

# LAW-AND-ECONOMICS OF THE THIRD STRATUM: IS IT A LA MEDDLE, MUDDLE BUT STAY IN THE MIDDLE?

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## ABSTRACT

*The early 1990s engendered two distinct yet critical decisions in Indian legal firmament -- economic reforms and political decentralization. While the former is renowned for unshackling dormant talent, the latter continues to languish. In spite of the 1993 constitutional amendments, local bodies -- Panchayats and Municipalities -- envisaged to be flag-bearers of empowerment, remain a mere footnote in the political system.*

*The paper deals with the law and economics of the aforementioned local bodies. Utilizing the methodology of the economic analysis of law, it finds that the constitutional mandate for decentralization could be located in the agency cost theory. A detailed analysis of the constitutional text (provisions) as well as the context (legislative history) augments the logic.*

*Frustrated with lethargic movement on empowerment of local bodies, many scholars have demanded constitutional amendments to address the same. The paper notes that such calls ignore high transaction cost involved. Since amendments would require cooperation of the states, who are currently stonewalling the issue, such demands appear naive and gloss over hold-out problems.*

*The paper finds that an ingrained incompleteness of contract, including that of a social concordat such as the Constitution, is inevitable. Hence it utilizes the jurisprudential tool such as principles of interpretation to get over the conundrum. The paper argues that a purposive, context based interpretation of the Constitution indicates that a reduction in agency cost is ordained. Federal government, state governments as well as institutions such as the Finance Commission ought to embellish not emasculate local bodies.*

*The paper underscores the significant practical ramifications of the law-and-economics based analysis of constitutional provisions dealing with local bodies.*

## **LAW-AND-ECONOMICS OF THE THIRD STRATUM: IS IT A LA MEDDLE, MUDDLE BUT STAY IN THE MIDDLE?**

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### I. INTRODUCTION

While India unleashed the forces of market liberalization in 1991 in order to tap the hitherto latent entrepreneurial spirit of individuals, concomitantly through constitutional amendments in 1992, it also ushered in decentralized governance. The eleventh and twelfth schedules delineate areas where rural as well as urban local bodies could play a seminal role in democratizing governance in India.

Though Constitution has laid down entries on which rural and urban local bodies can legitimately function, it is clearly not enough. In the absence of financial autonomy many a time rural/urban local bodies are hamstrung from realizing the goals that Mahatma Gandhi had envisaged for them.

Art. 243G of the Constitution of India lays down the powers, authority and responsibilities of Panchayats.<sup>1</sup> The Eleventh Schedule of the Constitution contains areas where Panchayats could play an effective role in economic development and social justice.

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<sup>1</sup> Article 243 G of the Indian Constitution states: “Subject to the provisions of this Constitution the Legislature of a State may, by law, endow the Panchayats with such powers and authority as may be necessary to enable them to function as institutions of self-government and such law may contain provisions for the devolution of powers and responsibilities upon Panchayats, at the appropriate level, subject to such conditions as may be specified therein with respect to -- (a) the preparation of plans for economic development and social justice; (b) the implementation of schemes for economic development and social justice as may be entrusted to them including those in relation to the matters listed in the Eleventh Schedule”

Similarly, Art. 243W of the Constitution of India deals with powers, authority and responsibilities of Municipalities.<sup>2</sup> The Twelfth Schedule of the Constitution draws up matters where Municipalities could work towards securing the constitutional mandate of economic development and social justice.

Furthermore, the Directive Principles of State Policy, which is ‘fundamental in the governance of the country’<sup>3</sup>, in Art. 40 states that it is the duty of 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’.

It is hard to imagine urban/rural local bodies emerging as units of self-government in the absence of clarity over financial autonomy. Indeed, Article 266 defines the Consolidated Funds of India and of the States. Whilst the Consolidated Fund of India is net of the share of taxes of the States, all revenues of the state governments find their way to the Consolidated Funds of the State. Funds allocated to the local bodies as per the recommendations of the State Finance Commissions are first voted upon by the State Legislature and then passed on to the local bodies. These funds are, therefore, subject to various deductions and adjustments against loans disbursed by the state government, prior dues of state power utilities or for supply of drinking water, etc.

The paper looks into the constitutional architecture and the rationale behind the aforementioned dissonance in the approach. Its central argument is that what economic liberalization has achieved for the untapped, latent entrepreneurial spirit, decentralization, if implemented in its constitutional letter and spirit, has the potential to do for social capital.

The paper utilizes the methodological tool of law-and-economics and borrows from the agency cost theory of corporate governance.<sup>4</sup> Economic agents are self-interested and rational.<sup>5</sup> There is no logical reason why political agents would not follow

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<sup>2</sup> Article 243 W of the Indian Constitution states: “Subject to the provisions of this Constitution, the Legislature of a State may, by law, endow -- (a) the Municipalities with such powers and authority as may be necessary to enable them to function as institutions of self-government and such law may contain provisions for the devolution of powers and responsibilities upon Municipalities, subject to such conditions as may be specified therein, with respect to -- (i) the preparation of plans for economic development and social justice; (ii) the performance of functions and the implementation of schemes as may be entrusted to them including those in relation to the matters listed in the Twelfth Schedule; (b) the Committees with such powers and authority as may be necessary to enable them to carry out the responsibilities conferred upon them including those in relation to the matters listed in the Twelfth Schedule”.

<sup>3</sup> Article 37 of the Indian Constitution states: “The provisions contained in this Part shall not be enforceable by any court, but the principles therein laid down are nevertheless fundamental in the governance of the country and it shall be the duty of the State to apply these principles in making laws.”

<sup>4</sup> See generally, Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property*, Revised Edition, Harcourt, Brace & World, Inc., New York, 1967. [Hereinafter Berle and Means]

<sup>5</sup> Roger E. Backhouse, *The Penguin History of Economics*, Penguin Books, London, 2002, p. 136.

the rationality model.<sup>6</sup> Berle and Means noted the significance of difference in ownership and control of firms leading to principal (shareholder) and agent (managers) problem.<sup>7</sup> The inevitable divergence of interests between principal and agent leads to welfare losses.<sup>8</sup> Decentralization has similar principal (stakeholders) and agent (institutions of governance) issues.

Being aware that a linkage with economic reforms process may lead to the problem of *post hoc ergo propter hoc*,<sup>9</sup> the paper uses the agency cost on corporate governance as an analogy. The discipline of law is no stranger to analogy, as the usage of case laws exemplify analogical reasoning where *staire decisis* is critical.<sup>10</sup> Further, usage of case laws ensures that the paper remains grounded in empirical logic.<sup>11</sup>

Accordingly, the paper construes the constitutional mandate of the third stratum to be limiting or reducing the divergence of self interests between stakeholders (principal) and institutions of governance (agent). The paper argues that the increasing decentralization could be viewed in light of principle-agent conundrum. Hence constitutional provision for local self-government ought to be analyzed in furtherance of reduction of agency cost.

This clarity in thesis statement achieves another purpose. Percy Mistry has noted in the context of economic reforms agenda that India revels in ‘meddle and muddle but stay in the middle’.<sup>12</sup> Amartya Sen would perhaps euphemistically call this distinct trait to be of the *Argumentative Indian*.<sup>13</sup> The paper in analyzing the purpose of constitutional amendment as reduction of agency cost, seeks to obtain certainty and clarity that Percy Mistry found to be elusive.

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<sup>6</sup> See generally, Amartya Sen, “Rational Behaviour”, in John Eatwell, Murray Milgate & Peter Newman (Eds.), *The New Palgrave Dictionary of Economics*, Vol. 4, pp.68-76.

<sup>7</sup> Berle and Means, *supra*

<sup>8</sup> Shareholders, for instance, would want to maximize profit while managers may increase their salaries. This pans out in our everyday life as well. An auto driver in Bangalore city, who figures that you are an outsider would likely charge excess fare. Suketu Mehta, speaking about Mumbai, termed it as ‘newcomers tax’. See, Suketu Mehta, *Maximum City*, Penguin Viking, New Delhi, 2004, p. 32.

<sup>9</sup> See, Vinod Vyasulu, *Crisis and Response: An Assessment of economic reforms*, Madhyam Books, Delhi, 1996

<sup>10</sup> Brian H. Bix, “Law as an Autonomous Discipline” in Peter Cane & Mark Tushnet, *The Oxford Handbook of Legal Studies*, Oxford University Press, 2003, pp. 975 - 987.

<sup>11</sup> John Baldwin & Gwynn Davis, “Empirical Research in Law” in Peter Cane & Mark Tushnet, *The Oxford Handbook of Legal Studies*, Oxford University Press, 2003, pp. 880 - 900.

<sup>12</sup> See, “The Idea Exchange with Percy Mistry: ‘Are we prepared to lose 30 per cent of GDP to save 3 per cent because of a financial shock?’”, <http://www.indianexpress.com/news/are-we-prepared-to-lose-30-per-cent-of-gdp-to-save-3-per-cent-because-of-a-financial-shock/363921/0> (visited on December 28, 2008).

<sup>13</sup> See generally, Amartya Sen, *The Argumentative Indian: Writings on Indian History, Culture and Identity*, Allen Lane, New York, 2005.

Structurally, the paper is divided into several parts. Part II deals with the history of decentralization. It deals with the constituent assembly debate as well as case laws prior to the 73<sup>rd</sup> and 74<sup>th</sup> amendment. The agency cost is located in the case law. Part III utilizes the agency cost model to describe the constitutional mandate of decentralization. It emphasizes the ideals of autonomy, legitimacy and social capital ingrained within constitutional amendments. Part IV builds upon earlier sections to mount a jurisprudential basis for the constitutional amendments. It evolves a framework of interpretation. It analyzes the social contract, namely Indian Constitution, and argues that the paradigm of its interpretation ought to be purposive, context-based. It deals with constitutional architecture as well as recent cases in order to understand apparent constitution asymmetry in devolution of finances, best practices and extension of benefits to Schedule Areas. It also deals with auditing of finances for the local bodies. Part V concludes the discussion.

## II. GENESIS OF THE THIRD STRATUM

### A. *Via Media*: Gandhi, Ambedkar & DPSP

The history of the emergence of the third stratum in India is unique. There has been attempt to locate decentralized governance in the ancient period.<sup>14</sup> Nevertheless, at the cusp of independence, the third stratum was at best seen as a mixed blessing and at worst understood to be a tool that could reinforce existing hierarchy in the villages.<sup>15</sup>

Indeed, a *via media* was sought to be located in Art. 40 of the Directive Principles of State Policy that mandated 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’.<sup>16</sup> Art. 40 is unenforceable in any court of law. It is, nevertheless, ‘fundamental in the governance of the country’ and it is the duty of the state

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<sup>14</sup> See, V.N. Alok, “Local Government Organization and Finance:Rural India” in Anwar Shah, *Local Governance in Developing Countries*, The World Bank, Washington, 2006, p. 206.

<sup>15</sup> See for instance, Dr. B.R. Ambedkar’s opposition to Mahatma Gandhi’s idea of decentralization. Hoshiar Singh, “Constitutional Base for Panchayati Raj in India: The 73rd Amendment Act”, *Asian Survey*, Vol. 34, No.9, Sep. 1994, p. 818.

<sup>16</sup> Art. 40 of the Constitution of India states: “The State shall 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”.

to ‘apply...[the]...principles in making laws’.<sup>17</sup> As K. Santhanam had suggested in the Constituent Assembly Debate, the purpose of constitutional provision was to merely provide for a ‘definite and unequivocal direction towards local self-government’<sup>18</sup>

The inarticulate major premise of the nascent nation-state was that hundred years of loss of freedom was due to a weak federal government. A duty to decentralize under Directive Principles of State Policy would ensure that once the nation-state is relatively secure about its governance model, it could gradually empower individuals at the lowest level.

### B. *British Raj through the Backdoor?*

It is ironical, however, that in spite of much celebrated Gandhiji’s concept of *swaraj*<sup>19</sup>, the Constituent Assembly could not come to a consensus about an effective local self-government. This is *a fortiori* problematic if one juxtaposes the legitimacy of the nascent nation-state with that of British India. Indeed, four decades later, Justice Krishna Iyer, India’s one of the most respected judges, lamented in *Municipal Council, Ratlam* case<sup>20</sup>:

*“It may be a cynical obiter of pervasive veracity that municipal bodies minus the people and plus the bureaucrats are the bathetic vogue – no better than when the British were here”*

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<sup>17</sup> Art. 37 of the Constitution of India states: “The provisions contained in this Part shall not be enforceable by any court, but the principles therein laid down are nevertheless fundamental in the governance of the country and it shall be the duty of the State to apply these principles in making laws”.

<sup>18</sup> “What is attempted to do here is to give a definite and unequivocal direction that the State shall take steps to organize Panchayats and shall endow them with necessary powers and authority to enable them to function as units of self-government. That the entire structure of self-government, of independence in this country should be based on organized village community life is the common factor of all the amendments tabled and that factor has been made the principal basis of this amendment. I hope it will meet with unanimous acceptance.” See, Constituent Assembly Debate on November 22, 1948.

