In the era of globalization, privatization and decentralization, the financial management of ULBs has assumed many new dimensions. The unprecedented pace of urbanization and rapid transformation of urban lifestyles over the last few years has put unforeseen demands on urban infrastructure and finance. The finances of Urban Local Bodies (ULBs) form an important element of the larger fiscal scenario of the country as ULBs are the Constitutional entities engaged in providing a variety of civic amenities and infrastructure. The 74th Amendment assigned enormous responsibilities to municipalities, which include the preparation of plans for economic development and social justice as well as the implementation of schemes as may be entrusted to them including those in relation to the 18 items listed in the Twelfth Schedule to the constitution. In addition to the items of responsibilities referred to in the Constitution, the Legislature of a State, by law, can assign responsibilities to Urban Local Bodies relating to the two
items mentioned above. To perform these tasks, local bodies have to be financially sound with commensurate amount of powers for raising resources. However, while the Constitution has specified and listed the expenditure responsibilities, it does not provide a clear regime of taxes and revenue sources of ULBs.

The expenditure liability of a municipality depends on the service cost, service norms and population parameters. This applies to all categories of services. Revenues raised depend on the size of revenue base, extent of access to the base, the rates and the collection efficiency. This is true for all collectible resources. The fiscal gap can be redressed in the following broad ways: (a) reducing municipal responsibilities, (b) scaling down municipal service norms, (c) cutting costs and unnecessary expenditures, (d) enhancing municipal power to raise revenues, (e) increasing transfers from higher levels of government, and (f) stepping up local effort to raise revenues. Reforms to correct the municipal fiscal gap will need to address all of these factors in a comprehensive manner.¹

Till date, a separate list of taxes exclusively for municipal bodies does not exist. Many commissions such as the Local Finance Committee (1951) and Taxation inquiry Commission (1953-1954) have been set up from time to time to look into the issue of Municipal finance. However, even today the municipal finance is largely left to the discretion of the respective State Governments.
Table-3.1

Distribution of Taxes between the Centre, States and ULBs

<table>
<thead>
<tr>
<th>Government of India</th>
<th>State Government</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax, Wealth Tax, Corporate Tax, Customs Duties and Excise Tax</td>
<td>State Excise, Professional Tax, Sales Tax, Entertainment Tax and Land Revenue Tax</td>
</tr>
</tbody>
</table>

**Urban Local Bodies (As permitted under State Acts)**

| Tax on Land and Buildings, Taxes On Vehicles, Entry Tax on Goods (Octroi), Use Consumption and Sale, Theatre/ Show Tax and Tax on Advertisements other than in Newspapers. |

Source: Finance Commission

As a result, most ULBs find it difficult to match the available resources with the responsibilities assigned to them by the Constitution and the respective States. The taxes, duties, tolls and fees to be levied by the municipalities and assigned to them as also the grants-in-aid to be given to them have been left at the discretion of State Governments. This has allowed the fiscal mismatches to continue because there is not adequate decentralization of ULB resources to correspond to the decentralization of ULB expenditures.

Figure 3.1

Conventional Sources of ULB Revenue

- **Conventional Resources**
  - **Tax**
    - Tax on entry/consumption of goods
    - Property Tax
    - Professional Tax
    - Tax on animals vehicles
    - Sp. benefit tax
    - Local Excise
  - **Non-Tax**
    - User charges for urban services
    - Income from sale of goods/services
    - Rents
    - Returns on investments
    - Profits
    - Licence Fees
    - Fines
  - **Transfers/Grants**
    - Formulae based devolution or share in resources of higher govt.
    - Formulae based Grants
    - Untied Grants
    - Adhoc Grants
    - Special purpose Grants
  - **Govt. Loans**
    - From central government
    - From state or provincial govt
    - Government Agency
    - Municipal development funds
Need for Promoting the Model Practices of ULB Management

It does not need much emphasis or explanation that the ‘measures’ needed to improve the finances and functioning of ULBs imply much more than the fiscal devolution alone. It points to the improved practices of ULB management as a whole. It is a widely acknowledged fact that the different aspects of ULB management such as revenue optimization, cost-effectiveness, process reform & reengineering, transparency & accountability, people-centeredness, etc., are all interlinked and therefore need simultaneous and synchronous reforms. In a country of great diversity and multiplicity it is difficult to device standard formulae of ULB reforms. Hence, perhaps the best strategy of consolidating the wisdom on ULB reforms is to map the best practices in this sector and to attempt a generic analysis of these practices with a view to promote their replication and scale-up.²

While it is necessary to explore the avenues of greater fiscal autonomy of ULBs it is equally necessary to build their capacities to handle the funds in a meaningful, effective and transparent manner. The financial management of ULBs is faced with an omnipresent challenge of balancing the economic growth with social justice. While focusing on the resource mobilization and public-private-partnership for creation of better urban infrastructure and services, it is equally necessary to ensure that the infrastructure and services remain accessible and affordable to the urban poor. Often the enthusiasm of creating high-end infrastructure and services undermines the concerns of urban poverty thus creating a progressive social imbalance. Greater autonomy of ULBs in planning and expenditure also means their greater responsibility and accountability towards the citizens. Unfortunately, a large
majority of ULBs, especially the smaller municipal councils, still lack in the basic systems, skills and capacities necessary for good urban management.

**Finances of Urban Local Bodies**

Till 1992 India functioned as a two tier structure (centre and states). The third tier (local bodies) came into recognition after the 73rd and the 74th amendments in 1992. The 74th Amendment added a new component pertaining to the ULBs to provide for; and among other items, this included constitution of the following municipalities:\(^3\)

(a) Nagar Panchayats: Areas in transition from rural area to urban area
(b) Municipal Councils: Smaller urban areas
(c) Municipal Corporations: Larger urban areas

Municipal Corporation is divided into zones. Each zone has its Municipal Commissioner (Chief Executive Officer and head of the executive arm of the Municipal Corporation), followed by the Municipal Corporation Inspectors.\(^4\)

In India, in 2011, 4041 towns had urban local bodies (Government of India, 2013a). In the country, there are three different types of urban local bodies - as discussed in the previous section. The municipal corporations for major cities in the country, like Ahmedabad, Bengaluru, Delhi, Chennai, Hyderabad, Kolkata and Mumbai, are able to raise and generate resources by some techniques but in case of smaller towns, dependence on the government is significantly large. In general, financial resources of urban local bodies are scarce, and unable to meet the expenditure requirements, and therefore the dependence on other two upper tiers of government is substantial. The constitution of India specifies the taxes to be divided between
the centre and state governments but does not specify the revenue base for urban and local bodies. Even the 74th amendment is not specific about the type of taxes that urban local bodies should have. The resource base of ULBs typically consists of their own sources, state revenue, government grant, loans from state governments, and market borrowings. The urban local bodies are sometimes not even aware of the opportunities and avenues of generating revenues through taxes and non-tax charges. Even if they are aware they do not have the skill to optimize tax collection. The urban bodies, specially the smaller ones, find it difficult to demonstrate their credit worthiness and therefore would require help and assistance in designing financial instruments for mobilizing resources from the market.

The existing pattern of municipal finances has not been able to meet the required expenditure on infrastructure development in urban areas. Municipal finance involves planning of revenue and expenditure decisions of the municipalities. Their budgets comprise plans with details regarding proposed expenditure and sources of financing during a financial year. Revenues of municipalities come from different sources but are limited in amount. Rao (1986) classified municipal revenue sources as follows: a) municipal own revenue comprising tax and non-tax revenue; (b) shared taxes with the state government; (c) grants-in-aid from the state and central government; and (d) borrowings from financial institutions.6

RBI (2007) also broadly categorized the revenue base of municipal corporations. Following are some important revenue sources of select municipal corporations in India.7
- Tax revenue: property tax, vacant land tax, octroi, tax on animals, taxes on carriages and carts, advertisement tax.

- Non-tax revenue: municipal fees, sale and hire charges, user charges, lease amounts.

- Other receipts: sundry receipts, lapsed deposits, fees, fines and forfeitures, Law charges costs recovered, rent on tools and plants, miscellaneous sales.

- Assigned (shared) revenue: profession tax, surcharge on stamp duty, entertainment tax, motor vehicles tax.

- Grants-in-aid:

- Plan grants made available by way of planned transfers from the upper tier of Government under various projects, programmes and schemes, and Non-plan grants made available so as to compensate against the loss of income and some specific transfers.

- Borrowings: Loans undertaken by the local authorities for capital works etc., mainly from - Life Insurance Corporation of India, State and Central Governments, banks and municipal bonds in select cases.

