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# FISCAL FEDERALISM AND URBAN LOCAL GOVERNANCE IN INDIA: A CONSTITUTIONAL ANALYSIS OF THE CENTRAL AND STATE FINANCE COMMISSIONS UNDER THE TWELFTH SCHEDULE

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## I. ABSTRACT

*India's constitutional framework of fiscal federalism seeks to balance national unity with decentralised governance by distributing financial powers among the Union, States, and local self-government institutions. The enactment of the Seventy-Third and Seventy-Fourth Constitutional Amendments marked a decisive shift by constitutionally recognising Panchayats and Municipalities as institutions of self-government and by introducing the Eleventh and Twelfth Schedules. Within this framework, the Central Finance Commission and the State Finance Commissions assume a pivotal role in translating constitutional functions into fiscal capacity. This paper critically examines the constitutional design, evolution, and operational interface of the Central Finance Commission and State Finance Commissions in relation to municipal functions enumerated under the Twelfth Schedule. It analyses whether existing devolution mechanisms have effectively addressed vertical and horizontal fiscal imbalances and enabled meaningful urban self-governance. The study highlights persistent structural challenges, including weak own-source revenues, delayed constitution of State Finance Commissions, selective implementation of recommendations, and increasing reliance on conditional transfers. Drawing upon constitutional provisions, judicial interpretation, and institutional practice, the paper argues that decentralisation without assured finance undermines the constitutional promise of local self-government. It concludes that strengthening State Finance Commissions, ensuring predictable and rule-based transfers, and aligning fiscal flows with functional responsibilities are essential to realise the constitutional vision of cooperative and finance-backed urban governance.*

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## II. KEYWORDS

Fiscal Federalism, Central Finance Commission, State Finance Commission, Twelfth Schedule, Urban Local Self-Government, Constitutional Decentralisation, Municipal Finance

## III. INTRODUCTION

### A. Background of Research

India's model of fiscal federalism deliberately places public finance at the centre of constitutional governance. Part XII designs the Union-State revenue arrangement, while Article 280 creates the Central Finance Commission as a periodic, expert constitutional body to recommend principles for tax devolution and grants. After the 73rd and 74th Amendments, this framework no longer stops at States. It expressly reaches local self-government. Article 280(3) empowers the Central Finance Commission to recommend measures to augment State resources so States can supplement Panchayats and Municipalities, which makes local finance a constitutional concern, not only a policy preference.<sup>2</sup>

The 74th Amendment constitutionalised urban local bodies through Part IX-A. Article 243W links municipal empowerment to functional devolution by allowing State legislatures to confer powers and responsibilities for planning and implementation, including the subjects in the Twelfth Schedule. The Twelfth Schedule then lists core municipal functions, such as urban planning, water supply, sanitation, public health, slum improvement, and environmental protection. These functions demand predictable finance streams. The Constitution therefore couples the idea of "effective institutions of self-government" with fiscal tools like municipal taxation and assigned revenues under Articles 243X and 243Y, even though States still control the enabling legislation.<sup>3</sup>

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<sup>2</sup> INDIA CONST. art. 280.

<sup>3</sup> INDIA CONST. art. 243W, sched. XII.

Yet the operational record shows a chronic mismatch between the Twelfth Schedule's service obligations and the real fiscal capacity of municipal corporations. The RBI's thematic Report on Municipal Finances highlights how weak own-source revenues and uneven property tax performance constrain municipal service delivery, and how cities often rely on intergovernmental transfers that arrive with uncertainty or conditions. This background matters for constitutional analysis because decentralisation without finance becomes symbolic. It also matters for administrative law because municipal duties often translate into enforceable obligations, while resource scarcity becomes a recurring State defence in practice, sometimes used to justify under-performance.<sup>4</sup>

## **B. Research Questions**

1. What is the constitutional role of the Central Finance Commission and State Finance Commissions in strengthening municipal finance under the Twelfth Schedule?
2. To what extent have the Seventy-Third and Seventy-Fourth Constitutional Amendments translated functional devolution into effective fiscal empowerment of Municipalities?
3. What institutional and structural challenges hinder the implementation of State Finance Commission recommendations for urban local bodies?
4. Does the existing framework of intergovernmental fiscal transfers adequately realise the constitutional vision of cooperative and decentralised urban governance?

## **C. Research Objectives**

1. To examine the constitutional framework governing fiscal federalism in India with specific reference to the Central and State Finance Commissions.

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<sup>4</sup> RESERVE BANK OF INDIA, REPORT ON MUNICIPAL FINANCES (Nov. 10, 2022), <https://jana-cityfinance-live.s3.ap-south-1.amazonaws.com/objects/5b1a4e36-ebfb-4311-84c6-8213bee1a284.pdf>.

2. To analyse the interface between the Finance Commissions and municipal functions enumerated under the Twelfth Schedule of the Constitution.
3. To evaluate the effectiveness of fiscal devolution mechanisms in enabling functional autonomy and service delivery by urban local bodies.
4. To identify structural gaps and institutional weaknesses affecting municipal finance and accountability.
5. To suggest reforms for strengthening finance-backed urban local self-government in line with constitutional mandates.

#### **D. Research Methodology**

This study adopts a doctrinal research methodology, grounded in analysis of primary and secondary legal sources. It examines the constitutional text governing fiscal federalism and local self-government, particularly Part XII, Part IX-A, Articles 280, 243W, 243X and 243Y, and the Twelfth Schedule, to evaluate the normative design of fiscal devolution to Municipalities.

The research relies on authoritative judicial precedents interpreting federalism, decentralization, and municipal obligations, alongside Finance Commission and State Finance Commission reports to assess institutional practice within the constitutional scheme. To strengthen doctrinal evaluation, the study also draws upon scholarly commentary and institutional publications (including policy and thematic reports on municipal finances) to identify implementation gaps and to develop reform-oriented conclusions consistent with constitutional intent.