<sup>19</sup> Gandhiji said: “My idea of Village Swaraj is that it is a complete republic, independent of its neighbours for its wants, and yet interdependent for many others in which dependence is a necessity. Thus every village’s first concern will be to grow its own food crops and cotton for its cloth. It should have a reserve for its cattle, recreation and playground for adults and children. Then if there is more land available, it will grow useful money crops, thus excluding ganja, tobacco, opium and the like. The village will maintain a village theatre, school, public hall. It will have its own waterworks ensuring clean supply. This can be done through controlled wells and tanks. Education will be compulsory up to the final basic course. As far as possible every activity will be conducted on the co-operative basis. There will be no castes such as we have today with their graded Untouchability...” See, <http://www.mkgandhi.org/revivalvillage/views.htm> (visited on November 22, 2008).

<sup>20</sup> *Municipal Council, Ratlam v. Vardichan*, (1980) 4 SCC 162 (para 7) (emphasis supplied)

Interestingly, *Municipal Council, Ratlam* arose on simple facts. The Municipal Council had persistently refused to carry out its basic statutory obligation of cleanliness.<sup>21</sup> Frustrated in their attempts to attract the attention of the Municipal Council, local inhabitants moved the criminal court to ensure that the Council is obligated to act under the Code of Criminal Procedure<sup>22</sup> and the Indian Penal Code.<sup>23</sup> The Magistrate enjoined the Municipal Council to act as per its responsibility to keep the city clean.<sup>24</sup> Instead of following the simple order of the Magistrate to carry out its obligation of cleaning the streets, the Council preferred appeals to all possible higher courts and ultimately the case reached the apex court of the land – the Supreme Court of India.<sup>25</sup>

Justice Krishna Iyer roots this perverse incentive of the Municipal Council in agency cost.<sup>26</sup> Whenever there is a dissonance between the incentive of a principal (citizens/stakeholders) and an agent (Municipal Council), there is a possibility of the agency cost where the agent may take the principal for a ride.<sup>27</sup> Indeed, one of the

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<sup>21</sup> *Municipal Council, Ratlam v. Vardichan*, (1980) 4 SCC 162 (para 2)

<sup>22</sup> See, § 133 of the Code of Criminal Procedure (CrPC). Relevant portion of § 133 CrPC states: “(1) Whenever a District Magistrate or a Sub-Divisional Magistrate or any other Executive Magistrate specially empowered in this behalf by the State Government, on receiving the report of a police officer or other information, and on taking such evidence (if any) as he thinks fit, considers - (a) that any unlawful obstruction or nuisance should be removed from any public place or from any way, river or channel which is may be lawfully used by the public...such Magistrate may make a conditional order requiring the person causing such obstruction or nuisance, ..., within a time to be fixed in the order - (i) to remove such obstruction or nuisance...or, if he objects so to do, to appear before himself or some other Executive Magistrate subordinate to him at a time and place to be fixed by the order, and show cause, in the manner hereinafter provided, why the order should not be made absolute.”

<sup>23</sup>See, § 188 of the Indian Penal Code (IPC). § 188 IPC states: “Whoever, knowing that, by an order promulgated by a public servant lawfully empowered to promulgate such order, he is directed to abstain from a certain act, or to take certain order with certain property in his possession or under his management, disobeys such direction, shall, if such disobedience causes or tends to cause obstruction, annoyance or injury, or risk of obstruction, annoyance or injury, to any person lawfully employed, be punished with simple imprisonment for a term which may extend to one month, or with fine which may extend to two hundred rupees, or with both; and if such disobedience causes or tends to cause danger to human life, health or safety, or causes or tends to cause a riot or affray, shall be punished with imprisonment of either description for a term which may extend to six months, or with fine which may extend to one thousand rupees, or with both.

<sup>24</sup> *Municipal Council, Ratlam v. Vardichan*, (1980) 4 SCC 162 (para 5)

<sup>25</sup> See, *Municipal Council, Ratlam v. Vardichan*, (1980) 4 SCC 162 (para 2) where Justice Krishna Iyer, J suggests: “Had the municipal council and its executive officers spent half this litigative zeal on cleaning up the street and constructing the drains by rousing the people’s *sramdan* resources and laying out the city’s limited financial resources, the people’s needs might largely been met long ago.”

<sup>26</sup> “But litigation with other’s funds is an intoxicant, while public service for common benefit is an inspiration; and, in a competition between the two, the former overpowers the latter”. *Municipal Council, Ratlam v. Vardichan*, (1980) 4 SCC 162 (para 2)

<sup>27</sup> Kenneth E. Scott, “Agency Costs and Corporate Governance” in Peter Newman Ed., *The New Palgrave Dictionary of Economics and the Law*, Vol. 1, 1998, pp. 26-30.



arguments of the Municipal Council, based upon *volunt non fit injuria*, advanced before the High Court embodies the agency cost and divergence of self interest of the principal (citizens) and the agent (Municipal Council) to the extreme of a being a perverse incentive.<sup>28</sup>

Would Municipal Council have similar perverse incentive, if contrary to what Justice Krishna Iyer found out, it were minus the bureaucrats and plus the people? If the Municipal Council were to be truly a unit of local self-government, would it spend its time, energy and resources litigating in the courts or simply clean up the streets? At the very least, a democratically elected Municipal Council is unlikely to advance a perverse plea such as *volunt non fit injuria*.<sup>29</sup>

### C. 73<sup>rd</sup> and 74<sup>th</sup> amendment & Statement of Objects and Reasons

Is it possible to align the interests of the principal (stakeholders) and the agent (local bodies) or to limit the extent of divergence? The purpose of the 73<sup>rd</sup> and 74<sup>th</sup> amendment to the Constitution was to reduce this agency cost and align the interest of denizens with the local bodies through ensuring regular elections and impart certainty, continuity and strength to the local bodies.<sup>30</sup> The Statement of Objects and Reasons of the 73<sup>rd</sup> and 74<sup>th</sup> amendment noted that ‘though Panchayat Raj Institutions have been in existence for a long time, it ...has not been able to acquire the status and dignity of viable responsive people’s bodies’.<sup>31</sup> Reasons identified for the same were, absence of regular elections, prolonged supercessions, insufficient representation of weaker sections like Scheduled Castes, Scheduled Tribes and women, inadequate devolution of powers and lack of financial resources.<sup>32</sup>

Forty years of accumulated experience leading to the identification of reasons for the problems could be the broadly classified under the following broad heads:

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<sup>28</sup> *Municipal Council, Ratlam v. Vardichan*, (1980) 4 SCC 162 (para 18) “A strange plea was put forward by the Municipal Council before the High Court which was justly repelled, viz., that the owners of houses had gone to that locality on their own choice with eyes open and, therefore, could not complain if human excreta was flowing, dirt was stinking, mosquitoes were multiplying and health was held hostage’.

<sup>29</sup> Indeed, the Municipal Council had dropped this plea before the Supreme Court. *Municipal Council, Ratlam v. Vardichan*, (1980) 4 SCC 162 (para 18) “Luckily, no such contention was advanced before us”.

<sup>30</sup> ‘In the light of the experience in the last forty years and in view of the short-comings which have been observed, it is considered that there is an imperative need to enshrine in the Constitution certain basic and essential features of Panchayat Raj Institutions to impart certainty, continuity and strength to them’. Para 2 of the Statement of Objects and Reasons.

<sup>31</sup> Para 1 of the Statement of Objects and Reasons

<sup>32</sup> Para 1 of the Statement of Objects and Reasons

- (i) Autonomy (inadequate devolution of powers and lack of financial resources)
- (ii) Legitimacy (prolonged supercession, absence of regular elections)
- (iii) Social capital (insufficient representation of weaker sections like SC/ST/BC/Women)

The following section would show how the Constitution, through the landmark amendments sought to bridge the problem.

### III. CONSTITUTIVE ASPECTS OF THE THIRD STRATUM

The problems of autonomy, legitimacy and social capital were sought to be rectified through the 73<sup>rd</sup> and 74<sup>th</sup> amendment to the Constitution. Notwithstanding the presence of the Article 40 of the Constitution, endeavour by states in order to further local self-government fell widely short of the constitutional promise.

An autonomous and legitimate local self-government minus the bureaucrats plus the people would be better situated to limit the principal-agent problem. The agency cost would be further addressed through the advancement of social capital.

#### A. *Autonomy*

The third stratum perhaps does not indicate a third-tier in Indian federalism.<sup>33</sup> In spite of 73<sup>rd</sup> and 74<sup>th</sup> amendment, Article 1 of the Indian Constitution still continue to suggest that India is a ‘union of states’.<sup>34</sup> In the absence of any concomitant amendment to Article 1, it is unlikely that the third stratum was intended as an additional layer of federalism.<sup>35</sup> Further, it is well settled that entries in schedules, such as eleventh and twelfth schedule, are not *per se* powers but merely fields of legislation.<sup>36</sup> However, this

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<sup>33</sup> *Per* Justice PS Narayana, *Ranga Reddy District Sarpanch Association v. Government of Andhra Pradesh*, MANU/AP/0001/2004 (para 2).

<sup>34</sup> Article 1(1) Constitution of India states: “India, that is Bharat, shall be a Union of States”.

<sup>35</sup> For a general discussion on federalism, see, *State of Rajasthan v. Union of India*, MANU/SC/0370/1977.

<sup>36</sup> *India Cement Ltd. V. State of Tamil Nadu*, MANU/SC/0019/1990; *Jilubhai Nanbhai Khachar v. State of Gujarat*, MANU/SC/0033/1995.

debate is unnecessary as the 73<sup>rd</sup> and 74<sup>th</sup> amendment of the Constitution has mandated a *sui generis* role for local self-government.<sup>37</sup> The *sui generis* status is particularly reflected in the constitutional mandate of autonomy for local bodies. The following table summarizes the position:

**Table 1: Constitutional mandate of autonomy**

Particulars	Panchayats	Municipalities
I. <i>Definition</i>	Art. 243(d): ‘Panchayat’ means an institution (by whatever name called) of self-government constituted under Art. 243B, for rural areas	Art. 243P(e): ‘Municipality’ means an institution of self-government constituted under Art. 243Q
II. <i>“self-government”</i>	Art. 40 Art. 243(d) Art. 243G ( <u>Devolution</u> ) Entry 5, List II	Art. 243P(e) Art. 243W ( <u>Devolution</u> )
III. <i>Taxes</i>	Art. 243H	Art. 243X
IV. <i>Duration &amp; Dissolution</i>	Art. 243E (1) ‘no longer’ Art. 243E(3) ‘shall’ 5 years unless dissolved sooner ‘under any law for the time being in force’ <b>No PNJ rights</b>	Art. 243U(1) ‘no longer’ Art. 243E(3) ‘shall’ 5 years unless dissolved sooner ‘under any law for the time being in force’ <b>But, has PNJ rights Why?</b>

Part IX and IXA of the Indian Constitution has ushered a unique pedestal for local self-government. Article 243(d) and 243(P)(e) defines ‘Panchayat’ and ‘Municipalities’ respectively as an ‘institution of self-government’. Entry 5, List II which entails the field of legislation for the states reiterates the significant qualification of ‘local self-government’.<sup>38</sup>

Further, though the construction of Article 243G and 243W may appear discretionary rather than mandatory owing to the usage of the word ‘may’, the phrase is succeeded by two significant qualifications – ‘institutions of self-government’ and

<sup>37</sup> Per Justice G. Raghuram, *Ranga Reddy District Sarpanch Association v. Government of Andhra Pradesh*, MANU/AP/0001/2004 (para 61) “The debate as to whether the Panchayats constitute part of the federal structure under the Constitution, is pointless and sterile”.

<sup>38</sup> Entry 5, List II states: “Local government, that is to say, the constitution and powers of municipal corporations, improvement trusts, district boards, mining settlement authorities and other local authorities for the purpose of local self-government or village administration”.

‘devolution’. Usage of ‘devolution’ as opposed to ‘delegation’ indicates an independent status for local bodies.<sup>39</sup> Hence, states do not possess unguided discretion to regulate local bodies but are constricted by the constitutional mandate to enable them to function as institution of self-government through devolution of power.<sup>40</sup>

Further, Article 243H and 243X respectively deals with powers of Panchayats and Municipalities to levy, collect and appropriate taxes, duties, tolls and fees. This may again appear discretionary owing to the usage of the word ‘may’. Nevertheless, this has to be understood in light of the constitution mandate of ‘devolution’ and ‘self-government’ as discussed above. Denial of the power to collect taxes by the state legislature in order to emasculate local bodies would violate the constitutional purpose.<sup>41</sup>

An autonomous agent merely addresses the question whether the agent would have requisite independence to be able to perform certain duties. In order to address agency cost that may be entailed, the agent in a democratic context also needs to be legitimate.

## B. Legitimacy

Legitimacy is a complex concept to grapple with.<sup>42</sup> It could be of *intrinsic* as well as *instrumental* value. Instrumentally, in an empirical study of the performance of 18 core countries in the post-war era (1948 – 1983), noted sociologist Bornschier found that

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<sup>39</sup> See, S.S. Meenakshisundaram, “Decentralization in Developing Countries”, in SN Jha & PC Mathur (Eds.) *Decentralization and Local Politics*, Sage Publications, New Delhi, 1999 where the author suggests that ‘devolution’ is creation and strengthening of sub-national units of the government, activities of which are substantially outside the direct control of the central government, and ‘delegation’ is transferring responsibility for specifically defined functions to organizations that are outside the regular bureaucratic structure and are only indirectly controlled by the central government.

