Municipal Finance in India:An Assessment

Article · January 2008

Source: RePEc

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Reserve Bank of India

Development Research Group

Study
No. 26

Municipal Finance in India: An Assessment

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December 27, 2007

Printed at Alco Corporation, A2/72, Shah & Nahar Industrial Estate,
Lower Parel (W), Mumbai - 400 013. Tel. : 2498 3737/38/39.

Issued for Discussion

DRG Studies Series

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ACKNOWLEDGEMENTS

I thank Reserve Bank of India for sponsoring the study on "Municipal Finance in India : An Assessment" under the ambit of Development Research Group.

I express my sincere thanks to Dr. Rakesh Mohan, Deputy Governor, who interacted with the study team, despite his busy schedule and made valuable suggestions for improvement in the study from policy perspective at the work-in-progress seminar of this project.

I thank Dr. Narendra Jadhav, former Principal Adviser and Chief Economist, and Dr. R.K. Pattnaik, Adviser, Department of Economic Analysis and Policy, who took active part in the deliberations of the team and provided crucial inputs for the study.

I express my special gratitude to Professor O.P. Mathur, NIPFP who very painstakingly reviewed the study and made important suggestions for improvement in the study. Sincere thanks are due to all academicians and policy makers for their suggestions at the work-in-progress seminar of the study.

The RBI core team consisting of Shri B.M.Misra, Adviser, Shri Rajan Goyal, Director and Dr. P.D.Jeromi, Assistant Adviser in the Department of Economic Analysis and Policy worked hard for preparation of the study. Dr. A. Samantaraya, Research Officer, had provided support at the initial stage of the study. Dr. P.D. Jeromi, who made valuable contribution to the study, unfortunately met with sad demise when the final draft of the study, after referee's comments, was being submitted.

The Centre for Good Governance (CGG), Hyderabad provided excellent infrastructure and research support for preparation of the study. I gratefully acknowledge the academic support received from Ms. P. Anuradha (Programme Manager – Local Government, CGG) and Dr. B. Navin (Knowledge Manager – Public Finance and Policy, CGG). Notable contribution by Mr. N. Ramakrishna (Knowledge Manager – Infrastructure & Environment, CGG), who undertook the data compilation and computation work, is acknowledged. I express my sincere thanks to officials of DRG in providing the necessary support in the course of preparation of the study.

I hope the findings of the study would provide inputs for policy formulation and generate debates and discussions leading to further research in the area. I also hope that this research would facilitate the design and pursuit of municipal finance reforms in India to carry forward the decentralization process as envisaged in the Constitution (74th Amendment) Act, 1992.

Dr. P.K. Mohanty

MUNICIPAL FINANCE IN INDIA : AN ASSESSMENT

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EXECUTIVE SUMMARY

This study, entitled "Municipal Finance in India – An Assessment", undertaken for the Development Research Group (DRG), Reserve Bank of India examines the performance of Urban Local Bodies (ULBs) in India. Using data from 35 Metropolitan Municipal Corporations, the study attempts to analyze the reasons for their differential performance with respect to fiscal parameters and provision of civic amenities. In the light of the findings of the study and international experience in this regard, the study makes suggestions for improving the municipal financial system in India.

1. Local Self-Government Institutions or Local Bodies directly influence the welfare of the people by providing civic, social and economic infrastructure services and facilities in both urban and rural areas. Given their strategic position in delivering services in the hierarchy of Government set up, following the Constitutional (73rd & 74th) Amendment Acts, more functions, powers and resources have been provided to them. However, over a period of time, the functions and responsibilities of LBs have increased considerably without commensurate enhancement of their resource base.

2. Constitutionally built-in imbalances in functions and finances assigned to various levels of government eventually reflect in the high dependency of local bodies on State Governments and the latter, in turn, on Central Government for funds. Moreover, in the absence of financial support coming from the upper tiers of Government, these bodies may have to resort to borrowings from financial institutions and the capital market. Being responsible for the soundness and stability of the financial sector and in view of the government sector tending towards financial markets to meet fiscal gaps, the Reserve Bank of India (RBI) sponsored this study of finances of Urban Local Bodies (ULBs) in India. The key objective is to obtain a holistic view on local government finances and factors affecting municipal fiscal performance.

3. Urbanisation is an important ingredient of economic development. The trend towards greater urbanisation is observed across the developing world. Going by this trend, India is slated to have 50 per cent of its population living in cities and towns in the

next few decades, up from the current proportion of about 30 per cent. Although India's urban population has been growing, the level and pace of urbanisation have been low in comparison with other developed and developing countries. After liberalisation of the economy, India made strides in economic growth; a large part of it has been through the contribution of urban areas.

4. Globalisation has been resulting in further concentration of economic activities in cities, in a manner that leads to cost reduction and increasing competitiveness. Cities offer distinct advantages of economies of scale, scope and agglomeration and returns to sharing of infrastructure and public services. The rising economic importance of cities is evident from their contribution to the nation's Gross Domestic Product (GDP), which is reportedly more than 50 per cent. Given the strategic importance of cities, provision of civic infrastructure services has assumed critical importance socially, economically and politically. While the expectations from the public are rising, the fragility of civic infrastructure and services has been exposed during the floods in some of the major Indian cities recently.

5. In the case of ULBs in India, the 74th Amendment to the Constitution of India, 1992 identified enormous responsibilities for the urban local governments. Besides the 18 items listed as municipal responsibilities in the Twelfth Schedule of the Constitution, the Legislature of a State, by law, can assign any tasks relating to: (i) the preparation of plans for economic development and social justice; and (ii) the implementation of schemes as may be entrusted to them.

6. For strengthening the finances of urban local governments, two positive features were provided in the 73rd and 74th Amendments to the Constitution: (a) provision for the constitution of State Finance Commissions (SFCs) every five years (Article 243-I as per the 73rd Amendment) and (b) amendment of Article 280 of the Indian Constitution by inserting section 3(C) which requires the Central Finance Commission (CFC) to suggest measures needed to augment the consolidated fund of the states to supplement the resources of municipalities devolved on the basis of the respective SFC recommendations. However, the progress in the implementation of SFC recommendations in several states has not been very

encouraging. The CFC has also grappled in making recommendations of resource transfer to local governments in states. However, in the absence of authentic data, successive CFCs have made recommendations for the transfers of funds for local bodies on *ad hoc* basis.

7. With this background, the study attempts to take a view of the finances of the 35 Municipal Corporations (MCs) of the metropolitan cities, with population more than 1 million as per 2001 Census. The objectives of the study are as follow:

- To critically examine the provisions relating to revenues and expenditure of municipalities and bring out the mismatch between their revenue authority and expenditure responsibilities in the light of international as well as national experiences.
- To examine the trends in major revenue sources and expenditures of municipalities and assess their fiscal position.
- Analyse performance of ULBs with respect to fiscal parameters and provision of civic infrastructure.
- Examine and identify major constraints that could influence the overall performance of ULBs in the provision of civic infrastructure.
- To estimate and project the resource requirements of the municipal sector in the country during the 10-year period from 2004-05 to 2013-14 and suggest measures for improving municipal financial system.

8. Aggregate revenue of all ULBs in India, is very low at around 0.75 per cent of the country's GDP. In contrast, the ratio is 4.5% for Poland, 5% for Brazil and 6% for South Africa. As per the Twelfth Finance Commission report, there are 3,723 ULBs, of which 109 are Municipal Corporations, 1,432 are Municipalities and 2,182 are Nagar Panchayats. The total revenue of these ULBs grew from Rs.11,515 crore in 1998-99 to Rs.15,149 crore in 2001-02 at a compounded average growth rate (CAGR) of 9.6 per cent. Their total expenditure increased from Rs 12,035 crore to Rs 15,914 crore during the same period, registering a CAGR of 9.8 per cent.

9. The total revenue of ULBs has been growing at a lower rate (9.6 per cent during 1998-99 to 2001-02) than the growth of combined Central and State Government revenues (10.8 per cent during 1998-99 to 2001-02). This has reflected in a marginal decline in the share of municipal revenue in total government revenues from 2.5 per cent in 1998-99 to 2.3 per cent in 2001-02.

10. Primary data obtained from budget documents of 35 major MCs for the period 1999-2000 to 2003-04 reveal broad trends about the structure and composition of their revenue and expenditure. Component-wise, tax revenue accounted for 45.2 per cent of its total own revenue, followed by non-tax revenue (28.7 per cent) during 2000-04. Establishment and administration expenditure accounted for about 36 per cent of total expenditure during 2000-04. Expenditure on public works accounted for about 44 per cent of the total expenditure, with that on roads and parks and playgrounds accounting for about 19.5 per cent of the total expenditure.

11. Analysis of the revenues and expenditure of these MCs reveals that most MCs are generating revenue surplus and overall resource gaps are not very large. At the same time, it could be observed that spending by all the municipal bodies is lower than that required for providing a minimum level of civic amenities. This apparent contradiction of sound fiscal health and high level of under-spending is due to statutory obligations, whereby ULBs are generally bound to restrict their expenditure to the resources available and are also not granted liberal permission by State Governments to incur debt. In view of the above factors, the study has undertaken the assessment of municipal finance in "normative terms", besides the "standard approach" of revenue or fiscal balance.

12. A comparison of per capita spending on core services by the Metropolitan MCs in terms of the Zakaria Committee norms indicates that the level of under-spending on an average works out to be about 76 percent. The extent of under-spending varied between 30.78 per cent in the case of Pune to 94.43 per cent in the case of Patna. Significantly, MCs belonging to Bihar and Uttar Pradesh are the ones that have highest level of under-spending whereas those belonging to Maharashtra and Gujarat (the only states imposing Octroi) are among

the best performers. Reasons for under-spending are traced to MCs' own operations (*endogenous*) as well as to policy issues related to the upper tiers of Government (*exogenous*). *Exogenous* factors include dependency for resources on the upper tiers of Government and inadequate delegation of revenue-raising powers. *Endogenous factors* include inefficient revenue (tax) administration, low cost recovery and poor quality of expenditure.

13. The exogenous factors are essentially those factors over which the MCs do not have any control. The delegation of revenue powers and grants (inter-governmental transfers), which determine the resources of the local bodies, are the key exogenous factors influencing the ability of the MC to spend and provide these services. These factors can be captured in the form of *'dependency ratio'* and *'decentralization ratio'*. *Dependency ratio* is defined as the share of grants a MC receives in relation to its total expenditure. *Decentralisation ratio* refers to the proportion of the MC's per capita revenue to State per capita revenue receipt.

14. Decentralisation increases efficiency of the lower levels of Government in the provision of various local services due to their limited jurisdiction and better matching of resources, services and preferences. An increase in decentralisation is expected to delegate more powers to local government authorities and augment their capacity to mobilise resources. Dependency of local government on the upper tiers of Government arises from the support extended to them in the form of grants, which arise largely out of vertical mismatches between functions and finance, as well as out of the compulsions necessitated by horizontal disparities between different jurisdictions. However, greater dependency on the upper tiers renders the local governments vulnerable regarding spending on the provision of basic infrastructure and services. This adversely affects the performance of the local governments.

15. Spearman's rank correlation coefficient between under-spending and dependency ratio in respect of the MCs works out to 0.61, statistically significant at 1 per cent level of significance. Further, the rank correlation between under-spending and revenue decentralization works out to be - 0.81 and has a desired negative

sign. It is highly significant at 1 per cent level of significance. Thus, lower decentralisation or higher dependency leads to higher under-spending.

16. Efficiency in revenue administration, reflected by per capita own revenue as a proportion to per capita GSDP, improves the availability of resources with a MC and lowers the under-spending. Rank correlation among the two parameters works out to -0.913, which is statistically significant at 1 per cent level.

17. There is a very weak link between under-spending and cost recovery. Interestingly, MCs such as Mumbai, Surat and Pune, which are among the best performers in terms of other financial parameters, have below average user charges. On an average, the cost recovery is below 1/4th of the expenditure incurred by the MCs. Considering the opportunities to adopt the benefit principle, there is a large scope for improvement in levying local user charges.

18. Quality of expenditure, measured as establishment and administrative expenditure as a proportion of total expenditure also turns out to be a major factor in determining the ability of MCs to provide basic services. Some of the MCs have an unsustainably high proportion (more than 50 per cent) of total expenditure on establishment and administration, which affects the sustainability of their finances and their service delivery capacity. Lower spending on administrative and establishment purposes would leave more resources with the MCs to provide civic amenities. Accordingly, the study suggests that guidelines/norms may be framed for the ULBs towards spending on capital and maintenance works as well for rationalizing the staffing pattern.

19. The debt position of MCs have been assessed in terms of the following: a) use of debt and b) debt sustainability. The former has been studied by using debt to capital expenditure ratio. Analysis indicates that for most of the MCs, borrowing/capital expenditure ratio is more than one, suggesting that the borrowed funds have been utilized for capital expenditure only. Further, aggregate revenue-expenditure balance is positive, indicating scope for capital expansion.

20. Debt sustainablity of the MCs has been measured in terms of interest coverage ratio, debt coverage ratio and ratio of debt repayment to revenue receipt. Interest coverage ratio defined as interest payment to operating surplus and debt coverage ratio as debt repayment to operating surplus have been very low. Similiarly, the ratio of debt repayment to revenue receipt has been below 10 per cent for all the MCs excepting those of Chennai, Madurai and Vijaywada. These indicate that probability of debt default is low.

21. Investment requirement for urban infrastructure including basic civic amenities, mass urban transport and road infrastructure (at 2004-05 prices) has been estimated at about Rs. 63,000 crore per annum for the ten-year period (2004-05 to 2013-14), which forms about 2.2 per cent of GDP. Of this, about Rs. 28,000 crore is required for basic civic amenities alone. Assuming the current status quo in fiscal federal relationship, the study has projected that ULBs in India together have the potential to raise revenues only up to about 1.0 per cent of the GDP. Of these funds, in a best case scenario, only 2/3rd would be available for asset creation after meeting the current expenditure. Thus, the short fall, even for basic civic amenities, would be at least to the tune of Rs. 10,000 crore or about 1/3rd of the requirement. Accordingly, the study has suggested wide-ranging reforms to revamp the current system of municipal finances in the country.

22. It is apparent from the analysis that there is a need to substantially increase the spending by urban local bodies. Given the constraints faced by State Governments, it is essential that the MCs be granted access to borrowed funds. At least there are two convincing arguments in favour of MCs going for borrowed funds. First, there is a scope for MCs to go in for borrowed funds as their current level of indebtedness is not very large. Secondly, there is a scope to raise user charges which are abysmally low across the States. Enhancement of user charges would make the new projects undertaken with borrowed funds economically viable and ensure that MCs are debt-sustainable.

23. MCs which have lower levels of under-spending or better performance have fared well on 4 out of 5 criteria viz., dependency, decentralization, tax administration and expenditure quality. On the

other hand, MCs with ranking “below average” on these 4 parameters are also the ones which have been spending less on core civic amenities. Notably, those MCs which had better delegation of revenue powers and less dependency on the upper tiers of Government were the best performers, in terms of provision of core services (lower under-spending). Thus, the analysis suggests that restructuring of revenue powers may be given top priority by the State Governments if urban amenities are to be improved significantly.

24. Though the delegation of revenue powers is a key factor, the need for efficient revenue (tax) administration cannot be underplayed. Examination of various taxes across the local bodies reveals that property and profession taxes are important sources. Octroi, however, is the most important source of revenue in municipal corporations belonging to Maharashtra and Gujarat. The local bodies need to adequately tap the existing avenues. Unit area system of computation, based on self-assessment principle, with respect to property tax needs to be extended to all ULBs. ULBs, where Octroi has been a major source of revenue, should be adequately compensated when Octroi is abolished. Other sources like entertainment tax, development charges, betterment levies, *etc* need to be tapped.

25. The 12th Schedule introduced in the Constitution by 74th Amendment Act envisages that functions like ‘safeguarding the interests of weaker sections of society, including the handicapped and the mentally retarded’, ‘slum improvement and upgradation’ and ‘urban poverty alleviation’ belong to the legitimate functional domain of urban local bodies. However, there are no commensurate resources with these institutions to discharge these functions. This is a case of expenditure assignment without a corresponding revenue assignment. An implicit assumption may be that these functions will be discharged by ULBs, but financed by higher levels of government which have access to buoyant and redistributive taxes.

26. The mix of municipal revenues in India - taxes, user charges and fees, transfers and loans - is narrow compared to international benchmarks with regard to the financing of local public services. The revenue instruments assigned to urban local bodies by State

Governments at present are grossly inadequate and not commensurate with the functions expected to be performed by them in accordance with the 74th Amendment Act. This is also evident from the structure of municipal finance in federal countries like United States, Canada, Brazil and China.

27. The study concludes that there is a need for certain lines of reforms to restructure the system of municipal finances in the country by revisiting expenditure assignment and revenue assignment, finding an alternative to Octroi, developing national consensus on a Municipal Finance Schedule, careful matching of revenues and expenditures based on Bahl-Linn principles, raising local revenue efforts, reforming property tax, using urban land as a resource, adopting 'users pay', 'beneficiaries pay' and 'polluters pay' principles, linking individual services with user charges and collective services with benefit taxes, restructuring inter-governmental transfers with a simple distributive formula that gives due weights to needs, rights to minimum basic services, incentives to performance and inter-jurisdictional equity, easing borrowing restrictions on ULBs, financing urban infrastructure through exploring the options of i) specialized banks for municipal lending, ii) municipal bond markets, and iii) specialized municipal funds and strengthening the creditworthiness of ULBs, developing public-private partnerships, addressing poverty alleviation through linkage to buoyant redistributive taxes, improving expenditure management and disclosure, promoting fiscal responsibility and professionalizing municipal management.

28. A 'Municipal Finance Schedule' for assignment to the ULBs to match the list of functions included in the 12th Schedule may comprise property tax including vacant land tax and taxation of Central and State Government properties (or service charges in lieu thereof), professional tax, entertainment tax, advertisement tax, business licensing fee or tax, motor vehicle tax or a share from the same, planning permission fee, development impact fee, betterment levy, a surcharge on stamp duty on registration deeds or a share from it and a proportion of the Value Added Tax. State Governments may provide freedom to ULBs in matters relating fixation of tax base and tax rate. Restrictions, if any, may only be by stipulation of ceilings or maximum rates of levy and limiting the power to grant exemptions.

29. The study suggests that the CFC may consider a "normative" approach for assessing the resource requirements of local bodies to decide the quantum of grants for them. This is necessary as the time lag between the submission of reports of SFCs, actions taken by State Governments on SFC recommendations and the constitution of CFCs is bound to continue. Norms for sub-national expenditures may be evolved and depending on the normative estimates of expenditures to be incurred by State Governments and local bodies, a share in the central divisible pool of resources may be considered for the local bodies in lieu of *ad hoc* grants. As urban poverty issues are going to assume critical proportions, the CFC may also consider revenue assignment for 'redistributive' functions such as urban poverty alleviation and slum development and linking such functions to an appropriate share in 'redistributive'/buoyant taxes like personal income tax, corporation tax and service tax.

30. As regards SFCs, the study suggests that they may follow the suggestions made by the Twelfth Finance Commission regarding approach to be adopted to study the finances of local bodies, identifying problems and making recommendations. SFCs may accord priority to 'measures' for improving municipal finances and financial management to address the fundamental factors leading to vertical imbalance rather than adopting a gap-filling approach.

31. The study has extensively used the Zakaria Committee norms (adjusted to study period) for working out under-spending by the urban local bodies and for projecting resource requirement for 10 years. In this context, it could be indicated that the Zakaria Committee norms, developed during the early 1960s, pertain to only five core services. Moreover, the costs of services may be subject to convexity due to technological changes and lack of natural advantages (*e.g.* on account of over-growth of cities). Therefore, there is a strong case for developing new benchmarks for estimating the costs of municipal services in India by constituting new groups and by undertaking more primary studies.

32. The study has employed a couple of quantifiable parameters relating to revenue balance, fiscal balance, debt sustainability, dependency, decentralisation, cost recovery, revenue administration

and quality of expenditure to make comparative assessment of finances of municipal corporations. There is a need for the regular conduct of similar studies for ULBs, state-wise and ULB group-wise to draw benchmarks and pursue reforms scientifically. A national network of resource centres on urban development, urban poverty alleviation and local public finance and a national bank on urban best practices and innovations by urban local bodies in the country and outside may also be instituted.

33. One serious difficulty encountered while studying the municipal finances in India related to the lack of availability of comprehensive and consistent data. There is no source of reliable data on finances of all local bodies in India to estimate their resource gaps. There is also a lack of uniformity in classification and reporting of financial data, which do not allow precise comparison on various parameters. Thus, an imperative need exists to develop a robust database on municipal finances and the same may be made public on a regular basis. With increasing urbanization, urban public finance is going to have important implications for state and national finances. The Reserve Bank of India may steer the building of such a national database on municipal finances. The study provides formats based on the National Municipal Accounting Manual and suggests that an online National Municipal Finance Information System (MFIS) be created.

Municipal Finance in India: An Assessment

P.K.Mohanty, B.M.Misra, Rajan Goyal, P.D.Jeromi*

Chapter 1

INTRODUCTION

1.1 Introduction

Local Self-Government Institutions (LSGIs) or Local Bodies in India, being at the cutting edge level of administration, directly influence the well-being of the people by providing civic services and socio-economic infrastructure facilities. The Constitution (73^{rd} and 74^{th}) Amendment Acts, 1992 (for rural and urban local bodies, respectively) have accorded a constitutional status to these institutions as the third-tier of Government. The Constitution (74^{th} Amendment) Act, 1992 has mandated grassroot level democracy in urban areas by assigning the task of preparation and implementation of plans for economic development and social justice to elected municipal councils and wards committees. It has incorporated the Twelfth Schedule into the Constitution of India containing a list of 18 functions as the legitimate functional domain of Urban Local Bodies (ULBs) in the country. In view of this position, the demands placed by the public on municipal authorities for the provision of various civic services have increased considerably. Further, with globalization, liberalization, the rise of the service economy and revolution in information and communication technologies, cities are being increasingly required to compete as centres of domestic and foreign investment and hubs of business process outsourcing. Civic infrastructure and services are critical inputs for the competitive

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edge of cities in a fast-globalizing world. However, without a commensurate enhancement of their resource-raising powers, cities are faced with fiscal stress as a result of which their capacity to contribute to national development as engines of economic growth is severely constrained.

While the Twelfth Schedule of the 74th Amendment Act, 1992 demarcates the functional domain of municipal authorities, the Amendment Act has not provided for a corresponding 'municipal finance list' in the Constitution of India. The assignment of finances has been completely left to the discretion of the State Governments, excepting in that such assignment shall be 'by law'. This has resulted in patterns of municipal finances varying widely across States and in a gross mismatch between the functions assigned to the ULBs and the resources made available to them to discharge the mandated functions. The ULBs depend on the respective State Governments for assignment of revenue sources, provision of inter-governmental transfers and allocation for borrowing with or without State guarantees. Constitutionally built-in imbalances in the functions and finances eventually reflect in the high dependency of urban local bodies on State Governments and of the State Governments on the Central Government[1].

