 2022). Until then, urban local bodies depend on state compensation for such losses.

**f) Equity among Local Bodies:** Disparities in capacity and need among local bodies pose a design challenge for transfers. Within a state, an economically advanced district’s panchayats may have higher tax capacity (more businesses, richer residents) than those in a backward district. SFCs are supposed to account for this through appropriate formulae, but in practice data paucity often leads to rough justice (like per capita lump-sum allocations). Ensuring that grants equalize fiscal capacity without disincentivizing local revenue effort is tricky. One promising approach is the use of an “Index of Decentralization” or similar criteria – the 14th FC encouraged states to consider giving more to local bodies that are making good effort in raising their own income (Heller et al., 2007; Finance Commission, 2020). Incentive grants from the Centre have also been mooted: for instance, a challenge fund for municipalities that significantly increase property tax collection or efficiency. The 15th FC’s performance grants (tied to improving revenue and service levels) moved in that direction, though they were later discontinued by GoI for being too complex in implementation. The debate continues on how to strike the right balance between *ensuring minimum services everywhere (equity)* and *encouraging self-reliance and innovation (efficiency)* at the local level.

**g) Legal Status and Justiciability:** Finally, a fundamental challenge is that, unlike states, local governments do not have the same degree of constitutional protection for their share of finances. If the Union government cuts a state’s share of taxes arbitrarily, the state can invoke the Constitution (Article 270 etc.). But if a state government fails to pass on due funds to a panchayat, the legal remedy is less direct – panchayats or their associations could potentially go to court citing Article 243-I/Y and Finance Commission reports, but courts may view it as a

political question. The Kerala High Court in *ManjulanBhavani v. State of Kerala* (2019) did entertain a petition when the state diverted funds meant for a district panchayat, ruling that finance commission-recommended devolution has to reach the local body as intended (citing the constitutional obligation). If more such cases set precedents, we might see the emergence of a judicial principle that *financial devolution to local bodies, once decided by the proper authority, is not at the whim of state executive to delay or deny* (Mukherjee, 2020; Sahu et al., 2024).

**Way Forward:** Legally, some experts propose another round of constitutional amendments – sometimes dubbed “the 3rd Generation of Reforms” – to strengthen local government finances. These could include: making SFCs’ recommendations binding in a manner similar to UFCs’, constitutionally guaranteeing a minimum share of state revenue to local bodies, or adding a clause that no new function shall be delegated without funds (preventing unfunded mandates). Even without formal amendments, states can voluntarily adopt laws or even constitutional-like statutes (as Karnataka did with its Fiscal Responsibility Act for state finances) to assure certain transfers to local governments. Financially, building robust local revenue systems (through modernizing taxes and fees and exploring new sources like tourism tax, congestion charges in cities, etc.) will reduce over-reliance on higher governments. The central government and RBI have also been exploring ways to improve municipal access to debt for infrastructure – e.g., pooled financing mechanisms for small municipalities, development of muni-bond market with credit ratings for cities (RBI Report on Municipal Finances, 2022 flagged that only a handful of ULBs have raised bonds and mostly with central incentives).

Administrative reforms are equally vital: this includes not only capacity building but fostering a culture of planning and budgeting at the local level. The Constitution’s Article 243ZD and ZE mandated District and Metropolitan Planning Committees to integrate local plans with state plans. These bodies, where functional, can help rationalize expenditures and avoid overlaps, ensuring funds are spent where needed most. Many states have not operationalized these committees effectively. Strengthening them could improve the coherence of spending and inter-governmental coordination (for example, aligning a city’s development plan with the state’s investment in that city’s infrastructure).

Lastly, there is the normative shift – recognizing local governments as genuine partners in governance. This is gradually happening, with terms like “cooperative federalism” now often extended to include local bodies (the NITI Aayog occasionally consults municipalities and panchayats on implementation of schemes). Public opinion and civil society also have a role: if citizens demand better local services, pressure mounts on officials at all levels to fund local bodies adequately. The example of Kerala’s empowered panchayats shows that when local bodies are given both responsibility and resources, they can become effective instruments for participatory development (Isaac & Heller, 2003).