<sup>40</sup> Per Justice G. Raghuram, *Ranga Reddy District Sarpanch Association v. Government of Andhra Pradesh*, MANU/AP/0001/2004 (para 114) “...The discretion is not absolute but is conditioned by the constitutional instruct that the Panchayats should be enabled to function as institutions of self-Government. While it is within the discretion of the State Legislature to determine whether powers and responsibilities should be devolved at one level or the other of the Panchayats (village, intermediate or District) and the conditions subject to which the different levels of Panchayats should exercise the conferred powers and authority, neither the discretion to devolve nor the conditions to be specified could be such as would destroy the character of the Panchayats as ‘self-Government. The ‘self-Government’ characteristic of the Panchayats is a core constitutional value that cannot be subverted by the State legislative exercise.”

<sup>41</sup> Per Justice G. Raghuram, *Ranga Reddy District Sarpanch Association v. Government of Andhra Pradesh*, MANU/AP/0001/2004 (para 116) “...denial by the State Legislation of any financial resources to the Panchayats whether by way of empowering them to levy, collect and appropriate taxes, duties etc., and/or assigning to them such taxes, duties etc., collected by the State Government, as would invalidate the functionality of these institutions, would negate the constitutional purposes”.

<sup>42</sup> See generally, Rahul Singh, “World Trade Organization and Legitimacy: Evolving a Framework for Bridging the Democratic Deficit”, Vol. 42(2) *Journal of World Trade*, 2008 pp.348 -350.

legitimacy or ‘effective social order’ was a competitive advantage and contributed to greater comparative economic success.<sup>43</sup>

Bornschier adopted a minimalist notion of legitimacy: relative absence of mass political protest.<sup>44</sup> Legitimacy undoubtedly requires more than mere refrain from rebellion, for there are many economic failures that have managed to keep public protests under check. In its extended, positive form, legitimacy would entail active participation by the public in socio-economic development process. And, citizens would voluntarily partake of an economic system *if* they feel that institutions have come into being through *right process*.

While attempting to answer the elusive question of why do powerful nations obey the powerless rules, and seeking to find the answer in the potent concept of legitimacy, Thomas Franck noted the following definition of legitimacy:

"Legitimacy, is a property of a rule or rule-making institution which itself exerts a pull toward compliance on those addressed normatively because those addressed believe that the rule or institution has come into being and operates in accordance with generally accepted principles of right process."<sup>45</sup>

Franck’s definition of legitimacy places the agency on the recipients of an institutional basis of power. It is a leap forward from the minimalist notion of Bornschier. As Franck has expounded upon it elsewhere, in a community organized around rules, compliance is secured (to whatever degree it is), at least in part by perception of rule as legitimate by those to whom it is addressed. So, legitimacy refers to that quality of a rule that derives from a perception on the part of those to whom it is addressed that it has come into being in accordance with right process.<sup>46</sup>

In legal theory, Hart’s enjoinder of adherence to a ‘critical reflective attitude’ or the ‘internal aspect of law’ achieves the same purpose, for a ‘compliance pull’ exerted by internalized rules would affect the general behavior in critical manner.<sup>47</sup> Indian

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<sup>43</sup> See, Volker Bornschier, “Legitimacy and Comparative Economic Success at the Core of the World System: An exploratory study, *European Sociological Review*, Vol. 5, No.3 (Dec., 1989), p. 226. [Hereinafter Bornschier]

<sup>44</sup> Bornschier, p. 220.

<sup>45</sup> Thomas Franck, *The Power of Legitimacy Among Nations*, Oxford University Press, Oxford, 1990, p. 24.

<sup>46</sup> Frank has, however, been cautious enough to add that the right process includes the notion of valid sources but also encompasses literary, socio-anthropological and philosophical insights. See, Thomas M. Franck, "Legitimacy in the International System", 82 AJIL 705 (1988).

<sup>47</sup> H.L.A. Hart, *The Concept of Law*, 2<sup>nd</sup> ed., Clarendon Press, Oxford, 1994, pp. 88-89 (noting that officials responsible for enforcement of laws have an additional burden to internalize the laws within themselves).

Constitution in order to lend credence to local bodies mandates regular, periodic direct elections. The following table summarizes the position:

**Table 2: Constitutional mandate of legitimacy**

Particulars	Panchayats	Municipalities
I. <i>Duration &amp; Dissolution</i>	Art. 243E 5 years unless dissolved sooner 'under any law for the time being in force' <u>But, no PNJ rights</u>	Art. 243U 5 years unless dissolved sooner 'under any law for the time being in force' <u>Has PNJ rights Why?</u>
II. <i>Elections</i>	Art. 243K SEC	Art. 243ZA SEC

In order to address the problem of prolonged supercession and impart certitude and vigour to the local bodies, Article 243E and Article 243U respectively fix a duration of 5 years for Panchayats and Municipalities.<sup>48</sup> Indeed, owing to the prevalent problem of undue extension of term to local bodies, dissolution is still permissible, but not extension.<sup>49</sup> In the case of dissolution, an election has to be completed within six months.<sup>50</sup> There is no *force majeure* exception to holding elections within six months; only *vis major* may act as an exception.<sup>51</sup> The rule against postponement of elections has been construed strictly: even an anticipation of impending constitutional amendment that may have an implication on conduct of elections, cannot be a ground for postponement of

<sup>48</sup> Article 243E(1) states: "Every Panchayat, unless sooner dissolved under any law for the time being in force, shall continue for five years from the date appointed for its first meeting and *no longer*". Similarly, Article 243U(1) states: "Every Municipality, unless sooner dissolved under any law for the time being in force, shall continue for five years from the date appointed for its first meeting and *no longer*."

<sup>49</sup> See, *Professor BK Chandrashekhar v. State of Karnataka*, AIR Kant 461 (Para 16).

<sup>50</sup> Article 243E(3)(b); Article 243U(3)(b)

<sup>51</sup> Unreported judgment of the Supreme Court of India as cited in *Government of Andhra Pradesh v. C. Prakash Goud*, MANU/AP/0543/2001. (para 22). "The Supreme Court in the above referred unreported judgment held as under: [t]he concerned States cannot be permitted to withhold election of Panchayats except in case of genuine supervening difficulties to hold such elections e.g., unforeseen natural calamities in the State like flood, earthquake, etc., or extremely urgent situation prevailing in the State for which election of the Panchayats cannot be held within the time frame. It will be unfortunate if the concerned States remain insensitive to the Constitutional mandate of holding election of Panchayats in time and by unjustified action, allows old bodies to continue in the office of the Panchayats. We hope and trust that the State Government will be alive and sensitive to the duties and responsibilities flowing from the mandates of the Constitution in holding Panchayat elections."

elections.<sup>52</sup> Unlike Panchayats, Municipalities have an additional safeguard against dissolution: the principle of natural justice right of *audi alterum partem*.<sup>53</sup>

Further, akin to the Election Commission at the federal level, as per Article 243K state would have a State Election Commission with the power of ‘superintendence, direction and control’ of elections.<sup>54</sup> The State Election Commission also has a *locus standi* to approach the court for relief in case state government creates difficulty in conduct of elections.<sup>55</sup>

Autonomy and legitimacy are necessary but not a sufficient condition for robust local bodies. Further, legitimacy through periodic, regular elections has a critical limitation: degree of participation. If the principal (citizens) do not adequately participate in the process of elections, can the organization retain legitimacy? What could act as an incentive to ensure greater level of participation, particularly by the marginalized?

### C. Social Capital

Ambedkar, while opposing Gandhi’s idea of local bodies, was concerned about a variant of principal-agent conundrum: certain constituents of the principal would perforce be excluded from participation due to socio-economic inequality thereby denuding the local bodies of its legitimacy. This would mean that the promised social capital of local bodies would be nipped in the bud.<sup>56</sup> Accordingly, 73<sup>rd</sup> and 74<sup>th</sup> amendment to the Constitution ensure that benefits of social capital are available. The amendments utilize the tool of reservation to achieve the same. The following table summarizes the position:

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<sup>52</sup> See generally, *Secretary, State Election Commission v. Secretary, Panchayat Raj Department*, MANU/AP/0828/2000

<sup>53</sup> There are three principles of natural justice: (1) *audi alterum partem*: no person shall be condemned unheard; (2) *nemo iudex in sua causa*: no person shall be judge in his own cause; and (3) speaking order: judgment must be reasoned one.

<sup>54</sup> Art. 243K(1) states: “The superintendence, direction and control of the preparation of electoral rolls for, and the conduct of, all elections to the Panchayats shall be vested in a State Election Commission consisting of a State Election Commissioner to be appointed by the Governor”.

<sup>55</sup> *Secretary, State Election Commission v. Secretary, Panchayat Raj Department*, MANU/AP/0828/2000 (Para 56)

<sup>56</sup> See generally, Amy Chua, *World on Fire: How exporting free market democracy breeds ethnic hatred and global instability*, Anchor Books, New York, 2003

**Table 3: Constitutional mandate of social capital**

Particulars	Panchayats	Municipalities
A. Reservation for SC/ST	Art. 243D(1)(a),(b) (Proportional)	Art. 243T(1) (Proportional)
B. Reservation for SC/ST Women	Art. 243D(2)	Art. 243T(2)
C. Reservation for Women	Art. 243D(3) 33.33%	Art. 243T(3) 33.33%
D. Chairperson Reservation	Art. 243D(4)	Art. 243T(4)
E. Enabling Provision for OBCs	Art. 243D(6)	Art. 243T(6)
F. Sunset Clause for SC/ST Reservation ( <b>not applicable to women</b> )	Art. 243D(5)	Art. 243T(5)

Article 243D(1)(a) and (b)<sup>57</sup> and Article 243T(1)<sup>58</sup> mandate that seats would be reserved for Scheduled Castes and Scheduled Tribes in Panchayats and Municipalities respectively. Indeed, the concept of reservation goes a step further to ensure reservation for SC/ST women.<sup>59</sup> Besides SC/ST, there is also a general, one-third reservation for women.<sup>60</sup> The position of Chairperson is also subject to reservation.<sup>61</sup> There is an enabling provision for reservation for backward class.<sup>62</sup> Interestingly, there is also a clear sunset clause for such reservation (barring for women) in order to ensure that reservation promotes social capital and does not impede it.<sup>63</sup> This is in accordance with ensuring that

<sup>57</sup> Article 243D(1) states: “Seats shall be reserved for - (a) the Scheduled Castes; and (b) the Scheduled Tribes, in every Panchayat and the number of seats so reserved shall bear, as nearly as may be, the same proportion to the total number of seats to be filled by direct election in that Panchayat as the population of the Scheduled Castes in that Panchayat area or of the Scheduled Tribes in that Panchayat area bears to the total population of that area and such seats may be allotted by rotation to different constituencies in a Panchayat”.

<sup>58</sup> Article 243T(1) states: “Seats shall be reserved for the Scheduled Castes and the Scheduled Tribes, in every Municipality and the number of seats so reserved shall bear, as nearly as may be, the same proportion to the total number of seats to be filled by direct election in that Municipality as the population of the Scheduled Castes in the Municipal area or of the Scheduled Tribes in the Municipal area bears to the total population of that area and such seats may be allotted by rotation to different constituencies in a Municipality”.

<sup>59</sup> Articles 243D(2) and Article 243T(2).

<sup>60</sup> Article 243D(3) and Article 243T(3).

<sup>61</sup> Article 243D(4) and Article 243T(4).

<sup>62</sup> Article 243D(6) and Article 243T(6).

<sup>63</sup> Article 243D(5) and Article 243T(5).



non-beneficiaries of reservation are not crowded out of the system.<sup>64</sup> The sunset clause for reservation is in accordance with Article 334.<sup>65</sup>

This social capital, in short run, would perhaps be adequate to take care of the principal-agent conundrum that was the concern of Ambedkar. A clear sunset clause would also ensure that other sections of the society who are not the beneficiaries of reservation do not grow antithetical to reservation.

From the above discussion of autonomy, legitimacy and social capital, the constitutional architecture of local bodies seems impregnable. Nevertheless, the jurisprudence has been challenged from an unlikely source: the National Commission to Review the Working of the Constitution.<sup>66</sup>

#### IV. JURISPRUDENCE OF THE THIRD STRATUM

The characterization of local bodies on the triumvirate of autonomy, legitimacy and social capital indicates as if the constitutional architecture is capable of bridging the principal-agent problem where principal is a diffused population at large and agent is the institution of governance. There would be little problem if the jurisprudence of local bodies were clear. Unfortunately, the National Commission to Review the Working of the Constitution has created another layer to the snag.

##### A. NCRWC

Arguably, the biggest blow to increasing decentralization and clarity in jurisprudence emerged from the recommendations of the NCRWC. The NCRWC noted that there was reluctance amongst the state governments to share their fiscal powers with

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<sup>64</sup> See generally, Olivier Jean Blanchard, "Crowding Out" in John Eatwell, Murray Milgate & Peter Newman (Eds.), *The New Palgrave Dictionary of Economics*, Vol. I, p. 728.