Government of India (2003) lists the following taxes, tolls and fees which are relevant to the ULBs and for which State Legislatures are competent to frame laws:

a) Taxes on: Lands and buildings; Entry of goods into a local area for consumption, use or sale therein; Consumption or sale of electricity; Advertisements other than advertisements published in the newspapers and advertisements broadcast by radio or television;
Goods and passengers carried by road or inland waterways; Animals and boats; Professions, trades, callings and employments; Luxuries, including taxes on entertainments, amusements, betting and gambling.

b) Tolls.

c) Fees in respect of any of the matters in this List, but not including fees taken in any court.

**Financing Urban Services: User Charges and Local Taxation**

An important rule of sound fiscal decentralization is that finances should follow functions. Local governments need access to adequate revenue sources to finance the public services they are mandated to provide. In India, however, under funding of municipal services is a common feature. Although all States have devolved the municipal functions listed in the Twelfth Schedule to a greater or a lesser degree, in the absence of adequate resources, municipal bodies have not been able to provide satisfactory levels of the assigned public services. One reason is simply because the revenue handles assigned to them to carry out these functions are clearly inadequate. At the same time, however, until now municipal bodies have neither taken the task of delivering public services sufficiently serious nor made adequate efforts to mobilise revenues efficiently from the sources assigned to them. Similarly, there are also not yet in place properly designed systems of intergovernmental transfers to sufficiently offset the fiscal disabilities of the municipal bodies to ensure minimum standards of important municipal services. In total, the net result of assigning the constitutionally mandated functions to municipal bodies has thus been to impose unfunded mandates on them, as we discuss further in the next section.\(^9\)
The consequence is that municipal services in India are significantly underfunded as mentioned in section 1 above. The serious under-spending documented by Mohanty et al (2007) has resulted in such inadequate infrastructure and poor public service delivery by municipal bodies that it has seriously constrained the potential role of cities as centres of economic growth. In 2005, the poor state of urban infrastructure and services was a major motivation for initiating a central programme, the Jawaharlal Nehru National Urban Renewal Mission (JnNURM) with the objective of improving developmental incentives by linking grants for urban renewal to reforms at both State and local levels aimed at improving fiscal efficiency of the urban local bodies, freeing urban land and housing markets, and preventing the municipal bodies and the States from adopting protectionist policies. The first phase of the programme is for the period 2005-12. Although in the first two years the progress was slow, the resource transfer from the centre has picked up. Nevertheless, much more remains to be done to augment urban infrastructure and services. Furthermore, the global financial crisis and the slowdown in the Indian economy as a consequence have recently led the central government to dilute the reform requirements in order to provide more immediate fiscal stimulus. In particular, a considerable portion of JnNURM funds have recently been spent in purchasing buses for urban transport in order to revive the commercial automobile sector as a component of fiscal stimulus strategy. Despite such shortcomings, as discussed further in the next section, the JnNURM approach may both foster urban renewal and motivate the States and local governments to undertake some of the reforms needed to
generate significant own resources through the reform of property taxes and the liberalisation of land and housing markets.

According to the principles of fiscal federalism, local services, by and large, should be paid for, by local residents. User charges are appropriate for financing locally provided services of a ‘private good’ nature. Local public goods should be financed through local taxes, and the cost of financing services whose benefits spillover jurisdictions should be shared through specific purpose transfers. Additional transfers from higher levels of government are required to offset the fiscal disabilities of jurisdictions with low revenue raising capacity and higher unit cost of providing services in order to enable comparable levels of public services at comparable tax rates. Finally, large local capital expenditures producing a stream of benefits flowing over a number of years should be financed through borrowing or perhaps the proceeds from selling land or other assets belonging to the local government.

As with expenditures, revenue sources, capacities and patterns may differ vastly not only between different classes of municipal bodies but also within each class. Although the expenditure needs of large metropolitan governments are large, for example, so are their capacities to raise revenues. To ensure that local decision-makers face hard budget constraints, it is important to avoid transfer dependency and bailouts. To ensure efficiency and accountability, it is important that there is a strong linkage between the expenditures incurred on behalf of local residents and the payments by way of user charges and taxes those residents make.11

Statutorily, local governments in India cannot run deficits; they are required to restrict their expenditures to available revenues. However, the
absence of deficits in the municipal bodies does not mean that the standards of public services are provided by them are even close to adequate. As Mohanty et. al (2007) recently showed, for example, on average 30 large municipal corporations with more than one million population according to Census 2001 were spending less than that one-quarter of the amount needed to provide the (inflation-adjusted) service norms set out almost 50 years ago by the Zakaria Committee (India, 1963).\textsuperscript{12} Municipal spending is so low both because of problems in mobilising own revenues and the inadequacy of transfers from central and State governments. Unfortunately, reliable data on municipal finances are not available; for example, the data reported in the Finance Commission reports have several infirmities. According to the information contained in the Twelfth Finance Commission Report, in 2001-02 the aggregate revenues of urban local bodies as a ratio of GDP amounted to an abysmal 0.67 per cent while their own revenues were only 0.38 per cent. Information collected at NIPFP for the same year shows aggregate revenues marginally higher at 0.76 per cent of GDP, with 0.26 per cent from tax devolution transfers and grants, and the balance from own revenues of urban local bodies at 0.51 per cent, of which local taxation accounted for 0.38 per cent and user charges 0.13 per cent. Such figures are very low in comparison with countries like Brazil, where municipal revenues account for 7.4 per cent of GDP, municipal own revenues for 2.58 per cent, and municipal taxes for 1.95 per cent. It is unsurprising that the standards of municipal services in India are abysmal.

**User Charges**

In many respects, the most important source of finance at local levels should be from user charges imposed for services provided. To a
considerable extent a local government is like a business providing direct services in the form of ‘private goods’ (like water) to its customers - local residents. Financing such services through user fees or charges not only provides funds with which to supply such services but also provides invaluable information on which services should be provided, in what quantity and quality, and to whom. Given the proximity to the population and the predominance of private good characteristics of many local services, levying user charges is feasible. Often, however, it is complained that it is not possible to levy user charges when the quality of the services rendered is poor. The result is that a vicious circle is set up, with low quality public services leading to an inability to collect user charges leading to further deterioration in the service levels.¹³

This circle needs to be broken, not only to get more revenues but also to improve standards of principal services. User charges are especially important as for providing signals to consumers of the scarcity value of the services and to providers about the demands that need to be met through service provision. Establishing this strong link between demand and supply both helps to generate resources and ensures efficiency in production and accountability in service delivery. User charges are particularly relevant for services such as water, sewers, electricity, garbage disposal, public transit, and recreation. User charges are more important in large metropolitan areas. Marginal cost pricing will improve efficiency by imposing higher charges on far away consumers. However, if poorer people live further away and congestion is serious in metropolitan centres, it may sometimes be argued that it might be advisable to charge more uniform (average cost) prices throughout the urban
region for certain services even at the price of perpetuating (and encouraging) some continued inefficiency in urban land use, transportation patterns, and the allocation of urban public sector resources. Of course, this is very much a ‘second-best’ approach, and depends very much upon the physical and social characteristics of each city. Marginal cost pricing of the ‘disservice’ provided by congestion (as discussed later) combined with marginal cost pricing of other services would clearly be preferable but seems unlikely to be feasible soon in most large Indian cities.

At present, urban fees are not significant in India, with the proceeds from non-tax revenues from all urban local bodies amounting to a mere 0.13 per cent of GDP. Mohanty et. al (2007) show that in 10 large municipal corporations less than 10 per cent of the cost of providing services was recovered through fees; in another six, cost recovery was between 10 to 20 per cent. Only in two of the 25 municipal corporations examined was cost recovery greater than 75 per cent. Interestingly, on the whole cost recovery was relatively greater in those cities in which the estimated normative under-spending was lower. If low cost recovery and poor service quality are thus connected, it may prove possible to collect more user charges, especially if the quality of the services provided can be improved - for example, by well-directed transfer payments, as discussed in a later section.

Other important sources of non-tax revenues are license fees for shops and establishments and parking fees. A common feature seen virtually in every urban local body, particularly in large corporations is the poor implementation of regulations relating to land use and commercial space occupation. Both the present system of issuing licenses and the common
flouting of regulations by shops and establishments provide enormous rent seeking opportunities. Public interest litigation relating to the construction and running of businesses in residential areas against the regulations led to the demolition of several shops and establishments in Delhi in 2005. In some cities, from time to time, the poor implementation of the regulations has been accompanied by periodic amnesties that legalize them after the fact, favouring in particular the politically well connected and powerful. For instance, recently the State government of Karnataka attempted to pass an ordinance regularizing 7000,000 illegal constructions within the Bangalore Municipal Corporation area on the eve of an election to the municipal body. The scheme (called the Akrama-Sakrama Scheme) was approved by the State cabinet but in the end did not receive the approval of the Governor on the grounds that the government should pass the legislation and not simply pass an ordinance.

