

PART II. LOCAL GOVERNMENT FINANCE AND ECONOMIC DEVELOPMENT

Chapter 6

Toward a System of Municipal Finance for Twenty-first Century India

Om Prakash Mathur

This chapter is set in the context of two major initiatives to strengthen local government in India: the *74th Constitution Amendment Act 1992*, part of an overall decentralisation strategy which aims at empowering municipalities; and the Jawaharlal Nehru National Urban Renewal Mission (JNNURM), a central government initiative designed to impart greater efficiency and transparency in the functioning of urban local governments. The two initiatives mark a step forward for municipalities to meet the contemporary challenges of growth, urbanisation and improved service delivery. Positioned in this context, the chapter:

- discusses the challenges facing India's municipal finance system;
- sets out the constitutional and legislative boundaries within which the municipal finance system functions, including the changes that have been made therein in recent years;
- provides a brief account of the state of the finances of municipalities; and
- presents a framework of suggestions that might prepare municipalities to address future challenges.

6.1 Challenges for municipal finance

The central theme of this chapter is making municipal finance work for growth, management of the urban agenda and improved service delivery. This theme represents a key public policy challenge for India, and is discussed under three major subthemes.

6.1.1 Improving municipal finance is central to the achievement of India's economic growth objectives

Over the past 20 years, India has registered annual gross domestic product (GDP) growth rates of more than 6.5 per cent – a major achievement in macroeconomic policy management. The same period has witnessed a dramatic shift in India's economic structure, moving to create growth through knowledge-based, financial and other services. As a result, urban areas have come to account for 52 per cent of the net domestic product (NDP, 2004–05), having risen from 45.7 per cent in 1993–94 (Tables 6.1 and 6.2).

Table 6.1 GDP growth rates

Year	Annual growth rate (%)
1971–1981	3.2
1981–1991	5.4
1991–2001	5.6
2001–2010	7.5

Source: Central Statistical Organisation, New Delhi, www.mospi.nic.in

Table 6.2 Urban share of net domestic product

Year	Share (%)
1980–81	41.1
1993–94	45.7
1999–2000	51.9
2004–05	52.0

Source: Central Statistical Organisation, New Delhi, www.mospi.nic.in

While the economic base has shifted inexorably to cities, India's recognition of the role of cities in promoting and accelerating economic development, and subsequent prioritisation of the municipal sector to manage the process of growth and urbanisation, has proceeded slowly. As this chapter will demonstrate, municipal governments have been at best a passive participant in the process of economic growth. Moreover, they have experienced little success in consolidating reform measures to manage the complex and interdependent dimensions of urbanisation. Municipalities have been unable to capture the benefits of urban-based economic growth of recent decades, be that its contribution to national and private incomes, or to government tax revenues. There are questions about the sustainability of the existing system and its capacity to achieve expected development outcomes, such as the maintenance of high economic growth and poverty reduction. There exists a strong perception that the level of urban-based growth in India is held back because of inadequate municipal infrastructure, high regulatory costs and weak municipal institutions.

While there are no India-specific studies on the economy-wide effects of inadequate municipal infrastructure, studies in other countries estimate such costs to be extremely high, reducing both urban productivity and competitiveness, and resulting in increased financial, economic and institutional pressures on the private sector (Anas, Lee and Oh 1996).¹ These studies also show that poor municipal policy and institutional performance in the provision of infrastructure and services contribute to the growth of urban poverty and not to its alleviation. Reforming the system of municipal finance is therefore a priority for both the central and state governments, which as the trends indicate will increasingly depend on cities for accelerated growth and poverty reduction.

6.1.2 A robust municipal finance system is necessary for effective implementation and management of India's urban policy agenda

Over the past two decades, several initiatives have been taken to open up India's urban sector, strengthen municipal institutions to face changing socio-economic

realities, and put in place fresh governance structures for deepening local-level decision-making. These initiatives include the *74th Constitution Amendment Act 1992*; an amendment to the *Income Tax Act 1961*, allowing municipalities to issue tax-free bonds; and the Jawaharlal Nehru National Urban Renewal Mission (JNNURM). The initiatives, which collectively constitute the broad parameters of the urban-municipal reform agenda in India, comprise:

- a constitutional status for municipalities;
- functional reform aimed at an enlarged role for municipalities;
- an institutional framework for redesigning central–state–municipal fiscal relations;
- inter-local government linkages and co-ordination;
- market-based financing of municipal services;
- incentives for municipalities to undertake reform of property taxation and the system of user charges;
- public–private partnerships in the provision of municipal services;
- tenural security for slum dwellers;
- reform of the urban land and property market; and
- disclosure and transparency in municipal functioning.