## **IV. CONSTITUTIONAL FRAMEWORK OF FISCAL FEDERALISM IN INDIA**

### **A. Federal Structure and Distribution of Legislative and Financial Powers**

The Indian Constitution adopts a federal structure with a strong unitary tilt, where sovereignty is constitutionally divided rather than politically negotiated. Article 246, read

with the Seventh Schedule distributes legislative competence between the Union and the States through three lists. This distribution directly shapes fiscal federalism because the power to legislate on a subject usually determines the power to tax or spend on that subject. The Union List contains subjects of national importance such as defence, foreign affairs, customs, income tax and excise, which provide the Union with broad and elastic revenue sources. The State List includes subjects like public order, police, public health, agriculture and local government, but comparatively fewer high-yield taxes, creating an inherent vertical fiscal imbalance.<sup>5</sup>

This imbalance is not accidental. The Constituent Assembly consciously designed a system where revenue collection remains largely centralized while expenditure responsibilities are widely decentralized. B.R. Ambedkar defended this choice by stressing the need for national unity and economic stability in a newly independent country. As a result, the States depend significantly on transfers from the Union to discharge their constitutional obligations. Part XII of the Constitution, comprising Articles 268 to 293, provides the legal framework for this financial relationship and attempts to correct the imbalance through tax sharing, grants-in-aid and borrowing controls.<sup>6</sup>

Articles 268 to 271 deal with the distribution of tax revenues. Some taxes are levied by the Union but collected and appropriated by the States, such as stamp duties on certain instruments. Others are levied and collected by the Union but shared with the States, most notably income tax under Article 270 after the Eightieth Amendment. Article 271 further allows surcharges for Union purposes, which remain non-shareable, and this provision has often attracted criticism for reducing the divisible pool available for States. These mechanisms show that fiscal federalism in India operates through constitutional rules rather than political bargaining, though the outcomes remain contested.<sup>7</sup>

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<sup>5</sup> INDIA CONST. art. 246, sched. VII.

<sup>6</sup> H.M. SEERVAI, *CONSTITUTIONAL LAW OF INDIA* vol. 3, 2290–2305 (4th ed. 2013).

<sup>7</sup> Govinda Rao & Nirvikar Singh, *The Political Economy of Federalism in India* 45–47 (Oxford Univ. Press 2005).

The Supreme Court has repeatedly affirmed that this division of fiscal powers forms part of the basic structure of the Constitution. In *State of West Bengal v. Union of India*, the Court rejected the idea of absolute sovereignty of the Centre and held that States are not mere administrative units. At the same time, it recognised that financial powers are constitutionally distributed to maintain national coherence. Later, in *S.R. Bommai v. Union of India*, the Court reiterated that federalism is a basic feature, which implies respect for the financial autonomy of States within the constitutional framework.<sup>8</sup>

Article 275 introduces grants-in-aid as an equalizing tool, especially for States with weaker fiscal capacity. These grants operate alongside tax devolution and allow the Union to support States in meeting specific needs, including those related to welfare and development. The Central Finance Commission has become the key constitutional institution in this context. Under Article 280, it recommends principles for distributing net tax proceeds between the Union and the States, and amongst States themselves. This mechanism institutionalizes cooperative federalism by placing revenue sharing on an expert and periodic footing rather than on executive discretion.<sup>9</sup>

The federal distribution of financial powers underwent a significant transformation after the 73rd and 74th Constitutional Amendments. These amendments recognized Panchayats and Municipalities as institutions of self-government and inserted Parts IX and IX-A into the Constitution. Although local bodies do not feature in the Seventh Schedule, Articles 243G and 243W authorize State legislatures to devolve functions, funds and functionaries. This creates a three-tier federal finance structure in practice, even if not explicitly labelled as such. The Twelfth Schedule lists municipal functions, but the fiscal capacity to perform them depends heavily on State legislation and intergovernmental transfers.<sup>10</sup>

State Finance Commissions, mandated under Articles 243I and 243Y, occupy a crucial place in this structure. They examine the financial position of local bodies and

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<sup>8</sup> *State of West Bengal v. Union of India*, A.I.R. 1963 S.C. 1241; *S.R. Bommai v. Union of India*, (1994) 3 S.C.C. 1.

<sup>9</sup> INDIA CONST. arts. 275, 280.

<sup>10</sup> INDIA CONST. arts. 243G, 243W, sched. XII.

recommend how State revenues should be shared with them. Their existence reflects a constitutional acknowledgment that fiscal federalism does not end at the State level. However, unlike the Central Finance Commission, SFCs lack uniform standards, enforcement mechanisms, and political visibility. This asymmetry weakens the overall design of fiscal decentralisation and often leaves municipalities fiscally dependent and administratively constrained.<sup>11</sup>

### **B. Evolution of Local Self Government in the Constitution**

Local self government in India did not begin as a fully constitutional idea. The original Constitution treated local bodies largely as administrative units under State control. Entry 5 of the State List placed local government within State legislative competence, covering municipalities, improvement trusts, district boards and other local authorities. This position reflected a belief that democratic decentralisation could evolve through ordinary legislation rather than constitutional command. Financial autonomy was therefore indirect and fragile, dependent on State laws and executive discretion rather than enforceable constitutional guarantees.<sup>12</sup>

The Constituent Assembly debates show an awareness of village and municipal governance, yet no consensus on constitutionalizing them. Mahatma Gandhi's vision of Gram Swaraj influenced political discourse, but the farmers prioritized national integration and economic planning. Local bodies remained peripheral to the constitutional design of fiscal federalism. States controlled their structure, powers, and finances. Revenue authority stayed narrow. Grants and permissions dominated municipal finance, creating early dependency patterns that persisted for decades.<sup>13</sup>

Judicial interpretation during this period reinforced the subordinate status of local bodies. In *Union of India v. R.C. Jain*, the Supreme Court analyzed the meaning of "local

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<sup>11</sup> Manish Gupta & Pinaki Chakraborty, State Finance Commissions: How Successful Have They Been in Empowering Local Governments? NIPFP Working Paper No. 263 (2019), [https://www.nipfp.org.in/media/documents/WP\\_263\\_2019.pdf](https://www.nipfp.org.in/media/documents/WP_263_2019.pdf).