Finally, revenue from parking fees in major metropolitan cities could generate substantial revenues. The main rationales for levying parking fees are to reduce congestion of vehicles on the roads and to generate resources to construct parking spaces. At first glance, these two objectives may seem contradictory since increasing parking spaces in itself might seem more likely to induce rather than reduce road congestion. However, in most metropolitan cities in India, the combination of the poor quality of public transportation system, inadequate provision of parking spaces for vehicles and the present negligible charges for parking either legally or illegally, results in large scale traffic congestion on roads. With sharp increases in household incomes and the emergence of a large middle class, the number of vehicles is going to increase sharply in the coming years. Introducing as part of a more rational
road and urban policy a more comprehensive policy of charging parking fees in accordance with the scarcity value of open spaces in cities should both reduce traffic and at the same time generate revenues to construct multi-storied parking places.  

**Local Taxation**

Reliable and effective local taxation is essential to ensure hard-budget constraints in financing local public goods (Oates, 2005). In particular, it is important that local governments have adequate tax powers to ensure a strong linkage between revenue and expenditure decision at the margin.

On the whole, the fiscal federalism literature suggests that not only should governments (at all levels) bear clear public responsibility at the margin for financing expenditures for which they are politically responsible but that, ideally, local own-source revenues should be sufficient to enable at least the richest local government to finance from its own resources at least those services that they provide which primarily benefit their residents. Indeed, to avoid distorting the allocation of resources, to the extent possible local taxes should burden only local residents, preferably in relation to the benefits they receive from the services provided. For this reason, in general immobile tax bases are best suited at the local level because taxes on mobile bases may result in their migration from higher to lower taxed localities and even result in a “race to the bottom”. However, in many cases, particularly in larger cities, taxing immobile bases alone will not yield the revenues required to provide local public goods and services, some of which benefit mobile factors. Indeed, as Oates (1999, p. 1125) says, "...on efficiency grounds decentralized governments should tax mobile economic units with benefit levies."
Determining an appropriate tax structure for local governments thus requires a careful compromise between fiscal autonomy and tax efficiency.\textsuperscript{16}

A local tax designed to satisfy these requirements should in principle have the following characteristics:\textsuperscript{17}

a) The base should be relatively immobile to allow the local authorities to vary the rates without losing the base.

b) The tax should yield adequate revenues to meet local needs and should be sufficiently buoyant overtime.

c) The tax should be stable and predictable overtime.

d) It should not be possible to export the tax burden to non-residents except to the extent that such burdens capture benefits non-residents obtain from local services.

e) The tax base should be visible to ensure accountability.

f) The taxpayers should perceive the tax to be reasonably fair.

g) The tax should be relatively easy to administer.

The most appropriate tax at the local level is clearly the tax on real properties not only because real property is immobile but also because to a considerable extent differences in service levels are reflected in property values so that the tax on real property is like a benefit tax. In addition, income taxes generate significant revenues for local governments in many OECD countries, and a good case can be made for a supplemental local income tax to supplement property taxes particularly in metropolitan areas in which local governments provide substantial services to people (health, welfare) that are not significantly capitalised into property values; in effect, the local income tax might serve as a kind of (very rough) benefit tax with respect to such services.
The best way to levy an income tax at the local level is to 'piggyback' it on higher level income taxes so that, although some flexibility with respect to the tax rate can be given to local governments, the determination of the base and tax administration will remain at the higher level. A local payroll tax may be easier to administer but it is generally not a good idea since it acts as a tax barrier to employment and may reduce the employment intensity of production. Another tax often used at the local level is some form of sales or consumption tax, including selective taxes on (for example) entertainment services and hotels. Finally, a number of countries have local business taxes that take such forms as corporate income tax, differentially heavy non-residential property tax, transit taxes such as octroi and entry tax, and various forms of gross receipts and crude sales or 'industry and commerce' taxes. Most of these local business taxes involve significant exportation of tax burden to non-residents, are costly to administer, and impose substantial compliance burdens.

In India, municipal bodies can levy and collect only those taxes that are specified by the State governments from the State List in the Seventh Schedule to the constitution. Although the taxing powers assigned are non-uniform across States, on the whole the most important tax bases assigned to municipal governments include (i) taxes on lands and buildings (49), the tax on the entry of goods into a local area for consumption, use or sale which is known as octroi (52), (iii) taxes on luxuries including those on entertainment, amusement, betting and gambling (55), (iv) taxes on advertisements other than advertisements published in newspapers, or broadcast in radio or television (55), (v) taxes on non-motorized vehicles (57), (vi) taxes on animals
and boats, (vii) tolls, and (viii) taxes on professions, trades, callings and employment.\textsuperscript{18}

In actual practice, however, most of these taxes are simply not levied. The most important tax actually levied at the local level is undoubtedly that on land and buildings (real properties). Octroi was an important source of municipal revenue in some States until recently, but as the tax was considered obnoxious, distorting, iniquitous, and a major source of corruption, it is not surprising that all States except Maharashtra have abolished the tax and even in Maharashtra, the tax is levied only in municipal corporations. Some States replaced octroi with entry tax which is not much better in economic terms and is also an impediment to internal trade. In most cases, even when the States replaced octroi by entry tax, they did not compensate municipal governments for the loss of revenue. Generally, when States abolished octroi, they provided no alternative source of revenue and simply increased the size of the unfunded mandates confronting municipal governments. In a few States, however, municipal governments have some access to consumption taxes. In Kerala, for instance, the power to levy entertainment tax is given to the urban local governments. In Andhra Pradesh, local governments receive a fixed share of the revenue from entertainment tax. In a few States, urban local bodies collect some revenue from advertisement tax.\textsuperscript{19}

Although the property tax is the most important source of own revenues of municipal bodies, it suffers from several infirmities as evidenced by the generally poor collections and low buoyancy of this tax. However, initiatives in some municipal corporations in recent years have shown that
revenues from this tax can be substantially increased with proper reform of the tax system. Bruhat Bangalore Mihanagara Palike (Greater Bangalore Municipal Corporation), for example, reformed its property tax by revising the area-based values, introducing a self-assessment system and improving the technology of the payments system with the result that revenue increased from Rs. 4,400 million in 2007-08 to Rs. 7,800 million in 2008-09 and is expected to further increase to Rs. 10,000 million in 2009-10.

The starting point for property tax reform in India was the introduction of area-based assessment to determine the tax base by the Patna Municipal Corporation in 1992-93. Previously, the tax was collected on the basis of the annual rental value, defined as gross annual value rent at which the property may ‘reasonably’ be expected to be rented out. This system gave enormous discretion to the tax collectors and yielded little in tax revenue. The prescription of unit values (per square foot) based on the area of location and type of construction of the property instead of the annual rental value removed most of the discretion from the tax collectors and resulted in such a large increase in base that the tax rate was reduced from 44 per cent to 9 per cent. Subsequently, municipal corporations in a number of States adopted the Patna model. In Bangalore, for example, properties are classified into different zones based on the guidance values set by the Department of Stamps and Registration. For each zone, rental value per square foot was determined on the basis of type and quality of construction and age of the buildings. A handbook was brought out detailing the above so that each individual property owner would compute his tax liability simply by plugging in the location, type of construction and sq. feet area of his property, and then pay the tax online.
Similar reforms in other urban local bodies might also double their revenues from property tax.

A major weakness of this system, however, is the need to revise the unit values periodically in keeping with changes in prices. In the absence of periodic revision, revenues will not respond to changes in the values of properties, and the buoyancy of the tax will depend only upon the addition of new properties. As a rule, it is politically difficult to change the values periodically. One way to overcome this problem might be to link the guided values automatically to the index of property values in various cities determined by the National Housing Bank. This system could be expanded if States would initiate the estimation of price changes on real property in every urban local body based on the methodology adopted by the National Housing Bank and then link the guided values automatically to the price index to estimate the tax liability.20

Some important lessons from the Bangalore experiment in the reform of property tax must be noted. First, the system should be simple and transparent enough to be easily understood by the general public. Second, there should be clarity in the reform process with thorough public discussion and debate when the reform is adopted. It is important for the tax department to provide prompt and clear answers to queries by the general public in newspapers, videos, and audio channels. It is also important to facilitate online payment of the tax so that the taxpayer does not have to be in contact with the tax collector. Computation of the property tax liability based on the guided values and online payment of the tax obviates the need for taxpayers
to go to the tax department and face harassment simply in order to pay the tax.