Such changes amount to a prescription for a fundamental realignment of the functions, finances and powers of municipal governments, primarily through the state governments and to an extent via the central government. The notable example of the latter has been the long-standing demand for formal constitutional recognition of municipal governments as a full-fledged order of government, which would be tantamount to a form of home-rule or ‘natural person powers’, giving them greater autonomy in their relations with both central and state governments.²

The process of municipal sector and finance reform has been set in motion. However, progress on key aspects of the reform process has been tardy and uneven. The passage of the *74th Constitution Amendment Act 1992*, for instance, was intended to formally recognise municipalities and delineate a space for them to play a larger role in the Indian economy and deepen the process of decentralisation. In reality, however, there is a motley array of institutional arrangements for undertaking several of the functions envisioned for municipalities, resulting in ad hoc responses to the unprecedented demand for urban infrastructure and services. Consequently, low-quality urbanisation is observed in most parts of the country.

The municipal revenue base (property taxes and user charges) continues to suffer from substantial inefficiencies and under-utilisation. Incentives for initiating reforms that have a direct bearing on property taxes – such as the abolition of rent controls – either have not worked or are clearly inadequate. Consequently, the municipal finance system in India remains vulnerable to a broad range of both endogenous and exogenous conditions, which result in poor performance and efficiency in the

provision of local public goods. The entire process of reform needs to be deepened and made more broadly based, in order to bring about long-run improvement in the finances of municipalities and thus contribute to the achievement of India's urban policy agenda.

6.1.3 A sound municipal finance system is a pre-requisite for improved service delivery

Most studies on Indian municipal finance point to the insufficiency of municipal spending levels for providing and maintaining infrastructural services at normative levels (Mathur et al. 2002; Mohanty et al. 2007). In 2007/08, municipal government spending (both capital and revenue expenditure) on infrastructure and services such as water supply, sewerage, solid waste treatment and disposal, storm water drainage, city-wide roads and street lighting was placed at 470 billion Indian rupees (Rs; approximately US\$10.5 billion³) or 1.09 per cent of India's GDP. It comprised Rs186 billion of expenditure to create new infrastructural assets (0.43 per cent of GDP) and Rs284 billion for infrastructure maintenance, establishment charges and salaries (0.66 per cent of GDP). A comparison of these spending levels with the norms recently established by the High-Powered Expert Committee (HPEC) on estimating urban infrastructure investment requirements indicates that municipalities in India underspent to the tune of 1.04 per cent of GDP on infrastructure maintenance.⁴ In cash terms, this underspending amounted to Rs226 billion, or Rs731 per capita (~US\$16.5) – a phenomenal deficit by any measure. Further, the current level of investment for creating infrastructural assets is a fraction of the amount needed, both to wipe out an accumulated deficit placed at Rs12,376 billion and to meet the infrastructural needs of urban population growth for the period 2012–2031 (Rs18,605 billion).⁵

Other estimates focusing on the aggregate demand for basic standards of infrastructure and service provision also point to significant financing gaps. In their recent report, *India's Urban Awakening: Building Inclusive Cities, Sustaining Economic Growth*, the McKinsey Global Institute (2010) estimated that India needed to invest US\$1.2 trillion in capital expenditure in its cities and towns over the next 20 years, equivalent to US\$134 per capita per year. This is almost eight times the level of current spending. They further estimate that more than half of this capital investment is necessary to erase India's infrastructure backlog and the balance to fund the future needs of cities. Reforming the municipal finance system is thus a first requirement for mobilising the scale of investment needed to improve infrastructure.

Currently, the capacity of municipalities to generate resources from their tax and non-tax revenue bases is seriously limited. As noted previously, in 2007–08 municipal own-source revenues accounted for a mere 0.54 per cent of GDP. In several states – the majority of these being low income and mainly rural – municipal own-source revenue was only half the national average. The municipal share of national tax revenues continued to stagnate at 1.7 per cent, despite a country-wide trend towards an improved tax to GDP ratio. Decentralisation, as embodied in the 74th Amendment, has made little difference to the tax-raising efforts of municipalities; their tax base

Table 6.3 Shares of tax revenues

Year	Central government (%)	States (%)	Municipalities (%)	Panchayats (%)
(Rural local governments)				
2002–03	44.1	53.2	2.5	0.2
2007–08	50.0	48.1	1.7	0.2

Sources: Government of India, Ministry of Finance, Indian Public Statistics; Thirteenth Finance Commission (2009)

continues to be narrow and marked by low buoyancy. On the other hand, it has been estimated (Mathur 2011) that municipalities have the potential to increase revenues significantly (by about 110 per cent) without any fundamental change in the system of property valuation or the structure of tax rates (Table 6.3).