<sup>65</sup> Article 334 states: "Notwithstanding anything in the foregoing provisions of this Part, the provisions of this Constitution relating to - (a) the reservation of seats for the Scheduled Castes and the Scheduled Tribes in the House of the People and in the Legislative Assemblies of the States; and (b) the representation of the Anglo-Indian community in the House of the People and in the Legislative Assemblies of the States by nomination, shall cease to have effect on the expiration of a period of sixty years from the commencement of this Constitution".

<sup>66</sup> Hereinafter NCRWC

the local self-government.<sup>67</sup> NCRWC recommended an amendment to Article 243G.<sup>68</sup> The NCRWC recommended that local bodies should be categorically declared to be ‘institutions of self-government’ and exclusive functions should be assigned to them.<sup>69</sup> This was conveniently relied upon by Justice P.S. Narayana in *Ranga Reddy District* to denude the local bodies of their powers. Justice Narayana’s opinion reverberated in the majority opinion leading them to endorse the deferential standard of judicial review.<sup>70</sup>

NCRWC’s opinion however, glosses over several settled jurisprudence. In particular it fails to take note to two significant points – firstly, Indian Constitution is not a usual, run-of-the-mill statute but a social contract and secondly, literal interpretation of any law is meaningless.

### B. *The Concordat of Indian Constitution: John Rawls*

The Constitution is the foundational document on the basis of which Indian nationhood has been constructed. The preamble begins with ‘We, the people’. It is not an ordinary document but is our social concordat. Constitution signifies the terms and conditions on the basis of which people of India have come together to form a society. It is a social contract embodying the principles of justice. The preamble unambiguously proclaims that the social contract of Constitution was for the purpose of achieving justice – social, economic and political.<sup>71</sup> The objectives specified in the Preamble have been

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<sup>67</sup> See, Report of the National Commission to Review the Working of the Constitution [hereinafter NCRWC Report] para 9.5.2 that states: “In the process of implementation of the 73rd and 74th Amendments, considerable gaps have been noticed. The Union Government and the State Governments continue to exercise powers in planning and the Panchayats and Municipalities do not enjoy autonomy - financial or administrative - as institutions of local self-government. While today Panchayats elect some three million members of whom one-third are women, the objectives envisaged in the Amendments have not been fully achieved ...”

<sup>68</sup> Substitution of Article 243G.--For Article 243G, the following Article shall be substituted namely:—"243G. Powers, authority and responsibility of Panchayats: Subject to the provisions of this Constitution, the Legislature of a State shall, by law, vest the Panchayats with such powers and authority as are necessary to enable them to function as institutions of self-Government and such law shall contain provisions for the devolution of powers and responsibilities upon Panchayats at the appropriate level, subject to such conditions as shall be specified therein, with respect to--

(a) preparation of plans for economic development and social justice;

(b) the implementation of schemes for economic development and social justice as shall be entrusted the them including those in relation to the matters listed in the Eleventh Schedule. "Similar amendments should be made in Article 243W relating to the powers, authority and responsibilities of Municipalities, etc."

<sup>69</sup> See, para 9.7.1 NCRWC Report

<sup>70</sup> See, Devinder Gupta, CJ for self and for Dr. Motilal B. Naik and B. Sudershan Reddy (para 6) *Ranga Reddy District*

<sup>71</sup> See, The Preamble of the Indian Constitution.

elevated to the status of ‘basic structure’ of the Constitution which is not amenable to amendment.<sup>72</sup>

The theoretical co-relation between social contract and justice is ample. Indeed, the political theory of justice, as enunciated by John Rawls, is rooted in traditional theory of social contract represented by Locke, Rousseau and Kant.<sup>73</sup> Unlike earlier social contract theories, Rawls’ idea behind original contract is not to formulate a particular society but upshot of the original agreement is the principles of justice for the basic structure of society.<sup>74</sup> It is a hypothetical state, where free, rational, self-interested persons, in an initial position of equality, would set up terms for future cooperation that would be an epitome of the principles of justice.<sup>75</sup> This original position of equality is critical for Rawls in order to arrive at principles of justice. An additional essential feature of original position is “veil of ignorance”: where no one knows his status in society, distribution of natural assets in abilities, intelligence, strength, conceptions of good and special psychological propensities.<sup>76</sup>

If Indian Constitution follows Rawls’ idea of ‘original position’ and ‘veil of ignorance’, the social contract entered into denotes that democracy ought to be devoid of middlemen. Emergence of local self-government would definitely act as an important means of reducing the costs imposed by layers of government acting in their own self-interest, ignoring the interests of the citizens. In order to address the divergence of interest that citizens and layers of government may have, how should Constitution be interpreted – in the narrow, literal sense or in a broad, purposive manner leading to the constitutional goal of justice?

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<sup>72</sup> *Keshavananda Bharati v. State of Kerala*, AIR 1973 SC 1461 (paras 292, 437, 599, 682, 1164, 1437); *Excel Wear v. Union of India*, AIR 1979 SC 25, para 24.

<sup>73</sup> John Rawls, *A Theory of Justice*, Harvard University Press, Cambridge, 1971, p. 11. [Hereinafter ‘ToJ’] The two principles of justice that he originally formulated state: The First Principle of Justice: Principle of Liberty - Each person is to have an equal right to the most extensive basic liberty compatible with a similar liberty for others. The Second Principle of Justice: Difference Principle - Social and economic inequalities are to be arranged so that they are both: (a) to the greatest benefit of the least advantaged, and (b) attached to offices and positions open to all under conditions of fair equality of opportunity. The twin principles of justice were partially amended later. See generally, John Rawls, “The Basic Liberties and Their Priority”, Sterling M. McMurrin, Ed., *Liberty, Equality, and Law*, University of Utah Press, Salt Lake City, 1987, p. 5.

<sup>74</sup> ToJ, p. 11. Rawls defines the “basic structure of society” as political constitution and the principal economic and social arrangements such as the legal protection of freedom of thought and liberty of conscience, competitive markets, private property in the means of production, and the monogamous family. ToJ, p. 7.

<sup>75</sup> ToJ, p.11

<sup>76</sup> Rawls’ “original position” along with “veil of ignorance” ensures that principles of justice are agreed to in an initial situation that is fair. Since no one is exceptionally preferred in natural chance or the contingency of social circumstances, no one would be able to design principles that are lop sided. ToJ, p. 12.

### C. *Constitutional Hermeneutics: Thomas Paine*

Notwithstanding the endeavour to write a detailed Constitution, the status of stakeholders remains a paradigm of highly incomplete contract.<sup>77</sup> A further detailed contract, even if plausible, would involve high transaction cost.<sup>78</sup> Besides, no one's crystal ball is so clear to envisage all possible future scenarios.<sup>79</sup> There would be inevitable gaps in the contract that would be available for interpretation in the future.<sup>80</sup>

In order to interpret the gaps in the contract, the usual rule to be employed is that of literal rule: when the statute is plain and unambiguous, it ought to be interpreted as it is.<sup>81</sup> When the words clearly govern the situation before the court, the words must be applied with nothing added or nothing taken away.<sup>82</sup> The principle applies even though Parliament would have modified words had it foreseen the situation.<sup>83</sup>

However, the practical reason for continued existence of literal rule is that judges are afraid of being seen as making laws.<sup>84</sup> For, application of literal rules appears to be a rule against using common sense.<sup>85</sup> In general, we understand the meaning of words from

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<sup>77</sup> The Constitution of India is a very detailed document.

<sup>78</sup> For a general understanding of transaction cost, see, Guido Calabresi, "Transaction Costs, Resource Allocation and Liability Rules -- A Comment", 11 J. Law & Econ. 67,68

<sup>79</sup> See generally, HLA Hart, *The Concept of Law*, pp. 124 - 154.

<sup>80</sup> See generally, Ian Ayres & Robert Gertner, "Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules", 101 Yale Law Journal 729 -773; Alan Schwartz, "Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies", 21 Journal of Legal Studies 271 - 318 (1992); Alan Schwartz, "The Default Rule Paradigm and the Limits of Contract Law", 3 S. Cal. Interdisc. L. J. 389 (1993).

<sup>81</sup> FAR Bennion, *Bennion on Statutory Interpretation: A Code*, 5th edn., LexisNexis, London, 2008, p. 548. [Hereinafter Bennion]

<sup>82</sup> *Ibid.* p. 549.

<sup>83</sup> Lord Diplock in *Duport Steels Ltd. v. Sirs* [1980] 1 All ER 529, 541 where he stated: "Where the meaning of the statutory words is plain and unambiguous it is not for the judges to invent fancied ambiguities as an excuse to for failing to give effect to its plain meaning because they themselves consider that the consequences of doing so would be inexpedient, or even unjust or immoral". Referring to possible modification due to unexpected consequence, he suggested that "[but] if this be the case it is for Parliament, not for the judiciary, to decide whether any changes should be made to the law as stated in the Acts...". [1980] 1 All ER 529,542.

<sup>84</sup> For the legitimacy of judges in making decisions, see, HLA Hart, *The Concept of Law*, *supra* p. 154 where he states: "Here. at the fringe of these very fundamental things, we should welcome the rule-sceptic, as long as he does not forget that it is at the fringe that he is welcome; and does not blind us to the fact that what makes possible these striking developments by courts of the most fundamental rules is, in great measure, the prestige gathered by courts from their unquestionably rule-governed operations over the vast, central areas of the law".

<sup>85</sup> Glanville Williams, *Learning the Law*, 11th ed., Universal Book Traders, New Delhi, 1993, p. 105.

the context in which it occurs.<sup>86</sup> An example would illustrate this: when parents asked a child-minder to keep the children amused by teaching them a card game, the child-minder teaches “strip poker”.<sup>87</sup> If one strictly follows literal rule, strip poker falls within “card game”. However, as per context rule, it was not the sort of game intended by the parents. This follows from the customary ideas as to the proper behaviour and upbringing of children and reasonableness of actions.<sup>88</sup> Indeed, ‘no text is plain until it is interpreted, every text is plain - for purposes of the interpretative problem in question - at the conclusion of the interpretive process’.<sup>89</sup>

73<sup>rd</sup> and 74<sup>th</sup> amendment of the Constitution read along with Article 40, provide for a clear context to interpretation of cases involving institutions of local self-government. Nevertheless, NCRWC recommended that Panchayats and Municipalities ‘should be categorically declared to be institutions of self-government’.<sup>90</sup> A purposive, context based interpretation of the Constitution would indicate that it is already as categorical as it can get. It is unlikely that in the absence of political will, tinkering with words ‘may’ and ‘shall’ would make any difference at all.<sup>91</sup>

Usage of purposive interpretation ensures that the Constitution is respected as ‘living and organic’ document.<sup>92</sup> A document written and finalized decades ago needs to keep with the changing times.<sup>93</sup> The realities of 1950 may have been vastly different when the framers of the Constitution opted for mere hortatory language for institutions of local self-government.<sup>94</sup> In order to maintain inter-generational equity in interpreting Constitution, the present’s generation’s right of purposive interpretation ought to be

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<sup>86</sup> *Ibid.* p. 104.

<sup>87</sup> *Ibid.* p. 104.

<sup>88</sup> *Ibid.* p. 104.

<sup>89</sup> See, Aharon Barak, *Purposive Interpretation in Law*, Universal Law Publishing Pvt. Ltd., New Delhi, 2005, p. xii. [hereinafter ‘Aharon Barak’]

<sup>90</sup> See generally, NCRWC Report paras 9.7.1, 9.7.2

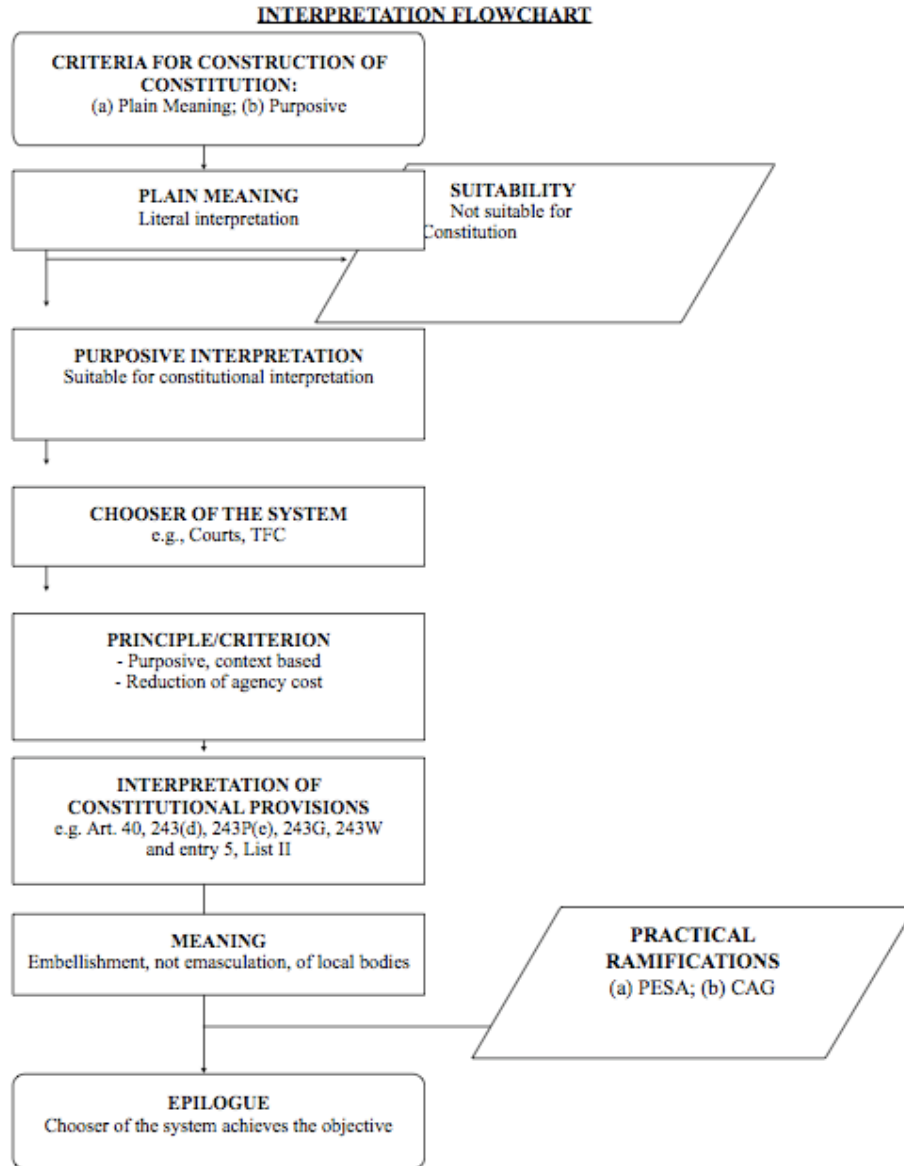
<sup>91</sup> See, Lok Satta’s argument in *Ranga Reddy District Sarpanch Association v. Government of Andhra Pradesh*, MANU/AP/0001/2004 (para 19)

<sup>92</sup> See, *Goodyear India v. State of Haryana*, AIR 1990 SC 781.