The Administrative Reforms Commission has noted that only about 60-70 per cent of the properties in urban areas are actually assessed. A large number of property owners seem to be simply not paying the tax although they benefit from the local public services. The Commission recommended the matching of the properties paying the tax with those in the Geographical Information System (GIS) to identify those that are not paying the tax. In fact, BBMP has undertaken this exercise for all properties within its 800 sq kilometer area. By matching the actual properties paying the tax, excluding government buildings and slums, it is possible to identify the properties evading the tax. The Bangalore reform experiment is worth emulating in other municipal corporations and municipalities.

One reason for widespread evasion is because much new construction as well as additions to existing buildings has been done without getting proper approval. Some have expressed the fear that allowing such properties to pay the tax could mean giving them legal recognition. It is important to keep these two issues separate. It is also important to examine the nature of violations. In general, if violations are not major, property owners should be allowed to pay the penalty and regularize them. On the other hand, in cases where the violations are major, the structures should be demolished.

Apart from the property tax, which is potentially a good source of local revenues but definitely needs to be reformed substantially, larger cities in particular are likely to need some additional broad-based tax source, such as a supplemental rate 'piggybacked' on a national or State tax and administered
with that tax, but with the proceeds going to the local government. Any such local rates should be set within predetermined limits. A ceiling is needed to prevent localities from ‘exporting’ tax burdens (in excess of benefits received) to non-residents and a floor to prevent richer areas from ‘stealing’ tax base from poorer areas.21

In India, at present the centre can levy income tax only on non-agricultural incomes. The power to levy the tax on agricultural income is vested with the States and the latter have not levied the tax except on income from the plantation sector. Ideally, this distinction between sources of income should be done away with to have comprehensive income as the tax base while making adequate provision for insuring fluctuations in agricultural incomes and allowing carry over losses. If and when such a tax exists, and is operating relatively well on a comprehensive income base determined by the Centre, presumably both State and even some larger local governments might be allowed to piggyback their rates subject to a ceiling rate. Such a system would reduce the scope for evasion and avoidance of income tax, provide a stable source of revenue to both State and local governments and in particular provide large business and manufacturing centres like Mumbai with funds to maintain and upgrade their infrastructure to sustain their key role in India’s national economic dynamism. However, before such measures can be considered many changes would have to take place not only at the constitutional level but also, equally importantly, in terms of political willingness to tax adequately and properly at all levels of government. Finally, major efforts would also be required to ensure that the central income tax
system was functioning properly before it was further complicated by adding on such sub-national components.\textsuperscript{22}

Of more immediate interest is the possibility that a surcharge on the consumption tax might perhaps be an important additional source of revenue for the municipal governments. The consensus is that there will be a dual GST - one at the Centre and another at the State level. By and large there will be uniformity in the tax base and rates. As the economy is gearing up to move over to the goods and services tax (GST) at both Central and State levels, it would in principle be feasible to levy a small surcharge on the State GST. In fact, even in the prevailing State VAT, Gujarat decided to impose an additional one percentage point levy on the sales tax and earmark the levy for compensating the municipal corporations for the loss of revenue by abolishing octroi. As the present consumption tax system is replaced by the GST regime, the possibility of providing some additional revenue to local governments by (as in Japan, for example) levying an additional percentage point for this purpose at either the central level or perhaps as each state decides at the State level, and then distributing the revenues to localities by formula might perhaps be considered. Conceivably, some States may perhaps even want to consider allowing at least the large metropolitan areas to ‘piggyback’ an additional rate of their own on the State tax base but this is unlikely to be a good idea given the complexities involved in making such a system work.\textsuperscript{5} Firm estimates of GST base are not available but a conservative estimate made at NIPFP for 2007-08 put the GST base at Rs. 16,000 billion after adjusting for the prevailing exemptions.\textsuperscript{23} A one per cent levy on this base would yield Rs. 160 billion for municipal governments which is about 0.34 per
cent of GDP. Since even the most optimistic estimate of revenue from property tax is just about 0.2 per cent of GDP, a one per cent levy on the GST could yield virtually double the amount collected from property tax. This possible important source of revenue deserves to be considered seriously in the immediate future.

As a final note on local taxes, it is particularly important that States cease the pernicious practice of abolishing local taxes without providing adequate substitute sources of revenue to municipalities. For example, the Gujarat government abolished octroi to fulfill its election promise without any mechanism to compensate the municipal corporations, although later they decided to levy a one percentage point additional rate on the sales tax. Rajasthan and Haryana simply abolished the property tax without even consulting the urban local governments. Punjab put the threshold for the property tax so high that almost two-thirds of the properties are exempted. Since property tax is the only important tax for municipal governments, when a State government abolishes or severely restricts this tax, it is deliberately disempowering its municipalities.

**Financing Urban Services: Intergovernmental Transfers**

In principle, municipal governments should raise revenues to finance local public services from their residents. In reality, however, not only is the assignment of revenue powers generally inadequate but in many cases municipalities do not have tax bases large enough to generate the required revenues. Transfers from higher levels of government either by way of tax devolution or grants are therefore found in every country, as are specific
purpose transfers intended to ensure minimum standards of services for those with significant benefit spillovers.

(i) General Grants

In the Indian context, under Article 243 (1) of the constitution, the State governments are required to appoint a State Finance Commission (SFC) every five years to determine:

- the distribution between the State government and the municipalities of the net proceeds of the taxes, duties, tolls, and fees that can be levied by the State which may be divided between them, and the allocation of such proceeds between the municipalities at all levels;
- the determination of the taxes, duties, tolls and fees which may be assigned to, or appropriated by the municipalities;
- the grants-in-aid to the municipalities from the consolidated fund of the state;
- the measures needed to improve the financial position of the municipalities; and
- any other matter referred to the SFC by the Governor in the interest of sound finance of municipalities.

After the 74th Amendment to the constitution, the terms of reference to the Central Finance Commissions (CFC) were amended under Article 280 (3) (cc) to include an additional clause to make recommendations on the “measures needed to augment the Consolidated Fund of the 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.” In fact, however, the CFCs could not make recommendations on the reports of the
SFCs in part because there was no coordination of the timing of the submission of the reports of the SFCs with the result that their reports were simply not available to the CFCs. In any case, many SFC reports were simply unusable, either because they were not accepted for implementation by the States or because the methodology employed was not only not uniform but also left much to be desired.

The Twelfth Finance Commission at the Centre reviewed the progress in setting up SFCs as well as their recommendations and concluded that (i) several States did not appoint the SFCs on a regular basis; (ii) in many States the recommendations of the SFC were simply not followed up; and (iii) even when they were accepted by the governments, they were not fully implemented in either letter or spirit and the annual budgetary allocations were often well short of the recommendations. In many cases, the SFCs appointed did not have the expertise to undertake the technical exercises required to estimate the requirements of the municipalities. Furthermore, in most states, the information and data required to undertake technical exercises either do not exist or the SFCs do not have the time or capacity to collect the information required to undertake the task. Not surprisingly, the transfer system to municipalities suffers from several shortcomings in most states and is ad hoc, inadequate, opaque, and often discretionary. The objective of providing an objective and scientific basis for such transfers by appointing SFCs has definitely not been achieved.25

Since the CFCs are unable to take account of the recommendations of the SFCs, they simply set some token amount for municipal grants in their recommendations. For instance, the Eleventh Finance Commission
recommended a grant of Rs. 20 billion for the five years, 2000-05 and the Twelfth Finance Commission recommended Rs. 50 billion grants to urban local bodies for the period, 2005-10.

The upshot is that the block transfers given to urban local governments from both the Centre and States are wholly inadequate and bear no relationship to their expenditure needs. The constitution provides for the appointment of State Finance Commissions to determine the requirements of urban local bodies. However, State governments do not take this task seriously when it comes to appointing the Commission or considering their recommendations. SFCs are ill equipped to undertake the difficult task of assessing the revenue potential and expenditure needs of the municipal governments. Not only that most of them do not have the professional capacity to undertake the task, but the information and data required for the purpose are not collected regularly or reliably. The result is that the grants given are not only grossly inadequate but also are ad hoc and usually based on past trends. After transfers, as before, urban local bodies are left with large unfunded mandates and woefully inadequate public services.26

(ii) Specific Purpose Grants

Most specific purpose grants are given by central government ministries for various central sector and centrally sponsored schemes. The major specific purpose transfer for urban local bodies is under the Jawaharlal Nehru Urban Renewal Mission (JnNURM) in which grants are given to upgrade the urban infrastructure on the condition that the States and the municipalities will undertake reforms. As mentioned earlier, this ambitious programme is designed to augment urban infrastructure and services and is
linked to a reform agenda that includes doing away with urban land ceiling act and rent control act as well as reforms in property tax etc. The Government of India proposes to spend about Rs. 500 billion during 2006-12 with matching contributions from cities/States. In Track I, under JnNURM, assistance to augment urban infrastructure will be given for 63 identified cities to enable planned development of the cities, ensure integrated development of urban infrastructure and ensure provision of urban services to the poor. Under Track II, assistance under Urban Infrastructure Development Schemes for Small and Medium Towns (UIDSSMT) and Integrated Housing and Slum Development Programmes (IHSDP) will be extended to other cities.