With the increasing recognition of the contribution of urbanisation to economic growth, the strengthening of the fiscal position of municipalities through finance reforms has become a key component in the Government of India's development agenda. The Indian economy stands to benefit enormously from increases in the rate of urbanisation over the next 50 years. While the overall urbanisation rate in India has been comparatively low in relation to the economic growth patterns of the past two decades, accelerations in the rate of internal migration and natural urban population growth are predicted to increase the urban population from 364 million to about 590 million within the next 20 years (United Nations 2009).⁶ The country is projected to have nearly 85 cities with populations of more than 1 million by 2030, and will witness conversion of at least 1,000 villages into new towns if past trends are any guide to the future (Table 6.4).

In summary, the challenges of urbanisation, of higher rates of economic growth, of a shift in the composition of growth towards increasingly urban-based economic activities, and of increasing global competition are unprecedented in their scale and complexity, with enormous implications for municipal governments.⁷ As the country urbanises, cities will be required to respond more effectively to the needs and preferences of citizens, business and industry. An effective response to these challenges requires a municipal fiscal policy and strategy that can ensure and balance long-term economic growth and welfare, delineating the respective roles of the three

Table 6.4 The scale of India's future urbanisation

Year	Urban population (million)
2010	364
2015	410
2020	463
2025	532
2030	590

Source: United Nations 2009

tiers of government in financing urban development and services, and establishing fiscal rules that are consistent with the changing socio-economic realities.

Existing fiscal arrangements are inadequate for this purpose, even if current municipal tax powers are utilised to their optimum level.⁸ Municipal finance in the context of open economies, decentralisation and globalisation is vastly different from that envisaged in the past, when municipalities functioned in accordance with Dillon's Rule⁹ or within the framework of John Stuart Mill's initial formulation of the responsibilities of local governments.¹⁰ International scholars have begun to emphasise that, 'if fiscal decentralisation is to produce sustainable net benefits in developing countries, subnational governments require much more real taxing power than they now have' (Bahl and Bird 2008: 1). In a country where reforms have barely touched this complex subject, questions such as what is a local tax, what constitutes own-source revenue, whether India follows the widely held principle that finance follows functions and what explains current tax assignment choices have surfaced more pointedly than ever before, raising doubts as to how far the principles that should guide municipal finance have been translated into contemporary practice. As Bahl and Cyan (2010) write, 'the story (about practice matching the theory) is more complicated and there is much still to be learned about why governments (or constitutions) make the revenue assignment decisions they do'. This chapter raises these questions in order to initiate a larger debate on the municipal sector and municipal finance.

6.2 India's municipal finance system: basic features

India is a union of 28 states and seven centrally administered territories. In this union, the functions, finances and powers of the central government and state governments are laid out in the seventh schedule of the *Constitution of India*, in what are known as the Union List, State List and Concurrent List. While the constitution now recognises municipalities as a tier of government and provides for their establishment and continued existence, they remain subject to state governments in matters relating to their powers, functions and responsibilities, and also the degree of autonomy that they can exercise. Thus, from their own powers specified in the State List, state governments assign certain functions and duties to municipalities. A municipality has no inherent powers in the Indian set-up.¹¹

There have been periodic shifts and changes in the functional domain of municipalities, due to the withdrawal of functions (such as water supply and sewerage) in some states, and the assignment of new responsibilities (such as poverty alleviation and planning for economic and social development) in others. The 74th Amendment offered a different vision for municipalities by incorporating a new Schedule 12, which provides a list of functions that is considered appropriate for municipal governments. Although the list is illustrative rather than binding, it makes a strong commitment to decentralisation. The significance of these Schedule 12 functions for municipalities lies not so much in enlarging the scope of municipal operations as in the fact that many of the functions have been drawn from the Concurrent List of the constitution. At the minimum, it suggests that there is a group of functions where there exists a concurrency of interests across all three tiers of government, including municipal

governments. Also, many of the functions listed in Schedule 12 have distributional and developmental attributes: thus their inclusion on the one hand represents an important departure from the past, and on the other hand signals a deviation from the typical Musgrave–Oates model (Oates 1972) of fiscal federalism, under which redistribution is a function best performed at the higher tiers of government.

However, the 74th Amendment failed to spell out how these new functions might be financed. Instead of providing an illustrative list of taxes considered appropriate for municipalities, it mandates the states to constitute, once in every five years, a State Finance Commission (SFC) for making recommendations on:

- the taxes, levies and duties that should be assigned to municipalities;
- the taxes, duties and levies that should be shared between the states and municipalities;
- grants-in-aid to be provided to municipalities; and
- other measures that would augment the finances of municipalities.

In addition, recognising that this process may still leave unmet revenue needs, the amendment requires the Central Finance Commission (CFC) to make supplementary grants to municipalities.¹² The evidence to date is that the SFCs have not been able to bring about any noticeable change in the fiscal domain of municipalities, with the result that municipal taxing authority remains limited to property taxation and a few minor taxes such as advertisement taxes and a tax on non-motorised vehicles. The fiscal base of municipalities is thus dominated by intergovernmental transfers, which account for nearly 50 per cent of their revenues.