<sup>93</sup> *S.P. Gupta v. Union of India*, 1981 Supp SCC 87, 758 per Venkataramiah, J. para 964 where he states: “A Constitution of a country is a living document and cannot, therefore, be interpreted in a narrow pedantic sense. A broad and liberal spirit should inspire those who are called upon to interpret the Constitution”.

<sup>94</sup> See, NCRWC Report, para 9.2.

ensured.<sup>95</sup> Indeed, a purposive interpretation is most suited for a Constitution.<sup>96</sup> The following flowchart summarizes the position:



<sup>95</sup> Thomas Paine, *Rights of Man*, Part I, Everyman’s Library, London, p.94 where he states: “The rights of men in society, are neither devisable, nor transferable, nor annihilable, but are descendable only; and it is not in the power of any generation to intercept finally, and cut off the descent. If the present generation, or any other, are disposed to be slaves, it does not lessen the right of the succeeding generation to be free: wrongs cannot have a legal descent”.

<sup>96</sup> See, Aharon Barak, *supra*, p. 371.

The constitutional hermeneutics of purposive, context-based interpretation can be used in order to analyze apparent constitutional asymmetry in devolution of financial powers, examine best practices in legislations envisaging local bodies and explore whether the third stratum could be extended to schedule areas.<sup>97</sup>

#### D. *Constitutional Hermeneutics in Action*

##### 1. *Constitutional Asymmetry*

There is an apparent difference in the manner in which Indian Constitution deals with financial position of the Union and the States. Article 266 defines the Consolidated Funds of India and of the States. The Consolidated fund of India is net of the share of taxes of the States. Whilst the Consolidated Fund of India is net of the share of taxes of the States, all revenues of the state governments find their way to the Consolidated Funds of the State. Funds allocated to the local bodies as per the recommendations of the State Finance Commissions are first voted upon by the State Legislature and then passed on to the local bodies. These funds are, therefore, subject to various deductions and adjustments against loans disbursed by the state government, prior dues of state power utilities or for supply of drinking water, etc.

Previous Finance Commissions have understood constitutional provisions to be major stumbling block in strengthening institutions of local self-government. This is owing to the erroneous perception of pervious Commissions that the constitutional mandate in Article 280(3)(bb)<sup>98</sup> and (c)<sup>99</sup> applies only ‘on the basis of the recommendations made by the Finance Commission of the State’.<sup>100</sup> NCRWC took note of the difficulty of the Eleventh Finance Commission and recommended that the words ‘on the basis of recommendation’ in sub-clauses (bb) and (c) of clause (3) of Article 280

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<sup>97</sup> *Infra*

<sup>98</sup> Article 280(3) (bb) states: “It shall be the duty of the [Finance] Commission to make recommendations to the President as to -- (bb) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats in the State on the basis of the recommendations made by the Finance Commission of the State”.

<sup>99</sup> Article 280(3)(c) states:”It shall be the duty of the [Finance] Commission to make recommendations to the President as to -- (c) the measures needed to augment the Consolidated Fund of the a State to supplement the resources of the Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State”.

<sup>100</sup> See, Article 280(3)(bb) and (c), *supra*

should be replaced with ‘after taking into consideration the recommendations’.<sup>101</sup> This recommendation reverberated in the Twelfth Finance Commission as well.<sup>102</sup>

NCRWC, Eleventh Finance Commission and Twelfth Finance Commission failed to take note of the changed context 73<sup>rd</sup> and 74<sup>th</sup> amendment to the Constitution. After the insertion of Part IX and IXA to the Constitution, the goal described in Article 40 is not merely hortatory. It is an enumerated, actionable provision within the Constitution. Further, the provisions for local bodies in Parts IX, IXA, IV(DPSP) and Article 280(bb) and (c) are strewn with significant, positive qualifier such as ‘enable’<sup>103</sup>, ‘devolution’,<sup>104</sup> ‘self-government’<sup>105</sup>, ‘augment’<sup>106</sup> and ‘supplement’<sup>107</sup>.

The Directive Principles of the State Policy are *per se* ‘fundamental in the governance’ of India.<sup>108</sup> Furthermore, it a mandatory ‘duty of the state apply these principles’ in formulating laws.<sup>109</sup> As Ronald Dworkin has explained, law cannot be understood as mere system of rules.<sup>110</sup> There are ‘principles, policies and other sorts of standards’ that govern the legal system.<sup>111</sup> This is illustrated through the ‘Original Problem’ propounded by Dworkin.<sup>112</sup> In a situation where a person sought to bequeath

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<sup>101</sup> See, para 9.8.3 of NCRWC recommendations which states: “Sub-clauses (bb) and (c) of clause (3) of article 280 require the Finance Commission to make its recommendations in respect of the Panchayats and Municipalities ‘on the basis of the recommendations made by the Finance Commission of the State’. The Eleventh Finance Commission found it difficult to work within this framework because of various problems. It found that in some States, the State Finance Commissions (SFCs) were either not constituted or did not submit their reports. Again, in view of the ‘heterogeneity of approach’ of different SFCs and differences in contents and periods covered by them, the Eleventh Finance Commission found it difficult to form its opinion only on the basis of their recommendations. **For avoiding such a situation in future and in order to enable the Finance Commission to take a macro-level view, it is recommended that the provisions of article 280(3)(bb) and (c) should be suitably amended. The words ‘on the basis of the recommendation’ in these clauses may be replaced by the words ‘after taking into consideration the recommendations’.** (emphasis in original)

<sup>102</sup> para 8.24(iv)

<sup>103</sup> Articles 40, 243G, 243W

<sup>104</sup> Articles 243G, 243W

<sup>105</sup> Articles 40, 243(d), 243P(e), 243G, 243W, entry 5, List II

<sup>106</sup> See, Article 280 (3) (bb) and (c)

<sup>107</sup> Article 280 (3) (bb) and (c)

<sup>108</sup> Article 37, *supra*

<sup>109</sup> Article 37, *supra*

<sup>110</sup> See generally, for an account of law as system of rules, HLA Hart, *The Concept of Law*, *supra*

<sup>111</sup> Ronald Dworkin, *Taking Rights Seriously*, Universal Law Publishing Co. Pvt. Ltd., New Delhi, 1978, p. 22 [Hereinafter Dworkin]

<sup>112</sup> *Ibid.* p. 23.



property of a person who he himself had killed, the principle of ‘no person should profit from her own wrong’ was applied.<sup>113</sup> The application of this unarticulated principle -- *Riggs* principle -- according to Dworkin, was justified owing to its content – the moral requirement of fairness.<sup>114</sup>

The principles for strengthening local bodies, contrary to *Riggs*, are not unarticulated. The federal Finance Commission need not feel hamstrung because of the working of State Finance Commissions. It should carry out its constitutional mandate of augmenting and supplementing resources of Panchayats and Municipalities. It is possible to recommend direct devolution of funds to institutions of local self-government.

As suggested in a recent Karnataka High Court decision, direct devolution of funds to the local bodies appears to reduce transaction cost and enhance welfare.<sup>115</sup> *Manjamma* involves an interesting fact-situation: what is appropriate role of the state government in implementing Integrated Child Development Service Programme (ICDS) which the central government has assigned directly to the local bodies?<sup>116</sup> Relying upon the scheme of ICDS and Part IX and IXA of the Constitution, the Court held that the state government ought to confine itself to the role of coordination and supervision leading to uniformity in guidelines for selection process.<sup>117</sup> Effective implementation is best left to the local bodies.<sup>118</sup> The court came down heavily upon the encroachment of the Members

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<sup>113</sup> *Riggs v. Parmer*, 115 N.Y. 506, 22 N.E. 188 (1889) cited from Dworkin, *supra*

<sup>114</sup> Dworkin, *supra* pp. 23-31.

<sup>115</sup> *Smt. T.J. Manjamma v. State of Karnataka*, MANU/KA/0081/2008 [hereinafter *Manjamma*]

<sup>116</sup> *See*, para 3, 63, *Manjamma*

<sup>117</sup> para 102, *Manjamma*

<sup>118</sup> para 102, *Manjamma* states “The state government to take such steps as are necessary for coordinating and effective implementation of the scheme and to restrict its functioning only to the aspects of coordination and supervision and if it is required to supplement the scheme of the central government for proper implementation, particularly in the matter of selection etc., by evolving a uniform guideline, bearing in mind the guidelines under the ICDS programme so that the selection process is uniform at all centres i.e. the method of selection is uniform and confines its role only to this aspect and not to interfere in the actual process of implementation of the scheme, which function is clearly now given up in favour of panchayat raj institutions”.

of Legislative Assembly (MLAs) into the ICDS and recognized the effectiveness of the scheme could be ensured through decentralized implementation.<sup>119</sup>

Article 282 of the Constitution *a fortiori* aids the Finance Commission in recommending direct devolution of funds to institutions of local self-government for any ‘public purpose’<sup>120</sup>. There is an erroneous premise that only the Planning Commission may utilize the provision of Article 282. While the Finance Commission is a creature of the Constitution, the Planning Commission is an extra-constitutional body, established through central government’s executive decision.<sup>121</sup> It is open to the Finance Commission to utilize the constitutional mandate.<sup>122</sup> This would in tune with the spirit of the Constitution that envisages the Finance Commission, not the Planning Commission as balance wheel of Indian federalism.<sup>123</sup>

Indeed, Article 282 categorically extends the meaning of public purpose not to be fettered with the legislative competence of Parliament or the State Legislature.<sup>124</sup> Therefore, even if the federal Parliament lacks legislative competence to legislate on entries listed in the domain of the State Legislature, it is open to the Parliament to make grants for public purpose. The framers of the Constitution, in their wisdom, have left the meaning of ‘public purpose’ to be open-ended. Embellishment of institutions of local self-government would squarely fall within the meaning of public purpose. Perhaps an an

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<sup>119</sup> Para 67, *Manjamma* states “The manner in which the state government has been preoccupied with the task of constituting and reconstituting the selection committees and modifying the composition of selection committees, very clearly indicates that the state government is more interested in yielding to political pressure in the matter of composition of selection committees, which in turn selects the *Anganwadi* workers, obviously leading to the inference that the representatives of people, particularly the MLA of the area are keen to have their say in the matter of selecting and appointing *Anganwadi* workers and also to retain their control even after the appointment, as *Anganwadi* workers of their choice will obviously remain loyal even after their appointment. The very notifications produced as annexures to the statement of objections filed on behalf of the state government traces the devolution of power over a period of time and ultimately as per the government order dated 15-7-2006 being concentrated in the hands of MLAs, who in terms of this government order is appointed as chairperson of the selection committee. In fact, the subsequent notifications have gone still further in issuing a corrigendum to allow a nominee of such MLA to function in place of the MLA as the chairperson! There cannot be any better illustration of the manner in which the power [of appointment] is sought to be relinquished in favour of the MLAs and even dealt with as though the ICDS scheme is a scheme for empowerment of MLAs rather than as a scheme for the welfare and development of children upto the age of six and nursing mothers!”

<sup>120</sup> Article 282 of the Constitution states: “The Union or a State may make *any* grants for *any* public purpose, notwithstanding that the purpose is not one respect of which Parliament or the Legislature of the State, as the case may be, make laws”. (emphasis supplied)

<sup>121</sup> M.P. Jain, *Indian Constitutional Law*, Vol. I, 5th ed., Wadhwa Nagpur, 2003, p. 845. See also, <http://planningcommission.nic.in/aboutus/index.html> (visited on March 25, 2009).