The admissible components for assistance under JnNURM include urban renewal, sewerage and water supply, solid waste management, storm water drainage, urban transport, parking spaces on PPP basis, development of heritage areas, prevention and rehabilitation of soil erosion, and preservation of water bodies. As mentioned earlier, the grants under the scheme are linked to reforms both at the State and at municipal level. Municipal level reforms include introduction of an accrual based accounting system, reform of the property tax by using GIS information, levying user charges to recover 100 per cent of operation and maintenance charges, provision of basic services to urban poor, and internal earmarking of budgets for this purpose. State level reforms under JnNURM include enactment of public disclosure law, full implementation of the provisions of 74th Constitutional Amendment including the setting up of District Planning Committees (DPC) and Metropolitan Planning Committees (MPC), enactment of community participation law, associating elected representatives with the
function of city planning, repeal of urban land ceiling act and reform of rent control act, and rationalisation of stamp duty to bring it down to no more than 5 per cent within the next five years. In addition, there are optional reforms relating to revision of bye-laws, simplification of legal and procedural frameworks for conversion of agricultural land for non-agricultural purposes, earmarking 20-25 per cent of developed land for economically weaker sections (EWS) of the population, introduction of computerised process of registration of real properties, making water harvesting mandatory in all buildings, and bye-laws to introduce re-cycling of water, encouraging public-private partnerships, and sundry structural and administrative reforms.27

JnNURM is clearly a comprehensive specific purpose scheme for urban renewal and infrastructure support. Indeed, it is if anything too comprehensive and might perhaps have been more effectively focused on a shorter and more easily attainable list of objectives. In any case, not that much has yet happened since states have so far been reluctant to undertake reforms and avail the assistance. In the first year (2005-06) of operation, the revised estimate of grants was just about 15.6 per cent of the budget estimate. In the second year, although the estimate increased to 78 per cent of budget, the total amount disbursed was less than Rs. 36 billion. Since 2008-09, however, actual disbursements have increased sharply. Unfortunately, this increase in part reflects some dilution of reform content and in part the fact that the funds were liberally used to purchase buses in municipal corporation areas as a part of the fiscal stimulus to the commercial vehicles sector. Putting more buses on already overcrowded urban streets is perhaps more likely to increase than to reduce congestion and other ongoing
urban management problems. More fundamentally, the reluctance of States to undertake the pro-market reforms called for by JnNURM is a matter for concern.\(^28\)

**Financing Urban Infrastructure**

If India’s cities are to be centres of dynamism in the country, considerable investment in augmenting urban infrastructure and services is unavoidable. As mentioned above, reforms in user charges, property tax, and the transfer system as well as perhaps additional funding through a ‘local’ surcharge on the GST can do much to bring about significant improvement in the resources required for basic urban public services and maintenance expenditures. However, substantial improvements in urban infrastructure will require resources well beyond the capacity of even the best run urban local bodies to generate. International experience shows that major capital works in urban areas are often financed at least in part from central funds, and this seems right when some of the benefits from such works may be felt nationally, as well as locally. The major effects of urban infrastructure projects, however, are clearly felt locally and the major benefits are reaped, usually through capitalisation in local property values, by local residents (including local businesses as well as households). It thus seems only right that much of the cost should also be substantially borne by local residents.

Four ways to finance major capital expenditures are discussed briefly below: local borrowing; levying developmental charges in the residents; selling land and other assets; and public-private partnerships.
(i) Borrowing

When the benefits from infrastructure projects are enjoyed over a period of time, it may be both fair and efficient to finance such projects in part or whole by borrowing. Moreover, borrowing may be the only practical way to finance large capital projects without large and undesirable fluctuations in local tax rates from year to year. However, municipalities in India can contract loans only if they are permitted to do so by the State government. In most cases, the State governments have to guarantee local borrowings, in which case the loan becomes the liability of the State and is included in the overall ceiling under the respective fiscal responsibility legislations. States are reluctant to guarantee municipal bonds because their fiscal responsibility legislation requires them to limit their committed liabilities to half a per cent of Gross State Domestic Product (GSDP) and their fiscal deficit at 3 per cent of GSDP. Municipal corporations must thus issue bonds on the strength of their own credit rating rather than based on State government guarantees.

The State governments permit urban local governments to borrow under their respective municipal laws, which lay down the framework for borrowing: the projects for which the borrowing is allowed, the volume of borrowing and the security to be pledged, the procedure for applying to the State for the permission to borrow, and the manner in which accounts must be kept. If local bodies borrow without State government guarantees, generally they must place some revenue stream in escrow in order to guarantee the service of the debt. In most cases, State governments only allow municipal corporations to borrow from the market-based on the value of their real property tax base. Most States have issued guidelines for local borrowing
such as that borrowing should be for less than 30 years, that the interest rate should not exceed interest rate on government securities and that there should be sufficient provisioning for debt servicing.

The practice of municipal corporations accessing funds from the capital market is relatively recent. By and large, most borrowing by municipal corporations has been from public institutions such as Housing and Urban Development Corporation (HUDCO) or Life Insurance Corporation (LIC) for housing and water supply schemes. After the Credit Rating Information Services Ltd (CRISIL) began credit rating municipal corporations in 1996, the groundwork necessary for the municipal bond market was established. Ahmedabad Municipal Corporation was the first municipal entity to issue Rs. 1 billion bond with the credit rating of A+. Subsequently, other credit rating agencies also have joined the business of rating municipal corporations and a number of municipal corporations have issued bonds, particularly after the Ministry of Urban Development issued guidelines for tax-free municipal bonds. The critical requirement for issuance of such bonds is that the municipal corporation issuing the bonds is required to maintain a debt-service coverage ratio of at least 1.25 throughout the period.  

Despite these developments, not much has happened in the municipal bond market in India. The volume of bonds issued has been very small, and the trading in bonds very thin. In total, only nine municipal corporations have so far issued bonds amounting to Rs. 6.2 billion, in part because few can fulfil the over-collaterisation condition mentioned above. Although so far the amount of resources raised for investment from the bond market by the municipal corporations is small, with the exception of the bonds issued by
Bangalore Municipal Corporation and Indore Municipal Corporation, all others were issued on their own strength and not based on State government guarantee. So long as there is no state bailout, as time goes on the demonstration effect may lead to still more municipal recourse to borrowing for capital finance. Furthermore, another impetus for widening and deepening the bond market is that under the JnNURM the Centre and States will together provide 50 per cent of the resources required for investment in urban infrastructure as grants, provided the other 50 per cent is generated or borrowed by the municipal corporation.\textsuperscript{31}

(ii) Development Charges

One way to finance basic urban infrastructure, particularly in new areas being developed within the areas covered by municipal bodies, is to levy development charges based on the land area being developed. This is a one-time levy imposed on property developers (including development authorities) to finance growth-related capital costs relating to the area where the development takes place. The objective is to finance the infrastructure associated with the new development project by taxing those who are presumed to benefit directly in the form of increased property values as a result of the new infrastructure. Generally, the developers recover the amount by charging the property owners based on the land area owned by them in the new development project. Who ultimately bears the cost of course depends on the demand and supply conditions for land and housing in the area. On the whole, however, in view of the relative scarcity of land and the strong demand for land and houses in urban areas, in most cases presumably development charges are ultimately borne by the buyers. When well-designed and
implemented, development charges in effect amount to a form of marginal cost pricing of urban infrastructure and may thus encourage more orderly and efficient development of urban agglomerations.

As mentioned, development charges are feasible in newly developed areas within urban agglomerations. However, in places where parallel development authorities have been set up to create housing infrastructure, the charges are collected by them and not by the municipal bodies. Unfortunately from the perspective of sensible urban finance and planning, such authorities are directly responsible to the respective State governments and not to the municipal body concerned. Dividing up capital and operational functions and finances in this way may make it more difficult to develop coherent urban policies.