Thus the municipal fiscal framework that supports urban services in India has remained largely unchanged, notwithstanding the fact that the macroeconomic context has been transformed and the relationship between municipalities and other tiers of government is in a phase of significant transformation whose implications are still to be fully grasped. Many local taxes and the supporting user-charge system were designed in the nineteenth- or early twentieth-century, and therefore for a different time and a different context. Now they have lost their relevance and can hardly be considered sufficient for meeting the needs of the new environment (United Cities and Local Governments 2010).

6.3 Municipal finances: ground-level realities

Table 6.5 provides an overview of the finances of India's 3,667 municipalities aggregated across the 28 states. In 2007–08, total municipal revenue amounted to Rs444 billion and total municipal expenditure to Rs470 billion. In per capita terms, revenue was placed at Rs1,430 (approximately US\$32) and expenditure at Rs1,513 (US\$34). Own-source revenues provided 53 per cent of the total, with the balance contributed by assignment, devolution and grants-in-aid from states (33.4 per cent), central government grants (5.3 per cent) and grants from the finance commissions (2.0 per cent). Operating expenditure accounted for 60.5 per cent of the total. Municipalities recorded an operating surplus of approximately 37 per cent, but an overall deficit of about 6 per cent once capital expenditure was included.¹³

Table 6.5 The finances of municipalities (all states)

	2002–03		2007–08		CAGR (%)
	Amount (Rs billion)	Rs per capita	Amount (Rs billion)	Rs per capita	
Revenue					
Own-tax revenue	88.38	311	152.78	492	11.57
Own non-tax revenue	44.42	156	82.44	265	13.16
Total own revenue	132.80	466	235.21	757	12.11
Assignment and devolution	36.57	128	91.71	295	20.19
Grants-in-aid	22.60	79	56.76	183	20.23
Other grants	11.38	40	28.18	91	19.90
Transfers from central government	3.09	11	23.73	76	50.35
Finance Commission transfers	2.77	10	8.69	28	25.74
Total expenditure	209.20	733	444.29	1430	16.26
Revenue expenditure	156.91	550	284.31	915	12.62
Capital expenditure	59.38	208	185.94	598	25.64
Total	216.30	758	470.26	1,513	16.80
GDP India	22,614.15	21,415	43,208.92	37,969	13.83
Own tax as % of GDP	0.39%		0.35%		
Own revenue as % of GDP	0.59%		0.54%		
Municipal expenditure as % of GDP	0.96%		1.09%		

Note: GDP at factor cost (current prices); CAGR=compound average growth rate

Source: Thirteenth Finance Commission (2009)

Important changes took place in the structure of revenues and patterns of expenditure over the period 2002–03 to 2007–08. First, the ratio of own-tax revenues to total revenues declined from 42 per cent to 34 per cent, and the share of own non-tax revenues also fell, from 21 per cent to 18 per cent, meaning that municipalities were raising only a little over half of their total revenues. As a proportion of GDP, own-tax yields dipped from 0.39 per cent to 0.35 per cent, and total own-source revenues from 0.59 per cent to 0.54 per cent.

This decline is a significant development. It is attributable in part to the widespread abolition of *Octroi*,¹⁴ which was an important source of revenue for municipalities (and still is in the municipal corporations in the state of Maharashtra), and in part to the dilution of the property tax regime in several states, such as Haryana, Punjab and Rajasthan, where large numbers of properties have been exempted from paying property tax. It indicates that, unlike the reform of central and state taxes undertaken in India in the mid-1990s, there has been no comprehensive effort to modernise municipal taxes. It also speaks of the low level of buoyancy of municipal tax instruments. While state municipal statutes enumerate close to 50 different kinds of revenue instruments, most of them either are not in use or have extremely low levels of productivity. Several are obsolete, with no relevance to modern socio-economic realities and the changing economy of cities. At the same time, several municipal taxes have been transferred to or appropriated by higher tiers of government. Additionally, as municipalities face greater responsibilities, the issue of

their access to central and state government taxes, such as the goods and services tax (GST), needs deeper examination.¹⁵

Second, despite the relatively slow growth of own-source revenues, total municipal expenditure grew at a compound annual rate of 16.8 per cent, increasing on aggregate from Rs216.29 billion to Rs470.26 billion. Moreover, capital expenditure rose at twice the rate of revenue expenditure from 2002–03 to 2007–08. Thus, despite a decline in own-source revenue as a proportion of GDP, total expenditure registered an increase from 0.96 per cent of GDP in 2002–03 to 1.09 per cent in 2007–08. Nevertheless, this figure remains low compared with other federal Commonwealth countries: for example, an increase in total municipal expenditure of 2.3 per cent in Australia and 7.2 per cent in Canada (International Monetary Fund 2008).