<sup>122</sup> This is not to suggest discontinuance of the Planning Commission. As the Sarkaria Commission had observed: “We are of the view that the present division of responsibilities between the two bodies, which has come to be evolved with mutual understanding of their comparative advantage in dealing with various matters in their respective spheres, should continue”.

<sup>123</sup> M.P. Jain, p. 846.

<sup>124</sup> Article 282, *supra*

unintended consequence, the Finance Commission's endeavour to interpret Article 282 proactively may nudge an efficient transfer of funds for centrally sponsored schemes through adoption of information technology mechanism.<sup>125</sup>

Article 282 and *Manjamma* instantiate that agency cost can be greatly minimized if stakeholders can deal directly with their primary agent rather than undergoing a convoluted scheme of agents dealing with each other. *Manjamma* could be utilized as one of the 'best practices' by the Finance Commission.

Furthermore, 'best practices' need not wait for constitutional amendment which is arduous and has high transaction cost.<sup>126</sup> If one were to follow NCRWC recommendation of an independent tax domain for local bodies involving amendment to the Seventh Schedule of the Constitution that denotes fields of legislation, one would have to wait for a constitutional amendment that would require ratification by the Legislature of at least one-half of the states.<sup>127</sup> This could lead to problem of 'hold-outs'.<sup>128</sup> Best practices denote a healthy competition between the states to carry out the constitutional mandate of embellishing local bodies.

## 2. Best Practices

Since Best Practices ought to embellish local bodies than emasculate them, an appropriate touchstone could be the triumvirate of autonomy, legitimacy and social capital as noted in Section III. Several suggestions are already in the public domain.<sup>129</sup> Most recommendations target augmenting the revenue of local bodies. As noted above, any suggestion requiring constitutional amendment has tremendous transaction cost.

The practical way out for the federal Finance Commission for incentivizing devolution is to link revenue and grants with decentralization index, reflecting autonomy,

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<sup>125</sup> For a scheme involving computerization program that may potentially resolve the ongoing dispute between centre and state on direct transfer of CSS funds to district level agencies and local bodies, *see*, Ashutosh Dikshit, Renuka Viswanathan, TR Raghunandan, "Efficient Transfer of Funds for Centrally-Sponsored Schemes", *Economic and Political Weekly*, June 9, 2007.

<sup>126</sup> *See generally* Article 368

<sup>127</sup> Proviso to sub-section(2) of Article 368, in relevant part states: "Provided that if such amendment seeks to make any change in - (a) ...article 162(Extent of executive power of state), or (b) ... Chapter I of Part XI (Distribution of legislative powers), or (c) any of the Lists in the Seventh Schedule, or...(e) the provisions of this article, the amendment shall also require to be ratified by the Legislatures of not less than one-half of the States by resolution to that effect passed by those Legislatures before the Bill making provision for such amendment is presented to the President for assent".

<sup>128</sup> *See generally*, Lloyd.R. Cohen, "Holdouts and Free Riders", 20 *Journal of Legal Studies* 351-362 (1991).

<sup>129</sup> *See for instance*, Twelfth Finance Commission Report, para 8.19

legitimacy and social capital.<sup>130</sup> Decentralization index needs functional approach and would be subjective.<sup>131</sup> Additionally, as suggested by NCRWC, local bodies should also have power to borrow from financial institutions and capital market.<sup>132</sup> An enabling legislation ensuring power of local authorities to borrow already exists.<sup>133</sup> The legislation, however, may be insufficient owing to lack of bankruptcy provision for local authorities. Perhaps this fetters lenders' discretion forcing them to look for specific borrowing powers in the respective enactments. In any event, akin to the 80<sup>th</sup> Constitution Amendment suggesting a fixed percentage of union taxes to be devolved to states, a certain percentage ought to be earmarked for local bodies as well.<sup>134</sup>

The Finance Commission may specifically focus on human resources and capacity building issues.<sup>135</sup> This is especially critical when in the absence of statutory provisions granted by state enactments, courts have been reluctant to read local bodies' supremacy in appointments of teachers<sup>136</sup> or District Panchayat President's powers to supervise District Development Officers in matters of recruitment, transfer, promotion and posting of Panchayat employees.<sup>137</sup> The latter judgement, however, recognizes significant autonomy of local bodies in policy making.<sup>138</sup>

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<sup>130</sup> See generally, V.N. Alok & Laveesh Bhandari, "Rating the Policy and Functional Environment of PRIs in Different States of India—A Concept Paper" (on file with the author)

<sup>131</sup> Y.K. Alagh, Vivek Bhandari, Debiprasad Mishra & HS Shylendra, *The State of Panchayats: 2007-08: An Independent Assessment*, Vol. I, Institute of Rural Management, Anand, 2008, p. 395.

<sup>132</sup> para 9.8.6. NCRWC Report. Some state legislations such as that of Madhya Pradesh and West Bengal already provide for a power to borrow.

<sup>133</sup> See, The Local Authorities Loans Act, 1914. This existing law is force owing to Article 372(1) of the Constitution that states: "Notwithstanding the repeal by this Constitution of the enactments referred to in article 395 but subject to the other provisions of this Constitution, all the laws in force in the territory of India immediately before the commencement of this Constitution shall continue in force therein until altered or repealed or amended by a competent legislature or other competent authority".

<sup>134</sup> para 8.38 of the Twelfth Finance Commission Report. See generally, V.N. Alok, "Local Government Organization and Finance: Rural India" in Anwar Shah, *Local Governance in Developing Countries*, The World Bank, Washington, 2006.

<sup>135</sup> Para 9.9.1 NCRWC Report.

<sup>136</sup> See, *N. Sumathi Reddy v. Government of Andhra Pradesh*, MANU/AP/0639/1996.

<sup>137</sup> See, *Gujarat Pradesh Panchayat Parishad v. State of Gujarat*, MANU/SC/3228/2007.

<sup>138</sup> *Guajarat Pradesh Panchayat Parishad*, supra in para 30 states: "...suppose a primary health centre or a primary school is to be set up by the Panchayat. In taking such a decision, elected wing of the District Panchayat would play primary role as that wing is alive to the needs of the people in the area. If the President finds undue delay in implementation or improper implementation of such decision, he may instruct the District Development Officer to take necessary steps for securing proper implementation of the resolution of the Panchayat or the decision of its Committee. But, once the centre is set up or the school is established, it is for the District Development Officer, District Health Officer or District Primary Education Officer to decide as to who should be appointed as Doctor in the health centre or teacher in the school. Such matters must be left to the administrative wing of the District Panchayat".

In accordance with the constitutional mandate of embellishing local bodies, the Supreme Court of India in *Associated Cement Companies v. State of Madhya Pradesh* [hereinafter *ACC*] upheld the right of the Municipal Council to impose ‘export tax’ on cement and other commodities which are exported from the limits of the Municipal Council.<sup>139</sup> Interestingly, in *ACC* the state government wanted to reduce the rate of tax from 0.5% to 0.2%.<sup>140</sup> Relying upon the principle of autonomy, the Supreme Court rightly located the power within the Municipal Council, and without the approval of the Council the state government lacked power to reduce the rate of tax.<sup>141</sup> The lack of uniformity in the rate of tax was immaterial since the proper procedure respecting the autonomy of the Municipal Council was not followed.<sup>142</sup>

*ACC* recognizes that there is greater possibility of convergence of interest between stakeholders (citizens) and the Municipal Council which is nearest to the stakeholders in governance pyramid. Hence autonomy of the local body ought to be respected.

### 3. PESA

Is there a need for different strokes for different folks? Should Scheduled Areas be treated differently? There is no jurisprudential *rationale* behind keeping the Scheduled Areas out of the purview of the 73<sup>rd</sup> and 74<sup>th</sup> amendment. Indeed, keeping in mind a calibrated extension of the amendments to hitherto untouched locations, the amendment had left a window open that extension law shall not be construed to be an amendment to the Constitution.<sup>143</sup> This would ensure that the transaction cost of extension would be low.

Instead of waiting for Parliament’s nod, states such as Andhra Pradesh and Himachal Pradesh extended the local bodies enactment to the scheduled areas.<sup>144</sup> This was challenged and held to be unconstitutional by the Andhra Pradesh High Court.<sup>145</sup>

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<sup>139</sup> *Associated Cement Companies Ltd v. State of Madhya Pradesh*, (2005) 5 SCC 347.

<sup>140</sup> Para 2 and para 3 of *Associated Cement Companies Ltd v. State of Madhya Pradesh*, (2005) 5 SCC 347.

<sup>141</sup> Para 14 and 15 of *Associated Cement Companies Ltd v. State of Madhya Pradesh*, (2005) 5 SCC 347.

<sup>142</sup> Para 2,3 and 15 of *Associated Cement Companies Ltd v. State of Madhya Pradesh*, (2005) 5 SCC 347.

<sup>143</sup> Article 243M (4)(b) states: “Notwithstanding anything in this Constitution - (b) Parliament may, by law, extend the provisions of this Part to the Scheduled Areas and the tribal areas referred to in clause (1) subject to such exceptions and modifications as may be specified in such law, and no such law shall be deemed to be an amendment of this Constitution for the purposes of article 368”.

<sup>144</sup> Mahi Pal, “Panchayats in Fifth Scheduled Areas”, *Economic and Political Weekly*, May 6, 2000, p. 1602.

<sup>145</sup> *Arka Vasanth Rao v. Government of AP*, AIR 1995 AP 274.

Subsequently, owing to the recommendation of Dileep Singh Bhuria committee, the Panchayats (Extension to Scheduled Areas) Act, 1996 [hereinafter 'PESA'] came into existence.<sup>146</sup> The underlying spirit of PESA has been adoption of decentralized participatory democracy in the form of *gram sabhas* than representative democracy in the form of panchayati raj institutions.<sup>147</sup> PESA provides for a legislative framework for the indigenous community to preserve their separate identity and culture<sup>148</sup> and retain control over natural resources.<sup>149</sup> Continuing with the spirit of 73<sup>rd</sup> and 74<sup>th</sup> amendment, though it envisages Panchayats to be 'enable[d] ... to function as institutions of self-government', it categorically enjoins safeguards 'ensur[ing] that Panchayats at the higher level do not assume the powers and authority of any Panchayat at the lower level or of the *Gram Sabha*'.<sup>150</sup>

The sanctity of *gram sabha* is critical as they enable each stakeholder at the village level to participate in decision-making process.<sup>151</sup> This is seemingly the farthest that Plato's concept of participatory democracy can reach in such areas. This would go a long way in stamping out agency cost and principal-agent problem.

The Finance Commission may allocate financial resources if it feels that *gram sabhas*' powers have been preserved. In the absence of *gram sabha*, the Finance Commission may rely upon Rawls' second principle of justice which suggests that 'social and economic inequalities are to be arranged so that they are to the greatest benefit of the

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<sup>146</sup> See, *Arka Vasanth Rao v. Government of AP*, AIR 1995 AP 274, 285 (para 25).

<sup>147</sup> Mahi Pal, *supra*, EPW, p. 1603. See also. S. 4(n) of PESA

<sup>148</sup> See, section 4(a) of PESA that states: "Notwithstanding anything contained under Part IX of the Constitution, the Legislature of a State shall not make any law under that Part which is inconsistent with any of the following features, namely :- (a) a State legislation on the Panchayats that may be made shall be in consonance with the customary law, social and religious practices and traditional management practices of community resources;..(d) every Gram Sabha shall be competent to safeguard and preserve the traditions and customs of the people, their cultural identity, community resources and the customary mode of dispute resolution."

<sup>149</sup> See, section 4(i) of PESA that states: " Notwithstanding anything contained under Part IX of the Constitution, the Legislature of a State shall not make any law under that Part which is inconsistent with any of the following features, namely :- (i) the Gram Sabha or the Panchayats at the appropriate level shall be consulted before making the acquisition of land in the Scheduled Areas for development projects and before resettling or rehabilitating persons affected by such projects in the Scheduled Areas; the actual planning and implementation of the projects in the Scheduled Areas shall be coordinated at the State Level"

<sup>150</sup> Section 4 (n) of PESA states: "the State Legislations that may endow Panchayats with powers and authority as may be necessary to enable them to function as institutions of self-government shall contain safeguards to ensure that Panchayats at the higher level do not assume the powers and authority of any Panchayat at the lower level or of the Gram Sabha"

<sup>151</sup> See, section 4(c) of PESA that states: "every village shall have a Gram Sabha consisting of persons whose names are included in the electoral rolls for the Panchayat at the village level". See also, Mahi Pal, "A People-Oriented Panchayat Raj Framework", *Economic and Political Weekly*, February 23, 2002, p. 700.

least advantaged'.<sup>152</sup> Article 275(1) of the Constitution instantiates Rawls' principle in its mandate to adopt a need-based approach for assistance.<sup>153</sup>

It appears that so far the Finance Commission has disbursed funds only to the three tier structure of Panchayati Raj. It follows from the discussion of PESA and Article 275 above that the Finance Commission, may, in its wisdom, also explore the possibility of disbursing funds to the Gram Sabhas.

The above discussion *a fortiori* applies to Sixth Schedule and excluded areas. In spite of an enabling provision in PESA, Panchayats have not been extended to Sixth Schedule and excluded areas. For such areas, it would be impractical for the Finance Commission to rely upon Article 280(3)(bb) that presumes the existence of Panchayats. Hence, for Sixth Schedule as well as excluded areas, the optimal option as noted above, is Article 275(1) that relies upon 'need of assistance'.