(iii) Proceeds from Sale of Land and Buildings

In all urban areas, given the high growth of urban population, land for housing and for commercial purposes is scarce. In many urban agglomerations, as just mentioned, development authorities have been set up to acquire land and to develop it either for sale or to directly build affordable houses for the poor and middle income groups. They acquire land from private owners, mostly agricultural lands in the surrounding areas, put the basic infrastructure in place, and sell them for housing or commercial building purposes. Generally, they generate considerable surpluses which could be used to improve infrastructure and services in municipal areas.

Despite what was just said about the scarcity of land for housing and commercial purposes in most cities, in fact there is often considerable such land potentially available in urban areas, much of which is owned by public
sector agencies such as railways and defence as well as by municipal bodies themselves. An essential first step is to make a complete inventory of land available for development and sale in municipal areas. Once this is done, it may be possible in many cases to develop such lands, sell them, and use the proceeds to finance urban infrastructure. In the case of the defence sector, for example, when cantonments were initially created they were outside cities. However, as cities expanded over the years, they have come within the urban agglomeration. Cantonments run their own systems of service delivery including schools and hospitals and can certainly be located outside the city limits, reducing the risk to the safety of civilians at the same time. The central government, with co-operation from the State governments, should take action to relocate such establishments, with the State government or the municipal corporation paying for the cost of land acquisition and redevelopment. The relocation of defence establishments could release large chunks of land and thus help reduce skyrocketing real estate prices. The proceeds from the sale of these properties can be used for the redevelopment of defence establishments outside the city, and the surplus revenue after meeting the redevelopment cost may be earmarked for augmenting urban infrastructure and services.33

Much the same could be done with vacant land belonging to other agencies which could also, after proper development, be disposed of, and the proceeds shared between the municipal body and other owners. When the development of infrastructure by the municipal body increases the capital value of such land, any gains realized through sale should be shared with the municipal body that has increased the urban infrastructure and services in the
area. Of course, all these issues are contentious, and consensus on them will not be easy to achieve. Nonetheless, if Centre and State governments can cooperate in doing so, it should certainly be possible to work out a formula for sharing the proceeds from the sale of land.

In some instances, the development authority has ended up acting as a monopoly agency, thus restricting the supply of housing in cities and defeating its original purpose.

(iv) Public-Private Partnerships

Getting different components of the public sector to cooperate is sometimes so difficult that many may think a better approach might be to deal with the private sector. Indeed, public-private partnerships (PPPs) may have significant potential for financing and delivery of urban services. For example, the private sector may be asked to contribute funds for specified services in return for certain rights or future incomes. There are many services such as water supply sewerage, solid waste management, recreational facilities, rain water harvesting, and urban transportation where public-private partnerships are eminently feasible, in principle.

Indeed, PPPs have a number of potential advantages in delivering urban public services. First, the urban local government does not have to spend the money upfront. Second, contracting out services may result in greater efficiency as better service delivery. Empirical studies show that contracting out generally results in lowering of unit costs of services. In India, Chennai was the first city to embark on the initiative to contract out municipal solid waste management services to a foreign private agency ONYX, a Singapore based company. The scope of privatization includes activities such
as sweeping, collection, storing, transporting of municipal solid waste and creating public awareness in three municipal zones. ONYX collects about 1100 metric tons of waste from three zones per day and transports it to open dumps. This experiment holds a lot of promise for other municipal corporations and municipalities as well. A number of other municipalities have contracted out waste disposal and solid waste management to the private sector including the NGOs.

Another example of successful PPP is in the provision of water supply in Hubli-Dharwar, Belgaum and Gulbarga cities of Karnataka State. Residents of these cities used to get water supply for only one or two hours a day. However, the PPP arrangement, undertaken on a pilot basis to cover about 2 lakh residents in the three cities, enabled them to enjoy the benefits of 24X7 water supply with a state of the art water distribution system and at little additional cost. The private partner in this case is a French water company ‘Veolia Water’ which was entrusted with the task of providing 100 per cent metered customer connections. The responsibility for providing adequate supply of bulk water was entrusted to the Karnataka Urban Water Supply and Drainage Board (KUWSDB). Considering the enormous success of this pilot, Karnataka government has approved upscaling of the project to the entire population in the three cities.34

Mixed public-private financing of urban infrastructure definitely deserves to be further explored in the Indian context. At the same time, care must be taken to ensure that certain conditions are satisfied if this approach is to produce beneficial results. This approach is most likely to prove successful when projects are carefully designed and implemented, and when the
responsible public agencies are technically and financially able to hold up their end of the deal. Weak governments cannot rely on private agents to overcome their weaknesses and expect to make the best possible bargains for the public, they represent. Governments must also be careful that they do not end up assuming the ‘downside’ risk of projects, while allowing their private partners to reap any ‘upside’ gains. Similarly, care must be exerted to ensure that what occurs is not simply the replacement of public sector borrowing by (often more expensive) private sector borrowing. Privatising the design, construction, and operation of urban infrastructure may have many merits if done properly, but it is neither a panacea, nor free.

**Municipal Bonds**

Apart from the traditional revenue sources of ULBs discussed in the last two sections, one of the modern sources of financing infrastructure projects is through the capital markets. The concept of municipal bonds is in its nascent stage in India, compared to other advanced countries where this is an important source of financing urban infrastructure. An instance is the USA, where the municipal securities market plays a vital role in infrastructure development. Aguilar (2015) mentions, the total amount of municipal bonds outstanding was $3.6 trillion, as of the end of the third quarter of 2014. As per the U.S.\(^{35}\) Securities and Exchange Commission (2012), the municipal securities market is a diverse market, with a total face amount of $3.7 trillion (as of December 31, 2011). Also, within the total aggregate principal amount of over $3.7 trillion, different municipal bonds outstanding were more than one million. The USAID (2004) states that, the prevalence of revenue bonds in the US, increased to over 70 percent in the past twenty years. This USAID
document also mentioned, “the revenue bond structure in the US is backed by strong and credible covenants related to the revision of user charges, debt service coverage ratio and additional debt mobilization”. In India, 28 municipal bond issues have been made since 1997, mobilizing funds amounting to approximately Rs. 30 billion.

According to Financial Institutions Reform and Expansion - Debt Market (FIRE-D) Project (USAID, 2004), municipal bonds are of two general types - General obligation (GO) bonds which carry full faith and credit of the issuing authority, and are appropriate for general services like, roads or street lighting wherein it’s difficult to levy user charges. And revenue bonds, which are tied to specified sources of revenue from the facilities or services which they finance.

In India, bond releases by the ULBs cannot be classified as either revenue bonds or as general obligation bonds. Instead, these are referred as structured debt obligations with a distinguishing feature that they are issued conditional on the borrower pledging or ‘escrowing’ certain sources of revenue for the debt servicing.

Though the municipal bond markets are yet to get predominance in India, there appears to be some consensus that municipal bonds could prove as a promising alternative. The system of municipal bonds was extensively discussed at a national workshop on the potential and relevance of a municipal bond system for India, conducted in 1995. In 1996, Rakesh Mohan Committee on Commercialization of Infrastructure Projects, recommended development of the municipal bond market in the country.
A noteworthy step in the history of municipal bonds in India was by the Ahmedabad Municipal Corporation, in 1998. Ahmedabad Municipal Corporation made the first municipal bond issue in India, without a state government guarantee. This involved raising Rs. 100 crore from the capital market and comprised 25 per cent public placement and 75 per cent private placement. Prior to this, in 1997, the Bangalore Municipal Corporation had issued bonds guaranteed by the State government.38

According to USAID (2004), in India, urban sector suffers from a number of constraints, including low tax base, lack of credible credit history, and low cost recovery, especially for water and sewerage, and market rigor. And that the investors are unlikely to accept even the GO structure of bonds, bearing in mind the lack of a track record and market image of municipal bodies. Further, the USAID (2004) mentions that, the FIRE-D Project, in association with CRISIL and IL&FS, worked to introduce Structured Debt Obligations (SDO) for municipal authorities. SDO helps to raise the credit quality of the proposed instrument by earmarking reliable and predictable streams of revenue from specific revenue sources of the municipal body. These cash flows, which are used for debt servicing, are monitored by an independent trustee.39

**Tax free municipal bonds**

The Government of India added a new clause in 2000-01, to the Income Tax Act, exempting interest income from bonds issued by the local authorities. Herein, the funds raised by way of such tax free municipal bonds are to be used only for capital investments in urban infrastructure to provide one or more of: potable water supply; sewerage or sanitation; drainage; solid
waste management; roads, bridges and flyovers; and urban transport (if this is a municipal function under respective state legislation).