The third important change that took place in the structure of revenues and patterns of expenditure was that, in order to fill the local revenue gap and boost capital expenditure, fiscal transfers from central and state governments rose from 36.5 per cent of municipal revenues in 2002–03 to 47.1 per cent in 2007–08. At the state level, grants-in-aid made to municipalities are used to correct imbalances in fiscal capacity. Municipalities also have access to assignment and devolution grants, which represent a share of state tax revenues. Transfers from the central government come in the form of grants linked to performance and reforms, designated specifically for asset creation and capital works. Intervention by the central government in the municipal sector has, within a short span of time, altered the intergovernmental fiscal framework. The Central Finance Commission determines grants-in-aid at five-yearly intervals, which are allocated through the states to municipalities. These are used to fill the revenue account gaps at local levels and are allocated according to a set of weighted criteria that take into account factors such as urban population, geographic area, level of development, local revenue effort, an index of decentralisation, an index of deprivation and the extent to which states have devolved functions to local government in accordance with the 74th Amendment. However, these criteria may change with every Commission, and the Thirteenth Finance Commission put forward some new ideas for funding municipalities that are outlined later in this chapter.

As Table 6.5 shows, the period 2002–03 to 2007–08 witnessed an extraordinarily large increase in transfers from the central government, which grew at an annual compound rate of more than 50 per cent due to grants under the JNNURM, launched in 2005.¹⁶ Significantly, the JNNURM requires state governments and municipalities to match the central government grants, and the procedure so established is likely to have a long-term impact in leveraging market funds for municipal infrastructure.¹⁷

This growth in transfers demonstrates that the central government has begun to appreciate the key role of cities in the Indian economy, recognising that investment in urban infrastructure is as much a central government responsibility as a municipal one. It further recognises that macroeconomic trends have important implications for municipal governments, warranting interventions by central government. Urban growth management is thus beginning to be seen as a multilevel developmental activity (Table 6.6).

Table 6.6 Central government grants to municipalities

Year	Amount (Rs billion)	Year	Amount (Rs billion)
2002–03	3.09	2005–06	33.69
2003–04	4.07	2006–07	122.19
2004–05	54.53	2007–08	237.29

Source: Thirteenth Finance Commission (2009)

However, notwithstanding the increased role of the central government, state policies continue to shape and determine the fiscal space of municipalities. There is, therefore, an enormous heterogeneity in revenue structures and arrangements, institutional systems and economic conditions that affect municipal financial performance across different states. Table 6.7 gives the state-level structure of municipal revenues and expenditure.

Table 6.7 State-level structure of municipal revenues and expenditures, 2007–08

States	Per capita own-source revenue (Rs)	CAGR of own-source revenue 2002–07 (%)	Own-source share of total revenue (%)	Per capita revenue expenditure (Rs)	CAGR of revenue expenditure, 2002–07 (%)
Andhra Pradesh	748	13.0	58.5	1,060	18.5
Assam	143	4.8	38.2	205	10.8
Bihar	105	4.8	14.6	711	48.8
Chhattisgarh	376	11.6	14.1	1,449	34.1
Goa	282	3.9	57.8	400	8.2
Gujarat	1,079	7.7	61.5	1,135	10.2
Haryana	281	3.6	33.5	328	2.9
Himachal Pradesh ^a	595	14.9	47.8	–	–
Jammu & Kashmir	90	21.2	9.9	452	20.1
Jharkhand	86	12.6	20.2	134	15.5
Karnataka	545	6.4	34.2	750	10.5
Kerala	329	3.6	39.5	517	14.4
Madhya Pradesh	121	6.8	11.6	998	16.9
Maharashtra	2,600	11.7	76.1	2,237	13.8
Orissa	38	14.7	4.5	405	17.6
Punjab	1,049	7.2	89.1	925	10.6
Rajasthan	387	16.6	39.5	447	11.0
Tamil Nadu	396	7.4	38.4	665	8.1
Uttar Pradesh	94	2.1	14.8	245	2.1
Uttarakhand	116	0.6	21.8	330	8.6
West Bengal	394	10.4	51.7	574	6.3

^aData relates to 2006–07; CAGR=compound annual growth rate

Note: This and subsequent tables in this section provide finance data for only 21 states

Sources: Statistics of India, 2003–04 and 2008–09; Thirteenth Finance Commission (2009) (calculations made by the author)

The data in Table 6.7 reveal high and rising inter-state disparities in the management of municipal finance. Although the coefficient of variation between states differs with the different constituents of municipal revenues and expenditures, it is large and has risen for all constituents except the state government grants-in-aid to municipalities (see Table 6.8). Some states have evidently paid far greater attention to the municipal tier than others: state policies hold the key to the reform of the municipal finance system.