Under the constitutional scheme of fiscal federalism, funds from the Central Government are devolved to the State Governments. Following the recommendations of the State Finance Commissions (SFCs) and taking into account the devolutions made by the Central Finance Commission (CFC), the State Governments are required to devolve resources to their local bodies. However, due to endemic resource constraints, they have not been in a position

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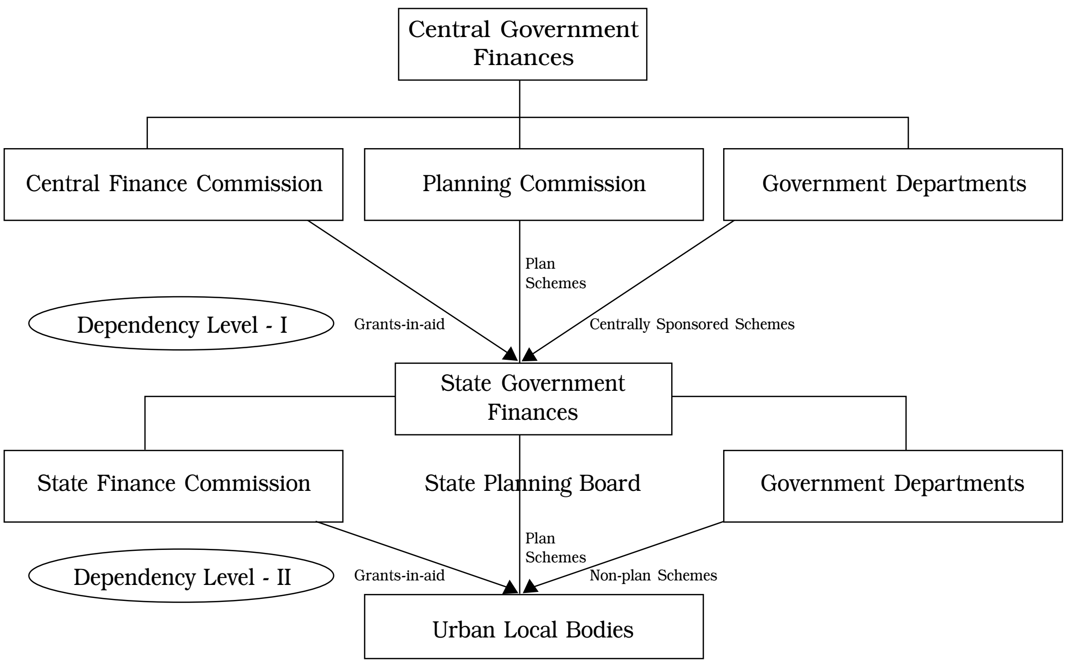
[1] The mismatch can be of two types. First, there is constitutionally in-built mismatch between the functions and finances of urban local bodies. Secondly, mismatch may arise due to the inefficient application of fiscal powers by the municipalities. Vertical imbalance arising from the first kind of mismatch is a common feature in most countries. However, in India the magnitude of the mismatch is much higher than other countries. Out of 18 functions to be performed by the municipal bodies less than half of them have a corresponding financing source. This study is primarily referring to the mismatch of the first type.

to allocate adequate resources to their ULBs. This is further compounded by the fact that even the existing sources of revenues are not adequately exploited by many of the ULBs. The above factors have led to rising fiscal gaps in these institutions, with resources drastically falling short of the requirements to meet the backlog, current and growth needs of infrastructure and services in cities, and, thereby, failing to meet with the expectations of citizens and business. To address the fiscal stress, some ULBs began to resorting to borrowings in recent years, often with State Government guarantees, from Housing and Urban Development Corporation (HUDCO), financial institutions, banks, open market, external lending agencies like the World Bank and the Asian Development Bank. This has implications for both Central and State finances, as it reflects the dependency of the ULBs and consequently, the provision of local public services on the policies and programmes of Central and State Governments (Figure 1). The launching of the

Figure 1: Fiscal Dependency of Local Bodies



Jawaharlal National Urban Renewal Mission (JNNURM) by the Government of India on 3rd December 2005 reflects the recognition, at the Government of India level, of the need to support ULBs to improve infrastructure facilities and basic services to the poor in cities and towns.

The rising fiscal gaps of ULBs have led to a search for best practices of local government reforms nationally as well as internationally. A study of international practice and experience on such reforms suggests the following key lessons for the conduct of effective local-self government in a federal structure:

- Functions of local bodies – expenditure assignment – must be clear;
- Finances of local bodies – revenue assignment – must be clear;
- Finances must be commensurate with the functions assigned;
- Functionaries must be aligned to functions and finances meant for discharging the functions;
- Functions performed or services delivered must be commensurate with the funds provided;
- Performance measurement framework, accountability channels, and reporting lines of functionaries must be clear;
- Professional civic management, committed civic leadership and informed public participation are critically important for the efficient and effective delivery of civic services to the people.

1.2 Importance of Local Public Finance

Any analysis of finances of State and Central Governments in isolation (excluding that of the local bodies) will not provide a holistic picture of the public finances of the country. Recognizing the fact that India is increasingly urbanizing, and given the estimate that of more than 50 per cent of India's population will live in urban areas in another 3 to 4 decades, one cannot afford to ignore the fiscal situation of ULBs. Civic infrastructure and services in most cities and towns are in a poor state. They are grossly inadequate even for the existing population, leave alone the need for planned urbanization and peripheral development to accommodate migrants and *in situ* population growth. The floods in Mumbai, Chennai, Hyderabad and Bangalore in the recent past have exposed the vulnerability of cities, their fragile ecology, weak infrastructure systems, faulty planning, long records of under-investment and fiscal imbalances. With rising expectations from the public, the financing of civic infrastructure and services has assumed critical importance socially, economically and politically.

The importance of local public finance also emanates from another critically important factor, *i.e.*, increase in poverty in cities and towns seen to be accompanying urbanisation – a phenomenon that is described as 'urbanisation of rural poverty' (Table 1).

Urban poverty alleviation and slum development are regarded as legitimate functions of urban local bodies according to the 74th Amendment Act. However, neither the ULBs have any well-defined "own" sources of finance to address urban poverty nor do they have recourse to a system of adequate and predictable inter-governmental transfers to undertake poverty alleviation.

Theoretically, the three main functions of the public sector are: stabilization, redistribution and allocation. With growing number of urban poor, the redistribution function, in addition to allocation, is

Table 1: Poverty Ratios of Select States (2004-05)

State	% of Rural Population Blow Poverty Line	% of Urban Population Below Poverty Line
Andhra Pradesh	11.2	28.0
Karnataka	20.8	32.6
Madhya Pradesh	36.9	42.1
Maharashtra	29.6	32.2
Kerala	13.2	20.2
Rajasthan	18.7	32.9

Source: Planning Commission Estimates based on National Sample Survey Organisation 61st Round.

emerging as a critical issue for Urban India. This needs to be addressed through the public finance system – Central, State and Local. Although the theory of public finance suggests that redistribution issues are best tackled by higher levels of government through the provisioning of inter-governmental transfers, there is no appropriate model of inter-governmental finance for local bodies in India to tackle the colossal problem of urban poverty. The 12th Schedule envisages that functions like 'safeguarding the interests of weaker sections of society, including the handicapped and the mentally retarded', 'slum improvement and upgradation' and 'urban poverty alleviation' belong to the legitimate functional domain of urban local bodies. However, there are no commensurate resources with these institutions to discharge these functions effectively. This represents a case of expenditure assignment without a corresponding revenue assignment.

1.3 Context of the Study

The world is passing through a remarkable period of transformation in recorded history. Globalization is sweeping across nations. New challenges and opportunities for development are emerging from: (a) rapid flows of goods, services, capital, technology, ideas, information and people across borders, (b) increased financial integration of the world economy, and (c) rise of knowledge as a key driver of economic growth. Innovations in transportation, information and communication technologies (ICT) are leading to unprecedented levels of integration between separated parts of the globe. The spread of ICT and the Internet are among the most distinguishing features of the new globalizing world. The world is shifting from a manufacturing-based industrial economy to a service-dominated and network-based knowledge economy. Economic activity is now structured on the "international" and "national" plains rather than "local". Cities are emerging as the hubs of the new economic activities fueled by globalization, ICT revolution and surge of the service economy. In the above background, the city finance systems need to be restructured to facilitate the emergence of competitive cities, catering to the infrastructure and civic service needs of business as well as residents.

With faster and more integrated economic growth, urbanisation is gaining momentum in the developing countries; nearly half of the world today is urban. In India, urbanisation has been somewhat slow. The country's urban population grew from 26 million in 1901 to 285 million in 2001, with the share of population in cities and towns steadily rising from 10.8 per cent in 1901 to 27.8 per cent in 2001. The number of metropolitan cities went up from 1 in 1901 to 35 in 2001. The percentage of urban population living in these million-plus cities increased from 5.84 in 1901 to 38.60 over the same period. Appendix 1 provides a statistical picture of the trends in urbanisation and metropolitan growth in India.

Even though India did not face an "urban explosion" as did some other countries, the absolute magnitude of the urban population is itself so large that the issues of shelter, civic amenities, public health and social security are too colossal to be ignored by national authorities. Moreover, sustainable growth of urbanisation is imperative for faster national development. The contribution of urban areas to country's Net Domestic Product (NDP) has been steadily increasing from about one-third in early 1970s to about 50 per cent in the post-liberalisation period (Table 2).

Another study, covering later indicate that Urban areas contribute to more than half of India's National Income (Table 3). Within Urban India, it is the large cities that generate the bulk of this contribution. Cities are the generators of economic wealth and centres of employment and income opportunities.

Table 2: Share of Urban Areas in National Income

Year	Total NDP (Rs. Billion)	NDP Urban (Rs. Billion)	Share of Urban in Total NDP (%)
1970-71	368	139	37.7
1980-81	1103	453	41.1
1993-94	7161	3312	46.2

Source: Central Statistical Organisation, reported in Mohan (2004).

Table 3: Contribution of Urban Areas to National Income

Year	Share of Population (%)	Share of National Income (%)
1951	17.3	29.0
1981	23.3	47.0
1991	25.7	55.0
2001	27.8	60.0

Source: Ministry of Urban Affairs, Government of India, reported in Kumar (2003).

1.4 Urbanisation and Economic Growth

Neo-classical economists view urban centres as the drivers of regional and national economic growth. Concentration of population and economic activity in space is regarded crucial for leveraging certain external economies that provide a base for improvement in productive efficiency, technological innovations and access to global markets [Kundu (2006)]. Research in urban economics suggests that urbanisation positively impacts on economic growth. Cities played a key role in the development of national economies of the developed world during their days of rapid urban growth. India's National Commission on Urbanisation Report (1988) stressed the role of cities as engines of economic growth, reservoirs of capital and skill, centres of knowledge and innovation, sources of formal and informal sector employment, generators of public financial resources for development, and hopes of millions of rural migrants. Globalisation and liberalization have made cities the preferred destinations of foreign investment, off-shoring and business process outsourcing.

1.4.1 Cities and Agglomeration Economies

Acceleration of urbanisation generally takes place in pace with corresponding acceleration of economic growth. Urbanisation is influenced by factors such as i) economies of scale in production, particularly manufacturing; ii) existence of information externalities; iii) technology development, particularly in building and transportation; and iv) substitution of capital for land made possible by technology. Jacobs (1984) holds the view that economic life develops via innovation and expands by import substitution. He cites the critical role of "import-replacement" in the growth of cities due to "five great forces": enlarged city markets, increased numbers and kinds of jobs, increased transplants of city work into non-urban locations, new uses of technology and growth of city capital. Cities form and grow to exploit the advantages of agglomeration economies made possible by the clustering of many activities leading to scale and networking effects. As economies of scale in production begin to take hold, larger size plants become necessary. This contributes to the need for larger numbers of suppliers and denser settlements of customers. The services needed by the growing agglomeration of people give rise to an even greater number of people living together [Mohan (2006)].

Urban economists distinguish between two types of agglomeration economies: localisation and urbanisation. Localisation economies emanate from the co-location of firms in the same industry or local concentration of a particular activity such as a transport terminal, a seat of government power or a large university. They are external to firms but internal to the industry concerned. Urbanisation economies occur from the increased scale of the entire urban area. They are external to both firms and industries.

Localisation economies in cities result from the backward and forward linkages between economic activities. When the scale of an activity expands, the production of many intermediate services: financial, legal, consultancy, repairs and parts, logistics, advertising, *etc.*, which feed on such activity, become profitable. Activities like banking and insurance are known for economies of scale. One obvious advantage of agglomeration is the reduction in transportation and communication costs due to geographical proximity. There are many other important economies associated with localisation. For example, the concentration of workers with a variety of special skills may lead to labour market economies to firms through a reduction in their recruitment and training costs. Similarly, the costs of collection and dissemination of information can go down significantly when different types of people work and live together. Pooled availability of capital, skill and knowledge, ease of contact, and informational spill-over between firms, institutions and individuals make cities the centres of technological innovation, incubation and diffusion.

Urbanisation economies arise due to the spatial concentration of population leading to the benefits of larger, nearer and more diverse markets, availability, diversity and division of labour and sharing of common infrastructure. These accrue to all firms located in an urban area and not limited to any particular group. A large concentration of firms and individuals results in lowered transaction costs and the benefits of face-to-face contact. It also promotes risk-sharing and access to wider choices by producers, consumers and traders. Larger urban areas provide better matching of skills to jobs and reduce the job search costs. The provision of civic infrastructure and services like water supply, sewerage, storm drainage, solid waste management and transport involves economies of scale and these facilities become financially viable only if the tax-sharing population exceeds a certain threshold level.

The prevalence of agglomeration economies, especially in large cities, suggests that cities are not only the centres of productivity and economic growth, but they are also the places that promote human growth, development and modern living. Large cities are, however, subject to the "tragedy of the commons" and "diseconomies of congestion", which require appropriate interventions by way of effective urban management. Size *per se* cannot be called a negative factor as long as the positive agglomeration economies outweigh the negative congestion diseconomies.

1.4.2 Cities as Generators of Resources

One important aspect, which has not been adequately highlighted in empirical research, is the phenomenal contribution of cities to the exchequers of State and Central Governments. Cities are reservoirs of public financial resources such as income tax, corporation tax, service tax, customs duty, excise tax, value added tax, stamp duty on registration, entertainment tax, professional tax and motor vehicles tax. They are also the places which facilitate the collection of user charges for the public services provided.

A study by the Centre for Good Governance (CGG), Hyderabad in 2005 revealed that Hyderabad and Ranga Reddy urban districts of Andhra Pradesh, containing Hyderabad Municipal Corporation and 10 surrounding Municipalities, had only 9.5 per cent share in the State's population in 2001. However, the combined shares of these two districts in the total collection of key State taxes in 2001-02, namely commercial tax, excise, stamp duty and registration and motor vehicles tax were 72.9 per cent, 63.0 per cent, 36.2 per cent, and 27.8 per cent respectively (Table 4). This shows that urban areas are the generators of resources for state and national development, including those needed for developing the rural areas. Urbanization is likely to lead to an increase in the buoyancy of key financial resources of Central and State Governments, presumably due to the close relationship between urbanisation and economic growth.

The finances of urban local bodies are bound to have critical implications for both Central and State Government finances in the future. These essentially translate into civic infrastructure and services, which are central to the health and productivity of city economies and their contribution to National and State Domestic Products as well as Treasuries. Moreover, the local government finance system in India forms an integral part of the State Government

Table 4: Share of Hyderabad and Ranga Reddy Urban Districts Combined in the Collection of Major Taxes in Andhra Pradesh

(Per cent Share in State Collection)

	1997-98	1998-99	1999-00	2000-01	2001-02
Commercial Taxes	58.37	68.73	69.84	72.04	72.85
Prohibition & Excise Taxes	53.34	53.53	59.20	56.84	63.03
Registration and Stamps	32.75	33.96	34.88	35.45	36.18
Transport and Motor Vehicles	27.00	26.80	27.93	28.27	27.80

Source: Centre for Good Governance, Hyderabad.

finance system. The latter is intricately connected with Central Government finances. Thus, in essence, the local, state and national public finance systems are closely inter-linked.

Despite the position described above and the mandate of the Constitution (73rd and 74th Amendment) Acts, 1992 requiring the local bodies to prepare and implement plans for economic development and social justice, the plans of urban and rural local bodies are yet to form parts of the State and Central Government plans. Similarly, the finances of these local bodies are yet to be counted for arriving at an aggregate picture of the public finance of the country.

1.5 Investment Requirements for Urban Infrastructure

Accelerating the flow of investible resources into urban infrastructure and services is key to India's agenda for economic growth, poverty reduction and urban renewal. However, the current levels of investment are low and the capital requirements particularly for the development of urban infrastructure in India are massive. Estimates of funding needed by urban infrastructure are available from several sources. The India Infrastructure Report (Rakesh Mohan Committee, 1996) pointed out that the average plan allocation for urban infrastructure comprising water supply, sanitation and roads was only about 9 per cent of the investment needed for their provision and maintenance. Placing the annual average aggregate investment requirements of urban infrastructure under the categories of water supply, sanitation and roads at about Rs.282 billion for the period 1996-2001 and another Rs.277 billion for the period 2001-2006, at 1996 prices, the Report observed that the planned investment was woefully inadequate for meeting even the required operation and maintenance of core urban services, let alone for financing the additional requirements of core civic services and other urban infrastructure.

Water supply, sanitation and solid waste management are important basic needs affecting the quality of life and productive efficiency of people. Provision of these basic services continues to be amongst the core activities of the ULBs. About 89 per cent of urban population has access to water supply and 63 per cent of urban population has access to sewerage and sanitation facilities (Economic Survey, Government of India, 2004-05). These data, however, only relate to access, which is different from quantity and quality of service. The quantity and quality of water as well as other services in most cities considerably fall short of the stipulated norms.

The Tenth Five Year Plan of the Government of India emphasized the provision of water supply and sanitation facilities to a level of 100 per cent coverage of urban population with potable water supply and 75 per cent of urban population with sewerage and sanitation by the end of the Tenth Plan period, *i.e.* March 31, 2007. The funds required for water supply, sanitation and solid waste management during the Tenth Plan period (2002-2007) were projected at Rs 53,719 crore. However, as against this amount, the likely availability of funds from different sources was estimated at Rs.35,800 crore only, indicating a shortfall of 33.4 per cent in the requirement of funds (Table 5).

The Central Public Health & Environmental Engineering Organisation (CPHEEO) has estimated the requirement of funds for 100 per cent coverage of urban population under safe water supply and sanitation services by the year 2021 at Rs.1,729 billion. Estimates by Rail India Technical and Economic Services (RITES) indicate that the amount required for urban transport infrastructure investment in cities with a population of one lakh or more during the next 20

Table 5: Funds Requirement/Availability for Water Supply, Sanitation and Solid Waste Management in the Tenth Plan

(Rs. Crore)

Estimates of Requirements of Funds		**Likely Availability from Different Sources**	
Water Supply	28,240	Central Government	2,500
Sanitation	23,157	State Governments	20,000
Solid Waste Management	2,322	HUDCO	6,800
Total	**53,719**	LIC	2,500
		Other PF/s & External Funding Agencies	4,000
		Total	**35,800**

Source: Economic Survey, 2004-05, Government of India.

years would be of the order of Rs.2,070 billion (reported in India Infrastructure Report, 2006). Obviously, sums of these magnitudes cannot be located from within the budgetary resources of ULBs. Innovative inter-governmental and public-private partnership approaches would be necessary to mobilise the resources required. But the urban local bodies would have to play a key role, being the 'most affected' institutional stakeholders and being the public authorities mandated to undertake the functions listed in the 12th Schedule of the Constitution. Hence the issues of local government finance assume critical importance.

Recognising the urban policy and finance challenges in the country, Jawaharlal Nehru National Urban Renewal Mission (JNNURM) was launched by the Prime Minister of India on December 3, 2005. The Mission encourages cities to initiate steps to bring about improvement in the existing service levels in a financially sustainable manner. The objectives of the Mission, *inter alia*, include planned development of identified cities including semi-urban areas, outgrowths and urban corridors, and improved provision of basic services to the urban poor. The admissible components under the Mission include urban renewal, water supply and sanitation, sewerage and solid waste management, urban transport, development of heritage areas, preservation of water bodies, housing and basic amenities to the poor *etc.* A provision of Rs.50,000 crore has been agreed to as Central Assistance to States under JNNURM spread over a period of seven years over 2005-12. Given that grants from the Central Government would constitute between 35 to 80 per cent of the JNNURM financing plan, the Mission would entail investment in urban infrastructure and basic services over Rs.1 lakh crore.

JNNURM aims at the following outcomes by ULBs at the end of the Mission period:

- Modern and transparent budgeting, accounting and financial management systems, designed and adopted for all urban services and governance functions;

- City-wide framework for planning and governance will be established and become operational;
- All urban poor people will have access to a basic level of urban services;
- Financially self-sustaining agencies for urban governance and service delivery will be established, through reforms to major revenue instruments;
- Local services and governance will be conducted in a manner that is transparent and accountable to citizens; and
- e-Governance applications will be introduced in core functions of ULBs resulting in reduced cost and time of service delivery processes.

Reforms in urban governance are central to the implementation of JNNURM. Linked to Government of India's support to States, they are based on an enabling strategy to strengthen the system of local public service delivery. JNNURM envisages a series of reforms at the State and ULB levels to address the issues of urban governance and provision of basic amenities to the urban poor in a sustainable manner. The key reforms envisaged at the ULB level are:

- Adoption of modern, accrual-based double entry system of accounting in ULBs;
- Introduction of system of e-governance using IT applications like GIS and MIS for various services provided by ULBs;
- Reform of property tax with GIS, so that it becomes major source of revenue for ULBs and arrangements for its effective implementation so that collection efficiency reaches at least 85% within the Mission period;
- Levy of reasonable user charges by ULBs/Parastatals with the objective that full cost of operation and maintenance is collected within the Mission period. However, cities/towns in North East and other special category States may recover at least 50% of

operation and maintenance charges initially. These cities/towns should graduate to full O&M cost recovery in a phased manner;

- Internal earmarking within local body budgets for basic services to the urban poor; and
- Provision of basic services to urban poor including security of tenure at affordable prices, improved housing, water supply, sanitation and ensuring delivery of other already existing universal services of the government for education, health and social security.

Amongst the key reforms to be pursued at the State level under the guidelines for JNNURM is the implementation of decentralization measures envisaged in the Constitution (74th Amendment) Act, 1992.

1.6 Imperatives of Decentralisation

International trends indicate that the globalising world is also becoming increasingly local. Along with globalization and liberalisation, decentralisation has also become a major plank of public policy all over the world in recent years. There are three important reasons for this phenomenon. First, top-down economic planning by central governments has not been successful in promoting adequate development. Second, changing international economic conditions and structural adjustment programmes designed to improve public sector performance have created serious fiscal difficulties for developing countries. Third, changing political climates, with people becoming more educated, better informed through improved communications and more aware of the problems with central bureaucracies, have led the public desiring to bring control of the government functions closer to themselves [Smoke, 2001].

Governments in developing countries have resorted to decentralization through various means: *deconcentration, delegation and devolution*. Deconcentration redistributes decision-making authority and financial and management responsibilities for providing services and facilities among different levels of central and provincial governments. Delegation reflects the transfer of centrally controlled responsibility for decision-making and administration of public functions to semi-autonomous organizations. Devolution means the transfer of authority for decision-making, finance and management to autonomous units of local government. It involves transferring responsibilities for services to local bodies that elect their own representatives, raise their own revenues, and have independent authority to make investment decisions (Rondinelli and Cheema, 2002). The 74^{th} Constitution Amendment Act, 1992 in India aims at a decentralisation regime through the mechanism of devolution of functions, finances and functionaries to urban local bodies.

Originally, the Constitution of India envisaged a two-tier system of federation. Until 1992, local governments had not been a part of the Indian planning and development strategy. It took nearly four decades to accord a constitutional status to Local Self-Governments and, thereby create a three-tier system of federation. With the Constitution (73^{rd} Amendment) Act, 1992 and the Constitution (74^{th} Amendment) Act, 1992, local bodies have come to enjoy the recognition of a third stratum of government. In the case of urban local bodies, enormous responsibilities have been identified in the 74^{th} Constitution Amendment. These include: i) preparation of plans for economic developments and social justice, and ii) implementation of such plans and schemes as may be entrusted to them, including those in relation to the matters listed in the Twelfth schedule to the Constitution (Article 243W). Besides the 18 items of responsibilities envisaged as legitimate functions of ULBs in the Constitution of India, the Legislature of a State, by law, can assign any tasks relating to the preparation and implementation of plans for economic development and social justice. In order to perform these responsibilities, urban local bodies have to be financially sound, equipped with powers to raise resources commensurate with the functions mandated. The crux of the financial problems faced by urban local bodies is the mismatch between functions and finances and that this mismatch is seen to be growing with urban growth, population concentration, liberalization and globalization.

While the 74th Amendment listed the expenditure responsibilities of ULBs, it did not specify the legitimate sources of revenue for these authorities. It simply stated that the Legislature of a State may, by law, i) authorize a municipality to levy, collect and appropriate such taxes, duties, tolls and fees, ii) assign to a municipality such taxes, duties, tolls and fees levied and collected by the State Government, iii) provide for making such grants-in-aid to the municipality from the consolidated fund of the state and iv) provide for the constitution of such funds for crediting all moneys received. Thus, while the municipalities have been assigned the responsibility of preparation of plans for a wide range of matters – from economic development to promotion of cultural, educational and aesthetic aspects, the power to raise resources by identifying taxes and rates to implement the plans are vested solely with the state legislature. This has created, what is referred to in public finance literature as vertical imbalances, *i.e.*, constitutionally built-in mismatches in the division of expenditure liabilities and revenue-raising powers of the Union, States and Local Bodies. To address this problem, two significant provisions introduced in the Constitution of India through the Constitutional Amendments are: i) the formation of State Finances Commissions (SFCs) to recommend devolution of State resources to local bodies and ii) enabling the Central Finance Commission (CFC) to recommend grants-in-aid for local bodies through augmenting the State Consolidated Funds.