<sup>12</sup> INDIA CONST. sched. VII, list II, entry 5.

<sup>13</sup> GRANVILLE AUSTIN, THE INDIAN CONSTITUTION: CORNERSTONE OF A NATION 192-95 (Oxford Univ. Press 1966).

authority” under tax statutes and emphasised statutory origin, defined functions, and limited fiscal powers. The decision clarified that local bodies exercise delegated authority rather than sovereign power. This understanding shaped administrative law and reinforced the view that municipalities functioned as State instruments, not autonomous constitutional actors.<sup>14</sup>

Policy dissatisfaction with this model grew steadily. Committees such as the Balwant Rai Mehta Committee and the Ashok Mehta Committee argued that democratic decentralisation required constitutional protection. They highlighted the absence of regular elections, weak financial bases, and excessive bureaucratic control. Their reports linked local democracy to development outcomes and fiscal accountability, especially in service delivery sectors like sanitation, housing, and water supply. Yet until the early 1990s, these recommendations remained largely persuasive rather than binding.<sup>15</sup>

The constitutional moment arrived with the Seventy Third and Seventy Fourth Amendments in 1992. These amendments inserted Parts IX and IX-A, transforming Panchayats and Municipalities into “institutions of self government.” Article 243W empowered State legislatures to devolve functions and authority to municipalities. The Twelfth Schedule listed eighteen functional domains, signalling a shift from discretionary delegation to constitutionally recognised responsibilities. The Constitution thus accepted that urban governance required stable institutional status and predictable public finance.<sup>16</sup>

This shift also altered fiscal federalism. Articles 243X and 243Y addressed municipal finance directly. They authorised State legislatures to assign taxes, duties, tolls and fees to municipalities and mandated the creation of State Finance Commissions. The SFCs were tasked with reviewing the financial position of local bodies and recommending revenue sharing arrangements. This design mirrored Article 280 and the Central Finance

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<sup>14</sup> *Union of India v. R.C. Jain*, (1981) 2 S.C.C. 308 (India).

<sup>15</sup> ASHOK MEHTA COMM., REPORT OF THE COMMITTEE ON PANCHAYATI RAJ INSTITUTIONS (1978) (Gov’t of India).

<sup>16</sup> INDIA CONST. art. 243W, sched. XII.

Commission, extending fiscal constitutionalism downward. Local finance moved from administrative convenience to constitutional expectation.<sup>17</sup>

The Supreme Court responded by acknowledging the elevated status of local self government. In *Kishansing Tomar v. Municipal Corporation of the City of Ahmedabad*, the Court insisted on timely municipal elections and treated continuity of elected local bodies as a constitutional obligation. The reasoning implied that democratic legitimacy and fiscal responsibility must coexist. An elected body without resources risks becoming ineffective, while fiscal authority without democratic control undermines accountability.<sup>18</sup>

### C. Constitutional Provisions on Financial Relations

Part XII of the Constitution structures financial relations through a mix of revenue assignment, revenue sharing, and equalisation. It begins by demarcating public funds through the Consolidated Fund, the Contingency Fund, and the Public Account for both the Union and the States, and it links withdrawals to legislative control and appropriation. This design matters because fiscal federalism is not only about who taxes, it is also about who authorises spending and who carries responsibility in audit and accountability. The scheme therefore places legislature at the centre, and it makes executive spending answerable to constitutional processes rather than administrative convenience.<sup>19</sup>

Articles 268 to 271 set out the core rules on how tax proceeds move across tiers. The Constitution uses different techniques. In some cases, the Union levies a duty but States collect and appropriate it, which helps preserve State receipts without fragmenting the levy. In other cases, the Union levies and collects taxes and then shares the net proceeds with States through a constitutionally defined divisible pool. The present architecture under Article 270, as revised over time, reflects a deliberate move toward formula-based

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<sup>17</sup> INDIA CONST. arts. 243X, 243Y.

<sup>18</sup> *Kishansing Tomar v. Municipal Corp. of the City of Ahmedabad*, (2006) 8 S.C.C. 352 (India).

<sup>19</sup> INDIA CONST. arts. 266–67.

sharing rather than ad hoc transfers. Yet Article 271 allows the Union to impose surcharges for Union purposes, and those surcharges do not enter the divisible pool. This power creates recurring debate on fiscal space, because States see it as a constitutionally valid but politically sensitive method of reducing shareable revenues.<sup>20</sup>

Equalisation appears most clearly through grants. Article 275 authorises grants-in-aid from the Union to States in need of assistance, and it enables targeted support to address structural disadvantages that a pure tax-sharing model cannot solve. The Constitution then assigns a central role to the Finance Commission under Article 280, making it the principal expert mechanism for recommending both devolution and grants. The Commission's recommendations do not operate as judicially enforceable commands, but they carry a distinctive constitutional weight because the President must constitute it periodically and place its report with an explanatory memorandum before Parliament. This reporting discipline is part of cooperative federalism, because it forces transparency in how the Union responds to State claims and fiscal disparities.<sup>21</sup>

Spending powers and borrowing controls add another layer. Article 282 permits the Union or a State to make grants for any public purpose, even outside their legislative lists, which in practice allows the Union to shape State policy through conditional transfers. Articles 292 and 293 regulate borrowing. The Union may borrow upon the security of the Consolidated Fund of India, while States may borrow upon the security of their Consolidated Funds, but Article 293 imposes consent conditions where a State remains indebted to the Union. This arrangement aims to protect macroeconomic stability, though it also limits State fiscal autonomy during periods of stress, and it can tighten the operating space for State-funded local government functions.<sup>22</sup>

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<sup>20</sup> INDIA CONST. arts. 268–71.

<sup>21</sup> INDIA CONST. arts. 275, 280.

<sup>22</sup> INDIA CONST. arts. 282, 292–93.