Of particular concern is the slow growth in own-source revenues in lower-income states, and the fact that the own-source share of total revenue is often low and declining. Increasing locally raised revenues should be seen as a prerequisite for the future growth of municipalities in India. However, as the share of own-source revenues declines, municipalities in several states are at a high risk of losing their fiscal identity as the third tier of government.

While the abolition of *octroi* can be seen as a positive step,¹⁸ it and the dilution of property tax regimes have caused severe erosion of the tax base of municipalities in several states and have resulted in increasing dependence on state government transfers and grants-in-aid. This is a matter of vital concern, touching upon the very nature of the relationship between municipalities and state governments. In response, the High Powered Expert Committee (2011) proposed the creation of an exclusive list of taxes for municipalities, evidently to provide protection to their fiscal domain. In addition, the Thirteenth Finance Commission (2009) proposed that each state should set up a Property Tax Board, which in part will ensure that state governments maintain property tax as the core revenue source for municipal governments and put in place appropriate methods of property valuation and assessment.

This analysis adds up to five major conclusions:

- India's municipal sector is small in relation to the position in other countries and what is required to address urban challenges. With own-source revenues equivalent to only 0.54 per cent of GDP and expenditures only 1.09 per cent, a

Table 6.8 Coefficient of variation in municipal revenues and expenditure

	Per capita average (Rs)		Coefficient of variation (CV)	
	2002–03	2007–08	2002–03	2007–08
Own-tax revenue	311	492	125	154
Own non-tax revenue	156	265	89	97
Assignment and devolution	128	295	86	99
State grants-in-aid	79	183	104	83
Transfers from the central government	11	76	109	123
Finance Commission dispensation	10	28	57	61
Revenue expenditure	550	915	69	77
Total expenditure (includes capital)	758	1,513	64	76

Source: Thirteenth Finance Commission (2009) (calculations made by the author)

sector of this size cannot be expected to deliver services at adequate, standardised levels.

- There are large-scale differences between states. These are partly attributable to state policies – what fiscal powers they assign or devolve to municipalities – as well as the efficacy with which municipalities exercise those powers. However, inter-state differences have also arisen on account of factors over which municipalities have little control; it is these exogenous economy-wide factors that have put municipalities in several states at high risk.
- Smaller municipalities in much of the country have cost disabilities and are characterised by a poor resource base, raising the vital issue of developing a revenue model that will be able to address their fiscal problems.
- Decentralisation as embodied in the 74th Constitution Amendment, when measured in terms of either resource generation or municipal expenditure, has made little progress over the past two decades. There is a need for a fiscal architecture that is consistent with the new functions of municipalities proposed in the 12th Schedule.
- The financing of urban infrastructure and services has to be a multi-tier responsibility.

It should also be noted that financial problems may be exacerbated by the limited management capacity and skills of many municipalities. There are no performance standards to be enforced – a major lacuna in the management structure. However, such issues extend beyond the scope of this chapter.

6.4 A system of municipal finance for the twenty-first century

Municipal finance reforms are currently under way in a number of developing and developed countries.¹⁹ Several countries have undertaken to reform the municipal system in order to pursue and deepen decentralisation goals and objectives or put in place the principle of subsidiarity; in others, reforms are being introduced to institute a new system of local government. In some cases, reforms have resulted in devolution of functions from the higher tiers to municipalities. In Central and Eastern Europe, reforms have focused on local taxation, municipal property management, budget formulation and budget implementation. Reforms in Canada have been designed to advance several overarching goals, such as enhancing governance capacity, improved intergovernmental relations between municipal governments and their respective provincial governments, and improved relations between municipal governments and local communities. However, these goals have not always been shared by all provinces (Garcea and Le Sage 2005).

The Brazilian Constitution of 1988 is often cited as upgrading the political and financial role of municipalities in the country. As Souza notes, ‘no Constitution prior to 1988 has provided local governments with the amount of resources they now enjoy – there is a consensus that Brazil is one of the most decentralised countries in the developing world and that financial decentralisation has favoured the municipalities

to a greater extent than the states' (Souza 2003). However, Brazil has also put in place a Fiscal Responsibility Law, which prohibits the bailing out by the federal government of new debts contracted by local governments (Brazil Ministry of Planning, Budget and Management 2000).

Beginning with the 74th Constitutional Amendment, India too has entered into an important phase of municipal reform. The rationale for the amendment as embodied in the Statement of Objects and Reasons is as follows:

In many states, local bodies have become weak and ineffective on account of a variety of reasons, including the failure to hold regular elections, prolonged supersession and inadequate devolution of powers and functions. As a result, urban local bodies are not able to perform effectively as democratic units of self-government. Having regard to these inadequacies it is considered necessary that provisions relating to urban local bodies are incorporated in the Constitution particularly for (i) putting on a firmer footing the relationship between the state government and urban local bodies with respect to (a) the functions and taxation powers, (b) arrangements for revenue sharing, (c) ensuring regular conduct of elections, and (d) providing adequate representation to the weaker sections.