Article 243Y, inserted into the Constitution of India by the 73rd Amendment Act, makes it mandatory on the part of the State Governments to constitute SFCs once in every five years to review the financial position of the Panchayats and the Municipalities. As far as the urban local bodies are concerned, it is mandatory for the SFCs to review and recommend the principles of devolution of resources from the State Government to their local bodies and suggest "measures" needed to improve their financial position.

The 73rd Amendment Act stipulates that the State Governor shall cause every recommendation made by the State Finance Commission, together with an explanatory memorandum as to the action taken thereon, to be laid before the Legislature of the State.

The Constitutional Amendment Acts provide for a safeguard regarding the implementation of the recommendations of SFCs. Article 280 of the Constitution under which a Central Finance Commission is appointed once every five years to assess the financial needs of the State Governments and to recommend a package of financial transfers from the Centre to States is amended. It is now mandatory on the part of the CFC to recommend "the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Municipalities in the State on the basis of the recommendations made by the Finance Commissions of the State". This provision is designed to establish a proper linkage between the finances of the local bodies, State Governments and Central Government.

1.7 Objectives of the Study

Even after a constitutional status was accorded to the local bodies in 1992, the finances of these authorities are yet to be recognized as an integral part of the public finance system in India. It is only recently that some attempts were made to analyse their fiscal situation as discussed in the subsequent chapter. Paucity of data and the consequent absence of authoritative literature have made the subject of local public finance in India a black box. The entire discussion in Chapter 8 of the Twelfth Finance Commission's report brings out the fact that, despite several attempts, there is no source of reliable data on finances of all local bodies in India to estimate their resource gaps. Hence, the Commission was constrained to fix the total amount of grants-in-aid to local bodies on an *ad hoc* basis. Availability of firm and comparable data on municipal finances in

India is conspicuous for its absence. There have been a very few comprehensive studies of municipal revenues and expenditure in India till date. In this context, this study sets the following objectives:

i) To critically examine the provisions relating to revenues and expenditure of municipalities and bring out the mismatch between their revenue authority and expenditure responsibilities in the light of international as well as national experiences.

ii) To examine the trends in major revenue sources and expenditures of municipalities and assess their fiscal position.

iii) Analyse performance of ULBs in the provision of civil infrastructure.

iv) Examine and identify major constraints that could influence the overall performance of ULBs in the provision of civic infrastructure.

v) To estimate and project the resource requirements of the municipal sector in the country during the 10-year period from 2004-05 to 2013-14, and suggest measures for improving municipal finances.

1.8 Analytical Framework, Data Source and Limitations

This study is an attempt to critically examine the fiscal position of ULBs in India. Before examining the fiscal position, it is imperative to look at the broad contours on which fiscal position of local bodies are evolving. Both urbanization and fiscal decentralization are putting increasing pressure on the fiscal position of ULBs to provide civic infrastructure facilities and services. Hence, the study starts with examining the aspects relating to urbanization and fiscal decentralization, having implication for the financial position of urban local bodies, based on a review of the existing literature, relevant acts and rules and secondary data.

For analyzing the fiscal position of municipalities, reliable secondary data on fiscal variables of comparable ULBs are not available from a single source. The report of the Twelfth Finance

Commission provides some broad data, which will not enable any detailed disaggregated analysis. In view of their large number (numbering more than 3,700), it is rather difficult to obtain data individually from all the ULBs. Hence, for the present study we have selected 35 major municipal corporations (MCs), situated in cities with population of more than one million according to 2001 Census. Budget documents from MCs were obtained and then data on major revenue and expenditure heads for a five year period from 1999-2000 to 2003-2004 (all actual figures) were compiled. As complete data on major variables were available in respect of 22 MCs, most of the empirical analysis of this study has been confined to those 22 MCs. The broad conclusions drawn from the analysis, however, apply to other municipalities in the country as well.

It may be stated upfront that there are several limitations to the data used in this study. First, budget documents of urban local bodies are not standardized and hence classification of many of the items is not uniform across the municipal corporations. The limited data provided in the budget documents of the municipal corporations lacks consistency and comparability. Second, some corporations have not provided data in respect of certain variables for the years considered for the study. Third, even the actual data given in the budget documents might undergo changes, after the statutory audits take place.

Besides the accuracy of the data, the study has some other limitations. First, since local bodies are statutorily not allowed to have deficits in their budgets, their resource gaps cannot be assessed from the budget documents. Due to this statutory provision, they are living within their own means, without resorting to deficit financing as adopted by State and Central Governments. Hence, unlike State and Central Governments, their fiscal constraints are not evident in the budget documents. Deficits and debts are not the issues of finances of ULBs. Their main problem is the inadequacy of resources to provide the needed urban services and infrastructure. This is not getting reflected in their budget documents. Hence, the data available from the municipal budgets can be used only for deciphering the trends in revenues and expenditure and their composition. Second, the benchmark used in the study (Zakaria Committee norm) with regard to minimum spending for urban services for estimating the resource gap for the ULBs is very old (developed in 1960-61). With technological changes and also changes on account of the nature of services required by the urban population, the benchmark used in the study may not be appropriate. In the absence of a better benchmark, Zakaria Committee norm has been used in this study, suitably adjusted for inflation.

1.9 Structure of the Report

Chapter 1 provides a brief introduction, background, objectives, data source and analytical framework of the study.

Chapter 2 reviews the literature on fiscal decentralization and finances of urban local bodies dealing with both theory and practice.

Chapter 3 looks at legal and institutional framework to bring out the in-built asymmetry in the functions and revenue sources of municipal bodies in India.

Chapter 4 presents all-India trends in municipal finances based on the data drawn from secondary sources. Thereafter, it reviews the trend and composition of municipal finances, based on five-year period budgetary data for 35 metropolitan municipal corporations spread across 14 States in the country.

Chapter 5 makes an assessment of finances of the selected ULBs, in term of both standard approach and normative approach and projects the resource requirements for urban infrastructure for a period of 10 years.

Chapter 6 makes concluding observation wherein the key findings are reiterated and broad directions for municipal reforms are spelt out.

Four Appendices are annexed to the Report as follows:

Appendix 1: Depicts tables indicating the trends in urbanization and metropolitan growth in India.

Appendix 2: Describes the pattern of local public finances in selected developed countries.

Appendix 3: Provides some details of the State Finance Commissions and their Reports.

Appendix 4: Sets out the formats for the proposed national database on finances of urban local bodies – Municipal Finance Information System (MFIS).

Chapter 2

FISCAL FEDERALISM: THEORY & PRACTICE

2.1 Approach to Review

This chapter reviews the literature relating to the role, functions, working and finances of Urban Local Bodies (ULBs). The review is sequenced under the following heads: fiscal decentralization, structure of local bodies, resources of local bodies, imbalances in revenues and responsibilities, fiscal transfers, role in economic development, *etc.* The international studies, are reviewed initially followed by the studies done in the Indian context. In the last section, an attempt has been made to bring out the major observations emerging from the review of literature.

2.2 International Studies

2.2.1 Fiscal Decentralization - Theoretical Aspects

The importance and significance of municipal finances arises in the context of fiscal decentralization (and also urbanization). Therefore, it is pertinent to start with examining the theoretical aspects of fiscal decentralization so that the role and relevance of the municipal finances can be established on a sound footing. The 'Decentralization Theorem', formulated by Oates (1972) states:

"For a public good – the consumption of which is defined over geographical subsets of the total population, and for which the costs of providing each level of output of the good in each jurisdiction are the same for the central or for the respective local government – it will always be more efficient (or at least as efficient) for local governments to provide the Pareto-efficient levels of output for their respective jurisdictions than for the central government to provide any specified and uniform level of output across all jurisdictions".

The theorem suggests that a public good should be provided by that geographical jurisdiction which internalises its provision and should include precisely the set of individuals that consumes it:

"each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalise benefits and costs of such provision". Oates (1972).

The above principle, known as 'subsidiarity' in the theory of fiscal federalism rests on the foundation that efficient allocation of public resources to match public preferences for services is facilitated by factors such as access to local knowledge, alignment of resources to services, local financial autonomy in planning and delivering services, scope for achieving cost-effectiveness in service delivery and performance accountability in service provision. The theory contends that welfare would be maximized if each local government provides the Pareto-efficient output for its constituency.

Two major factors in favour of decentralisation are enumerated in literature as follow:

i) The central government, while remaining more concerned with the functions like economic stabilization, income distribution and resource allocation that have macro implications, often neglects the activities relating to provision of basic services. Most central governments are primarily concerned with managing macroeconomic policies and maintaining national political stability. They are often less concerned with the provision of civic services, except to the extent that these involve large-scale capital-intensive investments (Rondinelli, 1990).

ii) Decentralisation of political, financial and administrative authority to the lower levels of government increases the efficiency in provision of various services due to the lesser jurisdiction and focused attention of the lower levels of government.

The following three forms of decentralization are distinguished in literature [e.g. Davey (1996) and Rondinelli and Cheema (2002)]:

i) Deconcentration of authority to field offices, lower echelons, *etc.*, *i.e.*, to officials within same organisational hierarchy;

ii) Delegation to separate legal persons, but ultimately under the same political direction; and

iii) Devolution to a representative body, such as a provincial government or local authority, *i.e.*, with independent political accountability.

In this background, it may be noted that fiscal decentralization is a subset of decentralization. Fiscal decentralisation can be defined as "the devolution of taxing and spending powers to lower levels of government" [Fukasaku and de Mello Jr. (1999)]. More specifically, fiscal decentralisation refers to the principles and practices concerning functional or expenditure responsibilities, revenue assignment and rectification of vertical and horizontal imbalances. In a broader sense, fiscal decentralisation is the fiscal empowerment of lower tiers of the government.

The theoretical literature on fiscal decentralization has tried to answer the basic question - 'who should do what' to ensure the most efficient and equitable allocation and distribution of resources consistent with the preferences of the people [see Oates (1972), King (1984), Bird (2000), Shah (1994), Litvack et al (1998) and Bahl and Linn (1992)]. These fiscal balance questions have particular significance in a vast country like India with significant regional disparities in resource endowment, level of income, stage of development, fiscal disabilities and even social deprivation.

As pointed out earlier, traditionally the theory of public finance [Musgrave (1959) and Musgrave and Musgrave (1989)] identifies the following three functions for the public sector:

i) macroeconomic stabilization;

ii) income redistribution; and

iii) resource allocation.

As per the theory, while the stabilization and redistribution functions are to be performed by the national government, the sub-national governments have a significant role in resource allocation. The basic argument provided by the theory of fiscal federalism [Oates (1972)] is that in a democracy, decentralization will result in a better match of supply and demand for local public goods. Being closer to the people, local bodies can more easily identify people's needs and thus supply the appropriate form and level of public services [Rondinelli (1989)]. The above demarcation is by and large true although there may be considerable overlapping and inter-governmental coordination required in regard to all these functions. To ensure the effective redistribution of income and alleviation of poverty, the national government has a dominant role [Hirsch (1970), Oates (1999)] although the local governments have to play important role for effective implementation. Sometimes a range of rewards and disincentives may have to be built into inter-governmental fiscal relations by the central government in order to achieve certain national goals and egalitarian objectives. Again, if more expenditure and resources are left to the control of local bodies, the stabilization function cannot be handled effectively by the national government alone. Ensuring some degree of correspondence between the benefits obtained from public services in a particular jurisdiction with the revenue potential is important because it also promotes accountability [(Litvack *et al* (1998), Bird (2000)].

Regarding expenditure, literature suggests that watertight assignment of several services and functions would be difficult. This is particularly so, when the relevant policy and regulatory framework and much of the financing come from higher levels of government with the actual service delivery being done at a lower institutional level (Bird, 2000). The need for clarity in expenditure assignment brings home the equally important question of matching functions and finances and the channels of accountability. Bird (2000) outlines three major rules in the context of accountability for local public expenditures:

i) Sub-national governments should, whenever possible, charge for the services they provide;

ii) Where charging is impracticable, sub-national governments should finance such services from taxes borne by local residents, except to the extent that the central government is, for whatever reasons, willing to pay for them through transfers and

iii) Where the central government does pay, sub-national governments should be accountable to the central government, at least to some extent. This is one way to ensure accountability. But in the context of decentralised democratic governance, it may be noted that, the concept means much more than 'answerability.' Actually, democratic decentralisation is expected to correct not only the distortions caused by the abuse of power of public agencies (the answerability aspect), but also to make them more responsive, participative and transparent. Transparency facilitates participation, and participation makes a public agency really responsive to people's needs.

2.2.2 Structure of Local Bodies

Cross-country experience reveals that in most of the countries, governments are characterized by multiple structures. Apart from the government at the national level, countries, in general, have governments at two sub-national levels, *i.e.* provincial (or regional) and local. Fjeldstad (2001) provides the structure of sub-national governments in selected countries which is produced in Table 6.

2.2.3 Resources of Local Bodies

A basic question in fiscal decentralisation, with regard to resources, is 'who should tax, where and what' (Musgrave, 1983). Several authors have advanced principles underlying revenue assignment. They range from broad principles to the rationale of specific taxes [See Oates (1972), Musgrave (1983), Mc Lure Jr. (1983), Bird and Wallich (1993), Stein (1998), Oates (1999), Bird (2000) and Bahl (2001)]. There is a broad consensus among the authors that the taxes dealing with redistribution or stabilization, taxes on

Table 6: Structure of Sub-national Governments in Selected Countries

Country	Intermediate level	Local level
Argentina	23 provinces	1617 minicipios
Brazil	27 states	4974 municipios
Colombia	32 departments	1068 municipalities
Ethiopia	9 region, plus 2 city administration, 66 zones	550 woredas
France	22 regions, 96 departments	36772 communes
India	25 states, 7 union territories	3586 urban local bodies, 234078 rural local bodies
Italy	22 regions, 93 provinces	8100 municipalities
Kenya	39 country councils	52 municipal, town and urban councils
Malaysia	13 states	143 city, municipal and district councils
Mozambique	10 provinces	33 municipalities
Philippines	76 provinces	850 local authorities
Tanzania	21 regions (incl. Zanzibar)	92 district councils, 18 municipal and town councils, 1 city council (Dar es Salaam)
Uganda	45 districts 13 municipalities	950 sub-counties 39 municipal divisions 52 town councils
United Kingdom	Counties	540 rural districts, metropolitan districts and London boroughs.
United States	50 states	39000 counties and municipalities 44000 special-purpose local authorities

Source: Fjeldstad (2001).

mobile factors, and taxes requiring national level information and involving significant economies of scale in tax administration should be levied by the federal government. The revenue instruments assigned to a tier of government should match, as far as possible, the expenditure requirements to induce "fiscal responsibility" [Ter-Minassian (1997)]. However, in reality, the mismatch in functions and finance is the major issue in fiscal decentralisation.

The literature on public finance addresses the issue of the suitability of types of taxes for various levels of government. Though there is no ideal assignment of taxes between central and lower levels of government, one can find a set of tax-assignment rules in the traditional theory of fiscal federalism. These principles are in accordance with the respective responsibilities of central and lower tiers of governments. Thus, taxes on international transactions (customs duties) and a considerable share of income and excise taxes should be assigned to central government. To perform the function of income redistribution, it is appropriate for the central government to collect corporate income and wealth taxes. Local bodies require relatively stable sources of revenues.

Following Musgrave (1983), the six principles of tax assignment in a federation are:

i) Taxes suitable for economic stabilization should be levied by the central government;

ii) Progressive re-distributional taxes should be assigned to central government;

iii) Personal taxes with progressive rates should be levied by the jurisdictions most capable of implementing a tax on a global base;

iv) Lower-level governments should tax revenue bases with low mobility between jurisdictions;

v) Tax bases distributed highly unequally between jurisdictions should be centralized and

vi) Benefit taxes and user charges may be appropriately used at all levels.

Broadway *et al* (2000) examines the suitability of various taxes and levies which can be collected by various tiers of government as set out in Table 7.

Research suggests that the urban local bodies need to have a good number of local taxes so as to become financially sound and match the range of assigned functions effectively. A local tax is one where the local authority (a) determines the tax revenue by setting the tax rate and/or defining the tax base and (b) retains the revenue collected for its own purposes [Bailey (1999) and Bird (2000)]. Oates (1972) suggests the following basic guidelines for the design of local taxation systems:

Table 7: Tax Assignment: Who should tax what?

Tax type	Determination of		Collection and Administration	Comments
	Tax base	Tax rate		
Customs	N	N	N	International trade taxes
Corporate income	N	N	N	Mobile factor
Personal Income	N	N, P, L	N	Redistributive, mobility, stabilization
Wealth taxes (incl. capital, inheritances)	N	N, P	N	Redistributive
Payroll	N, P	N, P	N, P	Social programme
Value Added Tax	N	N	N	Admin,Costs,Stabilization
Resource Taxes:				
Rent (profit) tax	N	N	N	Unequally distributed
Royalties/fees	P, L	P, L	P, L	Environmental preservation
Alcohol, tobacco	N, P	N, P	N, P	Health care shares
Gambling, betting	P, L	P, L	P, L	Province and local responsibility
Lotteries	P, L	P, L	P, L	Province and local responsibility
Taxation of 'bads':				
Carbon	N	N	N	Global/national pollution
Motor Fuels	N, P, L	N, P, L	N, P, L	Tolls on road use
Congestion tolls	N, P, L	N, P, L	N, P, L	Tolls on road use
Parking fees	L	L	L	Local congestion
Motor Vehicles:				
Registration	P	P	P	Provincial revenue source
Driver's license	P	P	P	Provincial revenue source
Business taxes	P	P	P	Benefit tax
Excises	P	P	P	Immobile tax base
Property tax	P	P	P	Benefit tax, immobile tax base
Land tax	P	P	P	Benefit tax, immobile tax base
User charges	N, P, L	N, P, L	N, P, L	Payment for services

N=National (or, Central); P=Provincial (or, State); L=Local
Source: Boadway, *et al* (2000).

- Local taxes should be as neutral as possible in terms of their effects on economic behaviour;
- The benefits and costs of local taxes should be clear to those to whom services are to be provided;
- The pattern of incidence of local taxes should meet the basic equity standards; and
- Administration and compliance costs should be minimized by avoiding the assignment of complex taxes to local governments.

Bird (1994) compares the major taxes in terms of the above criteria for qualifying as suitable local taxes (Table 8).

Table 8: Criteria for Choice of a Local Tax

Characteristics	Property Tax	Property Tax	Sales Tax	Business Tax
Immobility	+	-	-	-
Adequacy	-	+	+	?
Buoyancy	-	+	+	+
Stability	+	-	-	-
Non-Exportability	+/-	+/-	+	-
Visibility	+	+	+	-
Fairness	+	+	?	-
Acceptability	-	-	?	+
Administrative Ease	?	+	?	+

Note : '+' means that the tax is good, '-' means it is bad, and ' ?' means it is indeterminate. '+/-' means that the tax is good to the extent it falls on residents and bad to the extent it falls on non-residents. It may be noted that the table may not fully apply to all situations in all developing countries.
Source : Bird (1994).

Though the basic principles of local taxation are derived from the general principles of taxation in public finance, the following criteria are particularly relevant for making choice among local taxes:

Equity: The notions of vertical and horizontal equity should apply as far as possible.

Efficiency: Local taxes should promote allocative efficiency. This requires local voters to pay local taxes so that the use of service reflects the willingness to pay.

Transparency: The accountability of service providers to tax payers depends on voters knowing exactly how much they are paying in taxes.

Local autonomy: Local governments and their voters are free to determine the rates at which local rates are set.

Economy: Local taxes should be collected with least expenses.

Adequacy: The tax yield should be, as far as possible, adequate to finance the levels of services for which people vote. The local tax should, therefore, have an easily adjustable and/or an elastic tax base, expanding as fast as expenditure.

Revenue stability: There should not be undue fluctuations in the flow of local revenue.

Immobile tax base: Local taxes may do well to confine to immobile tax bases such as land, buildings, *etc.*, besides levying user charges wherever relevant. This does not rule out imposing fees or other levies on business, trade, and taxes on profession and so on.

Several researchers regard land-based taxes as the most appropriate sources of local body finances where the local authorities, as in India, are required to provide the basic civic infrastructure facilities. A key argument is that local government spending translates into rising land values and the land-owners benefit proportionately more than what they pay as taxes due to urbanization and infrastructure development leading to agglomeration economies.

The literature recognises 'users pay', 'beneficiaries pay' and 'polluters pay' as desirable principles of financing local infrastructure and services like water supply, sewerage, drainage, roads *etc.* When beneficiaries are identifiable and benefits can be measured, user charges are regarded as the 'first best' instruments of financing public services. They promote efficiency by providing information on demand to the providers of public service and also ensure that what the public sector supplies is valued (at the margin) by citizens. They act as instruments to ensure the accountability of public functionaries. The theory of local public finance suggests the following guiding principles for levying user charges and benefit taxes:

(i) Wherever possible, user charges may be levied for the services provided as the first resort;

(ii) For achieving efficiency, user charges should be levied on the direct recipients of benefits;

(iii) The poor may be subsidised directly, if needed, rather than through reduced prices and distortions in the entire market for services;

(iv) Where charging is impracticable, specific benefit taxes should be levied on local residents; and

(v) Inter-governmental transfers may be used to finance services only if user charges and benefit taxes are not adequate.

User pricing has been adopted in land development in certain countries as described below:

In Colombia road improvements, water supply and other public services have been financed by "valorisation" under which the cost of public works is allocated to the affected properties in proportion to the estimated benefits conferred on them by those works. The success of the scheme is seen to depend on (i) careful planning and execution, (ii) active involvement of beneficiaries, (iii) effective revenue collection system, and (iv) significant initial funding of the 'valorisation fund' by higher levels of government.

In Korea and some other countries, large land parcels have been developed by local governments. After development, a part of the property is returned to the original owner in proportion to his original occupation. The balance is sold at market prices to recover the development costs. The scheme requires fairly sophisticated procedures for success. In India, town planning laws of some States like Gujarat provide for town planning schemes which are similar to land readjustment. However, such schemes have not been used extensively in India.

Development charges, impact fees and lot levies are popular in North American countries. They are levied with a view to accommodating population expansion in new development areas. Levies are imposed on would-be property developers in proportion to the estimated costs of the needed infrastructure. Both off-site and on-site impacts are taken into account while calculating the fees.

In the case of 'collective' services where beneficiaries are not identifiable or services are not measurable and levying user charges is not possible, researchers regard benefit taxes as the appropriate instruments of financing local expenditures. It is argued that when clear linkages exist between the taxes levied and the expenditures financed, earmarked benefit taxes constitute indirect user charges or surrogate prices for services. Earmarking then facilitates the rational choice by tax payers.

Nobel laureate James Buchanan (1963) and a number other researchers regard 'earmarking' as a 'first best' operational way of dealing with the fundamental normative problem of public economics: how to provide public services that match peoples' preferences. They contend that earmarking aims at the introduction of market prices into the budgetary process. The strongest economic case for earmarking exists where there are clear benefit linkages between the taxes or charges levied and the expenditures financed so that earmarked taxes act as indirect forms of user charges or prices for services. Through the linking of user charges and specific benefit taxes to certain public services, earmarking facilitates the rational choice by taxpayers. The effectiveness of earmarking depends on the following three conditions:

- Expenditure specificity, *i.e.* the expenditures to be financed by earmarked revenues are well-defined and specific in the sense that taxpayers can identify their obvious benefits.
- Tight earmarking, *i.e.* the linkage between earmarked revenues and expenditures is tight at the margin. When the amount earmarked is substantially less than the amount spent on the designated functions, earmarking will have no effect on the margin and will be meaningless.
- Strong benefit linkage, *i.e.* revenues are in the form of direct user charges such as payments for use and indirect user charges such as specific benefit taxes.

Local public finance provides broad guidance for matching revenues with expenditure responsibilities. Bahl and Linn (1992) suggests the following general principles for identifying the revenue sources appropriate to financing particular types of local expenditures:

i) Where the benefits of public services are measurable and accrue to readily identified individuals in a jurisdiction, user charges are the appropriate financing instruments;

ii) Local public services such as administration, traffic control, street lighting and security, which are services to the general public in the sense that identification of beneficiaries and measurement of benefits and costs to individuals are difficult, are most appropriately financed by taxes on local residents;

iii) The cost of services for which significant spillovers to neighbouring jurisdictions occur (e.g., health, education and welfare), should be financed substantially by state or national inter-governmental transfers and

iv) Borrowing is an appropriate source to finance capital outlays on infrastructure services, particularly, public utilities and roads.