## 5. CONCLUSION

Critical analysis reveals that while constitutional law laid the foundation for empowering local bodies financially, administrative law and practice have often lagged and public finance outcomes have been sub-optimal in many respects. On one hand, there have been notable positive developments: local governments today indisputably have a seat at the table in India’s federal fiscal discussions; they receive a share of national revenue (through Finance Commission grants) far greater than in the pre-1993 era and some states have institutionalized regular transfers to panchayats and municipalities. Judicial interventions, like those ensuring timely elections and

upholding the accountability of local authorities (e.g. *Kishan Singh Tomar*, 2006; *Ratlam*, 1980), have buttressed the constitutional intent by stressing that democratic and service delivery obligations at the local level cannot be ignored for want of funds. These underscore an emergent understanding that local self-government is not a dispensable appendage but a core aspect of governance – indeed the Supreme Court has gone so far as to observe that strong panchayats are intrinsic to the constitutional goal of democracy (see *Bhanumati*, 2010, where it noted the Panchayati Raj amendments “provide for village governance as a constitutional mandate”).

On the other hand, the analysis also uncovers a persistent gap between the *de jure* provisions and the *de facto* situation. Many local bodies remain severely under-resourced, relying on ad hoc grants that are often insufficient. The failure of many states to timely constitute and meaningfully utilize SFCs betrays a lack of political commitment to fiscal federalism at the grassroots (Mathew, 2023). The dependency syndrome is still prevalent: as of mid-2020s, local governments raise only a minor share of total government revenues in India, with own-source revenues of villages and towns covering a small single-digit percentage of their expenditures on average (Finance Commission, 2020; Mohanty et al., 2016). The constitutional ideal that local bodies would become “institutions of self-government” with adequate powers and finances (Article 243W/G) remains work in progress – or as some critics contend, a still elusive goal given the reluctance of states to fully let go of financial control (Sonkar&Ojha, 2024).

From a constitutional law perspective, one may argue that the 73rd and 74th Amendments have indeed altered the basic structure of governance by adding a third tier and any attempt to weaken them (for instance, by not holding elections or not forming SFCs) is ultra vires. The courts have largely upheld state laws enacted under these amendments and nudged compliance, but have been cautious not to overstep into fiscal policy domain. There is room for the judiciary to further develop jurisprudence on the financial provisions – perhaps by recognizing a right of local bodies to reasonable financial accommodation by the state (implied from Article 243-I/Y). However, courts traditionally tread carefully on appropriations and finance (separation of powers), so innovative remedies may be needed (like directing states to explain deviations from SFC reports, rather than directly ordering funds).

From an administrative and public finance angle, the way forward appears to hinge on capacity enhancement, accountability and incentivization. Ensuring that local governments are not just recipients of funds but also accountable managers is crucial. This involves continued reforms in local budgeting, accounting and transparency (e.g. publishing budgets on websites, involving gram sabhas in auditing expenditures, etc.). It also means fostering a culture of performance – where well-performing local bodies (in terms of revenue effort, project execution, etc.) are rewarded. The Central Finance Commission’s efforts in this regard have broken new ground and states can emulate such performance-based approaches in their own transfers. At the same time, equity considerations demand that even the poorest local body has enough resources to provide basic services at some decent standard – a goal that justifies continued and even enhanced support from higher levels.

It is apt to recall a guiding principle from the *Ratlam* case which in a sense captures the ethos of what financial devolution aspires to achieve: governance (at any level) exists to serve the people’s basic needs and governance structures must find a way to fund that service. As Justice Krishna Iyer quipped, “*municipal bodies minus the people and plus the bureaucrats are... no better than when the British were here*”. True financial empowerment of local governments is ultimately about flipping that equation – putting people at the center, enabling their local

representatives to make decisions and reducing remote bureaucracy. The constitutional provisions have paved the road; it is now incumbent upon the state governments and the Union (as an enabler) to travel further down that road. With continuous refinement of policies, increased public awareness and possibly stricter enforcement of constitutional mandates, India can move closer to the ideal of fiscal federalism that is truly three-tiered – where local governments are not supplicants but empowered stakeholders in the country's development, accountable to their citizens and supported by a cooperative framework of center and state assistance.

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