**Trend in Bond Issuances**

As per the report of the Sub-Committee on financing urban infrastructure in the 12th plan, around Rs. 4,450 million have been mobilised by India’s city governments, from the domestic capital market via taxable municipal bonds. Table 3 provides details about borrowings through bonds in the primary markets. Tenor of the bonds ranges between 5 years and 15 years. As can be noted, data is scanty but the trend is clear that bond issuances are not very popular in India. 40

Referring to the trend in the value of municipal bond issues since 1997, Khan (2013) mentions that till 2005, the value of municipal bond issuances was on a rise, but it dropped sharply since then. Khan further mentions that since 2007, 41 very few issuances have taken place, and after 2010 practically no issuance has happened. As per SEBI (2014), the last municipal bond issue in India was in 2010 by the Greater Vishakhapatnam Municipal Corporation for Rs. 30 crore. Chakrabarti (2014) points out that the municipal bond market in India has difficulties due to reluctant investors, unclear regulation and low ratings. 42

A sound credit rating of the local body contributes to the confidence of the potential investors. The systems and processes of the organisation play a determining role, in the rating process. Also, lack of availability of orderly information about the ULBs could delay processes of determining and assigning rating by the rating agencies, which could in turn affect the ULBs approach to capital markets. According to CARE Ratings (2012), feasibility of a project (for which fund is being raised) is the key factor in a credit rating
besides other parameters and factors like financial, economic, administrative and legal.

**Five Year Plans and Urban Bodies Finances**

The Government of India as per the Constitution has been making allocations to local bodies through five year plans and finance commissions. This section provides a brief overview of such allocations.

**Five Year Plans (FYPs) and Local Bodies**

Five-Year Plans in India are centralized national economic agendas for a span of five years. The first FYP was introduced in 1951. First Five Year Plan made a lump-sum provision of Rs. 15 crore for local development works, so as to draw local initiative and resources. This was done with an expectation that the municipalities, district and taluka boards and other local bodies would prepare schemes, for which financial assistance would be allocated from this lump-sum provision. Some of the plans and attempts in the FYPs, concerning local bodies are listed in Table 3.2.
Table 3.2  
Select Measures for Local Bodies in India

<table>
<thead>
<tr>
<th>FYP</th>
<th>Year</th>
<th>Proposed Allocations or Recommendations for Local Bodies</th>
</tr>
</thead>
<tbody>
<tr>
<td>First</td>
<td>1951-56</td>
<td>Rs. 15 crore: Lump-sum provision for local development works</td>
</tr>
<tr>
<td>Second</td>
<td>1956-61</td>
<td>Clear distribution of functions, responsibilities and jurisdictions, Recognized that Local Bodies had inadequate finances</td>
</tr>
<tr>
<td>Third</td>
<td>1961-66</td>
<td>Financial assistance for housing for low income groups, improvements in habitable areas, improvements in structure and organization of financial resources for local bodies</td>
</tr>
<tr>
<td>Fourth</td>
<td>1969-74</td>
<td>Rs. 45 crore planned to be raised by local bodies for urban planning and development</td>
</tr>
<tr>
<td>Fifth</td>
<td>1974-79</td>
<td>Rs. 10.27 crore allocated to local bodies for improving urban sanitation and water supply; Market Borrowings of INR 3030 crore was also encouraged</td>
</tr>
<tr>
<td>Sixth</td>
<td>1980-85</td>
<td>Managerial efficiency of local bodies; financial assistance to local bodies; tax incentives; Rs. 1.60 crore allotted for policy formulation and research on urban development, to financially strengthen local bodies</td>
</tr>
<tr>
<td>Seventh</td>
<td>1985-90</td>
<td>Horizontal coordination at local governance level; Taxes recognized as main source of own revenues; recognition of physical and financial targets</td>
</tr>
<tr>
<td>Eighth</td>
<td>1992-97</td>
<td>73rd and 74th Amendments were passed; Decentralization; Recognized that Local Bodies needed regulatory as well as financial legislation and resources</td>
</tr>
<tr>
<td>Ninth</td>
<td>1997-02</td>
<td>Increase tax revenues; Autonomy and Power to Local Bodies; Financial Planning at Local level integrated with reports of State Finance Commissions; Concept of cooperative federalism</td>
</tr>
<tr>
<td>Tenth</td>
<td>2002-07</td>
<td>Centre to State transfers were recognized as main sources of finance; gap in managerial skills and expertise in Municipalities; Transparency of systems, levying of user charges, increasing non-tax revenues and cost control; improving credibility of municipalities to attract institutional finance and debt funding</td>
</tr>
<tr>
<td>Eleventh</td>
<td>2007-12</td>
<td>Municipalities sought to be made financially sustainable through Municipal Finance Improvement Program; recognized that there was a gap between revenues and financial requirements of Rs. 76,896 crore; Recognized that revenues of local bodies must be improved in terms of revenues from land, revenues from civic facilities like parking, hoarding fees, and the like (pooled financing), and from capital and secondary markets, municipal development funds and municipal bonds</td>
</tr>
<tr>
<td>Twelfth</td>
<td>2012-17</td>
<td>Proposal to set up an urban regulator at State level; Increase implementation of information technology at ULB Level</td>
</tr>
</tbody>
</table>

Source: Government of India, Various Reports

**The Role of Finance Commissions in Strengthening ULB Finance**

In acknowledgement of the need to periodically review the balance of functions and finances between the States and ULBs a provision has been made in the Constitution for the establishment of State Finance Commissions
(SFCs) every five years (Article 243-I as per the 73rd Amendment). The State Finance Commissions are expected to review the financial position of ULBs and to make recommendations regarding the “principles” of devolution of resources from the State Government to ULBs and the “measures” needed to improve their finances and functioning.

Further, the Amendment of Article 280 of the Constitution of India requires the Central Finance Commission to suggest measures needed to augment the consolidated fund of the states to supplement the resources of municipalities on the basis of the recommendations of the State Finance Commissions.

The X Finance Commission recommended a grant of Rs. 1,000 crore was recommended for municipalities. The FC-XI recommended a grant of Rs. 2,000 crore for municipalities. The FC-XII allocated a grant of Rs. 5,000 for municipalities. The FC-XIII recommended a percentage of the divisible pool for local bodies, estimated at Rs. 87,519 crore for the entire award period, after converting it into grant-in-aid under Article 275 of the constitution of this, the grant to municipalities was Rs. 23,111 crore.43

**Basis of Horizontal Distribution**

The X Finance Commission distributed its award exclusively on the basis of population (based on the 1971 Census). The FC-XI assigned a weight of 40 per cent to population (1991 Census), 10 per cent to area and 20 per cent to distance from highest per capita income. The FC-XII retained the weights used by FC-XI for each of these three criteria, but used the 2001 population data for distribution. The FC-XIII increased the weight attached to population to 50 per cent and retained the weight assigned to area at 10 per
cent. While they retained the weight assigned to distance from the highest per capita income at 20 per cent for urban local bodies. Apart from these three common criteria, others like index of decentralisation, revenue effort, index of deprivation, index of devolution and Finance Commission grant utilisation index have been used by different Finance Commissions. In the distribution of grants, factors such as population, area and deprivation related indices take into account the resource needs of the States. Other criteria such as index of decentralisation, index of devolution, revenue mobilisation linked the quantum of grants to the efforts of States to decentralise or to empower the local bodies.

The XII Finance Commission stipulated that in towns with a population of over 100,000, 50 per cent of the grant was to be earmarked for solid waste management schemes in public-private-partnership (PPP) mode. The urban and rural local bodies were also expected to give high priority to expenditure for the creation of database on local body finances and maintenance of accounts through the use of modern technology and management systems.44

The XIII Finance Commission provided grants for rural and urban local bodies in two parts - a general basic grant and a general performance grant. However, the FC-XIII set nine conditions in the case of urban local bodies. All these conditions had to be met in each of the award years.

The study on Municipal Finances and Service Delivery by ASCI highlighted the fact that governing cities is becoming a challenge because of inadequate finances, weak institutional framework and lack of capacity for service delivery. It suggested that a separate municipal revenue list should be inserted in the Constitution to assign assured and sustainable sources of
income to urban local bodies. The suggested sources include property tax, vacant land tax, service charge on State and Union properties, trade licensing and building permission fee. The study expressed the view that urban local bodies should tap all resources allowed to them under the statutes to bridge the gap in finances and that they should prioritise property tax reforms in order to improve finances. It added that they needed to review their service charges and periodically revise them in line with service improvements to meet the escalating costs. The study also proposed that State Governments should remove restrictions on borrowings by urban local bodies.