2.2.4 Imbalance of Revenues and Responsibilities

Notably, the nature of functions and finances in a federal set-up across a wide range of countries is similar. National governments assign more expenditure functions to the sub-national governments than the sources of revenues. The same is true of provincial governments which assign more responsibilities to their local governments as compared to revenues. The result is the mismatch between functions and finances - often referred to as 'vertical imbalance'. Hence, sub-national/local governments are generally dependent upon transfers from higher levels of government. The extent of vertical imbalance in resources of sub-national governments in different countries is given in Table 9. It is clear from the table that the resources raised by the sub-national governments are not sufficient to match the expenditure responsibilities, thus leading to what is called as the fiscal gap. The basic rationale for the system of inter-governmental fiscal

Table 9: Vertical Imbalances in Selected Countries

Country	Share of sub-national government (per cent)			
	In total public expenditure		In total tax revenue	
	1990	1997	1990	1997
Argentina	46.3	43.9	38.2	41.1
Brazil	35.3	36.5	30.9	31.3
Ethiopia	1.5	..	1.6	..
France	18.7	18.6	9.7	10.8
India	51.1	53.3	33.8	36.1
Italy	22.8	25.4	3.6	6.5
Kenya	4.4	3.5	2.2	1.9
Malaysia	20.2	19.1	3.7	2.4
Philippines	6.5	..	4.0	..
South Africa	20.7	49.8	5.5	5.3
United Kingdom	29.0	27.0	5.9	3.6
United States	42.0	46.4	33.8	32.9

Source: Fjeldstad (2001).

transfers, from higher levels of government, is the existence of fiscal gap at the local government level.

It may be noted that the term 'sub-national' includes both provincial and local governments. Some countries (e.g. India, United States) have two-tier sub-national governments while others have just one tier, that is, local government (e.g. United Kingdom).

2.2.5 Inter-Governmental Fiscal Transfers

The need for inter-governmental transfers arises largely out of vertical mismatches between functions and finance as well as out of the compulsions necessitated by horizontal disparities between different jurisdictions. Inter-jurisdictional spillovers of costs and benefits also justify transfers. A higher-level government may also wish to compensate local governments on considerations of fiscal disabilities like poor taxable capacity. It may also be because the national government may impose its preferences on the sub-national governments in the national interest (e.g. eradicating poverty, ensuring a national minimum of public services of standard quality such as health and education, reducing regional disparities *etc.*). Often programmes sponsored and funded by the central government are required to be implemented by local governments.

There is a broad typology of grants based on the prevailing practices in countries. Grants are broadly grouped into conditional or specific and unconditional or general. The conditional categories are divided into matching and non-matching, the latter further into close-ended or open-ended. There are also equalisation grants largely governed by the considerations of horizontal equity. Which of these or what combination of them is to be adopted is a policy decision largely governed by the objectives to be served by the concerned governments [Bahl and Linn (1992)]. The design of transfers is critical because whether a transfer is good or bad depends on the objectives to be served and the manner in which it is designed.

Inter-governmental grants, other things being equal, stimulate the provision of local government services, increase private sector demand and may even lead to the reduction of taxation. In theory, grant works by increasing the real income of the local citizens (the so called income effects) and/or by reducing the relative price of the services in question (substitution effects). The local residents' response to grants depends upon their respective income and price elasticities of demand. In all cases where the income effect is higher than the substitution effect, there is potential for stimulating more demand for goods as well as services. Grants also open the option for reducing local taxation. Whether grants will stimulate more positive impact or reduce local taxation or produce other effects is an empirical question.

While matching grants, particularly of the open-ended variety, have greater stimulating effect on grant-receiving institutions because of both income and substitution effects, there are empirical studies indicating that closed ended grants stimulate greater expenditure than open-ended ones [Gramlich (1977), Shah (1979) and Shah (1989)]. The chief weakness of this type of grants is that it may distort local priorities besides widening spatial disparities as richer governments can attract more resources especially in an open-ended grant programme. This has very serious implications for countries like India where reducing spatial disparities has been an avowed development objective of the Government.

Successful fiscal decentralisation depends, to a great extent, on designing inter-governmental transfers in a rational, equitable and accountable way. Given the wide institutional set-up and socio-economic factors governing countries, the transfer system has to be country-specific subjected to constant review depending on the changing demands of time. India is a country that has made constitutional provision for periodically evaluating and recommending inter-governmental transfers with separate arrangements for union-state as well as state-local transfers.

From the vast literature on inter-governmental transfers, a few principles, considered to be relevant for a federal system like that of India, are listed below:

i) Sub-national governments must be made an integral part of the revenue mobilization as much as it has shared responsibilities;

ii) Objectivity, transparency and predictability may be built into sub-national budgeting;

iii) Transfers should not perform a "gap filling" function as far as possible. (Any transfer from a higher to a lower government will help to close the fiscal gap and the objectives to be served therefore assume importance here). Needs, rights and incentives are key criteria of inter-governmental transfers. A simple distributive formula that gives due weights to needs, rights to minimum basic services, incentives to performance, inter-jurisdictional equity *etc.* is important;

iv) Medium-term expenditure and revenue framework may be put in place;

v) Efficiency and inter-jurisdictional equity have to be ensured. Efficiency requires that those responsible for any service should have adequate resources (assuming the best own revenue effort) and sufficient flexibility to make decisions, while being held accountable for results. Unless increased transfers are matched by a local contribution, however small that contribution may be in the poorest communities, the full efficiency benefits of decentralisation are unlikely to be realized;

vi) Transfers should not bail out the incompetent and the irresponsible. Hard budget constraints should be the rule and soft options need to be avoided;

vii) Fiscal autonomy cannot be built in a regime of grants, but the sub-national governments will have to progressively rely on tax effort and innovative revenue mobilisation including project–tied loans, public donation and the like and

viii) Sub-national governments should have defined responsibility including expenditure and performance conditionality and accountability.

2.2.6 Municipal Finance and Economic Development

Municipal finance can affect the nature and location of development. In some cases, municipal financial tools work in tandem with planning tools, but in other cases the two have opposite effects. In general, the effect of municipal financial tools in the nature, type and location of development is less understood. Slack (2002) analysed the impact of municipal taxes in Canada and found that they, in general, encourage low-density development, which is not advisable. The author suggested that a combination of user fees, based on marginal cost pricing, and development charges, levied on a development-by-development basis, could encourage efficient land and infrastructure use and result in developments located closer to existing services. Further, the user charges should be based on the marginal cost of additional units of services from the infrastructure, and development charges on the marginal cost of extending infrastructure to new developments. The study suggested that municipal financial tools should not work against planning objectives and tools.

Martinez-Vazquez and McNab (2001) reviews the impact of fiscal decentralization on economic growth. The authors state that though one of the stated primary objectives of fiscal decentralization is to foster economic growth, academic interest in fiscal decentralization as an engine of growth has not developed. At the theoretical level, the overall impact of fiscal decentralization on economic growth is uncertain. In terms of a direct impact, one can expect higher growth associated with decentralization. Further, there can be potentially a multiplicity of indirect effects of decentralization on growth including those through consumer efficiency, producer efficiency, geographical distribution of resources, macroeconomic stability, *etc.*

Mohan (2006), while analyzing the urbanization in Asia, has examined the financing needs of Asian urbanization over the next thirty years. The author noted that financial markets in Asia have not been sophisticated enough to allow for borrowing from the credit or bond markets as in case of Europe or North America. Financing of urban infrastructure in Asia usually comes from higher tier of governments who raise resources from taxes, or from banks and financial institutions that have been typically government owned or sponsored (hence it has some element of moral hazard). Ideally, cities have to develop self-sustaining local taxation and user charge systems so that they can tap national and international financial markets for their financing needs. The author has brought out an interesting international dimension to urban infrastructure financing. Historically, regions undergoing intensive urbanization had to mobilize external savings. Hence, urbanization of Asia in the coming years will put pressure on international resource mobilization and it will in turn get reflected in higher interest rates in the years to come, which is of relevance to central banks.

2.3 International Experience

The documentation of international experience is sparse on functions and finances of urban local bodies. One notable exception is Bahl & Linn (1992). Among the developing countries, few have seriously addressed fiscal federalism from the state to local level. There are not many relevant models from developing countries from which India could derive useful lessons. The practice of local government finance in countries as documented in government publications reveals varying degrees of adherence to or departure from principles of public finance. Revenue assignment remains the most conspicuous problem.

The Centre for Tax Policy and Administration in OECD periodically publishes statistical data and analytical papers on inter-governmental finances of OECD and non-OECD countries. Studies relating to OECD countries (see Appendix 2) reveal that property tax is the dominant local tax in Australia, Canada, Ireland, New Zealand, United Kingdom and the United States. These countries have either less important local governments (e.g., Ireland, Australia) or local governments that are more dependent on inter-governmental transfers (e.g., Canada, U.K.). Income tax is the most important local tax in Austria, Belgium, Luxembourg, Switzerland, Norway, Sweden, Denmark, Finland and Japan. A small number of countries have a balanced local tax structure. These include France, Spain, Portugal, Italy and Turkey. Countries influenced by the Anglo-Saxon tradition appear to depend heavily on property taxes and inter-governmental transfers. Property taxes seldom accounted for more than 20% of local current revenues in majority of developed countries. However, in many developing countries including India, the dependence of the municipal authorities on property taxes and inter-governmental transfers is inordinately heavy, reflecting their narrow revenue base.

There is a visible trend in the OECD countries towards more effective utilisation of user charges and benefit taxes by local governments. This is attributed partly to citizens' preference for user charges over general taxes. In contrast, user charges in India remain a grossly under-exploited source till today.

The structure and system of local government finance in selected countries are presented below:

United Kingdom

The finance regimes of local authorities in England include: (i) a system of non-domestic rates, being a property tax levied on industrial and commercial property - set by the Secretary of State for Environment for England and Wales, collected into the national pool and then distributed among the local jurisdictions based on adult population, (ii) a system of exchequer grants to local authorities, principally the Revenue Support Grant (RSG) designed to compensate local authorities for differences in the cost of providing municipal services, (iii) a capital finance system (grants and loans) within which the local authorities are also able to participate in partnerships with the private sector under the Private Finance Initiative and (iv) a system of local domestic taxation, known as the Council Tax. In 1995-96 the Government grants constituted about 52 per cent of the total revenue expenditures by local authorities in England. The share of non-domestic rates was 25 per cent and that of Council Tax was 21 per cent [DETR (1997)].

For the purposes of the Council Tax, each dwelling is assigned to one of eight bands: A to H according to its value on the open market as on 1st April, 1991. The Council Tax, which replaced the Community Charge in 1993, is a revision of the old property rating system. However, in stead of a notional annual letting value, for which market evidence was deficient, it is based on the capital value of property. All households in the same band pay the same amount of tax, but the tax increases upwards from A to H, the tax for H being treble that of band A. There is 50 per cent discount for unoccupied dwellings and second homes. Tax-exempt people include students, student nurses, apprentices, youth trainees, those on income support and the severely mentally handicapped.

United States

The United States which has a loose and flexible structure of fiscal federalism. The hallmark of the US local government finance system is the absence of too many specifications. State governments assign local governments taxes and their maximum rates. Rules are clear on whether local governments may seek voter referenda on fiscal decisions such as tax rates, new borrowings and so on. They can formulate their own user charges. On the whole, local government revenues finance about of 40 to 70 per cent of the expenditures. The result of relative openness in tax assignment rules and rates has been a relatively flexible, smoothly functioning system, while there has also been significant inter-state and inter-country competition for attracting industry. This could be one reason why overall tax levels in USA are low by standards of developed countries.

The main sources of local public finance in the United States include the following:

Property Tax

Property tax amounts to 70-75 per cent of all local tax revenues in USA. The tax is based on capital value of property (often at a rate exceeding 1 per cent). It is unpopular because of high visibility, linkage to unrealised gains, lumpsum nature of collection and uncertainty of assessment. However, it gives a stable source of local funds, is difficult to evade, and generates revenues to finance services which enhance property values. It also provides a degree of independence to the local bodies from the state and federal governments. Being a general benefit tax, it is assessed at a considerably higher rate on non-residential property compared to residential property.

Local Option Income Tax

States like Alabama, Arkansas, Delaware, Georgia, Kentucky, Indiana, Maryland, Michigan, Missouri, New York and Pennsylvania authorise their municipal authorities to levy local income tax. Some states like Georgia mandate a local choice of either an income tax or a general sales tax. While local jurisdictions usually collect the local option income tax themselves, some states like Indiana and Maryland collect it on behalf of their local governments by piggy-backing onto state income taxes. This is on consideration of lowering the administrative costs. It is argued that local option income tax adversely affects business and residence location decisions. However, it provides a buoyant source of local revenues, although a slump in the economy can lower the tax collections.

General Sales Tax

This tax is generally popular among taxpayers because it is collected in small amounts with many transactions. Local rates of this tax ranged from 0.25% to 6% in the United States in 1993. However, local plus state rates exceeded 6%. General sales tax, like income tax, is subject to the effects of cyclical changes such as boom and recession.

Excise Taxes

Excise taxes are sales taxes imposed on specific goods and services and are most commonly assessed on lodging, alcoholic beverages and tobacco products, utilities and motor fuel (local option gasoline tax). Some local jurisdictions levy an excise tax on new construction.

Impact Taxes

These taxes, notably levied in California, aim at generating resources from new developments to finance their infrastructure requirements. These taxes are imposed under the 'tax' powers of local authorities and not under their ‘police’ powers. These are comparable to excise taxes.

Special Assessments

Special assessments are levied on real property to fund improvements that benefit particular properties rather than the society at large. The charge to any specific property is a portion of the increase in the property value. Local jurisdictions normally advance construction funds from general revenues and collect one-time or multi-instalment special assessments as reimbursement. Sometimes special districts are set up as separate, limited-purpose units of government to provide specific services to areas. These special districts are authorised by concerned state governments to levy taxes, issue debt and contract for services.

User Charges & Fees

User fees and fees pay for the cost of operating and maintaining public facilities and services, as well as repay outstanding debts. Road tolls, park admission fees and water and sewer charges are representative user fees in the United States.

Development Exactions

Exactions are in-kind contributions (*i.e.* land or facilities) or in-lieu payments (fees) by developers, dedicated to provide specific infrastructure facilities for new development. They are negotiated on a project-by-project basis.

Debt Financing

Borrowing enables local authorities to raise large amounts of capital in a short period of time while spreading repayment over a long period. Forms of debt financing available to local governments in the United States include tax-free bonds (general obligation and revenue), taxable bonds, lease-purchase contracts, revolving loan funds and bond banks.

General Obligation Bonds

General obligation bonds are the most secure form of debt a local authority can issue and do not require a debt service reserve. They are limited by set debt ceilings and require the approval of voters. Unlimited-tax varieties of general obligation bonds pledge future tax collections to repay principal and interest. Limited-tax general obligation bonds are pledged against a fixed tax rate levied on taxable property. General obligation bonds are usually exempt from federal taxation.

Revenue Bonds

Revenue bonds are designed to finance revenue-generating facilities, backed by a stream of revenues pledged from user charges for services like water supply, sewerage, drainage, toll roads *etc.* In most cases, interest rates on revenue bonds are higher than those on general obligation bonds. This is mainly because revenue bonds are backed by variable revenues rather than by stable taxes. Revenue bonds are generally tax-exempt and do not require voter approval.

Taxable Bonds

These bonds are similar to commercial bonds and allow more leeway in the types of projects funded. To attract investors, a higher rate of interest is required than on tax-exempt bonds.

Tax Increment Financing

Tax increment financing (TIF) is similar to special assessment in that it defines a particular geographic area for special treatment. Property owners in the TIF area are assessed at the same tax rate as all other owners in the local jurisdiction. However, property within the TIF area is assessed at both pre- and post-development values. Taxes on pre-development values are deposited with other general funds. The difference between the pre- and post-assessed values is used to service TIF bonds or loans secured to finance infrastructure in the TIF area.

Lease-Purchase Contracts

These contracts allow local authorities to purchase equipment or property on an instalment basis while using the purchased items. Financing is arranged typically through a financial institution or manufacturer and the contracts generally carry higher rates of interest than outright purchases.

Revolving Loan Funds

These funds are established with a specific amount of federal and/or state money for clearly desired purposes. They function as permanent lines of credit for local governments which are often too small and not able to access the bond market.

Bond Banks

Bond banks are created by state statutes to purchase small bond issues of participating local governments and in turn issue bonds large enough to float on the national market. Interest rates are typically lower than the local governments could obtain on their own.

Impact Fees

Impact fees are 'one-time' charges levied by local governments to pay for public infrastructure required by new developments. They are imposed as a condition for approval to proceed with development. The facilities financed out of impact fees may include on-site and off-site infrastructure such as roads, water supply, sewerage, storm water drainage, flood control measures, open space, solid waster management, fire protection, libraries, schools, police services, public buildings and administration. Impact fees are assessed under the broad 'police' powers of local authorities (as distinct from 'tax' powers) to regulate the use and development of land. These powers have their root in the legal "nuisance" doctrine which dealt with the elimination of potential negative impacts of new development on the community. The fees differ from exactions, which are "negotiated" requirements mandating developers either to dedicate land or infrastructure for public use or to contribute cash for provision of facilities needed to serve a proposed development. Impact fees have a demonstrated potential for raising revenues to support new development.

US Department of Housing and Urban Development (1993) reported that the local governments in all 50 States in USA imposed impact fees in some form or other. The average level of impact fee assessment on a 2000 square feet single-family home based on a study of 206 representative local governments in the United States in 1991 was $ 9,425. State and federal courts and the US Supreme Court have generally ruled that the assessment of impact fees is within the legal powers of local governments to finance all types of public facilities as long as state statutes permit such levy and the "rational nexus" criterion is met. The local government imposing impact fees must show the nexus or link among the new development's need for public facilities (needs test), the benefits to the assessed development (benefits test) and the proportionality of the fee (proportionality test). Proportionality refers to the portion of the cost of public facility improvements which reasonably relates to the needs of and benefits accruing to new development.

A study of State legislations in the Untied States to enable the local authorities to levy impact fees suggests some desirable criteria for drafting an impact fee legislation. The same are presented in Box 1.

Canada

The main sources of municipal finance in Canada include: property tax, business tax, special taxes to raise revenue to pay for a specific service or purpose and local improvement taxes. Special service taxes in the province of Alberta, for example, include one or more of the following: (a) waterworks tax; (b) sewer tax; (c) boulevard tax; (d) dust treatment tax; (e) paving tax; (f) tax to cover the cost of repair and maintenance of roads, boulevards, sewer facilities and water facilities; (g) ambulance service tax; (h) tax to enable the

Box 1 : Lessons from Impact Fee Legislations in USA

- Clearly state the jurisdictions authorised to levy impact fees;
- Identify the specific types of developments/buildings brought under the net of impact fees and clearly specify the basis for that assessment (e.g. square footage, per unit *etc.*);
- Stipulate all types of facilities and expenditures (benefiting new development) that are eligible for funding by impact fees;
- Require the definition of service area of facility improvement to ensure that the impact fees are calculated, assessed, collected and spent only in the area served by improvement;
- Prescribe the application of rational nexus test among the new development's needs for facilities, the amount of fee charged to develop the facilities and the benefits accruing to new development from the facilities;
- Stipulate that impact fees finance only those eligible facilities projected for development in an existing Capital Improvement Plan (CIP);
- Require that the level of services provided by facilities funded by impact fees do not exceed that provided by existing infrastructure to the community as a whole. Otherwise remedy would be needed to meet the deficiency from sources other than impact fees;
- Include a system of credits for developer-donated in-kind contribution and revenue payments including taxes and fees;
- Allow jurisdictions to establish a system of exemptions for specified types of development with foregone fees paid from general revenues;
- Specify the time of fee payment. Since timing has consequences for land seller, builder and buyers, the fees may be assessed early in development process and collected late;
- Require the establishment of separate interest-bearing accounts for the deposit of impact fees so that they are not co-mingled with funds for other purposes;
- Require the adoption of a plan to refund fees not spent on the needed public facilities within a reasonable time period;
- Specify criteria to be taken into account while devising a formula to determine impact fee assessment and
- Include provision to guide inter-governmental agreements, citizen advisory committee requirements, public hearings, fee appeal process and procedures for fee fixation.

Municipality to provide incentives to health professionals to reside and practice their profession in the Municipality; (i) fire protection area tax; (j) drainage ditch tax; (k) tax to provide water supply for the residents of a hamlet; and (l) recreational services tax.

Local improvement taxes in Canada are generally in the form of betterment levies linked to benefits accruing to specific local areas due to the provision of infrastructure as a result of implementation of local improvement plans.

Australia

The Australian experience may be contrasted with that of the US in some important aspects. Australia remains a highly centralized federalist developed country with the central government collecting about 80 per cent of total tax revenue, while state and local governments remain responsible for most of the expenditure items. It delegates little tax raising power at the local level. This results in extreme vertical imbalance, with the states having to depend on central grants for 50 per cent of their expenditures and local governments collecting an insignificant amount on their own.

Brazil

Brazil's experience is of particular relevance to India since it is unique in the sense that municipalities are granted full autonomy, while these are, at least legally, under state tutelage in most countries. In Brazil, consumption and production taxes are assigned to all three levels of government. Selected excises on manufacturing with a set-off mechanism are assigned to the Centre, while a broad-based, harmonized value added tax is assigned to the states. Local governments are assigned a tax on selected services. Urban property is taxed by municipalities, while that on rural property is a central tax.

The main municipal taxes in Brazil are those on services (ISS) and urban property (IPTU). ISS rates are set by the municipalities, subject to ceilings introduced by the federal government. IPTU is levied on the capital value of land and buildings. Based on Constitutionally mandated revenue sharing, the municipalities are entitled to (a) 25 per cent of the revenue from state Value Added Tax (ICMS), (b) 50 per cent of revenue from the state tax on motor vehicles registration (IPVA), (c) 22.5 per cent from the federal Value Added Tax (IPI) and Income Tax (IR), (d) all revenue from the income tax held at source (IRPF) and paid by the municipalities or by their decentralized agencies, (e) 70 per cent of revenue from the federal financial-transactions tax levied on transactions with gold (IOF-Quro) and (f) 50 per cent of revenue from the federal rural-property tax (ITR). Municipalities also receive compensatory transfers and transfers related to healthcare and investment programmes. In 2002, total revenue of all municipalities in Brazil was 7.9 per cent of GDP of the country – own sources, 1.5 per cent; shared revenue, 3.2 per cent; specific grants and compensatory transfers, 2.2 per cent, and other revenues, 1.0 per cent [de Mello (2007)].

The Brazilian experience, however, indicates that local governments have been poor tax collectors. Tax on selected services basically remains an ignored tax. Even urban property tax has been implemented only by very few large cities, such as Sao Paulo. Many local governments ignore their taxing powers and responsibilities altogether. In some of the poorer municipalities, own tax revenues are meager, while transfers received per capita exceed those for state capitals and bigger cities reflecting the constitutional changes. Such low level of 'own' tax revenues indicates that assumptions for raising local tax efforts through purely legal provisions may be insufficient. As in the case of the US, certain basic parametric assumptions must be fulfilled before devolution can become successful. Similarly, for mobilizing resources through issuing municipal bonds, local bodies should have explicitly defined borrowing powers as in the case of the US.

China

China's fiscal system is highly decentralized among the 31 provincial, 331 prefecture, 2,109 county and 44,741 township-level units. Nearly 70 percent of total public expenditure in China takes place at the sub-national (*i.e.* provincial, prefecture, county, and township) level, of which more than 55 percent takes place at sub-provincial levels. Key sub-national expenditure responsibilities in China include sub-national administration, local capital construction, basic local services, maintenance, repair and operation of urban infrastructure, primary and secondary schooling, health and hospitals, support for agricultural production, price subsidies, poverty alleviation, cultural and heritage protection, environmental conservation, local and regional development and physical planning.

The Budget Law of China confers substantial autonomy – each level of Government should have an independent Budget that must be approved by the People's Congress at that level. The Chinese decentralization policy, implemented in the early 1980s, gave buoyant taxes to local governments, which made contractual commitments to transfer revenues up to the centre. The 1994 'Tax Assignment System Reform', however, introduced certain strong measures to increase tax collection by and resource flows to the centre.