#### 4. Coase, Cooter & CAG

One of the significant impediments to the federal government's endeavour to embellish local bodies is its inability to keep tab on accounts. The office of the Comptroller and Auditor General of India (CAG) has been set up under a constitutional mandate<sup>154</sup> in order to oversee federal, state as well as other accounts.<sup>155</sup> CAG has an autonomy to decide upon the form of keeping accounts.<sup>156</sup> The powers and duties of

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<sup>152</sup> See, *Rawls, ToJ, supra*

<sup>153</sup> Article 275(1) states: "Such sums as Parliament may by law provide shall be charged on the Consolidated Fund of India in each year as grants-in-aid of the revenues of such States as parliament may determine to be in *need of assistance*, and different sums may be fixed for different States: Provided that there shall be paid out of the Consolidated Fund of India as grants-in-aid of the revenues of a State such capital and recurring sums as may be necessary to enable that State to meet the costs of such schemes of development as may be undertaken by the State with the approval of the Government of India for the purpose of promoting the welfare of the Scheduled Tribes in that State or raising the level of administration of the Scheduled Areas therein to that of the administration of the rest of the areas of that State..." (emphasis added).

<sup>154</sup> Article 148(1) states: "There *shall* be a Comptroller and Auditor-General of India who shall be appointed by the President by warrant under his hand and seal..." (emphasis added)

<sup>155</sup> Article 149 of the Constitution of India states: "The Comptroller and Auditor-General shall perform such duties and exercise such powers in relation to the accounts of the Union and of the States and *of any other authority or body as may be prescribed by or under any law made by Parliament* and, until provision in that behalf is so made, shall perform such duties and exercise such powers in relation to the accounts of the Union and of the States as were conferred on or exercisable by the Auditor-General of India immediately before the commencement of this Constitution in relation to the accounts of the Dominion of India and of the provinces respectively. (emphasis supplied)

<sup>156</sup> Article 150 of the Constitution of India states: "The accounts of the Union and of the States shall be kept in *such form* as the President may, on the advice of the Comptroller and Auditor-General of India, prescribe". (emphasis supplied)

CAG is entailed in the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971.<sup>157</sup>

With respect to local bodies, however, CAG finds itself to be hamstrung owing to lack of statutory mandate to audit local bodies.<sup>158</sup> It believes that states would need to amend their enactments in order to enable CAG to audit accounts for local bodies.<sup>159</sup> Indeed, CAG would require amendments in order to effectively carry out capacity-building, training programs as well.<sup>160</sup>

The current auditing arrangement conceived by CAG under the DPC Act falls under the following broad heads<sup>161</sup>:

- (a) Substantial finance [§ 14(1)]
- (b) Specific purpose grants [§15(1)]
- (c) Public interest [§ 19(3)]
- (d) Residuary [§ 20(1)]

The following table summarizes the position of CAG under the applicable sections of DPC Act:

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<sup>157</sup> Hereinafter DPC Act for the sake of brevity.

<sup>158</sup> Samar Ray, "Capacity Building, Accounting Practices, Computerization, Data on own Revenue and Expenditure, Pitfalls and Way Forward", in Conference on Issues Before the Finance Commission: Empowering the Panchayati Raj Institutions, 22-23 December, 2008, IRMA Anand, p. 18 (on file with the author)

<sup>159</sup> *Ibid.* p. 19.

<sup>160</sup> *Ibid.* p. 13.

<sup>161</sup> *Ibid.* p. 6.



§	Initiator	Trigger	Conditions	Degree of Obligation	Durati on
§ 14(1) <b>“substantial finance”</b>  [see, explanation to § 14(1): not less than Rs. 25 lakhs and the amount is not less than 75% of the total expenditure of that body or authority]	CAG	“any body or authority is substantially financed by grants or loans from the CFI/CFS”	“subject to the provisions of any law for the time being in force applicable to body or authority as the case may be”	“shall”	1+2 years [§14(3)]
§ 15 (1) <b>“specific purpose grant”</b>	CAG	“any grant or loan is given for any specific purpose from the CFI/CFS to any authority or body not being a foreign state or international organization”	President/ Governor/ Administrator may relieve in public interest [See proviso to § 15(1)]	“shall”	N.A.
§19(3) <b>public interest</b>	Governor/ Admn. UT	Governor or Administrator “is of the opinion that it is necessary in the public interest so to do...”	prior request	“where such request has been made”, CAG “shall”	N.A.

§	Initiator	Trigger	Conditions	Degree of Obligation	Durati on
§ 20(1) <b>Residuary government power</b>	President/ Governor/ Admn. UT	“undertake the audit of the accounts of such body or authority on such terms and conditions as may be agreed upon between him and the concerned government”	- terms of agreement - President/ Governor/ Admn. “satisfied that it is expedient so to do in the public-interest” - <i>audi alterum partem</i> to the concerned body or authority”	voluntary	N.A.

Firstly, the DPC Act empowers CAG to audit inflow as well as outflow for bodies and authorities that are substantially financed from federal or state revenues.<sup>162</sup> The term ‘substantial finance’ is limited by absolute number (Rs. 25 lakhs) as well as percentage (75%).<sup>163</sup> Additionally, such audit could be carried out for further two years even if the condition of substantial finance is not fulfilled.<sup>164</sup>

<sup>162</sup> § 14(1) of the DPC Act states: “Where any body or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor-General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him”.

<sup>163</sup> Explanation to §14(1) of the DPC Act states: “Where the grant or loan to a body or authority from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly in a financial year is not less than rupees twenty-five lakhs and the amount of such grant or loan is not less than seventy-five percent of the total expenditure of that body or authority, such body or authority shall be, deemed, for the purposes of this sub-section, to be substantially financed by such grants or loans as the case may be”.

<sup>164</sup> § 14(3) of the DPC Act states: “Where the receipts and expenditure of any body or authority are by virtue of the fulfillment of the, conditions, specified in sub-section (1) or sub-section (2) audited by the Comptroller and Auditor-General in a financial year, he shall continue to audit the receipts and expenditure of that body or authority for a further period of two years notwithstanding that the conditions specified in sub-section (1) or sub-section (2) are not fulfilled during any of the two subsequent years”.

Secondly, CAG has the legislative mandate to audit specific purpose grant.<sup>165</sup> However, in public interest CAG may be relieved of its responsibility under this provision.<sup>166</sup> CAG's powers to access books and accounts are further circumscribed if another agency is already auditing the accounts of such body or authority.<sup>167</sup> In such a case, specific authorization of access to books and accounts is required and the affected corporation has a right of representation.<sup>168</sup>

Thirdly, at the initiative of the Governor or the Administration, CAG may audit in public interest.<sup>169</sup> In this context, the affected corporation enjoys the right of representation.<sup>170</sup> For instance, the state of Karnataka has entrusted auditing of Zilla Parishads and Taluk Panchayats (first and second tier of Panchayat institution respectively) to CAG under this provision.<sup>171</sup>

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<sup>165</sup> § 15(1) of the DPC Act states: "Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organization, the Comptroller and Auditor-General shall scrutinize the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body".

<sup>166</sup> Proviso to § 15(1) states: "Provided that the President, the Governor of a State or the Administrator of a Union Territory having a Legislative Assembly, as the case may be, may, where he is of the opinion that it is necessary so to do in the public interest, by order, relieve the Comptroller and Auditor-General, after consultation with him, from making such scrutiny in respect of any body or authority receiving such grant or loan".

<sup>167</sup> § 15(2) of the DPC Act states: "Except where he is authorized so to do by the President, the Governor of a State or the Administrator of Union Territory having a Legislative Assembly, as the case may be, the Comptroller and Auditor-General shall not have, while exercising the powers conferred on him by sub-section (1), right of access to the books and accounts of any corporation to which any such grant or loan as is referred to in sub-section (1) is given if the law by or under which such corporation has been established provides for the audit of the accounts of such corporation by an agency other than the Comptroller and Auditor-General."

<sup>168</sup> Proviso to § 15(2) states: "Provided that no such authorization shall be made except after consultation with the Comptroller and Auditor-General and except after giving the concerned corporation a reasonable opportunity of making representations with regard to the proposal to give to the Comptroller and Auditor-General right of access to its books and accounts".

<sup>169</sup> § 19(3) of the DPC Act states: "The Governor of a State or the Administrator of a Union Territory having a Legislative Assembly may, where he is of the opinion that it is necessary in the public interest so to do, request the Comptroller and Auditor-General to audit the accounts of a corporation established by law made by the Legislature of the State or of the Union Territory, as the case may be, and where such request has been made, the Comptroller and Auditor-General shall audit the accounts of such corporation and shall have, for the purposes of such audit, right of access to the books and accounts of such corporation".

<sup>170</sup> Proviso to §19(3) of the DPC Act states: "Provided that no such request shall be made except after consultation with the Comptroller and Auditor-General and except after giving reasonable opportunity to the corporation to make representations with regard to the proposal for such audit".

<sup>171</sup> Samar Ray, *supra* pp. 6-7.

Finally, government has residuary powers to entrust CAG with auditing of accounts of any body or authority not covered by extant laws.<sup>172</sup> Interestingly, CAG relies upon this provision to entrust it with capacity building program that it currently extends to aid the local bodies.<sup>173</sup>

CAG's legal entitlement to carry out account and audit of local bodies is at best an upshot of inelegant drafting and at the worst delightfully vague. CAG cannot possibly claim a *carte blanche* to follow the federal money trail irrespective of wherever it goes. CAG's powers are fettered by a melange of conditions as delineated in the table. However, could the problem be cured through CAG's initiative?

### Coase Theorem and CAG

A transaction between CAG and state governments is not a zero-sum game.<sup>174</sup> There is a possibility of a bargain between CAG and state governments. An application of Coase Theorem would predict that vague initial allocation of legal entitlements between CAG and state governments would not matter from an efficiency perspective so long as free exchange is permissible.<sup>175</sup> In other words, misallocation of legal entitlements will be cured in the market by free exchange of entitlements.<sup>176</sup> However, there are two strong obstacles to free exchange -- (a) market failure; and (b) transaction cost<sup>177</sup>.

The market failure interpretation of Coase Theorem would ensure that the existence of a perfectly competitive market for legal entitlements could solve CAG's

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<sup>172</sup> § 20(1) of the DPC Act states: "Save as otherwise provided in § 19, where the audit of the accounts of any body or authority has not been entrusted to the Comptroller and Auditor-General by or under any law made by Parliament, he shall, if requested so to do by the President, or the Governor of a State or the Administrator of a Union Territory having a Legislative Assembly, as the case may be, undertake the audit of the accounts of such body or authority on such terms and conditions as may be agreed upon between him and the concerned Government and shall have, for the purposes of such audit, right of access to the books and accounts of that body or authority".

<sup>173</sup> See, Samar Ray, *supra*. p. 7 where he states: "Entrustment of TGS (Technical Guidance and Support) over the local bodies audit and accounts, including technical support to the DLFA (Director Local Fund Audit), in most states is under the provisions of § 20(1) of the DPC Act..."

<sup>174</sup> A zero-sum game is a game in which one person's gain is another person's loss. See generally, John von Neumann & Oskar Morgenstern, *Theory of Games and Economic Behavior* (1944). Though state governments are usually reluctant to devolve powers to the panchayats and municipalities, some state governments have shown that devolution could also be beneficial.

<sup>175</sup> Ronald H. Coase, "The Problem of Social Cost", *Journal of Law and Economics*, Vol. 3, 1960, pp. 1-44.

<sup>176</sup> Robert D. Cooter, "Coase Theorem", John Eatwell, Murray Milgate & Peter Newman, *The New Palgrave Dictionary of Economics*, Vol. I, 1998, p. 457. [Hereinafter 'Cooter-New Palgrave']

<sup>177</sup> *Ibid.* pp. 457-458.

problem.<sup>178</sup> The well known conditions for perfect market include, atomism, absence of externalities, perfect information, and absence of transaction cost.<sup>179</sup> Nevertheless, perfectly competitive market is a mirage. In any event, CAG and state governments do not follow perfect market conditions. Hence, while the Coase Theorem asserts that a perfect market may lead to an exchange of entitlements between CAG and state governments, it is of little assistance.

The transaction cost interpretation of Coase Theorem would indicate that the initial allocation of legal entitlements would not matter from an efficiency perspective so long as the transaction cost of exchange is zero.<sup>180</sup> If transaction cost were nil, even if there is a lacuna in the initial allocation of rights, it could be cured through mutual agreement between CAG and state governments.

Owing to a multitude of state governments, there is a large transaction cost in such bargaining. There could be a problem of hold-out. Negotiation with 28 state governments is a mind-boggling and daunting task. Is Coase Theorem correct in its assertion that transaction cost is the real obstacle to bargaining? Robert Cooter suggested an alternative that may perhaps assist CAG.

### Cooter and CAG

Cooter argues that Coase was excessively optimistic in arguing that cooperation is bound to occur in the absence of transaction cost.<sup>181</sup> Interestingly, Cooter, also deals with the polar opposite, the ‘Hobbes Theorem’, which suggests that people are incapable of solving problems unless a stick is used against them, usually by a coercive government.<sup>182</sup> As per Cooter, the truth lies somewhere *via media* Coase and Hobbes

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<sup>178</sup> *Ibid.* p. 457.