**Fourteenth Finance Commission**

The Fourteenth Finance Commission recognised that one of the major difficulties local bodies need to deal with is insufficiency of finances. The Fourteenth Finance Commission (FFC) commissioned a study on finances of municipalities through the Administrative Staff College of India (ASCI). The FFC report mentions, that the ASCI study emphasized that governing cities is becoming a challenge due to issues of insufficient finances, weak institutional framework and lack of capacity for service delivery.

**Performance grant - urban**

As in the case of the performance grant for gram panchayats, a detailed procedure for the disbursal of the performance grant to urban local bodies would have to be designed by the State Government concerned, subject to certain eligibility criteria. To be eligible, the urban local body will have to submit audited annual accounts that relate to a year not earlier than two years preceding the year in which it seeks to claim the performance grant. It will also have to show an increase in own revenues over the preceding year,
as reflected in these audited accounts. In addition, it must publish the service level benchmarks relating to basic urban services each year for the period of the award and make it publically available. The service level benchmarks of the Ministry of Urban Development may be used for this purpose. The improvement in revenues will be determined on the basis of these audited accounts and on no other basis. For computing the increase in own revenues in a particular year, the proceeds from octroi and entry tax must be excluded. In case some amount of the performance grant remains after disbursement to the eligible urban local bodies, the undisbursed amount should be distributed on an equitable basis among all the eligible urban local bodies that had fulfilled the conditions for getting the performance grant.  

These guidelines for the disbursement of the rural and urban performance grants will remain in force for the period of our award. We recommend that the Union Government accept the detailed procedure prepared by the State which incorporates our broad guidelines without imposing any further conditions.

The study on municipal finances commissioned by XIV Finance Commission showed that the revenues from property tax of 478 sampled municipalities had risen from Rs. 5,555 crore in 2007-08 to Rs. 10,192 crore in 2012-13. The study indicates that the per capita revenue from property tax varied from Rs.42 to Rs.1,677 across States. These performance grants will be disbursed from the second year of our award period, that is, 2016-17 onwards, so as to enable sufficient time to State Governments and the local bodies to put in place a scheme and mechanism for implementation.
The study on municipal finances pointed out that the urban local bodies are reporting an increase in user charges collected. However, the study suggested that the user charges need rationalisation and also need to be linked with improvement in service levels. We noted that the SFCs have observed that there was a need in urban areas to rationalise and collect charges for basic services provided and that the charges should be so fixed such that the local body is able to recover at least the operation and maintenance cost of the services from the beneficiaries. The study on municipal finances points out that only ten States reported borrowings by urban local bodies. Of the Rs. 920 crore borrowed by them in 2012-13, Rs. 854 crore was borrowed by municipal corporations. The study recommends that State Governments should remove restrictions on the borrowing powers of urban local bodies and give them freedom to mobilise resources, based on their credit ratings. The grants under X to XII Finance Commissions is given in table 3.3.

Table 3.3
Grants recommended under Finance Commissions

<table>
<thead>
<tr>
<th>Finance Commission</th>
<th>Municipalities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tenth</td>
<td>Rs. 1,000 crore</td>
</tr>
<tr>
<td>Eleventh</td>
<td>Rs. 2,000 crore</td>
</tr>
<tr>
<td>Twelfth</td>
<td>Rs. 5,000 crore</td>
</tr>
<tr>
<td>Thirteenth*</td>
<td>Rs. 23,111 crore</td>
</tr>
</tbody>
</table>

*The Thirteenth Finance Commission recommended 1.93 per cent of the divisible pool of 2010-15, for local bodies after converting it into grant-in-aid, estimated at Rs. 87,519 crore.

Source: Government of India (2014)

Major Recommendations of XIV Finance Commission with Regard to Urban Local Bodies

1. The Commission suggests that the levy of vacant land tax by peri-urban Panchayats be considered. In addition, a part of land conversion
charges can be shared by State Governments with municipalities and Panchayats.

2. The Commission suggests that States may like to consider steps to empower local bodies to impose this tax and improve own revenues from this source.

3. The Commission recommends that States review the structure of entertainment tax and take action to increase its scope to cover more and newer forms of entertainment.

4. It is for the local bodies, particularly the urban local bodies, to take appropriate action, with the support of the State Governments, to augment their own revenue sources and also explore sources of borrowings, including issuance of bonds for meeting huge requirements for provision of basic civic services and creation of urban infrastructure.

5. The Commission note that the market for municipal securities has grown slowly but noticeably after the Corporation of Ahmadabad issued bonds.

6. In India, the market for municipal bonds is insignificant and the municipal bonds have played a limited role as a source of finance for funding urban infrastructure projects. The Commission recommends that local bodies and States explore the issuance of municipal bonds as a source of finance with suitable support from the Union Government. The States may allow the larger municipal corporations to directly approach the markets while an intermediary could be set up to
assist medium and small municipalities who may not have the capacity to access the markets directly.

7. The Commission recommends distribution of grants to the States using 2011 population data with weight of 90 per cent and area with weight of 10 per cent. The grant to each State will be divided into two - a grant to duly constituted gram Panchayats and a grant to duly constituted municipalities, on the basis of urban and rural population of that State using the data of Census 2011.

8. The Commission has worked out the total size of the grant to be Rs. 2,87,436 crore for the period 2015-20, constituting an assistance of Rs. 488 per capita per annum at an aggregate level. Of this, the grant recommended to Panchayats is Rs. 2,00,292.2 crore and that to municipalities is Rs. 87,143.8 crore. The grant assessed by us for each State for each year is fixed.

9. The Commission has recommended grants in two parts - a basic grant and a performance grant for duly constituted gram Panchayats and municipalities. In the case of gram Panchayats, 90 per cent of the grant will be the basic grant and 10 per cent will be the performance grant. In the case of municipalities, the division between basic and performance grant will be on a 80:20 basis.

10. The Commission has recommended that the basic grant for urban local bodies will be divided into tier-wise shares and distributed across each tier, namely the municipal corporations, municipalities (the tier II urban local bodies) and the Nagar Panchayats (the tier III local bodies) using the formula given by the respective SFCs. The State Governments
should apply the distribution formula of the most recent SFC, whose recommendations have been accepted.

11. In the case of urban local bodies, the share of each of the three tiers will be determined on the basis of population of 2011 with a weight of 90 per cent and area with a weight of 10 per cent, and then distributed among the entities in each tier in proportion to the population of 2011 and area in the ratio of 90:10.

12. The Commission provided performance grants to address the following issues: (i) making available reliable data on local bodies’ receipt and expenditure through audited accounts; and (ii) improvement in own revenues. In addition, the urban local bodies will have to measure and publish service level benchmarks for basic services.

13. The Commission suggests that States may like to consider steps to empower local bodies to impose advertisement tax and improve own revenues from this source.

14. The Commission recommends that States review the structure of entertainment tax and take action to increase its scope to cover more and newer forms of entertainment.

15. The Commission recommends raising the ceiling of professions tax from Rs. 2,500 to Rs. 12,000 per annum. The Commission further recommends that Article 276(2) of the Constitution may be amended to increase the limits on the imposition of professions tax by States.

16. The Commission recommends that the urban local bodies rationalize their service charges in a way that they are able to at least recover the operation and maintenance costs from the beneficiaries.
17. The Commission recommends that the local bodies and States explore the issuance of municipal bonds as a source of finance with suitable support from the Union Government. The States may allow the larger municipal corporations to directly approach the markets while an intermediary could be set up to assist medium and small municipalities who may not have the capacity to access the markets directly.

A detailed procedure for the disbursal of the performance grant to urban local bodies would have to be designed by the State Governments concerned, subject to certain eligibility criteria. To be eligible, the urban local body will have to submit audited annual accounts that relate to a year not earlier than two years preceding the year in which it seeks to claim the performance grant. It will also have to show an increase in own revenues over the preceding year, as reflected in these audited accounts. In addition, it must publish the service level benchmarks relating to basic urban services each year for the period of the award and make it publically available. The service level benchmarks of the Ministry of Urban Development may be used for this purpose. The improvement in revenues will be determined on the basis of these audited accounts and on no other basis. For computing the increase in own revenues in a particular year, the proceeds from octroi and entry tax must be excluded. In case some amount of the performance grant remains after disbursement to the eligible urban local bodies, the undisbursed amount should be distributed on an equitable basis among all the eligible urban local bodies that had fulfilled the conditions for getting the performance grant.
References


18. Ibid.

19. Ibid.

20. Ibid.

21. Ibid.

22. Ibid.


41. Khan, H.R. op.cit.
46. Ibid.
47. Ibid.