The revenue assignment between Central and Sub-national Governments after 1994 reforms stands as follows. Central revenues in China comprise import tariffs, consumption taxes, income taxes, import-related consumption taxes and VATs, taxes imposed on banks, non-bank financial institutions and insurance companies (including business taxes, income taxes, and the urban maintenance and development tax) and taxes on railroads. Sub-national revenues consist of business taxes (excepting taxes imposed on banks, non-bank financial institutions, insurance companies and railroads), company income tax (excluding local banks, foreign banks and non-bank financial companies), personal income tax, urban land use tax, urban maintenance and development tax (excluding banks, non-bank financial institutions, insurance companies and railroads), fixed asset capital gains tax, house property taxes, stamp taxes, agriculture and related taxes, tax on contracts and land-value increment taxes. Shared revenues include VATs (75 per cent central and 25 percent, sub-national governments), stamp taxes on security exchange (50: 50 sharing) and resource taxes.

As seen from the comparison of local government finance systems in United Kingdom, United States, Canada, Australia, Brazil and China, the patterns of local revenues vary widely across countries depending upon their diverse historical and political factors, stage of development and urbanisation and organisation of government, including constitutional provisions, institutional arrangements and inter-governmental fiscal relations. Political, economic and social contexts and the range of assigned expenditure responsibilities are critical for determining whether a particular model of revenue mix is appropriate for a country at a given point of time or not. It is not possible to make universally applicable recommendations for reforming the structure of local government finance without going into country-specific situations.

2.4 Indian Studies

In the backdrop of a review of the theories of multi-level finance, Rao and Chelliah (1991) provides a brief survey of literature on fiscal federalism in India and raises several issues pertaining to fiscal decentralization. The study, undertaken prior to the enactment of the 73rd and 74th Constitutional Amendment Acts, highlighted the "glaring" absence of a reasonably developed independent institutional structure to provide local public services in India.

The Expert Group on the Commercialisation of Infrastructure (GOI, 1996), also known as Rakesh Mohan Committee, *inter alia*, recommended for private sector participation in urban infrastructure development. It emphasized the need for accessing capital market, including the issuance of municipal bonds. The Committee also made projections of investment requirements in urban infrastructure.

NIPFP (1995) studied 293 municipalities in India spread over seven States: Andhra Pradesh (54), Assam (21), Gujarat (63), Kerala

(57), Maharashtra (33), Punjab (33) and West Bengal (32). The study documents the problems of vertical imbalance, horizontal imbalance, inadequate exploitation of existing resources by local authorities, high cost of administration and collection of local taxes and arbitrary system of fiscal transfers from State Governments to ULBs as the common features of the municipal finance system in the country:.

Kundu, Bagchi and Kundu (1999) find that the levels of inequity in the provision of basic services across the States and size categories of urban centres are extremely high. Given the resource crunch in State Governments and urban local bodies, the authors recommend privatization, public-private partnerships and promotion of community-based projects as options for undertaking investments to create civic amenities. However, the aspects of equity are required to be addressed through specific measures. The authors observe that in the case of private sector or joint sector projects, the poor are likely to get priced out due to various reasons. In the case of infrastructure projects taken up with borrowed funds, the finances generated from the common people are likely to get escrowed as a security for projects that are likely to benefit the better-off sections of population or elite colonies.

Bagchi (2000) examines whether the decentralisation initiative has succeeded in empowering the city governments, if there has been any empowerment of such entities and how such empowerment has been reflected in the resource generation capacity of the urban local bodies. The impact of decentralisation was studied on the basis of a decentralisation index constructed for the purpose. The author finds that though the decentralisation initiative has made some headway towards improving the tax generating capacity of city governments, it has, to a large extent, remained confined to the municipal corporations. However, the possibility of improvement in this count, for the lower tiers of urban local bodies, could not be ruled out in the long run, keeping the existing trend in view. The author observes that the decentralisation initiative has almost remained ineffective in improving the resource generation out of the non-tax sources for the ULBs.

The growing literature on rural decentralization, both official and non-official, emphasizes the need for ushering in a more efficient, equitable and accountable system of local governance in India. Jha (2002) examined the issue of fiscal decentralization in rural areas following the 73rd Constitutional Amendment. Based on field studies and the State Finance Commission reports of seven states, the author concludes that the progress made has been extremely uneven and tardy. The lack of progress along with the absence of administrative and technical capacity in the Panchayati Raj Institutions (PRIs) has weakened the process of fiscal decentralization in many cases. The basic dictum of devolution that functions, finance and functionaries should be devolved down in totality is observed in its breach, Kerala being a prominent exception. Although a formula-based devolution is welcomed by most State Finance Commissions, the criteria chosen by them are deficient in that they relate largely to population and area.

Rao (2001) analyses fiscal decentralization in Indian federalism within the three-tier framework for governance and addressed the issues of inter-governmental transfers and macro-economic stability. The author found that the aggregate fiscal deficit in 1997-98 worked out to almost 15 per cent of GDP, of which 7 per cent is due to the local governments. This finding, however, is questionable.

Bagchi (2001) analyses the nitty-gritty of alternative/ unconventional modes of financing urban infrastructure. The author notes that it is due to the inherent characteristics of infrastructure in general and urban basic services in particular – externality, non-excludability, inelastic price demand, huge capital investments with long gestation period – that these are to a large extent provided by the public sector. The study makes the following observations:

(i) An alternate approach to the traditional mode of financing is public-private partnership (PPP). However, presently, the objective of public-private partnership relates much to attracting capital and curtailing public sector employment rather than increasing the efficiency and effectiveness of service delivery. The basic reason for the failure of PPP model is the lack of customer approach in it and the extensive focus on technical and commercial aspects of infrastructure.

(ii) Just two sources, namely, Octroi and property tax, have been the major sources of revenue. Basically, Octroi is the only tax within the jurisdiction of city governments that has the potential to grow over time with the growth of economic activities. However, Octroi is on the verge of being abolished. Therefore, there is an urgent need for the State Governments to devolve some major tax sources to the municipalities which have their growth potential derived from the economic growth in cities.

(iii) Municipalities have not succeeded in realising the potential of the property tax, though property values are on rise. A major problem with the property tax system in India lies in the process of tax computation. The linking of the property tax – based on annual rental value (ARV) - with the rent control law has hindered the growth of collection.

(iv) For accessing capital market funds, municipalities need financial, structural, institutional and administrative changes. These include: i) placing certain buoyant revenue sources at their disposal, ii) transforming the urban governance system with limited control by the state, iii) changing the capital market structure and iv) recovering the cost of services to make infrastructure projects commercially viable.

Vaidya and Johnson (2001) gives a vivid account of how the Ahmedabad Municipal Corporation (AMC) issued municipal bonds worth Rs.1,000 million in early 1998, the first such instrument issued in India without a State guarantee and it marked the first step towards a market-based system of local government finance. Before the issue of the bonds, AMC introduced reforms to improve revenue collection so as to make up for the loss it had been incurring. Other preparatory steps taken by the AMC included preparing a five-year capital investment or corporate plan and credit rating by the CRISIL. For debt servicing, revenues from 10 Octroi collection centres were placed in an escrow account-structured debt obligation (SDO). Other credit enhancing measures adopted by the AMC were fixing minimum average debt service coverage ratio of 1.5 and having a sinking fund for repayment of principal and mortgage equal to 1.2 times the par value of the bonds. The authors suggested that the technical framework developed for the AMC bonds can act as a blueprint for future development initiatives in this area.

Pethe and Ghodke (2002) examine the status of Indian infrastructure, including urban infrastructure, and argue for accessing capital market funds to bridge the resource gap, in view of the changing role of Governments. The paper argued for newer financial instruments like ‘Municipal bonds’ for financing urban infrastructure. To impart liquidity and create an incentive for individual agents to invest in the bonds, a thick and efficient secondary market for debt instruments is needed.

Mathur and Ray (2003) provides a framework for municipalities to assess their creditworthiness for tapping the nascent but expanding capital market for financing urban infrastructure. The paper discusses the changes needed in the legal framework for municipal borrowing based on an analysis of finances of four municipal corporations (Agra, Allahabad, Bangalore and Vadodara).

Mathur and Thakur (2004) examined the fiscal performance of municipalities and assessed the load on state finances on account of the implementation of the State Finance Commission recommendations. The study found that the size of the municipal sector, in terms of revenues, was only 3.07 per cent of publicly raised resources (by municipalities, States and Central Government taken together). The study further found that the expenditure levels on services provided by municipalities across states were low when compared to the norms established by the Zakaria Committee. Another finding of the study was that per capita expenditure-revenue gap declined over the period of 1997-98 to 2001-02. Fiscal transfers to municipalities formed 3.85 per cent of the combined own resources of states.

Bagchi and Chattopadhyay (2004) analyses the impact of decentralization on the mechanism for financing urban basic services in India. The study finds that developed states and larger cities/towns are the major destinations for domestic institutional funds and external assistance. The emphasis made on full cost recovery and imposition of strict financial discipline on state governments by the Reserve Bank of India are likely to result in further concentration of funds in developed states or regions. Chattopadhyay (2004) further examined the impact of decentralization – both revenue and expenditure – on the financial health of urban local bodies through an empirical study of the aggregates of three states in the post-74th Constitutional Amendment Act era. The study observes that decentralization improved the revenue structure of the municipal corporations and positively affected their tax and non-tax revenue generation. However, the large urban local bodies benefited most from the decentralisation initiatives.

India Infrastructure Report 2004 (3i Network, 2004), *inter alia*, discusses the issues relating to creating local financial systems for infrastructure development, accessing capital markets by ULBs and reforming the property tax. In this Report, Jha (2004) lists a range of options and models available to developing countries on how to finance infrastructure projects locally. These options include i) specialized banks for municipal lending, ii) municipal bond markets, and iii) specialized municipal funds. The paper reviews the initiatives for issue of municipal bonds and the experience of Tamil Nadu Urban Development Fund. For strengthening the creditworthiness of local bodies, the paper suggests that they should be given autonomous authority to set realistic tax-rates and user-charges for the basic services provided by them and also for pursuing hiring-firing policies. Measures needed for strengthening Municipal Bond issuance, such as bond insurance facility, facilitating the listing of bonds on domestic stock exchanges, *etc.* are also discussed in the paper.

Ghodke (2004) examines the issues relating to capital market access by ULBs. The study documents that till 2004 the ULBs raised about Rs.700 crores from the domestic capital market by issue of municipal bonds. In view of their increasing resource gap, the paper makes a strong case for facilitating the access of ULBs to the capital market for debt financing, either through loans or bonds. It suggests 'pooled financing' as a promising method for financing urban infrastructure. Under the 'pooled financing' framework, small local bodies can pool their strength and jointly access the capital market. The paper points out that there are typically two models of municipal credit market followed in countries - the bank lending model used in Western Europe and the municipal bond model used in North America.

Oommen (2005) provides a critique of the approach and recommendations of the Twelfth Finance Commission with reference to the rural and urban local bodies. The author states that during 2002-03, the total tax revenues and expenditures of local bodies as a percentage of the combined taxes and expenditure of Union, States and local bodies was only 1.6 per cent and 4.7 per cent, respectively, indicating marginal presence of local finance in the fiscal structure of India. In advanced countries, local bodies normally account for 20-35 per cent of the total government expenditure (UNDP, 1993). The author reveals that the Tenth Finance Commission (TFC) did not follow the principle of horizontal equity while allocating grants-in-aids to states (local bodies). The TFC, the author argues, was wrong in abandoning the decentralization index for deciding the grants-in-aid. It is noted that the local bodies are yet to be put prominently on the public finance map of India, which is needed to facilitate an inclusive and equitable economic growth and to secure better horizontal equity. The author suggested that the Reserve Bank of

India may consider developing a reliable database of the finances of local bodies similar to the database of the finances of State Governments.

Mathur (2006) provides a comparative picture on the particulars of municipal bonds issued by urban local bodies in India to raise resources as shown in Table 10.

Pethe and Lalvani (2006) examined the finances of ULBs in Maharashtra and drew attention to the significance of sub-national governments accessing the financial markets in general, and debt market in particular. The paper finds that the powers of ULBs in Maharashtra are highly restricted with respect to both tax and non-tax sources of revenues, as there has been no sufficient devolution of taxation powers. The paper noted that the growth of revenue of the ULBs has been constrained by inherent structural bottlenecks like

Table 10: Details of Bonds Issued by Municipal Corporations

City	Amount (Rs million)	Interest %	Escrow Arrangement	Purpose	Credit Rating
Ahmedabad	1000	14	Octroi from 10 Octroi collection points	Water supply & sewerage project	AA-(SO)
Bangalore	1250	13	State Government grants and property tax	City roads/street drains	A-(SO)
Ludhiana	100	13.5 to 14	Water and sewerage taxes and charges	Water supply & sewerage project	LAA-(SO)
Nagpur	500	13	Property tax and water charges	Water supply & sewerage project	LAA-(SO)
Nashik	1000	14.75	Octroi from 4 Octroi collection points	Water supply & sewerage project	AA-(SO)
Indore	100		NA	Improvement of city roads	A(SO)
Madurai	300	12.25	Toll tax collection	City road project	LA+(SO)
Ahmedabad (Tax Free)	1000	9	Property taxes of 2 zones	Water supply & sewerage project	AA(SO)
Hyderabad (Tax Free)	825	8.5	Non-residential property tax, advertisement. tax, professional tax, *etc.*	Road construction and widening	LAA+(SO) AA+(SO)
Tamil Nadu (Pooled Financing	110	9.20	Monthly payments equal to one-ninth of their annual payments	Water supply & sewerage project in 14 MCs	LAA(SO)

Source: Mathur (2006)

limited autonomy regarding taxation, small bandwidth for non-tax revenues and the unpredictable nature of funds flowing from the State. For accessing the capital market, the paper extended the concept of 'pooled funds' and classified the ULBs in the State into three categories, namely, 'Cherries' (financially better off), 'Salvageables' (potentially better off) and 'Duds' (financially very poor). While the self-help group amongst the Cherries and Salvageables will be able to access the capital markets, infrastructure needs of Duds have to be taken care of by the State directly. The paper made two other suggestions. First, the existing infrastructure fund could be used to facilitate under-writing of the projects to be undertaken by coalition of ULBs coming together as virtual entities. Second, banks should look at the coalition formation of ULBs and encourage them by making more exposure a matter of policy mandate or guided by their profit motives.

India Infrastructure Report 2006 (3i Network, 2006), *inter alia*, discusses the trends and patterns of urbanization and urban public finance in states. It highlights the colossal needs of urban infrastructure investments in keeping with the projected urban trends and suggests measures for municipal reforms needed to access capital markets.

Chattopadhyay (2006) documented the problems and prospects of the municipal bond market in India. The paper finds that several policies and legal frameworks to facilitate the access of ULBs to capital market are already in place. These include: preparation of a Model Municipal Law (MML) to assist ULBs in the areas of accounting reforms, resource mobilization and the entry of private sector partnerships, tax exemptions in the case of bonds issued by ULBs and other local authorities, trading of municipal bonds in the National Stock Exchange, measures taken by RBI to deepen secondary market activities, *etc.* The paper notes that without the financial empowerment, it is difficult to make the municipalities more market-oriented and capable of mobilizing resources from the capital market. The paper concludes that local capacity building, financial empowerment, rationalization of the state-local fiscal relationship and further legislative changes are critical in developing a viable and vibrant municipal bond system in the country.

Lall and Deichmann (2006) report that while reforms in property tax administration have taken off and become quite popular, associated reform efforts focused on assessment and valuation are less evident. In most ULBs, property rental values are used as the base for assessing property taxes. However, in the face of rent control laws, this approach is limiting the growth of revenues. Based on their study of the assessment systems in Bangalore and Pune, the authors find that structural reforms that link tax assessments to market rental or capital values have the potential to significantly increase aggregate tax revenues. They found that in Pune Municipal Corporation, the use of market values also played a redistributive role by reducing the tax burden in areas with poor services and amenities. In case of Bangalore, a one-time move from the previously used rental value-based assessment to an area-based system increased revenues by around 62 per cent. The authors opine that a capital value system which requires the valuation of individual properties is difficult to implement in the present Indian context, especially because property records are in shambles and most local governments do not have a cadre of trained assessors to evaluate property values and update them regularly. Hence, they suggest that while the introduction of true capital value assessment system should be a longer term objective, local governments must implement other simpler and less costly reforms.

Srinivasan (2006) examined the equity, accountability and environmental concerns in Solid Waste Management (SWM) practices of a public body, a private body and non-profit organization in Chennai city. The study finds that private sector and civil society participation pose several challenges in terms of equity and accountability. The study shows that while a crucial role exists for the private sector, the intervention of the state and public policy is imperative to safeguard ecological and equity interests and to enable greater accountability on part of both the public and private actors.

Mathur (2006) finds that the finances of municipalities in India are in a grossly unsatisfactory state. The spending levels of municipalities are about 130 per cent lower compared with norms and standards. Own revenues of municipalities are insufficient to meet even the revenue account expenditure. The revenue-expenditure gap is particularly high in states like Madhya Pradesh, Rajasthan, Uttar Pradesh and West Bengal.

Oommen (2006) analyses the trends in fiscal decentralization in India focusing on the 15 non-special category states, based on the data given in the report of the Twelfth Finance Commission. The author finds that total expenditure of local government as a proportion of the combined expenditure of Union, States and Local Governments declined from 6.4 per cent in 1998-99 to 5.1 per cent in 2002-03. Thus, the extent of fiscal decentralization, which was already very low, has shown a pronounced decline in recent years. The author reiterates that in advanced countries, local governments normally account for about 20-35 per cent of total government expenditure. The average rate of growth in the tax revenues of Panchayati Raj Institutions (PRIs) and Urban Local Bodies (ULBs) in most of the States had been negative or declining. Another finding by the author is that the transfers to local governments as a percentage of State Domestic Product have declined in the country as a whole. Based on empirical analysis, the author concludes that the record of fiscal decentralization to sub-state level governments through the mechanism of inter-governmental transfers has been very poor.

An obvious shortcoming in the literature of local public finance in India is the inability to locate a suitable alternative to Octroi. Traditionally Octroi has been the most important source of municipal taxes in the country. Being regarded as an obnoxious tax, Octori has been on its way out and all but a limited number of States like Maharashtra and Gujarat have already abolished Octroi. However, the States which abolished Octroi have not been able to find an alternative for their ULBs as buoyant as Octroi. Several States have gone for experiments. Karnataka levied entry tax. Tamil Nadu permitted a surcharge on sales tax for the Chennai Municipal Corporation. States like Uttar Pradesh and Andhra Pradesh have not attempted instituting any major tax in the place of Octroi. The compensations to Municipalities in lieu of Octroi have been kept at abysmally low levels in the States that abolished it. Although in the interest of economic growth and free trade within the country there can be no case for Octroi, the need for assigning a substitute 'own' tax to ULBs as buoyant as Octroi continues to be strong.

The Report of the Committee on Octroi (1985), constituted by the then Ministry of Urban Development, Government of India, had made the following recommendations:

(a) Octroi might be retained in Municipal Corporations covering a population of three lakhs or more; the tax could be abolished in the smaller local bodies.

(b) Octroi should be replaced with taxes the incidence of which would be on the transport sector. The alternatives in the case of smaller Municipalities include surcharge on sales tax, entry tax, terminal tax, road tax, tax on motor vehicles, *etc.* If the revenue realised on account of these taxes was inadequate, augmentation measures through property tax, entertainment tax, professional tax, *etc.* might be considered. If the revenue still remains inadequate even after the imposition of these taxes, only then special grants-in-aid should be provided. Grants-in-aid should not be considered in isolation without augmentation of the tax base of the local bodies as this would take away their initiative and autonomy.

(c) The procedure for payment of grants to the Municipalities should be revised in so far as it related to the loss of Octroi revenue. They should be paid as a direct advance to the Municipalities by the Planning Commission at the time of plan allocation and should be adjusted against the revenues due to the State Governments.

(d) The alternative sources of revenue to the local bodies in lieu of Octroi should not only yield revenue equivalent to the amount lost as a result of its abolition, but should be elastic enough to ensure future revenue for the local bodies. Due regard should be paid to the potential of Octroi revenue while deciding the quantum of compensation.

The Eleventh Finance Commission also noted the following:

"Besides the property/ house tax, Octroi has been the major source of revenue for the municipalities, and in some states, even for the Panchayats. Many states have, however, abolished Octroi with a view to remove impediments to the physical movement of goods, though several other new barriers have been created. Some states have introduced a levy in lieu of Octroi, usually the entry tax, the net proceeds of which are transferred to the local bodies in the form of grant. During our interaction with representatives of the local bodies, we were told that through the grant in lieu of Octroi given to the local bodies was raised by certain percentage from year to year, it does not have as much buoyancy as the Octroi had. There have also been numerous complaints of delay in release of the compensatory grants. While we do not advocate re-introduction of Octroi, we do feel that there is a need for replacing it with a suitable tax that is buoyant and can be collected by the local bodies. Taxes, such as entertainment tax, which has shown a very good growth, are potential source of increasing the revenue for the local bodies, given that they are linked to the consumption characteristic of good and hence also buoyant."

2.5 Summary Observations

2.5.1 International Literature

The rationale for fiscal decentralization is well-grounded in theory and it is gaining momentum in many countries. The identified role of local bodies, in the public finance literature, is resource allocation, though they can also contribute to the two other objectives of public finance, namely, macroeconomic stabilization and income distribution. Literature has identified the suitable expenditure responsibilities and revenue sources of local bodies. However, in general, countries assign more expenditure responsibilities than resources to their local bodies, thereby leading to constitutionally-built vertical imbalance in functions and finances. This vertical imbalance, as prominently reflected in the resource gap of local governments, is the basis of inter-governmental fiscal transfers from national and provincial governments. In the urban context the vertical imbalance is getting more pronounced due to population concentration in cities and the inability of city governments to tap economic growth as a source of revenue. Urbanization of Asia in the coming years is likely to put pressure on international resource mobilization and it will in turn get reflected in higher interest rates in the years to come, which is of relevance to central banks. These considerations call for reforms in the structure of local government finance in India.

2.5.2 Indian Literature

Studies in Indian context have traced the progress of fiscal decentralization since the 73rd and 74th Constitutional Amendments. The record of fiscal decentralization to the sub-state level governments through revenue assignment and transfers has been poor. Fiscal decentralization has not made any significant progress in terms of revenues raised and expenditures incurred by a large numbers of local bodies. The dictum that functions, finance and functionaries should be devolved down is observed almost in breach. Decentralisation has resulted in improving the tax generating capacity of some urban local bodies, mainly corporations. However, there has not been much impact on non-tax revenues. The size of the municipal fiscal sector is small compared to any conceivable standard, whether in terms of international comparison or normative considerations. It is evident that the fiscal domain of urban local bodies in India is far narrower than that in most developed countries and several developing countries, mandated to discharge similar responsibilities.

In case of property tax, the introduction of capital value assessment system should be a longer term objective. However, the system is difficult and costly to implement. Area-based property tax system, based on a self-assessment scheme, holds promise. A suitable alternative to Octroi has not yet been found out. Given the resource crunch at State and ULB levels, privatisation, central-state-local and public-private partnerships and promotion of community-based projects are alternate options for creating civic amenities. However, sometimes, the poor are likely to be at a disadvantage in the case of these arrangements. While there is a crucial role for the private sector, the intervention of the state and public policy is imperative to safeguard equity and ecological interests of the society and to enable greater accountability of both public and private actors. The 74th Amendment has envisaged poverty alleviation and slum development as legitimate functions of urban local bodies. This has shifted some redistribution functions of the public sector to the urban local bodies unlike the case in developed countries. Thus, the urban local bodies in India are connected with two major planks of public sector responsibility: allocation and redistribution. However, the revenue assignment required by these institutions woefully falls short of the expenditure assignment.

2.5.3 Some Issues for ULBs in India

While the national expectations from the ULBs are too high, however laudable they may be, the fiscal arrangements for meeting these expectations are highly unsatisfactory. The expenditure levels on services provided by municipalities across the country, especially on infrastructure and poverty alleviation, are low when compared to the norms established by the Zakaria Committee. The devolution of funds to ULBs through the State and Central Finance Commissions has been on an *ad hoc* basis in the absence of normative estimates of their resource gap. In the above circumstances the local authorities are in need of major 'own' tax and non-tax sources, proceeds of which should grow along with the growth of the cities concerned and their economies.