Underlying the statement is the argument that only with such wide-ranging initiatives, in the form of constitutional support and enhanced financial jurisdiction and increased access to financial resources, would municipal governments be able to perform their governance and service delivery functions efficiently and effectively, and play the role expected of them in the twenty-first century. With this, the constitution has laid the foundation for reform of the municipal financial structure. Since the passage of the 74th Amendment, this objective has been advanced in several ways. The *Income Tax Act* has been amended to provide for issuance of tax-free bonds by municipalities. In 2002, the Government of India established a fund called the Urban Reform Incentive Fund (URIF), and the JNNURM established in 2005 now constitutes one of the largest initiatives to reform, among other things, the finances and functioning of municipalities.

But what do these initiatives bring in by way of a municipal finance system that addresses issues of growth, decentralisation and improved service delivery? Are they adequate in relation to India's changing socio-economic realities? What roles will be required of the central and state governments in reinforcing the existing system? This chapter cannot provide a comprehensive response to these questions – that requires further primary research. What it can do, however, is to provide a framework of suggestions to advance the existing reform agenda. This framework is in three parts: broadening the fiscal domain of municipalities; institutional re-engineering for improved municipal finance; and the role and participation of the central government in municipal affairs.

6.4.1 Broadening the fiscal domain of municipalities

Broadening the current municipal fiscal domain is a key imperative for addressing the challenges of growth, urbanisation and improved service delivery. This involves first making the property tax system – the main tax instrument for

municipalities – comprehensive, and restoring to municipalities those taxes that meet the criterion of immobility. Several suggestions have been made from time to time to reform the property tax system, the most recent being the Thirteenth Finance Commission's (TFC) proposal for state-level Property Tax Boards. As mentioned previously, these boards are expected to assist municipalities in putting in place independent and transparent procedures for assessing property tax.

Looking beyond property tax, it was shown earlier in this chapter that the fiscal domain of municipalities is too narrow and has a low level of buoyancy. It has also been stated that a key impediment to the devolution of 12th Schedule functions is the lack of an appropriate revenue model. Several states currently share a pool of their taxes with municipalities, albeit erratically. The TFC also suggested that the proposed goods and services tax (GST) be shared with local governments. Its recommendation is grounded in the fact that, since municipal governments now have several redistributive functions within their fold, they should have access to taxes that have greater buoyancy. This proposal warrants support.

6.4.2 Institutional re-engineering for improved municipal finance

Legislative and institutional changes are needed to ensure adoption of prudent financial management practices in carrying out municipal functions. This is critical, as unsustainable and populist fiscal policies often adopted by municipalities jeopardise public service delivery and safety, as well as the viability of the financial system.

Given the reluctance or inability of municipalities to adjust tax rates and other charges to the rising cost of delivering services, it may be necessary to establish a municipal regulator with the responsibility of indexing taxes and charges against costs, to ensure that the value of municipal revenue yields is maintained. Such a body might, for example, be given the power to frame rules in respect of necessary adjustments in tax rates and charges, as well as to penalise municipalities for not adhering to those rules.

6.4.3 The role and participation of the central government in municipal affairs

Thus far the central government has intervened in municipal affairs cautiously, on the grounds that urban development is the domain of the states. The JNNURM, however, brings home the crucial point that cities make a significant contribution to the national economy, and that their growth (or lack of it) has important macroeconomic implications. It thus appears necessary to introduce more proactive policies that involve the central government in urban development matters. Like municipal finance, urban development is emerging as a multilevel responsibility.

Municipal governments in India have in recent years changed phenomenally in terms of the roles and functions they perform. The prognosis is that the next 20 years will see changes of extraordinary significance in the way municipal governments are organised, in their functions and responsibilities, as also in their fiscal and financial architecture. The global evidence attests to the likelihood of such changes. This fact

alone requires that the municipal system be continually monitored and adjusted in order to be able to respond to the changes that are occurring both domestically and worldwide, and to prepare municipalities to address the new situations and realities. It places enormous responsibility on the Indian polity to begin to build far more trust and accountability in the functioning of municipal governments.