## V. CENTRAL FINANCE COMMISSION: CONSTITUTIONAL DESIGN AND EVOLUTION

The Central Finance Commission is a constitutionally entrenched institution created to manage fiscal relations between the Union and the States within a structured and rule-based framework. Article 280 mandates the President to constitute the Commission at intervals of five years or earlier if required. The constitutional design deliberately insulates the Commission from day-to-day political bargaining and places it within an expert domain. Its advisory nature does not dilute its authority, because its recommendations form the backbone of Union-State fiscal settlements and guide parliamentary appropriation processes.<sup>23</sup>

The original constitutional vision restricted the Finance Commission's mandate to three core functions. These included recommending the distribution of net proceeds of taxes between the Union and the States, determining principles governing grants-in-aid under Article 275, and advising on matters referred by the President in the interests of sound finance. This limited design reflected a two-tier understanding of fiscal federalism, where States were treated as the primary sub-national units. Local governments did not figure in this architecture, and their finances remained mediated entirely through State discretion.<sup>24</sup>

Early Finance Commissions focused heavily on correcting vertical imbalances and addressing horizontal disparities among States. Criteria such as population, income distance, tax effort, and special needs shaped devolution formulas. The approach prioritised equity over efficiency, and redistribution over fiscal autonomy. Scholars note that these Commissions played a stabilising role in a newly independent economy by ensuring predictable transfers to States with limited revenue capacity, even though the Union retained control over major elastic taxes.<sup>25</sup>

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<sup>23</sup> INDIA CONST. art. 280.

<sup>24</sup> H.M. SEERVAI, *CONSTITUTIONAL LAW OF INDIA* vol. 3, 2306–2312 (4th ed. 2013).

<sup>25</sup> Govinda Rao & Nirvikar Singh, *The Political Economy of Federalism in India* 63–70 (Oxford Univ. Press 2005).

A significant constitutional shift occurred after the Seventy-Third and Seventy-Fourth Amendments. Article 280(3) was amended to include a new clause empowering the Finance Commission to recommend measures needed to augment the Consolidated Fund of a State to supplement the resources of Panchayats and Municipalities. This change altered the institutional identity of the Commission. It no longer operated only as a Union-State arbiter. It became an indirect enabler of fiscal decentralisation. Local self-government entered the constitutional finance discourse through the Commission's reports, even though the primary responsibility for implementation remained with States.<sup>26</sup>

The Supreme Court has acknowledged the constitutional significance of the Finance Commission within the federal structure. In *State of Kerala v. Union of India*, the Court recognised that fiscal arrangements under the Constitution require institutional balance and mutual respect between levels of government. Although the Court refrained from judicially enforcing Commission recommendations, it affirmed that the constitutional process surrounding them carries democratic legitimacy and federal discipline.<sup>27</sup>

The evolution of the Commission's working style reflects changing governance priorities. Later Finance Commissions expanded their analytical base and incorporated performance-linked criteria. Grants shifted from general purpose assistance to sector-specific and outcome-oriented transfers. This trend intensified with local body grants, where conditions relating to audits, accounting standards, and service delivery benchmarks gained prominence. While this approach aims to strengthen accountability, critics argue that excessive conditionality risks undermining the autonomy promised to local institutions under Parts IX and IX-A.<sup>28</sup>

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<sup>26</sup> INDIA CONST. art. 280(3).

<sup>27</sup> *State of Kerala v. Union of India*, (1979) 3 S.C.C. 631 (India).

<sup>28</sup> Pinaki Chakraborty, *Intergovernmental Transfers and Local Governance in India*, 49 *Econ. & Pol. Wkly.* 63 (2014).

## VI. STATE FINANCE COMMISSIONS: POST 73RD AND 74TH CONSTITUTIONAL AMENDMENTS

The constitutional creation of State Finance Commissions marked a decisive shift in India's fiscal federal structure. Articles 243I and 243Y mandate every State to constitute a State Finance Commission at the expiration of every fifth year. The Constitution assigns the SFC the task of reviewing the financial position of Panchayats and Municipalities and recommending principles governing the distribution of State revenues between the State and local bodies. This mandate reflects a conscious move to embed fiscal decentralisation within the constitutional text rather than leaving it to executive goodwill or ordinary legislation.<sup>29</sup>

Before the 73rd and 74th Amendments, local bodies depended almost entirely on State discretion for funds. States controlled taxation powers, grants, and expenditure approvals. Local finance lacked predictability. Democratic accountability weakened because elected local institutions functioned without assured resources. The constitutional amendments sought to correct this imbalance by recognising Panchayats and Municipalities as institutions of self-government and by creating a parallel fiscal review mechanism at the State level, modeled broadly on Article 280 and the Central Finance Commission.<sup>30</sup>

The design of the State Finance Commission is intentionally advisory but constitutionally protected. States retain discretion over acceptance and implementation of SFC recommendations, yet the Constitution requires the Governor to place the SFC report and an action taken memorandum before the State legislature. This procedural requirement introduces transparency and legislative scrutiny. It also creates a normative expectation

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<sup>29</sup> INDIA CONST. arts. 243I, 243Y.

<sup>30</sup> GRANVILLE AUSTIN, *THE INDIAN CONSTITUTION: CORNERSTONE OF A NATION* 302–05 (Oxford Univ. Press 1966).

that State governments justify departures from recommendations, even if they are not legally bound to implement them fully.<sup>31</sup>

The functional scope of SFCs is wide. They examine revenue assignments, tax sharing arrangements, grants-in-aid, and measures to improve local financial management. They assess own-source revenue potential of local bodies, including property tax, user charges, and fees. They also review expenditure needs arising from functions listed in the Eleventh and Twelfth Schedules. This linkage between functions and finance lies at the heart of decentralised governance, because unfunded mandates dilute the constitutional promise of self-government.<sup>32</sup>

Empirical studies reveal uneven performance of State Finance Commissions across States. Research by the National Institute of Public Finance and Policy documents delays in constitution, overlapping terms, inadequate data access, and limited technical capacity. Many SFCs rely heavily on State finance departments for staffing and information, which affects independence. Some States have failed to constitute SFCs regularly, despite the clear constitutional mandate, weakening the credibility of fiscal decentralisation.<sup>33</sup>

Judicial responses to SFC-related issues remain cautious but significant. Courts have generally refrained from compelling implementation of SFC recommendations, respecting the advisory nature of the institution. However, they have emphasised constitutional compliance in procedural aspects. In *Kishansing Tomar v. Municipal Corporation of the City of Ahmedabad*, the Supreme Court underscored the mandatory character of constitutional provisions relating to local self-government. Although the case focused on elections, its reasoning reinforces the binding nature of constitutional processes under Parts IX and IX-A, including those relating to financial institutions like SFCs.<sup>34</sup>

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<sup>31</sup> INDIA CONST. arts. 243I(2), 243Y(2).