Urbanising states and larger municipal corporations are seen to be the major destinations of institutional funds channelised for public infrastructure. The first step towards a market-based system of local government finance in India was the issue of municipal bonds by Ahmedabad Municipal Corporation, which undertook several preparatory tasks to improve finance as well as financial management. For accessing capital market funds for the creation of infrastructure, urban local bodies are required to undertake financial, structural, institutional and administrative reforms. For strengthening the creditworthiness of urban local bodies, it is suggested that they should be given autonomous authority to set realistic tax-rates and user charges for the services provided by them and also for pursuing hiring-firing policies. The system of inter-governmental transfers to urban local bodies also needs a drastic overhaul. While municipal revenue reforms need to be pursued, banks should look at coalition formation by ULBs and encourage them by making more exposure to credit a matter of policy mandate or guided by their profit motives. Lastly, wasteful municipal expenditures need to be curtailed and steps must be taken to ensure that the cities are professionally managed.

A vibrant Urban India of the 21st Century, acting as an engine of inclusive growth, needs drastic reforms in the municipal finance system of the country so as to broaden and deepen the resource base required to match the growing needs of infrastructure and civic services to the urban population, especially the poor.

Chapter 3

LEGAL AND INSTITUTIONAL FRAMEWORK

3.1 Framework for Municipal Governance

This chapter makes an analytical review of the statutory provisions relating to the revenues and expenditure of municipalities in India. It covers the provisions relating to expenditure and revenue assignment contained in the Constitution of India and in the legislations passed by State Governments. An analysis has also been made of the recommendations made by the Central and State Finance Commissions. Lastly, the vertical imbalance ingrained in India's fiscal structure has been discussed.

The legal-institutional framework for the delivery of civic services in cities and towns as envisaged in the Constitution (74^{th} Amendment) Act, 1992 comprises a number of mandatory institutions:

- State Election Commission (Article 243K);
- Municipalities: Municipal Corporations, Municipal Councils and Nagar Panchayats (Article 243Q);
- Wards Committees and other Committees (Article 243R);
- State Finance Commission (Article 243I);
- District Planning Committee (Article 243ZD); and
- Metropolitan Planning Committee (Article 243ZE).

The responsibility for the creation and operationalisation of the legal-institutional framework – the aforesaid institutions and other entities, including para-statals impacting on civic service delivery, however, has been left to the State Governments.

The mandates of various key institutions as prescribed by the Constitution (74th Amendment) Act 1992 are as follows:

- State Election Commission to superintend, direct and control the preparation of electoral rolls, and conduct elections to all the rural and Urban Local Bodies (ULBs) [Article 243K(1)];
- Municipalities to function as 'institutions of self-government' - prepare 'plans for economic development and social justice', perform civic functions and implement schemes as may be entrusted to them by the State Government, including those related to the Twelfth Schedule [Article 243W(a)];
- Wards Committees and Special Committees to take Municipal Government physically closer to the people and carry out the responsibilities conferred upon them including those in relation to the Twelfth Schedule [Article 243W(b)];
- State Finance Commission to review the financial position of the rural and urban local bodies, and to make recommendations regarding the 'principles' of devolution of resources from the State Government to the local bodies and the 'measures' needed to improve their finances and functioning [Article 243I(1)];
- District Planning Committee to 'consolidate' the plans prepared by the Panchayats and the Municipalities in the district and to prepare a draft development plan for the district as a whole [Article 243ZD(1)];
- Metropolitan Planning Committee to prepare draft development plan for the Metropolitan area as a whole [Article 243ZE(1)].

3.2 Expenditure & Revenue Assignment

Governance of ULBs (and also rural local bodies) in India has remained a State subject in accordance with the stipulation of the Seventh Schedule and List II of the Constitution of India. Primarily, designed for a two-tier system, the Constitution of India has specified the expenditure responsibilities as well as the resource raising domains of the Union and States through three lists given under Schedule VII. This Schedule spells out the division of functions and finances into the Union List, the State List and the Concurrent List wherein the Union and the State Governments have joint jurisdiction. However, the scenario has changed substantially after the 74th Amendment, by which the ULBs have gained constitutional status and have become an integral part of India's decentralization strategy.

The 74th Amendment Act envisaged that elected Municipalities function as effective local self-government institutions preparing and implementing plans for economic development and social justice and discharging civic responsibilities envisaged in the 12th Schedule (Box 2).

In order to perform these tasks, the urban local bodies have to be financially sound and endowed with commensurate powers to raise resources. However, while the Constitution specifies the expenditure responsibilities, it has not listed out the sources of revenue of ULBs. Article 243X of the Constitution only stipulates that a State Legislature may, by law,

i) authorise a Municipality to levy, collect and appropriate such taxes, duties, tolls and fees in accordance with such procedure and subject to such limit;

ii) assign to a Municipality such taxes, duties, tolls and fees levied and collected by the State Government for such purposes and subject to such conditions and limits;

iii) provide for making such grants-in-aid to the Municipalities from the Consolidated Fund of the State and

iv) provide for the constitution of such Funds for crediting all moneys received, respectively, by or on behalf of the Municipalities and also for the withdrawal of such moneys there from, as may be prescribed by law.

Box 2: Functions of Urban Local Bodies: Twelfth Schedule (Article 243W)

1. Urban Planning including town planning;
2. Regulation of land use and construction of buildings;
3. Planning for economic and social development;
4. Roads and bridges;
5. Water supply for domestic, industrial and commercial purposes;
6. Public health, sanitation conservancy and solid waste management;
7. Fire services;
8. Urban forestry, protection of the environment and promotion of ecological aspects;
9. Safe-guarding the interest of weaker sections of society, including the handicapped and mentally retarded;
10. Slums improvement and upgrading;
11. Urban poverty alleviation;
12. Provision of urban amenities and facilities such as parks, gardens, playgrounds;
13. Promotion of cultural, educational and aesthetic aspects;
14. Burials and burial grounds; cremations, cremation grounds and electric crematoriums;
15. Cattle pounds; prevention of cruelty to animals;
16. Vital statistics, including registration of births and deaths;
17. Public amenities, including street lighting, parking lots, bus stops and public conveniences; and
18. Regulation of slaughter houses and tanneries.

Thus, the 74th Amendment has not clarified a critical area of fiscal federalism, *i.e.*, the matching of resources and responsibilities. The taxes, duties, charges and fees to be levied by the Municipalities, those to be assigned to them and the grants-in-aid to be provided to them have been left to the discretion of the State Governments. This has allowed the fiscal mismatches to continue in the absence of adequate decentralization of resources corresponding to the decentralization of expenditures envisaged in the Constitution (74th Amendment) Act, 1992.

However, for strengthening the finances of the local governments, as described in Chapter 1, the two positive features in the Amendments to the Constitution are:

i) provision for the constitution of State Finance Commissions (SFCs) every five years;

ii) amendment of Article 280 of the Constitution of India by inserting section 3(C).

Article 243(I), inserted into the Constitution by the 73rd Amendment Act, makes it mandatory on the part of the State Governments to constitute SFCs once every five years to review the financial position of the Panchayats and the Municipalities.

It may be noted that the role of the State Finance Commission is envisaged to be much broader (as set out subsequently) than that of the Central Finance Commission, which is primarily related to the distribution of the central divisible pool of resources among the State Governments. As stated earlier, the Constitutional Amendments also provide a safeguard regarding the implementation of the recommendations of the SFCs. Article 280 of the Constitution, under which a CFC is appointed once every five years to assess the financial needs of the State Governments and to recommend a package of financial transfers from the Centre to the States, has been amended. It is now mandatory on the part of the CFC to recommend measures to augment the Consolidated Fund of a State to supplement the resources of the Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.

The provision for the establishment of a SFC every five years is an important step toward redressing the fiscal imbalance of ULBs. The additional responsibility cast upon the CFC, to recommended measures to supplement the resources of local self-government institutions is a clear acknowledgement of the mismatch between functions and finances at various tiers of the India federal system. Table 11 provides a comparison of revenue assignment across states till recently.

Table 11: Revenue Powers of Municipalities across Major States 2004

State	Taxes		Fees
	Compulsory	Discretionary	
Andhra Pradesh	Property: (Lighting, Water, Scavenging, Drainage, General), Vehicles, Duty on Transfer of Immovable Properties, Animals	Advertisement	Advertisement Fee, Mutation Fee, Registration Fee, Market Fee, Trade License Fee, Compounding Fee, Slaughter House Fee, License Fee
Assam		Property : (Lighting, Water Drainage), Markets, Toll on Bridges, Transfer of Properties	License on Carts, Carriages, Animals, Dogs & Cattle, Boats, Betterment, Fire Brigade, Public Health
Bihar	Duty on Transfer of Property	On Persons in sole or joint occupation of Holding according to their circumstances and property (Lighting, Water, Latrine), Vehicles, Animals, Profession	Registration of Dogs, Carts, Vehicles, Vessels
Goa	Consolidated Property Tax: (General, Water, Lighting, Sanitary,) Advertisement, Profession, Theatre	Vehicle, Boats, Animals, Toll on Vehicles, and Animals not under above, Dogs, Garbage Treatment, Latrine, Drainage, Special Water Tax, Pilgrim, Special Education tax, Octroi	
Gujarat		Property, Vehicle, Boats, Animals, Motor Vehicles, Octroi, Dogs, Special and General Sanitation, Lighting, Sale of Cattle in the Market, Betterment Levy	Registration Fee, License Fee, Swimming Bath Fee, Slaughter House Fee, Building Construction Fee, Stock Registration Fee, Water Connection Fee, Cattle Pound Fee
Haryana	Property, Octroi, Duty on Immovable Property	Profession, Vehicles, Animals, Dogs, Show, Toll on Vehicles, Boats, Consumption of Electricity	License Fee, Building Application Fee, Teh Bazari Fee, Advertisement Fee, Slaughter House Fee, Cattle Pound Fee, Registration Fee, Street Fee
Himachal Pradesh	Property, Duty on Transfer of Immovable Properties	Profession, Non-motorized Vehicles, Animals, Dogs, Show, Toll on Vehicles, Boats, Consumption of Electricity, Advertisement, Building Application, Education Cess	Pilgrim, Drainage, Lighting, Scavenging, Latrines, Nature and Cost of Internal Service
Karnataka		Property, Advertisement, Boats, Animals, Lighting, Toll on Vehicles, Duty on Transfer of Immovable Property.	License Fee (Building, Trade & Hotel), Building Betterment Fee, Birth & Death Registration Fee, Food

Table 11: Revenue Powers of Municipalities across Major States 2004 *(Contd.)*

State	Taxes		Fees
	Compulsory	Discretionary	
			Adulteration Fee, Slaughter House Fee, Compounding Fee
Kerala		Property: (Lighting, Water, Drainage, General Purposes, Sanitary), Transfer of Properties, Profession, Animals, Vessels, Show, Timber, Advertisement	License Fee, Building Fee, Dangerous and Offensive Trade License Fee, Market Fee, Slaughter House Fee
Madhya Pradesh	Property, Water, Lighting, Sanitary, Fire, Local Body Tax on Entry of Goods	Latrine,Conservancy,Drainage, Profession, Vehicles, Animals, Dogs, Show, Toll on Vehicles and Animals not mentioned above, Betterment, Pilgrim, Persons occupying Houses, Buildings, Land according to circumstances and property, Toll on New Bridges, Entertainment, Advertisement, Terminal	License Fee, Market Fee, Animal Registration Fee, Hotel / Restaurant License Fee, Composting Fee, Teh Bazaar Fee, Building Application Fee, Compounding Fee
Maharashtra	Consolidated Property tax: (General, Water, Lighting, Sanitary) Advertisement, Profession, Theatre, Octroi	Vehicles, Animals, Dogs, Show, Toll on Vehicles, Boats, Animals not mentioned above, Dogs Latrine, Drainage, Special Water Tax, Pilgrim, Special Education Tax, *etc.*	License Fee, Slaughter House Fee, Building Permission Fee, Fee for Sale of Goods, Water Connection Fee, Warrant Fee, Prevent of Food Adulteration License Fee, Cattle Pounds Fee, Swimming Pool Fee, Birth & Death Registration Fee, Betterment/ Development Fee
Orissa		Property: (Lighting, Water, Drainage), Animals, Vehicles, Profession, Octroi, Education, Profession	License Fee, Advertisement Fee, Registration Fee, Market Fee, Slaughter House Fee, Cattle Pound Fee, Dog Registration Fee, Cart Stand Fee, Building Planning Fee
Punjab		Property, Profession, Vehicle, Animals, Menial Domestic Servants, Scavenging, Building Application	License Fee, Slaughter House Fee, Building Application Fee, Composition Fee, Teh Bazari Fee, Water Connection Fee
Rajasthan	Property, Octroi, Profession and Vocations	Vehicle and other Conveyance, Dogs, Animals, Toll on Vehicles, Boats, Scavenging, Latrine, Sanitary, Lighting, Water, Trade, and Calling, Artisans	Advertisement Fee, Building Permission Fee, Trade License Fee, Registration Fee, Cattle Pound Fee, Bus Stand Fee, Copying Fee

Table 11: Revenue Powers of Municipalities across Major States 2004 *(Concld.)*

State	Taxes		Fees
	Compulsory	Discretionary	
Tamil Nadu		Property, Profession, Carriage and Animals, Advertisement, Servants (hill stations)	License Fee (Building, Hotel, Restaurant, Dangerous and Offensive Trade), Market Fee, Slaughter House Fee, Cart Stand Fee, Encroachment Fee
Uttar Pradesh		Property, Trade, Calling, Vocation, Entertainment, Vehicle, Boat, Dogs, Animals, Inhabitants assessed on property and circumstances (Water, Drainage), Scavenging, Conservancy, Transfer of Property	
West Bengal	Profession, Property, Advertisement, Vehicles, Toll on Ferries and Bridges		License Fee, Advertisement, Building, Planning / Development Fee, House Connection Fee, Permission Fee, Market / Slaughter House Fee, Birth and Death Registration Fee, Fees from burning ghats

Notes: 1. Vehicles imply non-motorized vehicles unless otherwise specified

2. Rajasthan: Tax on Trade and Calling is different from Tax on Profession and Vocation which is a Compulsory Tax
3. General components like Water, Lighting, Sanitation *etc.* are included under a Consolidated Property Tax
4. Octroi has since been abolished in all States excepting Maharashtra and Gujarat.

Sources : Mathur and Thakur (2004), Budgets of Municipal Corporations.

3.3 Finance Commissions

3.3.1 Central Finance Commission

The Tenth Central Finance Commission was the first CFC to have the additional responsibility in its "Terms of Reference" (ToR) to consider the SFCs' recommendations regarding ULBs and PRIs, while recommending transfer of Centre's resources to the States. However, a major problem faced in the process was the mismatch in the timing of the constitution of the Tenth CFC and first generation of SFCs. The Tenth CFC could not incorporate the recommendations of the first generation of SFCs and as a result much of its recommendations towards augmenting the resources of local bodies were made arbitrarily.

The ToR for the Eleventh CFC required the CFC to make its own assessment about the manner and the extent of augmentation of the Consolidated Funds of the States to supplement local resources. Much of the recommendations of the Eleventh CFC were made arbitrarily in the absence of the Second SFCs' reports. The situation remained the same in case of the Twelfth CFC. The Twelfth CFC could not make a realistic assessment of the resource gaps of the local bodies, which would have been the basis for the earmarking of funds. Due to non-availability of authentic and reliable data, the Twelfth CFC made its recommendation on an *ad hoc* basis.

It may be stated that the assistance recommended for the ULBs via the institution of the CFC is not only inadequate but also, importantly, bears no relation to what the Municipalities need for maintaining services at minimum levels.

The reports of the CFCs, research studies conducted by academic institutions and the estimates made by the various Departments / Agencies of the Government do not provide either a realistic picture of the fiscal position of local bodies or a comprehensive agenda for municipal finance reforms to address the problems of mismatch between functional responsibilities and financial capability of ULBs in India.

The terms of reference, recommendations, criteria for distribution of grants and conditionality made by the Central Finance Commissions are given in Table 12.

All the three CFCs which gave reports after the 74^{th} Amendment Act came into existence have made allocations to local bodies based on certain *ad hoc* criteria in the absence of the relevant SFC Reports.

Table 12: Central Finance Commission and Municipal Finances

Items	Tenth Finance Commission (1995-2000)	Eleventh Finance Commission (2000-2005)	Twelfth Finance Commission (2005-2010)
Terms of Reference relating local bodies	Not specified. However, since Article 280 had been amended before the expiry of the term, the Commission felt that it was obliged to deal with the issue in terms of the amended Article 280.	To make recommendations to augment the Consolidated Fund of the states to supplement the resources of local bodies on the basis of SFC recommendations. The EFC was asked to make its own assessment, if the recommendations of SFCs were not available.	The measures needed to augment the Consolidated Fund of a state to supplement the resources of the panchayats and municipalities in the state on the basis of the recommendations made by the Finance Commissions of states.
Recommendations	Recommended Rs.1000 crore for municipalities to be distributed amongst the states.	Recommended ad hoc annual grant of Rs.400 crore for municipalities. Activities such as maintenance of accounts, development of database and audit to be the first charge on this grant.	Recommended a sum of Rs.5,000 crore for the period 2005-2010 as grants-in-aid to augment the Consolidated Fund of the states to supplement the resources of municipalities.
Criteria for distribution of grant among states	Inter-state ratio of slum population derived from 1971 census.	Based on the following factors and weights: 1. Population 40% 2. Geographical area 10% 3. Distance from Per Capita Income (PCI) 20% 4. Index of decentralization 20% 5. Revenue effort 10%	Based on the following factors and weights: 1. Population 40% 2. Geographical area 10% 3. Distance from highest PCI 20% 4. Index of deprivation 10% 5. Revenue effort 20%
Conditions	Local bodies were required to raise 'suitable' matching contribution for the purpose. No amount was to be used for expenditure on salaries and wages.	Matching contribution was not imposed.	No conditionality. No requirement of matching grant. Suggested that 50 per cent of the grants provided to each state should be earmarked for collection, segregation and transportation of solid waste. Central Government should not impose any conditions for releasing the grants-in-aid.

Source: Central Finance Commission Reports.

3.3.2 State Finance Commissions

As mentioned earlier, Article 243(I) of the Constitution (Seventy-fourth) Amendment empowers the SFCs, to review the financial position of the Municipalities and to make recommendations to the Governor of the State as to the principles which should govern:

i) 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;

ii) the determination of the taxes, duties, tolls and fees which may be assigned to, or appropriated by the Municipalities;

iii) the grants-in-aid to the Municipalities from the Consolidated Fund of the State;

iv) the measures needed to improve the financial position of the Municipalities; and

v) any other matter referred to the SFC by the Governor in the interest of the sound finance of the Municipalities.

The Twelfth CFC has reviewed the progress of the setting up of First and Second SFCs and the action taken on them by the respective State Governments. In case of First SFCs, 25 States had constituted their Commissions, of which 23 Commissions have submitted their reports. Further, 20 States have submitted the action taken report (ATR). Regarding the Second SFCs, only 19 states had constituted their Commissions, of which 16 Commissions have submitted their reports by November 2004. However, only 6 states submitted the ATRs (see Appendix 3).

With regard to the implementation of the SFC reports, the Twelfth CFC reported as follows:

i) several States did not initiate a follow-up action;

ii) recommendations under examination, met with “natural death”;

iii) very few States have honoured their commitment for the release of additional resources and

iv) budgetary provision regarding the recommendations have fallen short. It appears that the initial enthusiasm shown by the State Governments in constituting the SFCs got lost at the time of implementing the recommendations in their reports as it would have put undue pressure on the finances of the State Governments.

The analysis made by the Twelfth CFC indicates a clear time lag between the submission of reports of SFCs, actions taken by State Governments on the recommendations of SFCs and the constitution of CFCs.

The 74^{th} Amendment, in addition to not specifying a municipal revenue list in the Constitution also did not make any stipulation regarding the period within which the recommendations of SFCs are to be implemented by the respective State Governments. As a consequence, most of the SFC recommendations were far from being implemented.

Moreover, the 74^{th} Amendment did not specify the composition of the SFCs. Unlike the CFCs which always had eminent personalities as members, in many States the procedure of selection of SFC members has been routine and without regard to the expertise needed in areas of fiscal federalism, local government finance, public service delivery *etc.*

The very procedure of empowering the local governments appears to be misleading, without much of their financial strengthening coming to reality. In this context, the Twelfth CFC recommended that:

i) the SFCs should follow a normative approach in the assessment of revenues and expenditure in order to arrive at the gap that may be considered by the CFC,

ii) principal recommendations of the SFCs may be accepted without modification as in the case of CFC,

iii) the States should constitute SFCs with people of eminence and competence,

iv) the States should compile disaggregated time series data on finances of local bodies, and

v) there is a need for synchronization of time period of the SFCs with that of CFCs.

Some of the shortcomings of the SFCs have been brought out by research as follows (Oommen, 2004):

i) Most SFCs have failed to emphasize the link between revenue-raising and expenditure responsibilities, a link that is needed to induce fiscal responsibility.

ii) No SFC seems to have devoted attention to aspects of fiscal management or the need to impose a hard budget constraint at the local level. The accounting and budgetary practices leave many things to be desired.

iii) No suggestion has been made by any SFC so far to reduce the multiple channels of devolution that exists at the local level, *viz.*, Line Departments, State Planning Boards, SFC devolution, MP, MLA programmes, District Rural Development Agency and the like. This may not be their direct task; yet, there is a need for suggestions to place State-Local fiscal relations on a more rational footing.

iv) In the pre-Amendment days state-local grant system was unsystematic, *ad hoc*, dependency-promoting and above all operated through numerous channels; many SFCs have failed to fully address these shortcomings.

Furthermore, there has been a lack in uniformity of the SFCs across the States with regards to their approaches for delegation and devolution of resources to the ULBs.

3.4 Central-State-Local Finance Linkages

In the literature review carried out for this study, it has been noted that a vertical imbalance in the fiscal position of local bodies, in a federal set up, is prevalent across countries and provinces within countries and India is no exception to this trend. The vertical imbalance, *i.e.*, mismatch between the division of the expenditure liabilities and revenue-raising powers of the union and the states and states and local bodies, is constitutionally in-built in India. The link among the Central, State and Local finances, operating through the mechanisms of CFC, SFCs, Planning Commission, Centrally-sponsored Schemes, State Planning Boards *etc.* is attempted to be established to correct this imbalance so that the lower level governments can perform the tasks assigned to them effectively.

In case of the Central Government, the powers to raise resources are enormous. It has most of the elastic sources of revenue, which grow with the growth of the economy. It can resort to deficit financing by borrowing from the market or the RBI. The next layer (*i.e.* the States) has relatively less elastic sources of revenue and it has limits on borrowings and accessing funds from the RBI. The last layer (*i.e.* the local bodies) has only limited powers to raise resources. Further the taxes and duties collected by it (based on the decision taken by the State legislature) are not as elastic as in the case of Central and State revenue sources.

The ULBs cannot have deficit in their budgets as stipulated under law. The ULBs also need to take permission from the respective State Governments for resorting to debt-financing. Hence, the difference between total expenditure needed and 'own' revenues of Municipalities, called 'fiscal gap', is very high as compared to the Central and State Governments. The gap is expected to be filled by way of inter-governmental transfers recommended by the CFCs and SFCs and allocations made by the Planning Commission, Planning Boards of respective States, and Centrally-sponsored and State Plan schemes. Hence, urban local bodies have to depend on a number of institutions to have resources to perform the tasks assigned to them by the State Legislatures.

Furthermore, due to a shortage of resources, the services and facilities provided by the ULBs are inadequate, thereby affecting faster growth of cities and towns and exploitation of agglomeration economies. It has been reported time and again that some of the cities are not able to attract private investment in industrial and service sectors due to the poor quality of their civic infrastructure facilities and services. Vertical imbalance, fiscal dependency and borrowing constraints and limits affect the functioning of ULBs in India to a significant extent.

In addition to their 'own' revenues, a major source of revenue for ULBs is the grants-in-aid received from the concerned State Governments. However, the fiscal position of the States themselves has been weak with high level of deficits and outstanding liabilities. Hence, the State Governments are not in a position to provide sufficient funds to local bodies as per the recommendations of SFCs. Further, most of the States are committed to reducing the deficit, as per their Fiscal Responsibility and Budget Management Acts enacted in the recent times.