Notes

- 1 According to a recent paper on 'Infrastructure and city competitiveness in India', the supply of local infrastructural services such as municipal roads, street lighting, water supply and drainage has a positive and significant effect on city-level attractiveness to investment. According to the paper these effects are robust across econometric specifications and estimation procedures (Lall et al. 2010).
- 2 This is an elegant device for municipalities to conduct a wide range of activities with less encumbrance from legislations and other statutory regulations.
- 3 US\$1 equals approximately Rs45 (2009 conversion rate).
- 4 In 2008, the Government of India constituted a High-Powered Expert Committee and tasked it to estimate the investment requirements for urban infrastructure. The norms of expenditure as set by the HPEC are at 2009–10 prices. These have been adjusted to 2007–08 level.
- 5 See High-Powered Expert Committee (2011). The estimates include the proposed investment needs for water supply, sewerage, solid waste management, urban roads, storm water drains, urban transport, traffic support infrastructure and street lighting.
- 6 The 2011 Census of India places India's urban population at 377 million. A distinguishing feature of the 2011 Census results is that, for the first time, the net increase in urban population was marginally higher than the net increase in rural population during the decade of 2001–2011.
- 7 Recent literature on local government finance dwells on the impact of the global crises on subnational government finance and subnational dimension of stimulus packages. See Barcelona Economics Institute (2009).
- 8 Richard Bird's observations in this regard are pertinent. He writes: 'If the appropriate expenditure role for subnational governments is simply to provide a few minor local services and perhaps to act as delivery agents for nationally determined public expenditures, the revenue assignment questions turn out to be relatively simple. However, if subnational governments are expected to deliver important (and costly) public services and have some discretion in deciding how and to what extent they do so, determining the appropriate revenue assignment is much more difficult' (2010: 1).
- 9 Dillon's Rule is a judicial interpretation derived from a written decision by Judge John F Dillon of Iowa in 1868, and states that a municipality may only exercise powers conferred explicitly by the statutes of a superior level or order of government (Dillon 1911).
- 10 Dealing with the question regarding the powers of local authorities, Mill expounded: 'It is obvious to begin with, that all business purely local, all which concerns a single locality, should devolve upon the local authorities. The paving, lighting, and cleaning of the streets of a town, and in ordinary circumstances the draining of its houses, are of little consequence to any but to its inhabitants. But among the duties classed as local or performed by local functionaries, there are many which might with equal propriety be termed national, being the share, belonging to the locality, of some branch of the public administration in the efficiency of which the whole nation is alike interested: the goals, for instance – the local police – the local administration of justice' (Mill 1910: 354).
- 11 Most federal countries give the control over municipalities to provinces or states. Therefore, the powers a municipality possesses depend almost entirely on the powers the province wishes to grant. In Canada, for example, municipalities in some provinces operate legislation that spells out every power. By contrast, Alberta gives 'natural person powers' to its municipalities, and British Columbia has created what amounts to a 'bill of rights' for municipalities. In other cases, major urban areas are recognised in various ways as being different from other municipalities. For example, Toronto has been given additional powers under the *City of Toronto Act 2006*.
- 12 Article 280(3)(c) of the Constitution of India requires the Finance Commission to make recommendations on the measures needed to augment the Consolidated Fund of a state to

- supplement the resources of the municipalities on the basis of the recommendations made by the Finance Commission of the State.
- 13 Surplus of municipal revenue over expenditure should be read with caution: first, revenue income, according to the classification in which the finance data have been compiled, includes central government transfers which are meant for asset creation; and, second, most state governments require municipalities to either maintain a balanced budget or post a budget surplus.
 - 14 *Octroi* is a tax on the entry of goods into a local area for consumption, use or sale. It has been abolished in all states excepting the municipal corporations in Maharashtra.
 - 15 In Belgium, Germany and Switzerland, more than 80 per cent of local tax revenues are derived from personal and corporate income taxes. More than 80 per cent of local government tax revenues in Australia, Canada and the USA are derived from property taxation. Sales taxes are levied mainly by cities in the USA, and there is a mix of local taxes in Austria (30 per cent revenue from sales tax) and Spain (40 per cent revenues from sales tax). See Slack (2010).
 - 16 Reference to the JNNURM grants here includes central government support under the submissions of Urban Infrastructure and Governance (UIG), Basic Services to the Urban Poor (BSUP), Urban Infrastructure Development Scheme for Small and Medium Towns (UIDSSMT) and Integrated Housing and Slum Development Programme (IHSDP).
 - 17 Municipalities can raise resources in the capital market to finance infrastructure. Their powers to borrow are laid down in the *Local Authorities Loans Act 1914*, provisions of which have been incorporated in the respective state-level statutes. Further, taking note of developments in the country's capital market, the Government of India has issued regulations for issuance of tax-free municipal bonds. Fourteen municipal corporations and local authorities have issued such bonds. They are not supported by sovereign guarantees, and municipalities must set aside funds for their redemption.
 - 18 *Octroi* tended to inhibit free internal mobility of goods and services, with adverse effects on the economy. See Rao et al. 1985.
 - 19 Guess (2003); Celina (2003).

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