<sup>32</sup> INDIA CONST. scheds. XI, XII.

<sup>33</sup> Manish Gupta & Pinaki Chakraborty, *State Finance Commissions: How Successful Have They Been in Empowering Local Governments?*, NIPFP Working Paper No. 263 (Nat'l Inst. of Pub. Fin. & Pol'y 2019), [https://www.nipfp.org.in/media/documents/WP\\_263\\_2019.pdf](https://www.nipfp.org.in/media/documents/WP_263_2019.pdf).

<sup>34</sup> *Kishansing Tomar v. Municipal Corp. of the City of Ahmedabad*, (2006) 8 S.C.C. 352 (India).

## VII. THE TWELFTH SCHEDULE AND MUNICIPAL FUNCTIONS

Fiscal empowerment of urban local bodies flows directly from the constitutional promise of decentralised governance under Part IX-A. Article 243W read with the Twelfth Schedule recognises Municipalities as institutions entrusted with core civic and developmental functions. These functions include urban planning, regulation of land use, water supply, sanitation, public health, fire services, urban poverty alleviation, and environmental protection. Each of these responsibilities carries recurring expenditure obligations. The Constitution therefore envisages that Municipalities must possess adequate and predictable financial resources to perform these duties with autonomy and accountability.<sup>35</sup>

The constitutional scheme addresses municipal finance through multiple provisions rather than a single source. Article 243X empowers State legislatures to authorise Municipalities to levy, collect and appropriate taxes, duties, tolls and fees. This provision forms the backbone of municipal own-source revenue. Property tax, advertisement tax, user charges, and license fees emerge as primary instruments. However, the extent of these powers depends on State municipal laws, resulting in wide variation across States. This dependence often weakens fiscal autonomy, because States retain discretion over rate setting, exemptions, and enforcement mechanisms.<sup>36</sup>

Article 243Y introduces the State Finance Commission as a critical institution for strengthening municipal finances. The SFC reviews the financial position of Municipalities and recommends principles governing the sharing of State taxes, assignment of revenues, and grants-in-aid. This mechanism attempts to correct vertical imbalance at the State-local level. Yet empirical evidence suggests that many States either delay SFC constitution or selectively implement recommendations, leading to

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<sup>35</sup> INDIA CONST. art. 243W, sched. XII.

<sup>36</sup> INDIA CONST. art. 243X.

uncertainty in municipal revenue flows. Fiscal empowerment thus remains uneven despite constitutional backing.<sup>37</sup>

The Central Finance Commission adds another layer to municipal finance through Article 280(3). After the 73rd and 74th Amendments, the CFC may recommend measures to augment State resources to supplement Panchayats and Municipalities. Successive Finance Commissions have operationalised this mandate by providing basic, tied, and performance-based grants to urban local bodies. These grants have supported accounting reforms, sanitation outcomes, drinking water services, and infrastructure maintenance linked to Twelfth Schedule functions. While such transfers enhance capacity, they also introduce conditionality that may constrain local discretion.<sup>38</sup>

Judicial reasoning has indirectly reinforced the fiscal obligations attached to municipal functions. In *Municipal Council, Ratlam v. Vardhichand*, the Supreme Court rejected financial inability as a defence against failure to perform statutory civic duties. Although decided before Part IX-A, the judgment assumes greater constitutional relevance in the post-amendment era. It signals that once functions are legally assigned, the State must ensure financial arrangements that allow compliance. Fiscal scarcity cannot justify neglect of public health and sanitation, which now fall squarely within the Twelfth Schedule.<sup>39</sup>

Data on municipal finances reveals persistent structural weaknesses. The Reserve Bank of India's reports on municipal finances show that urban local bodies contribute a very small share to total public expenditure and GDP. Own-source revenues remain limited, and capital spending depends heavily on transfers and borrowing. Smaller municipalities face acute constraints due to narrow tax bases and administrative capacity gaps. This

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<sup>37</sup> Manish Gupta & Pinaki Chakraborty, *State Finance Commissions: How Successful Have They Been in Empowering Local Governments?*, NIPFP Working Paper No. 263 (2019), [https://www.nipfp.org.in/media/documents/WP\\_263\\_2019.pdf](https://www.nipfp.org.in/media/documents/WP_263_2019.pdf).

<sup>38</sup> INDIA CONST. art. 280(3).

<sup>39</sup> *Municipal Council, Ratlam v. Vardhichand*, (1980) 4 S.C.C. 162 (India).

financial fragility undermines service delivery and limits long-term planning, despite constitutional recognition of municipal functions.<sup>40</sup>

Borrowing and market access form another dimension of fiscal empowerment. Municipal laws permit borrowing for capital projects, subject to State approval. Bond issuance and pooled finance mechanisms have emerged in select cities, but access remains limited to a few financially strong corporations. Regulatory requirements, creditworthiness, and State guarantee shape this space. Without stable revenue streams and transparent accounts, most municipalities cannot leverage debt finance effectively, which restricts infrastructure development central to Twelfth Schedule mandates.<sup>41</sup>

Academic analysis emphasises that fiscal empowerment is inseparable from administrative and political reform. Studies by the National Institute of Public Finance and Policy argue that predictable formula-based transfers, strengthened property tax systems, and timely SFC implementation are essential for genuine decentralisation. Where States treat municipal finance as discretionary assistance rather than constitutional entitlement, urban governance suffers. Fiscal empowerment thus becomes a test of cooperative federalism, requiring alignment between Union transfers, State policies, and local accountability mechanisms.<sup>42</sup>

The constitutional framework therefore establishes multiple channels for empowering urban local bodies financially. Tax powers, State transfers, Finance Commission grants, and limited borrowing rights operate together. Yet the effectiveness of this framework depends on implementation. Where States respect the constitutional spirit of Part IX-A and the Twelfth Schedule, municipalities gain functional and fiscal credibility. Where discretion dominates, local self-government remains formally recognised but

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<sup>40</sup> RESERVE BANK OF INDIA, REPORT ON MUNICIPAL FINANCES (2022), <https://jana-cityfinance-live.s3.ap-south-1.amazonaws.com/objects/5b1a4e36-ebfb-4311-84c6-8213bee1a284.pdf>.