An option available to urban local bodies is to borrow from financial institutions and the market, which, however, needs State Government guarantees[2]. Given their poor financial position, the ULBs are not able to raise loans or issue bonds without such guarantees. With the introduction of ceiling on Government guarantees by some of the States, the ULBs may not be able to get State guarantees for all their projects in the future. In this scenario, the urban local bodies themselves will have to take measures to improve their financial position. It is also necessary for the Government to undertake structural, institutional and administrative reforms to make them more efficient (Bagchi, 2001). Only with comprehensive reforms, will the urban local bodies be able to raise

2 According to Mathur & Ray (2003), as of March 31, 2001, the State Governments had accumulated contingent liabilities of Rs. 52.5 billion on behalf of the municipalities.

funds from financial institutions and the capital market to undertake long-term infrastructure projects.

In view of having a three-tier federal system and inter-governmental fiscal transfers as an integral mechanism for solving the problem of vertical imbalance, any meaningful examination and assessment of the fiscal sector of the country has to take into account the finances of Central, State and Local bodies together. This is particularly relevant in the context of some of the State Governments, which are directly assuming the responsibility for repaying the loans taken by urban local bodies from external lending agencies, e.g. Kerala. This is directly increasing the outstanding liabilities of the States.

Presently the fiscal position of the country, especially with respect to the combined fiscal deficit, is analysed only in terms of the finances of Central and State Governments. To get a comprehensive idea about the fiscal sector, it is essential to consider the finances of local bodies as constitutional entities engaged in providing a variety of civic amenities and infrastructure.

A study of both theory and practice of fiscal federalism suggests that inter-governmental finance can be used as an effective tool to correct the vertical imbalance in the assignment of responsibilities and fiscal powers between the Centre and federating units, reduce the inequalities amongst such units due to a variety of factors including fiscal power, cost disabilities, revenue effort, *etc.* and to promote public spending in certain desired sectors like education, health, *etc.* In addition to the above factors of vertical balance, equalization principle and externalities, administrative justification in terms of economies of scale in tax collection at the Central and State levels also stand as arguments in favour of inter-governmental transfers.

Inter-governmental transfers can take the form of share in common pool of taxes, grants-in-aid and various centrally-funded schemes; they are closely intertwined with Sub-national Government financing in most developing and transition countries. As noted by

Bahl (2000), they serve the twin objectives of enabling the Central Government retaining overall control of the public finance system and offering a way to channel money into budgets of Provincial and Local Governments. However, there are serious problems in the inter-governmental finance system in India, especially at State and local body levels as elsewhere in the world.

Some of the major learnings from a cross-sectional study of intergovernmental fiscal relationships undertaken by the Institute on Governance (1998) have been summarized in Box 3.

Box 3: Learnings from Cross-sectional Study of Intergovernmental Fiscal Relationships

- There is no 'one best way' or magic formula on which to base a fiscal relationship between levels of government;
- Both case studies and international experience elsewhere confirm that revenue equalization approaches are relatively straight forward;
- All the case study countries have equalization mechanisms that provide an incentive for raising own source revenue by using tax potential and a standard tax rate as the main equalizing variables;
- Case studies and the principles both confirm the importance of establishing a robust set of own source revenues for sub-national governments;
- Expenditure equalization, in contrast to revenue equalization, appears to be fraught with political controversy;
- Fiscal transfer mechanisms create continual tension between the principles of simplicity and equity;
- Case studies reveal a wide variety of mechanisms available to enhance accountability;
- They also reveal a continuing tension in the degree to which the Central Governments 'control' or influence the activities of Sub-national Governments;
- Another contentious issue is that in any fiscal relationship between levels of government is the determination of the total amount to be transferred to all Sub-national Governments and the size or scale of Sub-national Governments appears to matter; and
- It is important to establish an ongoing process or mechanism for managing fiscal relationship given the inherent problem of dividing a fixed sum among a number of competing entities.

Mismatches of resources and responsibilities between the Centre, States and local bodies in India are similar across most parts of the country. Suitably designed inter-governmental transfers need to be adopted as appropriate instruments to address these imbalances. Mechanisms for an effective system of inter-governmental transfers are institutionalized by the Constitution of India through Article 280 and Article 243Y. Article 280 provides for transfers from the Centre to the States in the form of tax devolution and grants-in-aid through the institution of CFC constituted every five years.

The 74^{th} Constitutional Amendment Act has provided a role to the CFC to recommend "measures" needed to augment the Consolidated Fund of the States to supplement the resources of Municipalities in the States on the basis of the recommendations made by the SFCs. In addition to the Finance Commission transfers, there are provisions of resource flow through the Planning Commission and various Centrally-sponsored Schemes.

Article 243(I) inserted into the Constitution through the 73^{rd} Amendment Act provides for the institution of SFC to address State-Local transfer issues. The SFCs are required to make recommendations to the Governor of the State as to the principles of revenue assignment and transfers and the measures needed to strengthen the fiscal positions of the Municipalities.

Given the Constitutional provisions, what appears to be a problem in the context of instituting appropriate inter-governmental transfer systems for urban local bodies in India is the lack of adequate database and research support to CFCs and SFCs to scientifically examine the issues of fiscal federalism and make recommendations for ULBs. Further, a sound practice at the State level to establish SFCs with eminent personalities and seriously act upon the SFC recommendations also needs to be nurtured.

The 74^{th} Constitutional Amendment has envisaged greater autonomy and responsibilities for elected Municipalities for promoting social and economic development of the country. The Municipalities have been assigned the task of drawing up plans for economic development and social justice, and implementing the schemes relating thereto including the 18 functions included in the Twelfth Schedule of the Constitution. Though autonomy and discharging of the responsibilities require greater access to resources, yet the institutional mechanisms in place are not adequate to ensure a match between municipal functions and finances. Two important reforms urgently called for are: broadening the revenue base of ULBs and reforming inter-governmental transfer system. Given the limitations to raise own resources, there is a strong argument for institutionalizing resource flow from the higher level of Governments to ULBs based on principles. However, the issues of inter-governmental transfers to local bodies have not received due attention in India owing to a variety of reasons. Moreover, as noted by Mathur and Thakur (2004), the transfers to Municipalities in India remain discretionary in nature. As these are not determined based on any normative analysis, they are highly unpredictable sources of revenue for the Municipalities. This contrasts the fact that the transfers from the Centre to States based on the recommendations of the CFCs have always been determined by objective formulae.

3.5 Some Observations

The discussions in the foregoing paragraphs reveal that the fundamental concerns of municipal finance reforms in India revolve around the two basic issues of fiscal federalism, namely revenue assignment must be clear and revenue assignment must correspond to expenditure assignment. Addressing clarity, consistency and predictability in the systems of taxes, user charges, inter-governmental transfers, borrowings *etc.* is the starting point. However, that would not lead us far. We need to clarify what resources need to be aligned to what expenditures so that the delivery of the services most required by citizens takes place effectively. Once the revenue assignment is clarified, the next step is to institute systems to manage revenues and expenditure effectively to ensure one-to-one linkages between outlays and outcomes.

As per the 74th Constitutional Amendment, enormous responsibilities have been assigned to ULBs. However, it did not specify the sources of revenues. Legally, urban local bodies have only limited powers to raise resources. They cannot have deficits in their budgets and their borrowing capacities have been contained. These local bodies have to depend on a number of institutions for resources to perform the tasks assigned to them by the Constitution and State Legislatures. They also need to be professionalized to convert outlays to outcome efficiently and effectively. In short, the issues of vertical imbalance, fiscal dependency, borrowing constraints and inefficiency in municipal management are affecting the functioning of local bodies. They need to be addressed holistically.

Chapter 4

TRENDS IN MUNICIPAL FINANCES IN INDIA

4.1 Overview of Municipal Finances

This chapter presents an overview of municipal finances in India. The first section analyses the pattern and trends in municipal finances using all-India fiscal aggregates obtained from secondary sources[3] to provide a macro picture across the country . The second, third and fourth sections provide indepth analysis of the structure of municipal finances of select 35 Municipal Corporations (MCs). The analysis is based on data gathered from the budget documents of these selected MCs, covering the period 1999-2000 to 2003-2004.

4.2 Size of the Municipal Sector

As per the Report of the Twelfth Finance Commission, India has 3,723 ULBs, of which 109 are MCs, 1432 are municipalities and 2182 are Nagar Panchayats.

The total revenue of the municipalities grew from Rs.11,515 crore in 1998-99 to Rs.15,149 crore in 2001-02 at a compounded average growth rate (CAGR) of 9.6 per cent. The total expenditure increased from Rs 12,035 crore to Rs 15,914 crore during the same period, registering a CAGR of 9.8 per cent. In spite of the growth of the municipal sector in the country, it accounts for a very small proportion of both Gross Domestic Product (GDP) (at current prices) as well as revenue and expenditure of the upper tiers of Government.

Total revenue of the municipal sector accounts for about 0.75 per cent of GDP of the country. In contrast, the ratio is 4.5% for Poland, 5% for Brazil and 6% for South Africa [Buckley (2005)]. Similiarly, municipal revenue forms a little more than 2 per cent of

[3] Data set out in various government reports *viz.*, Twelfth Finance Commission Report, Eleventh Finance Commission Report and Economic Survey, have been used.

Table 13: Revenue Significance of Municipal Sector

Year	Municipal Revenue (Rs. Crore)	Percentage of GDP at Factor Cost	Relative share of Municipal Revenue (as per cent of Total Revenue of)		
			State Govt.	Central Govt.	Combined State & Central Govt.
1998-99	11,515	0.72	4.4	4.1	2.5
1999-00	13,173	0.75	4.2	4.4	2.5
2000-01	14,581	0.77	4.2	4.5	2.4
2001-02	15,149	0.73	4.1	4.2	2.3

Source : (i) Reports of Eleventh and Twelfth Finance Commission, (ii) Economic Survey, GoI 2004-05.

combined revenue of State and Central Governments. Total revenue of ULBs has been growing at a lower rate (9.7 per cent during 1998-99 to 2001-02) than the growth of combined revenue of Central and State Governments (10.8 per cent during 1998-99 to 2001-02). This reflected in a marginal decline in the share of municipal revenue in total government revenues from 2.5 per cent in 1998-99 to 2.3 per cent in 2001-02. Table 13 provides an overview of the relative importance of municipal revenues in relation to revenues of the States and the Centre.

In terms of total expenditure, the municipal sector accounts for about 0.79 per cent of the GDP of the country. While, municipal expenditure accounts for little over 2 per cent of the combined expenditure of State and Central Governments, it declined further between 1999-2000 and 2001-2002. Table 14 provides an overview

Table 14: Expenditure Significance of Municipal Sector

Year	Municipal Expenditure (Rs. Crore)	Percentage of GDP at Factor Cost	Relative share of Municipal Expenditure (as per cent of Total Expenditure of)		
			State Govt.	Central Govt.	Combined State & Central Govt.
1998-99	12035	0.75	4.52	4.31	2.21
1999-00	14452	0.82	4.60	4.85	2.36
2000-01	15743	0.83	4.53	4.84	2.34
2001-02	15914	0.76	4.22	4.39	2.15

Source: (i) Reports of Eleventh and Twelfth Finance Commission (ii) Handbook of Statistics on Indian Economy, RBI 2005-06 of the relative importance of municipal expenditure in relation to the expenditures of the States and Centre.

4.3 Finances of Select Municipal Corporations

This and subsequent sections undertake indepth analysis of municiple finances based on primary data obtained from the budget

Table 15: Study Sample - Cities with more than 1 million population in 2001

S. No.	Name of the City	Name of the State	UA/City Population (2001) (million)	MC Population (2001)
1	Greater Mumbai	Maharashtra	16.37	11914398
2	Kolkata	West Bengal	13.22	4580544
3	Delhi	Delhi	12.79	9817439
4	Chennai	Tamil Nadu	6.42	4216268
5	Bangalore	Karnataka	5.69	4292223
6	Hyderabad	Andhra Pradesh	5.53	3449878
7	Ahmedabad	Gujarat	4.52	3515361
8	Pune	Maharashtra	3.75	2540069
9	Surat	Gujarat	2.81	2433787
10	Kanpur	Uttar Pradesh	2.69	2532148
11	Jaipur	Rajasthan	2.32	2324319
12	Lucknow	Uttar Pradesh	2.27	2207340
13	Nagpur	Maharashtra	2.12	2051320
14	Patna	Bihar	1.71	1376950
15	Indore	Madhya Pradesh	1.64	1597441
16	Vadodara	Gujarat	1.49	1306035
17	Bhopal	Madhya Pradesh	1.45	1433875
18	Coimbatore	Tamil Nadu	1.45	930882
19	Ludhiana	Punjab	1.40	1395053
20	Kochi	Kerala	1.35	596473
21	Visakhapatnam	Andhra Pradesh	1.33	982940
22	Agra	Uttar Pradesh	1.32	1259979
23	Varanasi	Uttar Pradesh	1.21	1100748
24	Madurai	Tamil Nadu	1.19	928869
25	Meerut	Uttar Pradesh	1.17	1074229
26	Nashik	Maharashtra	1.15	1076967
27	Jabalpur	Madhya Pradesh	1.12	951469
28	Jamshedpur	Jharkhand	1.10	570349
29	Asansol	West Bengal	1.09	475439
30	Dhanbad	Jharkhand	1.06	198963
31	Faridabad	Haryana	1.05	1054981
32	Allahabad	Uttar Pradesh	1.05	975393
33	Amritsar	Punjab	1.01	1011327
34	Vijayawada	Andhra Pradesh	1.01	851282
35	Rajkot	Gujarat	1.00	967476

Source : (i) http://urbanindia.nic.in/mud-final-site/programs/urbandevelopment/nurm.htm Website of MUD (accessed on November 15, 2005);
(ii) http://www.censusindia.net/results/millioncities.html Census of India website (last accessed on March 24, 2006)
(iii) Secondary sources, including budget documents of the MCs

documents of 35 major MCs of the country whose population was 1 million and above as per 2001 Census. Table 15 shows the sample of MCs and the States to which they belong.

4.4 Municipal Revenues

4.4.1 Structure of Municipal Revenues

The revenue base of MCs can be broadly categorized into: (a) tax revenues, (b) non-tax revenues, (c) assigned (shared) revenue, (c) grants-in-aid, (d) loans and (e) other receipts. Table16 lists out revenue sources under each major revenue head. It may be mentioned that composition as well as relative importance of revenue sources of MCs varies across the States.

Table 17 sets out the major components of tax revenue of selected MCs in India. While, property tax is the major revenue source in most of the MCs, octroi is the major source in the MCs of Maharashtra and Gujarat. Octroi has been abolished in all other States excepting Maharashtra and Gujarat.

Table 18 illustrates the major user charges and fees levied by the select MCs in India. There is considerable heterogeneity in the levy of user charges by MCs across states.

Table 16: Revenue Sources of Municipal Corporations in India 1998-2002

Revenue Head/Category	Sources of revenue
Tax revenue	Property Tax, Octroi, Advertisement Tax, Tax on Animals, Vacant Land Tax, Taxes on Carriages and Carts
Non-Tax revenue	User Charges, Municipal Fees, Sale & Hire Charges, Lease amounts
Other receipts	Sundry receipts, Law charges costs recovered, Lapsed deposits, Fees, Fines & Forfeitures, Rent on Tools & Plants, Miscellaneous Sales *etc.*
Assigned (Shared) revenue	Entertainment Tax, Surcharge on Stamp duty, Profession Tax, Motor Vehicles Tax
Grants-in-aid	(i) Plan Grants made available through planned transfers from upper tier of Government under various projects, programmes and schemes (ii) Non-Plan Grants made available to compensate against the loss of income and some specific transfers
Loans	Loans borrowed by the local authorities for capital works *etc.* – HUDCO, LIC, State and Central Governments, Banks and Municipal Bonds

Source: Budgets of Municipal Corporations.

* Gujarat is reported to have abolished octroi recently.

Table 17: Sources of Major Tax Revenues of Selected Municipal Corporations in India 1998-2002

Name of State	Name of Municipal Corporation	Major Taxes
Andhra Pradesh	Hyderabad	Property Tax, Profession Tax
Bihar	Patna	Property Tax, Profession Tax
Delhi	Delhi	Property Tax, Advertisement Tax
Gujarat	Surat	Property Tax, Octroi
Karnataka	Bangalore	Property Tax, Advertisement Tax
Kerala	Kochi	Property Tax, Profession Tax
Madhya Pradesh	Indore	Property Tax, Advertisement Tax
Maharashtra	Mumbai	Octroi, Property Tax
Punjab	Ludhiana	Octroi, Property Tax
Rajasthan	Jaipur	Octroi, Property Tax
Tamil nadu	Chennai	Property Tax, Profession Tax
Uttar Pradesh	Varanasi	Property Tax, Advertisement Tax
West Bengal	Kolkota	Property Tax, Advertisement Tax

Source: Budgets of Municipal Corporations.

Shared tax revenue, which varies in terms of composition and nature across states, also forms significant proportion of MC resources (Table 19). Entertainment tax is an important tax, not levied by the MCs, but collected and assigned to the MCs by State Governments. In Andhra Pradesh and Tamil Nadu, in addition to entertainment tax, profession tax and surcharge on stamp duty are also assigned to local bodies.

Table 18: Sources of Major User Charges and Fees of Selected Municipal Corporations in India 1998-2002

Name of State	Name of Municipal Corporation	User Charges and Fees
Maharashtra	Greater Mumbai	Water Charges, Sewerage Charges, Building Licence Fees
West Bengal	Kolkata	Planning Fees, Car Parking Fees, Mutation Fees
Karnataka	Bangalore	Betterment Charges, Building Licence Fees, Penalty for Late Tax payment
Orissa	Bhubaneswar	Building Licence Fees, Market Fees
Gujarat	Surat	Water Charges, Building-related Fees, Betterment Charges
Tamil Nadu	Chennai	Building Licence Fees, Market Fees, Other Licence Fees, Parking Fees
Andhra Pradesh	Hyderabad	Dangerous and Offensive Trade Licence Fees, Market Fees, Slaughter House Fees
Uttar Pradesh	Kanpur	Building Licence Fees, Market Fees

Source: Budgets of Municipal Corporations.

Table 19: Sources of Shared Revenues of Selected Municipal Corporations in India 1998-2002

Name of State	Name of Municipal Corporation	Shared Municipal Taxes
Maharashtra	Greater Mumbai	Non-agricultural Assessment Tax, Entertainment Tax
West Bengal	Kolkata	Motor Vehicles Tax, Entertainment Tax
Karnataka	Bangalore	Entertainment Tax, Surcharge on Stamp Duty
Gujarat	Surat	Entertainment Tax
Tamil Nadu	Chennai	Surcharge on Sales Tax, Duty on Transfer of Property, Entertainment Tax
Andhra Pradesh	Hyderabad	Surcharge on Stamp Duty, Profession Tax, Entertainment Tax

Source: Budgets of Municipal Corporations.

Apart from their own revenue sources, *i.e.*, tax and non-tax revenue sources, the MCs depend upon grants from State Governments. These grants are primarily intended to compensate for the mismatch of functions and finance. Most of the MCs receive financial support in the form of revenue grants from State Governments to meet current expenses. Similiarly, capital grants are also provided for meeting project related expenditure. Table 20 shows the composition of grants-in-aid in selected MCs.

In addition to own revenues, shared revenues, user charges & fees and grants-in-aid, loans also constitute an important source of municipal revenues in some ULBs.

4.4.2 Composition and Trends of Municipal Revenues

Relative contribution of various components in the total revenue over the years has been presented in Tables 21(a) and 21(b).

Between 1999-00 to 2003-04, while the share of non-tax, assigned revenue, non-plan and plan grants improved, the share of tax revenue in total revenue receipts of MCs declined.

The average shares of major revenue components (average of 2000-04) based on the data of 35 Municipal Corporations are shown

Table 20: Major Sources of Grants-in-Aid of Selected Municipal Corporations in India 1998-2002

Name of State	Name of Municipal Corporation	Grants-in-Aid provided to Municipal Corporations
Maharashtra	Greater Mumbai	Primary Education Grant and Secondary Education Grant
West Bengal	Kolkata	Dearness Allowance Grant, Grant to Implement Recommendations of Pay Commission and Water Supply, Sewerage and Drainage Grants
Karnataka	Bangalore	Octroi Compensation, Motor-Vehicle Tax Compensation and Family Planning Scheme Grants
Orissa	Bhubaneswar	Salary and Dearness Allowance Grants, Road Development Grant, Primary Education Grant and Secondary Education Grant
Gujarat	Surat	Education Grant, Family Planning Grant and Small Savings Grant
Tamil Nadu	Chennai	Revenue Grant, Contributions and Compensation for Toll
Andhra Pradesh	Hyderabad	Property Tax Compensation, Octroi Compensation, Per Capita Grant, Motor Vehicle Tax Compensation and Road Grant
Uttar Pradesh	Kanpur	Octroi Compensation, Salary Grant, Education Grant (Primary & Secondary Education), Medical Grant, Road Grant

Source: Budgets of Municipal Corporations.

in the Figure 2. Among the various revenue sources, tax revenue assumes greater importance in terms of both size and share. The

Table 21(a): Composition of Municipal Revenue and Trends

(Rs.in Lakh)

Sl. No.	Revenue component	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	Average Growth Rate %
1	Tax revenue	458509	554597	461895	573952	599387	8.23
2	Non-Tax revenue	238670	297890	296487	421422	434905	17.42
3	Assigned revenue	87557	115909	110146	132588	131076	11.66
4	Non-Plan grants	26667	34145	33341	54876	50161	20.42
5	Other revenue receipts	98600	86769	48024	64177	63271	-6.11
	Revenue Receipts	910003	1089310	949893	1247015	1278800	10.18
6	Plan grants	16753	15665	31712	30027	49898	39.20
7	Loans	19917	47245	31805	28520	32835	27.33
8	Other capital receipts	11228	18101	18622	25785	33948	33.55
	Capital Receipts	47898	81011	82139	84332	116681	27.89
	Total Receipts	**957901**	**1170321**	**1032032**	**1331347**	**1395481**	**11.04**

Source: Based on the Budgets of Municipal Corporations.

Table 21(b): Composition of Municipal Revenue and Trends

(Per cent to Total)

Sl. No.	Revenue component	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	Average %
1	Tax revenue	47.87	47.39	44.76	43.11	42.95	45.21
2	Non-Tax revenue	24.92	25.45	28.73	31.65	31.17	28.38
3	Assigned revenue	2.78	2.92	3.23	4.12	3.59	3.33
4	Non-Plan grants	9.14	9.90	10.67	9.96	9.39	9.87
5	Other revenue receipts	10.29	7.41	4.65	4.82	4.53	6.34
	Revenue Receipts	95.00	93.08	92.04	93.67	91.64	93.08
6	Plan grants	1.75	1.34	3.07	2.26	3.58	2.40
7	Loans	2.08	4.04	3.08	2.14	2.35	2.74
8	Other capital receipts	1.17	1.55	1.80	1.94	2.43	1.78
	Capital Receipts	5.00	6.92	7.96	6.33	8.36	8.36
	Total Receipts	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**

Source: Based on the Budgets of Municipal Corporations.

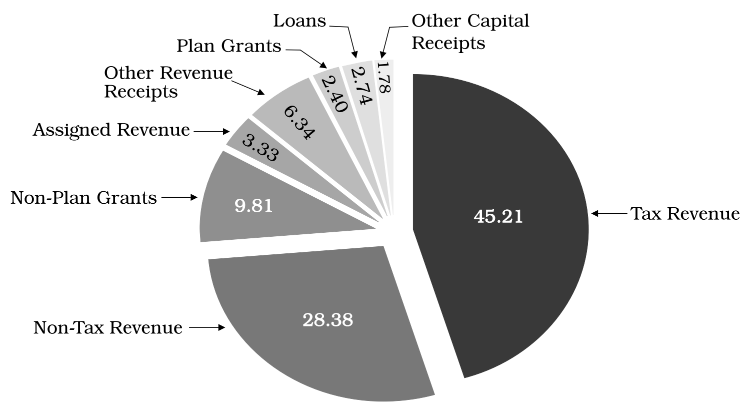
aggregate tax revenue of the 35 MCs constituted 45 per cent of average aggregate total revenue (total receipts), which was followed by non-tax revenue constituting 28 per cent of the average aggregate.

4.5 Municipal Expenditure

4.5.1 Structure of Municipal Expenditure

The expenditure incurred by the MCs can be broadly categorized into: (a) revenue expenditure and (b) capital expenditure.