<sup>179</sup> See generally, Keith N. Hylton, *Antitrust Law: Economic Theory and Common Law Evolution*, Cambridge University Press, Cambridge, 2003, pp. 4-8.

<sup>180</sup> Cooter-New Palgrave, *supra*

<sup>181</sup> Robert Cooter, Stephen Marks and Robert Mnookin, “Bargaining in the Shadow of Law: A Testable Model of Strategic Behavior”, 11 *The Journal of Legal Studies* 225, 243 (1982) where he argues that: “the bargaining interpretation of the Coase Theorem takes an optimistic view about the ability of people to resolve distributional disputes and cooperate”.

<sup>182</sup> Robert Cooter, “The Cost of Coase”, 11 *The Journal of Legal Studies* 1, 18 (1982) where he argues “the conception of law which is the polar opposite to Coase is articulated in Hobbes and is probably much older. It is based on the belief that people will exercise their worst threats against each other unless there is a third party to coerce both of them. The third party for Hobbes is the prince or leviathan - we would say dictatorial government- who has unlimited power relative to the bargainers. Without his coercive threats, life would be ‘nasty, brutish, and short’.” [hereinafter ‘Cooter-Cost of Coase’]

Theorems. Bargaining is immanently unpredictable and the real obstacle to the transaction is ‘strategic character of bargaining’.<sup>183</sup>

Though Cooter finds that obstacles to transactions go beyond what Coase had enumerated, he ultimately agrees with Coase’s suggestion that law ought to minimize transaction cost and ‘lubricate’ private agreements.<sup>184</sup> The polar opposite of Hobbes Theorem remains an anathema for contemporary understanding of regulation.<sup>185</sup> Perhaps the Thirteenth Finance Commission may aid in providing support to CAG in order that it may enter agreements with state governments. The following table deals with provisions of DPC Act which hitherto have remained dormant:

§	Initiator	Trigger	Conditions	Degree of Obligation	Duration
§ 14(2) <b>constructed substantial finance</b>  [Not less than Rs. 1 Crore]	Presumably CAG	- Overrides §14(1) <i>non obstante</i> provision  - “grants or loans to such body or authority from” the CFI/State/UTLA	“with the previous approval of the President or the Governor of a State or Administrator...”	“may”	1+2 years [§14(3)]

<sup>183</sup> Cooter - Cost of Coase, *supra*, p. 23 where he states: “the error in bargaining version of Coase Theorem is to suppose that the obstacle to cooperation is the cost of communicating, rather than the strategic nature of the situation. Bargainers remain uncertain about what their opponents will do, not because it costs too much to broadcast one’s intentions, but because strategy requires that true intentions be disguised. The error in Hobbes Theorem is to suppose that bargainers increase their demands without regard to the reduction in probability of settlement. In equilibrium when expectations are rational, players do not adopt strategies which always lead to noncooperation, nor do they adopt strategies which always lead to cooperation”.

<sup>184</sup> Cooter-New Palgrave, *supra*, p. 459.

<sup>185</sup> Cooter-New Palgrave, *supra*, p. 459.

§	Initiator	Trigger	Conditions	Degree of Obligation	Duration
§ 20(2) <b>Residuary CAG power</b> <i>suo motu</i> “he may be authorised to undertake the audit of accounts of any body or authority, the audit of the account of which has <i>not</i> been entrusted to him by law”	CAG	CAG is of the opinion that “such audit is <i>necessary</i> because a substantial amount has been invested in, or advanced to, such body or authority” by the CG/SG/ UT	- President/ Governor/ Admn. “satisfied that it is expedient so to do in the public-interest” - <i>audi alterum partem</i> to the concerned body or authority”	“may”	N.A.

The above table indicates that CAG is rather too quick to dismiss legal provisions and lay the blame on the doorsteps of lack of constitutional amendments. There are specific legal provisions which could be of immense help to CAG in its endeavour to audit the accounts of local bodies. The residuary CAG power to seek *suo motu* audit contained in § 20(2) of DPC Act deals with a situation of *non liquet* - where the audit of accounts have not been entrusted to CAG by law.<sup>186</sup> The limitation to CAG’s request would be any overriding public interest against such audit.<sup>187</sup> Given the significance of

<sup>186</sup> §20(2) of the DPC Act states: “The Comptroller and Auditor General may propose to the President or the Governor of a State or the Administrator of a Union Territory having a Legislative Assembly, as the case may be, that he may be authorized to undertake the audit of accounts of any body or authority, the audit of the account of which has not been entrusted to him by law, if he is of opinion that such audit is necessary because a substantial amount has been invested in, or advanced to, such body or authority by the Central or State Government or by the Government of a Union Territory having a Legislative Assembly, and on such request being made, the President or the Governor or, the Administrator, as the case may be, may empower the Comptroller and Auditor-General to undertake the audit of the accounts of such body or authority.”

<sup>187</sup> §20(3) of the DPC Act states: “The audit referred to in sub-section (1) or sub-section (2) shall not be entrusted to the Comptroller and Auditor-General except where the President or the Governor of a State or the Administrator of a Union Territory having a Legislative Assembly, as the case may be, is satisfied that it is *expedient so to do in the public interest* and except after giving a reasonable opportunity to the concerned body or authority to make representations with regard to the proposal for such audit”.

local bodies it would be arduous to prove overriding public interest against audit of accounts for local bodies.

Further, the constructed substantial finance provision in § 14(2) contains a *non obstante* provision that would override the onerous requirements of finding out whether the three-fourth of local bodies' funds is stemming from federal or state government. Indeed, § 14(2) is broader in scope than § 20(2). Unlike the latter, the former is not subject to the limitation of expedient public interest and *audi alterum partem*<sup>188</sup> rights of the concerned authority.

The residuary CAG power in § 20(2) and constructed substantial finance in § 14(2) ought to be understood in the backdrop of the general duty of CAG. § 13 enjoins CAG to audit by following the money trail stemming from federal as well as state governments outflow.<sup>189</sup> Similarly, the counterpart in § 16 mandates CAG to audit inflow.<sup>190</sup> The duties in § 13 as well as § 16 are couched in a mandatory language.<sup>191</sup>

The quartet of §13, §16, §14(2) and §20(2) instantiate that CAG is legislatively empowered to carry out audit of local bodies. CAG's special status is further embellished in the constitutional mandate. The Constitution of India has put the office of CAG on the same footing as that of a Judge of the Supreme Court of India. The oath of office administered to CAG is mentioned in the Third Schedule of the Constitution.<sup>192</sup> The Third Schedule clubs CAG's oath with that of a Supreme Court Judge.<sup>193</sup> The DPC Act

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<sup>188</sup> This is one of the PNJ requirements. Literally translated it means, no one shall be condemned unheard. *See, supra.*

<sup>189</sup> § 13 of the DPC Act states: "It *shall* be the duty of the Comptroller and Auditor-General--(a) to audit *all* expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it; (b) to audit *all* transactions of the Union and of the States relating to Contingency Funds and Public Accounts; (c) to audit *all* trading, manufacturing, profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State; and in each case to report on the expenditure, transactions or accounts so audited by him". (emphasis supplied)

<sup>190</sup> § 16 of the DPC Act states: "It *shall* be the duty of the Comptroller and Auditor-General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make for this purpose such examination of the accounts as he thinks fit and report thereon". (emphasis supplied)

<sup>191</sup> Note the usage of "*shall*" in § 13 and § 16 above.

<sup>192</sup> Article 148 (2) of the Constitution of India states: "Every person appointed to be the Comptroller and Auditor-General of India shall, before he enters upon his office, make and subscribe before the President or some person appointed in that behalf by him, an oath or affirmation according to the form set out for the purpose in the Third Schedule".

<sup>193</sup> *See* Form IV in the Third Schedule of the Constitution of India.



ensures that the salary of CAG is equivalent to a Supreme Court Judge.<sup>194</sup> The Constitutional mandate for removal of CAG is the same as that of a Supreme Court Judge.<sup>195</sup> Additionally, in order to ensure its independence, the Constitution enjoins that CAG would be ineligible for any further office.<sup>196</sup>

In Section III.(B) of this paper, we have seen that the state election commission has successfully utilized the courts to empower local bodies by asserting their independence to conduct elections.<sup>197</sup> The strategic nature of bargaining as delineated by Cooter suggests that there is wiggle room for CAG to utilize the courts. The quartet of §13, §16, §14(2) and §20(2) read along with the constitutional architecture of putting CAG at the pedestal of a Supreme Court Judge would ensure that CAG's power to audit local bodies' accounts would be insurmountable.

Nevertheless, in the interest of removal of any discretionary power and unnecessary doubts, the Parliament may also amend the DPC Act. This would ensure the involvement of Parliament in reform of local bodies.

Parliament's involvement may also lead to resolution of ancillary issues such as lack of uniformity of accounts. Part IX of the Constitution indicates as if there is a *sui generis* procedure for maintenance and audit of accounts for local bodies. The state legislature has been entrusted with the task of maintenance and audit of accounts for Panchayats<sup>198</sup> as well as Municipalities<sup>199</sup>. However, this anomaly has to be seen in light of Article 150 that ensures the supremacy of CAG in the arena of account-keeping.<sup>200</sup> The underlying rationale behind Article 150 is uniformity of federal and state accounts. It would be ludicrous if states can utilize Articles 243J and 243Z in Part IX of the Constitution to thwart the purpose behind Article 150. A contextual, purpose based

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<sup>194</sup> § 3 of the DPC Act states: "There shall be paid to the Comptroller and Auditor-General a salary which is equal to the salary of the Judge of the Supreme Court"

<sup>195</sup> Article 148(1) of the Constitution of India states: "There shall be a Comptroller and Auditor-General of India who shall be appointed by the President by warrant under his hand and seal and *shall* only be removed from office in like manner and on like grounds as a Judge of the Supreme Court." (emphasis added)

<sup>196</sup> Article 148 (4) of the Constitution of India states: "The Comptroller and Auditor-General shall not be eligible for further office either under the Government of India or under the Government of any State after he has ceased to hold his office."

<sup>197</sup> See, Section III.(B) of the paper.

<sup>198</sup> Article 243J of the Constitution of India states: "The Legislature of a State may, by law, make provisions with respect to the maintenance of accounts by the Panchayats and the auditing of such accounts".

<sup>199</sup> Article 243Z of the Constitution of India states: "The Legislature of a State may, by law, make provisions with respect to the maintenance of accounts by the Municipalities and the auditing of such accounts".

<sup>200</sup> Article 150 of the Constitution of India states: "The accounts of the Union and of the States shall be kept in such form as the President may, on the advice of the Comptroller and Auditor-General of India, prescribe".

interpretation of Articles 150, 243J and 243Z would mean that CAG retains its paramount power to ensure uniformity of accounts. Again, in the interest of clarity, it may be advisable to introduce constitutional amendments reflecting the significance of uniformity of accounts for local bodies as well.

While the Parliament is taking a close look at Panchayats and Municipalities, it may be apprised of the anomaly of Urban Development Authority, Regional Development Board and City Improvement Trusts functioning inconsistently with 73rd and 74th amendment. The 12th schedule needs specific entries ensuring that urban planning bodies function in accordance with the constitutional mandate of empowerment of local bodies.

## V. CONCLUSION

The aim of this paper was to analyze the constitutional text and context of the third stratum from a law-and-economics perspective. The paper characterized the problems faced by the third stratum to be akin to principal – agent problem, where stakeholders (citizens) are the principal and institutions of governance (such federal government, state government) are the agents.

The agency cost analysis of the third stratum yields interesting exploratory, as well as normative, insights. Descriptively, the paper found that the constitutional architecture of the third stratum relies upon the triumvirate of autonomy, legitimacy and social capital.

Normatively, the paper argues that constitution being a social contract, literal interpretation is inept. A purposive, context –based hermeneutics of the constitution and its amendments indicate that third stratum can only be embellished by institutions of governance, including the Finance Commission.

The descriptive as well as normative insights of the paper indicate that the constitutional amendments seamlessly reduce transaction cost and bridge principal – agent divergence of interests. This understanding of the constitutional architecture of the third stratum in the backdrop of cases has critical ramification upon asymmetry in devolution of finances, best practices, extension of benefits to scheduled areas and audit of finances for local bodies.

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## Summary

### *Potential Action Points for the Thirteenth Finance Commission*

1. The constitutional mandate for the Finance Commission is to reduce agency cost ensuring that local bodies emerge as the centre of a super-structure of concentric circles of governance. Accordingly, the Commission may take steps to embellish local bodies.
  2. The Commission need not feel hamstrung because of working of the state finance commissions. It may recommend direct devolution of funds.
  3. The Commission may link grants with functional decentralization index reflecting autonomy, legitimacy and social capital. A certain percentage of taxes ought to be earmarked for local bodies.
  4. Following Rawls' principles of justice and Article 275 of the Constitution, the Commission may allocate resources in schedule areas on a needs based approach.
  5. Usage of Coase Theorem and Robert Cooter's economic analysis of law indicates that there is wiggle room for CAG to explore audit of accounts for local bodies.
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