<sup>41</sup> Reserve Bank of India, *Municipal Borrowings and Urban Infrastructure Finance*, 77 RBI Bull. 45 (2023).

<sup>42</sup> M. Govinda Rao & Nirvikar Singh, *India's Fiscal Federalism 201–08* (Oxford Univ. Press 2012).

substantively constrained, weakening the decentralised vision embedded in the Constitution.<sup>43</sup>

## VIII. INTERFACE OF CENTRAL AND STATE FINANCE COMMISSIONS WITH THE TWELFTH SCHEDULE

The constitutional interface between the Central Finance Commission and the State Finance Commissions acquires its sharpest relevance when examined through the lens of the Twelfth Schedule. Article 243W assigns Municipalities a defined set of urban functions, while Articles 243X and 243Y contemplate a fiscal architecture that must support these functions. The Central Finance Commission enters this space through Article 280(3), which authorises it to recommend measures to augment State resources for supplementing Panchayats and Municipalities. This provision establishes a vertical linkage between Union level fiscal decisions and urban local governance, mediated through the States.<sup>44</sup>

The Central Finance Commission does not deal with Municipalities directly. Its constitutional mandate requires it to operate through State governments. Local body grants recommended by the Commission form part of State receipts, and States remain responsible for designing the intra-State transfer mechanisms. This structure preserves the federal balance, but it also creates dependence on State-level institutional capacity. Where States lack robust State Finance Commission processes, Central Finance Commission grants risk dilution, delay, or diversion, thereby weakening the intended impact on Twelfth Schedule functions.<sup>45</sup>

State Finance Commissions occupy a complementary but distinct position. Articles 243I and 243Y require SFCs to examine the financial position of local bodies and recommend how State taxes and grants should be shared with them. The Twelfth Schedule guides this exercise by identifying the functional responsibilities that generate expenditure

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<sup>43</sup> Bimal N. Patel et al., *Indian Federalism in the Era of Finance Commissions* 158–64 (Oxford Univ. Press 2020).

<sup>44</sup> INDIA CONST. art. 280(3).

<sup>45</sup> INDIA CONST. arts. 243W, 243X, 243Y.

needs. In theory, SFC recommendations should translate Twelfth Schedule functions into quantifiable fiscal requirements. In practice, many SFCs struggle with data limitations, unclear functional mapping, and constrained technical resources, which weakens this functional–financial linkage.<sup>46</sup>

The interaction between the two Commissions therefore depends on institutional alignment rather than formal hierarchy. The Central Finance Commission increasingly relies on SFC reports, municipal audit data, and State-level transfer formulas to design its local body grants. The Fifteenth Finance Commission explicitly emphasised the need for timely constitution and strengthening of SFCs, and it conditioned certain local body grants on the existence of audited accounts and State-level data frameworks. This approach reflects an attempt to use Union-level fiscal leverage to improve State compliance with constitutional decentralisation norms.<sup>47</sup>

At the same time, this interface raises concerns of over-centralisation. Performance-linked and tied grants, though aimed at improving service delivery, may narrow local discretion in performing Twelfth Schedule functions. When conditions are framed without sufficient sensitivity to local variation, Municipalities risk becoming implementers of centrally defined outcomes rather than autonomous planners. Scholars argue that this trend sits uneasily with the constitutional vision of self-government under Part IX-A, which prioritises local decision-making within a democratic framework.<sup>48</sup>

Judicial reasoning provides indirect support for a coherent interface between functions and finance. In *Municipal Council, Ratlam v. Vardhichand*, the Supreme Court stressed that statutory civic duties cannot be avoided on grounds of financial incapacity. In the post-constitutional amendment context, this logic implies that when the Constitution assigns

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<sup>46</sup> Manish Gupta & Pinaki Chakraborty, *State Finance Commissions: How Successful Have They Been in Empowering Local Governments?*, NIPFP Working Paper No. 263 (2019), [https://www.nipfp.org.in/media/documents/WP\\_263\\_2019.pdf](https://www.nipfp.org.in/media/documents/WP_263_2019.pdf).

<sup>47</sup> Fifteenth Finance Commission, Report for 2021–26, vol. I, ch. 9 (Gov't of India 2021), <https://fincomindia.nic.in/reports>.

<sup>48</sup> Pinaki Chakraborty, *Intergovernmental Transfers and Local Governance in India*, 49 *Econ. & Pol. Wkly.* 63 (2014).

functions through the Twelfth Schedule, fiscal arrangements must follow. Although courts do not adjudicate Finance Commission design, such jurisprudence strengthens the normative expectation that both Central and State Commissions align fiscal flows with constitutional responsibilities.<sup>49</sup>

The effectiveness of this interface varies significantly across States. Some States have institutionalised formula-based sharing of State taxes with Municipalities, drawing directly from SFC recommendations and aligning them with Central Finance Commission grants. In these cases, Twelfth Schedule functions receive relatively stable funding. In contrast, States that rely on discretionary transfers and delayed SFC reports weaken the vertical chain of fiscal accountability. This divergence produces asymmetrical urban governance outcomes across the federation, despite uniform constitutional text.<sup>50</sup>

## **IX. CRITICAL ANALYSIS: DOES THE PRESENT FRAMEWORK REALISE THE CONSTITUTIONAL VISION**

The constitutional vision underlying fiscal federalism and local self government rests on the idea of meaningful decentralisation. Articles 243W, 243X, 243Y and Article 280 together attempt to create a coherent system where functions, finances and institutions align. The Twelfth Schedule identifies municipal responsibilities. Finance Commissions are expected to translate those responsibilities into fiscal capacity. The critical question is whether this translation has occurred in practice, or whether decentralisation remains largely formal rather than substantive.<sup>51</sup>

The first structural concern arises from vertical imbalance. The Union continues to control the most buoyant sources of taxation. States depend heavily on shared taxes and grants. Municipalities depend even more on State transfers. This cascading dependency weakens the constitutional promise of self-government. While the Central Finance Commission has expanded local body grants since the Fourteenth Commission, these grants flow

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<sup>49</sup> *Municipal Council, Ratlam v. Vardhichand*, (1980) 4 S.C.C. 162 (India).

<sup>50</sup> M. Govinda Rao & Nirvikar Singh, *India's Fiscal Federalism* 214–21 (Oxford Univ. Press 2012).

<sup>51</sup> INDIA CONST. arts. 243W, 243X, 243Y; INDIA CONST. art. 280.

through States and remain vulnerable to administrative delay and policy filtering. Constitutional design assumes cooperation. The operational reality often reflects control.<sup>52</sup>

The second concern relates to functional devolution under the Twelfth Schedule. The Schedule lists eighteen functions, but State legislation rarely transfers all of them in full measure. In many States, urban planning, water supply, or transport remain fragmented across parastatal agencies. Municipalities retain nominal responsibility without command over staff or budgets. This misalignment creates unfunded mandates. Fiscal transfers then become compensatory rather than empowering. The constitutional vision of autonomous urban governance becomes diluted by administrative fragmentation.<sup>53</sup>

The role of the Central Finance Commission shows both progress and limitation. The Commission has acknowledged municipalities as constitutional actors and has created formula-based grants tied to population, area, and performance. Yet the increasing use of conditional grants raises concerns. Conditions related to audits, service benchmarks, or reforms may improve accountability, but they also constrain local discretion. When local priorities differ from centrally defined outcomes, the democratic space of municipal decision-making narrows. The Constitution envisages guidance, not managerial supervision, from higher levels.<sup>54</sup>

State Finance Commissions remain the weakest institutional link. Despite clear constitutional mandate, many States delay their constitution or fail to implement recommendations. Legislative scrutiny of SFC reports often remains perfunctory. Courts have avoided enforcing SFC recommendations, citing their advisory nature. This judicial restraint preserves federal balance, but it also allows chronic non-compliance. As a result,

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<sup>52</sup> Fifteenth Finance Commission, Report for 2021–26, vol. I (Gov't of India 2021), <https://fincomindia.nic.in/reports>.

<sup>53</sup> M. Govinda Rao & Nirvikar Singh, *India's Fiscal Federalism* 173–80 (Oxford Univ. Press 2012).

<sup>54</sup> Pinaki Chakraborty, *Intergovernmental Transfers and Local Governance in India*, 49 *Econ. & Pol. Wkly.* 63 (2014).

fiscal decentralisation depends more on political will than constitutional obligation, which undermines the normative force of Parts IX and IX-A.<sup>55</sup>

Judicial doctrine offers limited corrective force. Decisions such as *Municipal Council, Ratlam v. Vardhichand* emphasise that civic duties cannot be avoided due to lack of funds. Post-amendment, this reasoning implies that States must ensure fiscal arrangements for municipal functions. However, courts do not engage with Finance Commission architecture directly. They enforce duties but not the fiscal pathways that enable compliance. This creates a constitutional gap between rights and resources.<sup>56</sup>

Comparative data deepens this critique. Reserve Bank of India reports show that municipal expenditure remains a small fraction of total public spending. Property tax performance remains uneven. User charges often fail to recover costs. Smaller municipalities remain fiscally fragile. These outcomes suggest that constitutional recognition alone does not transform fiscal capacity. Without robust revenue assignment and predictable transfers, decentralisation remains shallow.<sup>57</sup>

## X. RECOMMENDATIONS AND SUGGESTED REFORMS

A first reform must address the weakest link in the fiscal decentralisation chain, namely the irregular and underpowered State Finance Commission system. States should institutionalise a strict constitutional calendar for constituting SFCs and submitting reports within a fixed outer limit, and the legislature should mandate debate on the report and the action taken memorandum within a defined session. This will not make recommendations binding, but it will raise political and legal costs for non-compliance. States can also create a permanent technical secretariat for SFCs, staffed with finance,

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<sup>55</sup> Manish Gupta & Pinaki Chakraborty, *State Finance Commissions: How Successful Have They Been in Empowering Local Governments?*, NIPFP Working Paper No. 263 (2019), [https://www.nipfp.org.in/media/documents/WP\\_263\\_2019.pdf](https://www.nipfp.org.in/media/documents/WP_263_2019.pdf).

<sup>56</sup> *Municipal Council, Ratlam v. Vardhichand*, (1980) 4 S.C.C. 162 (India).

<sup>57</sup> RESERVE BANK OF INDIA, *REPORT ON MUNICIPAL FINANCES* (2022), <https://jana-cityfinance-live.s3.ap-south-1.amazonaws.com/objects/5b1a4e36-ebfb-4311-84c6-8213bee1a284.pdf>.

audit, and urban service experts, so each Commission does not begin from zero every cycle.<sup>58</sup>

A second reform should tighten functional mapping under the Twelfth Schedule. State laws often devolve functions in fragments, while parastatals retain staff, assets, and revenue streams. States should adopt a clear “activity mapping” that links each Twelfth Schedule item to a responsible municipal tier, an identifiable budget head, and a defined revenue source. This mapping should be published and audited. It will reduce unfunded mandates and make service failure traceable to a specific institutional break, which improves administrative accountability.<sup>59</sup>

A third reform must strengthen municipal own-source revenue, without diluting equity. Property tax needs statutory simplification and better valuation practices. States should shift toward objective valuation methods, reduce discretionary exemptions, and protect enforcement from local political pressure. User charges should follow a cost-recovery path with targeted subsidies for vulnerable groups, rather than blanket under-pricing that harms municipal maintenance. These measures directly enhance municipal fiscal autonomy under Article 243X and reduce over-reliance on higher-tier transfers.<sup>60</sup>

A fourth reform should re-balance the relationship between rule-based transfers and discretionary grants. The Central Finance Commission’s local body grants have improved predictability, but parallel discretionary transfers through schemes still distort incentives. The Union and States should publish a unified “transfer statement” that consolidates all flows to urban local bodies, including scheme funds, Finance Commission grants, and State transfers, in a standard format. This transparency will

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<sup>58</sup> Manish Gupta & Pinaki Chakraborty, *State Finance Commissions: How Successful Have They Been in Empowering Local Governments?*, NIPFP Working Paper No. 263 (2019), [https://www.nipfp.org.in/media/documents/WP\\_263\\_2019.pdf](https://www.nipfp.org.in/media/documents/WP_263_2019.pdf).

<sup>59</sup> INDIA CONST. art. 243W, sched. XII.

<sup>60</sup> INDIA CONST. art. 243X.

allow comparison, reduce duplication, and help identify whether Twelfth Schedule functions receive stable baseline funding.<sup>61</sup>

A fifth reform should improve the quality of municipal accounts and audits, but with practical sequencing. Conditional grants often assume immediate compliance with uniform accounting systems, which smaller municipalities find difficult. States should phase reforms by creating shared accounting and procurement platforms, regional audit support units, and standard templates for budget disclosure. This improves compliance with financial discipline while preserving local decision making. It also strengthens the evidence base for future Finance Commissions and SFCs.<sup>62</sup>

## **XI. CONCLUSION**

The constitutional scheme on fiscal federalism does not treat money as a technical detail. It treats it as a condition for democratic governance. Article 280 creates the Central Finance Commission as a periodic constitutional forum for building trust between the Union and the States through rule-based transfers. After the 73rd and 74th Amendments, that trust must travel further down, because Article 243W and the Twelfth Schedule place real public functions on Municipalities. A function without finance becomes only a promise on paper. The constitutional vision therefore expects aligned devolution of functions, funds, and institutional authority, not symbolic recognition alone.<sup>63</sup>

This paper's analysis shows a mixed record. The Central Finance Commission has gradually expanded local body grants and has treated urban local bodies as constitutionally relevant actors. Yet the transfer chain still runs through the States. That design preserves federal balance, but it also creates friction. Delays, filtering, and conditionalities often weaken the last-mile impact. The growing share of Union revenues collected through cesses and surcharges also complicates the divisible pool logic, and it

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<sup>61</sup> Fifteenth Finance Commission, Report for 2021–26, vol. I, ch. 9 (Gov't of India 2021), <https://fincomindia.nic.in/reports>.

<sup>62</sup> RESERVE BANK OF INDIA, REPORT ON MUNICIPAL FINANCES (2022), <https://jana-cityfinance-live.s3.ap-south-1.amazonaws.com/objects/5b1a4e36-ebfb-4311-84c6-8213bee1a284.pdf>.

<sup>63</sup> INDIA CONST. art. 243W, sched. XII.

narrows the fiscal room States can use for municipal empowerment. Cooperative federalism then looks cooperative mostly in text, and less in routine fiscal practice.<sup>64</sup>

The State Finance Commissions remain the decisive hinge. The Constitution mandates their periodic constitution and requires their reports and action taken memoranda to reach the legislature, but many States treat this duty casually. Where SFCs function well, they can translate Twelfth Schedule responsibilities into predictable State-to-municipality transfers. Where they remain delayed or ignored, local self-government runs on uncertainty. This is not only a governance gap. It is also a constitutional gap, because Parts IX and IX-A were drafted to reduce discretion and to secure stability in local democratic institutions.<sup>65</sup>

Urban local bodies also face an internal constraint. Their own-source revenues remain weak and uneven. Property tax reforms, user charges, and transparent accounts matter because they create local accountability. They also reduce overdependence on higher-tier transfers. RBI assessments on municipal finance underline that municipal revenue effort and fiscal capacity do not match the scale of urban service demands. When cities cannot finance basic functions like water, sanitation, and public health, the Twelfth Schedule risks becoming aspirational rather than operational.<sup>66</sup>

Judicial doctrine adds a normative push, even if it does not redesign fiscal architecture directly. In *Municipal Council, Ratlam v. Vardhichand*, the Supreme Court rejected financial incapacity as an excuse for failure to perform civic duties. In the post-1992 constitutional order, that reasoning supports a deeper claim. States must build fiscal pathways that make municipal compliance possible. Courts cannot substitute finance commissions, yet

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<sup>64</sup> Fifteenth Finance Commission, Report for 2021–26, vol. I (Gov't of India 2021), <https://fincomindia.nic.in/reports>.

<sup>65</sup> Manish Gupta & Pinaki Chakraborty, State Finance Commissions: How Successful Have They Been in Empowering Local Governments?, NIPFP Working Paper No. 263 (2019), [https://www.nipfp.org.in/media/documents/WP\\_263\\_2019.pdf](https://www.nipfp.org.in/media/documents/WP_263_2019.pdf).

<sup>66</sup> RESERVE BANK OF INDIA, REPORT ON MUNICIPAL FINANCES (2022), <https://jana-cityfinance-live.s3.ap-south-1.amazonaws.com/objects/5b1a4e36-ebfb-4311-84c6-8213bee1a284.pdf>.

their insistence on enforceable civic obligations strengthens the argument that the State cannot devolve duties and then starve the institution expected to perform them.<sup>67</sup>

The constitutional vision therefore stands only partly realized. The framework exists. The vocabulary of decentralization is strong. Institutional behavior remains uneven. The most credible path forward lies in tightening State Finance Commission discipline, building activity mapping for Twelfth Schedule functions, strengthening own-source revenues, and making transfer flows transparent and rule-based. These reforms do not require abandoning federal balance. They require completing it. Fiscal federalism then becomes not a contest of tines, but a shared constitutional method for delivering everyday urban justice through accountable local institutions.<sup>68</sup>

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