Figure 2: Components of Revenue of Municipal Corporations 2000-04 (as average percent of Aggregate Total Revenues)



Source: Budgets of Municipal Corporations

Table 22: Categorisation of Municipal Expenditures

Expenditure Category	Expenditure Items
Establishment expenditure	Staff salaries, Allowances, wages, Pensions & Retirement benefits *etc.*
Administrative expenditure	Rents, rates & Taxes, Office maintenance, Communications, Books & periodicals, Printing & stationary, Travel expenditure, Law charges *etc.*
Operations & Maintenance	Power & fuel, Bulk purchases, Stores, Hire charges, Repairs & expenditure Maintenance and Interest payments made on loans
Capital expenditure	Buildings, Water supply & Sewerage, Energy/lighting, Solid waste management , Roads, Bridges, Culverts, Causeways, Health & sanitation, Parks and recreation spaces, Furniture & fittings, Tools & plant, Equipment *etc.*, Principal repayments of loans
Other expenditure	Miscellaneous expenses not accounted for in the above

Source: Budgets of Municipal Corporations.

Further, revenue expenditure broadly comprises (i) establishment expenditure, (ii) administrative expenditure, (iii) operations and maintenance expenditure, and (iv) interest payments on loans; the capital expenditure comprises (i) expenditure on capital formation and (ii) principal repayment. The component of these major expenditure categories are shown in table 22.

4.5.2 Composition and Trends of Municipal Expenditure

The composition of aggregate expenditure of the MCs, in terms of the above categories, and trends are shown in Tables 23(a) and 23(b).

Table 23(a): Composition and Trends of Municipal Expenditure

(Rs.in Lakh)

Sl. No	Expenditure component	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004 Rate %	Average Growth
1	Establishment and administration expenditure	279216	330414	329592	411432	402550	10.19
2	Operation and maintenance expenditure	107383	128165	142174	164406	154400	9.96
3	Other revenue expenditure	51830	56120	55954	58190	56265	2.17
4	Revenue Expenditure	438429	514699	527720	634028	613215	9.20
5	Capital Expenditure	96933	105942	119463	124817	150424	11.76
6	Other Expenditure (not classified)	209744	266611	210685	399205	470925	28.40
	Total Expenditure	**745106**	**887252**	**857868**	**1158050**	**1234564**	**14.34**

Source: Budgets of Municipal Corporations.

Table 23(b): Composition and Trends of Municipal Expenditure

(Percent to Total)

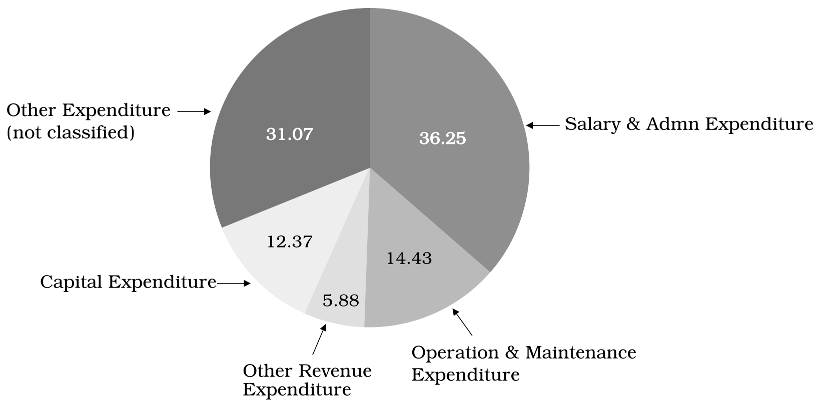
Sl. No	Expenditure component	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	Average%
1	Establishment and administration expenditure	37.47	37.24	38.42	35.53	32.61	36.25
2	Operation and maintenance expenditure	14.41	14.45	16.57	14.20	12.51	14.43
3	Other revenue expenditure	6.96	6.33	6.52	5.02	4.56	5.88
4	Revenue Expenditure	58.84	58.01	61.52	54.75	49.67	56.56
5	Capital Expenditure	13.01	11.94	13.93	10.78	12.18	12.37
6	Other Expenditure (not classified)	28.15	30.05	24.56	34.47	38.15	31.07
	Total Expenditure	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**

Source: Budgets of Municipal Corporations.

The average shares of different components in aggregate expenditure during the period of 2000-04 are shown in Figure 3.

Among all the components of municipal expenditure, the expenditures on capital works, establishment & administration, and operations & maintenance assume importance. The establishment & administrative expenditure constituted 36.25 per cent of the aggregate total expenditure, during 2000-2004. Capital expenditure, which is an important component, constituted less than 13 per cent of the total expenditure, during the same period.

Figure 3: Composition of Expenditure of 35 Municipal Corporations 2000-04 (As average percentage of total expenditure)



Source: Budgets of Municipal Corporations.

The above expenditure pattern indicates that the MCs' spending on capital works has been significantly low which is critical for building civic infrastructure for planned urban development.

The under-investment in public works is reflected in inadequate availability of civic amenities such as water supply, sewerage, transportation networks and storm drainage system as discussed in the next chapter.

4.5.3 Expenditure on Public Works

The expenditure on public works is an important component of the expenditure incurred by the Municipal Corporations. It includes both the expenditure on capital formation as well as the current expenditure incurred on public works by the MCs. The current expenditure comprises expenditure on staff, administration and operations & maintenance. The trends and compostion of expenditure on public works are shown in Tables 24(a) and 24(b). The total expenditure on all public works of the MCs accounted for 46.5 per cent of the total expenditure, on an average, during 2000-2004. Among the components, expenditures on health & sanitation and street lighting have grown the fastest, followed by expenditures on roads, education and sewerage. The growth in expenditures

Table 24(a): Composition of Expenditure on Public Works and its Trends

(Rs.in Lakhs)

Public Works	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	Average Growth Rate %
Health & Sanitation	14593	33708	38339	47695	49443	43.20
Water supply	28803	31742	34694	40792	40976	9.38
Roads	58730	85658	83420	92270	97390	14.85
Parks & Playgrounds	72658	77040	83298	88722	90533	5.68
Education	48500	57782	60533	72218	74885	11.72
Sewerage	20963	22742	27783	31013	32860	12.06
Solid waste management	42440	50696	50886	57511	57614	8.26
Energy/lighting	27436	43150	32092	81495	69277	42.65
All Major Works	314123	402518	411046	511716	512977	13.75

Source: Budgets of Municipal Corporations.

Table 24(b): Composition of Expenditure on Public Services and its Trends

(as Percentage of Total)

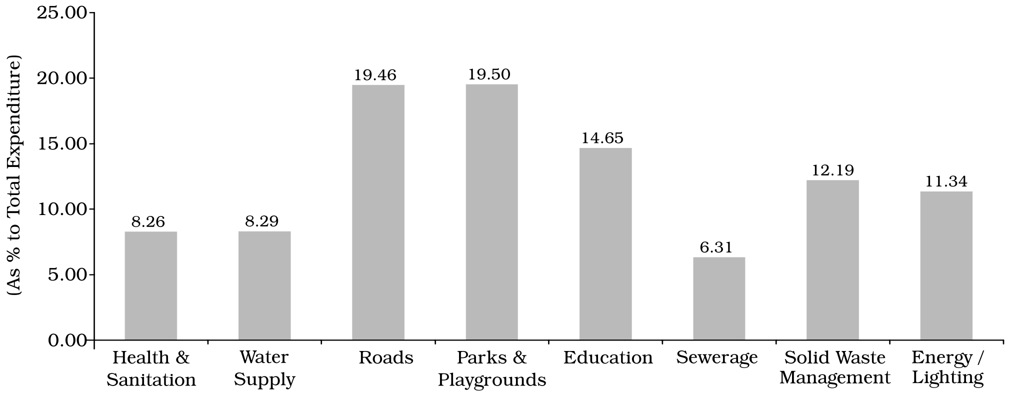
Public Works	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	Average Growth
Health & Sanitation	4.65	8.37	9.33	9.32	9.64	8.26
Water supply	9.17	7.89	8.44	7.97	7.99	8.29
Roads	18.70	21.28	20.29	18.03	18.99	19.46
Parks & Playgrounds	23.13	19.14	20.26	17.34	17.65	19.50
Education	15.44	14.36	14.73	14.11	14.60	14.65
Sewerage	6.67	5.65	6.76	6.06	6.41	6.31
Solid waste management	13.51	12.59	12.38	11.24	11.23	12.19
Energy/lighting	8.73	10.72	7.81	15.93	13.50	11.34
All Major Works	100.00	100.00	100.00	100.00	100.00	100.00
As share of Total Expenditure (%)	42.16	45.37	47.91	44.19	41.55	44.24

Source: Budgets of Municipal Corporations.

incurred on water supply, parks and play grounds and solid waste management has been relatively modest.

The MCs have been assigned some of the essential service delivery functions as defined under the respective Municipal legislations. It was laid down that they shall give primary attention to providing essential services like water supply, sewerage, street lights, solid waste management and public (only primary) health. A disproportionately high spending on non-discretionary items like

Figure 4: Composition of Expenditure on Public Services in the MCs (average of 1999-2000 to 2003-2004)



Source: Budgets of Municipal Corporations secondary education or secondary health care may not be desirable, unless an MC has already attained satisfactory levels of services on essential services.

The composition of expenditure on various public services in the MCs (shown in Figure 4) clearly indicates that the expenditure incurred on essential municipal functions (obligatory/non-discretionary items) like provision of water supply, drainage, sewerage, health & sanitation and solid waste management has been comparatively lower than the expenditure incurred on non-essential functions (discretionary items) like provision of education and parks. This calls for rationalising the discretionary spending by MCs through suitable guidelines; and to improve public accountability of expenditure through citizen's charters and social audits which will be discussed in Chapter 6.

Although water supply and sewerage functions are handled by separate boards in some metropolitan cities like Delhi, Hyderabad, Bangalore and Chennai, this fact does not affect the findings on municipal expenditures. In fact, the pattern of expenditure on public works, after deducting the corresponding figures for water supply and sewerage, of the above four metropolitan cities, more or less remains the same.

4.6 Summary Observations

The municipal sector in India has remained small with its total revenue accounting for about 0.75 per cent of GDP. In terms of both revenue and expenditure they account for a little above 2 per cent of the combined revenues and expenditure of Central Government, State Governments and ULBs. Analysis of the data for 35 major MCs indicated higher growth of expenditure (14.3 per cent) during 200-04 compared to the growth of total receipts (11.0 per cent). Component-wise, tax revenue accounted for 45.2 per cent of total revenue, followed by non-tax revenue (28.7 per cent) during 2000-04. Establishment and administration expenditure accounted for about 36 per cent of total expenditure during 2000-04. Expenditure on public works accounted for about 44 per cent of the total expenditure with expenditure on roads and parks and playgrounds accounting for about 19.5 per cent of the total expenditure.

Chapter 5

ASSESSMENT OF MUNICIPAL FINANCES

5.1 Approach to Study

The macro overview of municipal finance in India, attempted in the preceding chapter, brought out the significance of municipal finance for the overall financial well-being of the economy and provided an insight into the sources, structure, composition and trends of aggregate revenue and expenditure of the MCs in metropolitan cities in India. It should be noted that many of the conclusions drawn at aggregate level above may not hold good for individual ULBs and may not throw enough light on the constraints faced by individual local bodies and the need for requisite policy initiatives to address them. Therefore, the present chapter examines the financial parameters of individual municipal bodies, to assess their ability to provide the required civic amenities and to identify the constraints faced by them.

5.2 Analytical Framework

Fiscal assessment of any entity is generally based on revenue and fiscal balance. Similarly, to assess qualitative aspects, the ratio of revenue expenditure to total expenditure is considered. Any entity generating surplus in revenue account (and if possible, in capital account) and maintaining low proportion of revenue expenditure to total expenditure, is considered to have sound financial health. However, this "standard approach" for making assessment may not hold for the ULBs. Municipal authorities are constrained by statutory mandates of balanced budgets[4] and they are also not

[4] Statutorily, municipal bodies cannot run deficit and their revenue receipts must exceed revenue expenditure while presenting budgets. It is quite possible that MCs might be compressing its expenditure in order to meet the statutory requirement. Therefore, the surplus cannot be termed as a genuine surplus.

granted liberal permission by State Governments to incur debt [Mathur and Thakur (2004)]. However, revenue expenditure is not undesirable, if a good proportion of this goes for operation and maintenance of civic amenities provided by the ULBs.

With the above in the background, the assessment of ULBs needs to proceed on a different track, making use of an alternate set of parameters. These parameters are normative benchmarks which define the minimum level of expenditure that the ULBs are required to incur, in order to ensure a minimum standard of living to the inhabitants. A set of expenditure benchmarks, both for creating new assets, and for their maintenance were derived by the Zakaria Committee in 1964 for core urban services. These expenditure norms for service provision (capital) as well as operation & maintenance (O&M) are for the cities that are divided into categories AA, A, B, C, D and E, based on the population size. The expenditure norms for 5 core civic activities *viz.*, water supply, roads, storm water drainage, sewerage and street lighting for 3 major city classes covered by this study (at the 1996-97 prices) are shown in Table 25.

A comparison of municipal spending with these norms, after revising them to the current period, would reveal the level of under-spending by the ULBs. There are a host of factors which could be responsible for the level of under-spending, which can be divided into two broad categories. - *exogenous* and *endogenous*. As the terms

Table 25: Zakaria Committee Norms of Expenditure on Services

(Rupees per capita at 1996-97 prices)

City Class	Water Supply		Sewerage		Storm Drainage		Roads		Street Lights	
	Capital	O & M	Capital	O & M	Capital	O & M	Capital	O & M	Capital	O & M
AA	968	161	1117	182	611	-	1207	37	447	45
A	700	152	968	177	432	-	1043	33	372	42
B	699	146	819	161	387	-	611	27	328	37

AA - More than 20 Lakhs population; A - 5-20 Lakhs population; B – 1-5 Lakhs population

Source: Mathur and Singh (1998)

suggest, *exogenous factors* are those that are not within the control of concerned ULB whereas *endogenous factors* refer to those that have to do with the ULBs' own operations.

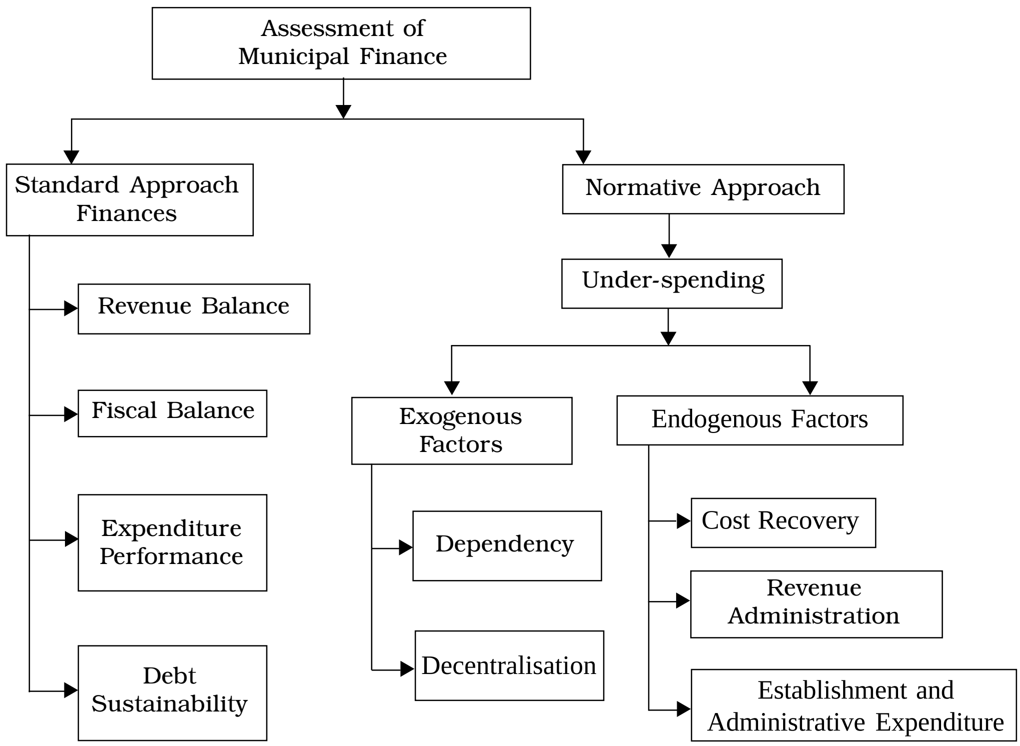
Exogenous factors include: delegation of revenue powers (decentralization) and dependency of ULB for resources on upper tier of government (dependency ratio). Endogenous factors include: revenue (tax) administration, cost recovery and quality of expenditure.

The framework of analysis proposed to be followed for assessment of ULB performance is set out in Figure 5.

Thus the assessment of finances of ULBs is proposed to proceed as follows:

- First, the ULBs have been assessed in terms of "standard approach" using revenue balance, fiscal balance and the ratio of revenue expenditure to total expenditure.

Figure 5: Municipal Finance Assessment Framework



- Secondly, ULBs were assessed in terms of "normative approach" by using Zakaria Committee norms. The Zakaria Committee norms for civic amenities are adjusted to the current prices of the period of 1999-2000 to 2003-2004, using an appropriate inflation index, *i.e.* WPI. The performance of individual MCs is compared against the respective norms, and, the level of under-spending is worked out. This is followed by the identification of the factors responsible for the level of under-spending.
- Next section, deals with 'use of debt' and 'debt sustainability' of the MCs and ascertain the capacity of the MCs to borrow for augmenting spending on provision of services.
- The subsequent section summarises the performance of individual MCs in terms of different parameters and attempts to rank them.
- In the last section, estimates of resource requirements of the urban sector and the potential of revenues of the ULBs in India have been attempted.

5.3 Major Inferences from Analysis

5.3.1 Standard Approach

i) Revenue Balance

Revenue balance, measured as revenue receipts net of revenue or current expenditure, indicates whether a municipal corporation (MC) is able to meet its revenue expenditure from its own resources including grants from the upper tiers of Government. Table 26 reveals that all the MCs, barring Pune and Patna, were able to generate revenue surplus[5].

[5] It has been pointed out that since a part of Municipal body expenditure is absorbed directly by the state government, particularly relating to deputed employees, expenditure shown by them (municipal bodies) is an underestimate. But this issue is not relevant for the bigger MCs considered in the study. For instance, proportion of deputed employees is miniscule in the case of Bangalore, Chennai and Hyderabad.

Table 26: Balance of Municipal Revenues and Expenditure (Average of 1999-2000 to 2003-2004)

Sl. No.	Municipal Corporation	Revenue Income (Rs Crore)	Per capita Revenue Income (Rs)	Revenue Expenditure (Rs Crore) (Rs)	Per capita Revenue Expenditure Deficit	Total Revenue Surplus/ deficit (Rs Crore)	Per capita Revenue surplus/
1	Hyderabad	338.8	964.5	273.4	779.1	65.4	185.4
2	Visakhapatnam	110.1	1093.3	74.6	742.5	35.5	350.8
3	Vijayawada	61.7	705.6	44.5	509.8	17.2	195.7
4	Patna	21.8	150.4	29.6	205.1	-7.8	-54.7
5	Delhi	880.3	872.3	361.1	341.1	519.2	531.2
6	Ahmedabad	599.4	1668.5	556.7	1551.6	42.7	116.9
7	Surat	662.3	2577.0	208.7	816.5	453.5	1760.4
8	Vadodara	159.3	1233.4	141.8	1099.1	17.4	134.3
9	Rajkot	NA	NA	NA	NA	NA	NA
10	Jamshedpur	NA	NA	NA	NA	NA	NA
11	Dhanbad	NA	NA	NA	NA	NA	NA
12	Bangalore	369.5	810.4	296.4	643.5	73.2	166.8
13	Kochi	51.7	858.8	25.8	430.4	25.8	428.4
14	Indore	180.0	1029.6	81.4	464.9	98.6	564.7
15	Bhopal	80.4	545.4	27.8	189.2	52.5	356.2
16	Jabalpur	54.0	551.0	33.7	344.4	20.2	206.6
17	Greater Mumbai	4162.0	3417.1	1560.2	1283.8	2601.8	2133.3
18	Pune	507.2	1890.3	697.9	2582.0	-190.7	-691.7
19	Nagpur	249.6	1197.8	204.0	979.4	45.6	218.4
20	Nashik	268.3	2344.7	138.7	1221.2	129.6	1123.5
21	Amritsar	NA	NA	NA	NA	NA	NA
22	Ludhiana	194.7	1333.2	109.4	749.6	85.2	583.6
23	Jaipur	122.9	493.7	49.7	198.9	73.2	294.8
24	Chennai	591.0	1385.5	242.7	570.1	348.3	815.5
25	Coimbatore	72.1	763.0	47.1	498.7	25.0	264.3
26	Madurai	56.6	610.7	45.4	489.3	11.2	121.4
27	Lucknow	84.6	369.0	62.8	274.8	21.8	94.2
28	Kanpur	100.3	382.9	86.2	330.4	14.1	52.5
29	Allahabad	36.4	365.0	25.8	259.0	10.5	106.0
30	Agra	39.7	303.5	24.7	189.2	15.1	114.3
31	Varanasi	36.5	325.4	21.8	195.8	14.7	129.6
32	Meerut	40.9	365.3	31.6	283.0	9.4	82.3
33	Faridabad	78.1	697.4	75.1	671.3	3.0	26.1
34	Kolkata	542.4	1178.5	387.1	841.4	155.3	337.1
35	Asansol	11.1	218.2	7.4	145.8	3.7	72.4
	Total for 35 MCs	**10228**	**1271**	**5456**	**678**	**4772**	**593**

Source: Budgets of Municipal Corporations.

ii) Fiscal Balance

This measure reveals the overall resource gap, after meeting both revenue and capital expenditure, that needs to be met through borrowings.

It can be observed from the above table that except 7 municipal corporations, *viz.* Mumbai, Chennai, Visakhapatnam, Surat, Delhi, Coimbatore and Faridabad, all other MCs had their revenue falling short of expenditure (having a negative surplus). This is significant in that for maintaining the present level of expenditure, revenues are inadequate and borrowed funds are used. Hence MCs are constrained to raise the expenditure to the desired level for ensuring minimum level of civic amenities. The level of shortfall ranges from Rs.3 per capita for Jabalpur MC to Rs.1,411 per capita for Pune MC. However, the 7 MCs which are enjoying surplus have the fiscal space and clear scope for improving the civic amenities in the immediate future. There was a surplus of more than Rs.750 and Rs.500 per capita in case of Surat and Mumbai, respectively[6] (Table 27).

iii) Expenditure Performance

A proportion of revenue expenditure to total expenditure reveals the quantum of funds spent for maintaining the current assets and that available for creating new capital assets.

Table 28 shows categorisation of the MCs on this parameter. It indicates that many of them have very high proportion of revenue expenditure as compared to the group average of 56 per cent. Faridabad, Vishakhapatnam, Kolkata, Kanpur and Pune have shown revenue expenditure constituting more than 70 per cent of their total expenditure, while Kochi, Indore, Greater Mumbai, Jaipur and

[6] Budget documents for the year 2002-03 and 2004-05 of Brihat Mumbai MC state that surplus has resulted on account of efforts made by various economy measures to control the expenditure and augment the revenue.

Table 27: Resource Gap of the Municipal Corporations

Sl. No.	Municipal Corporation	Resource Gap in Rupees per-Capita (Average of 1999-2000 to 2003-2004)		
		Revenue Receipts	Total Expenditure	Resource Gap
1	Greater Mumbai	3417	2912	-505
2	Delhi	739	721	-18
3	Kolkata	1178	1224	46
4	Chennai	1386	1216	-170
5	Hyderabad	964	984	19
6	Ahmedabad	1668	2040	372
7	Kanpur	383	395	12
8	Pune	1890	3301	1411
9	Surat	2577	1818	-759
10	Jaipur	471	508	37
11	Lucknow	369	449	80
12	Vadodara	1434	1678	244
13	Agra	304	345	41
14	Nashik	2345	2711	366
15	Meerut	365	398	32
16	Faridabad	697	671	-26
17	Visakhapatnam	1093	941	-152
18	Allahabad	365	370	5
19	Rajkot	1020	1325	305
20	Jabalpur	551	554	3
21	Coimbatore	763	700	-63
22	Madurai	624	874	249
23	Vijayawada	706	772	66
24	Kochi	813	1133	320
25	Asansol	218	367	149
	Total for 25 MCs	**843**	**910**	**67**

*: '-' indicates fiscal surplus.
Source: Budgets of Municipal Corporations.

Chennai have shown it at less than 40 per cent of total expenditure. The MCs with very a high proportion of revenue expenditure need to prioritise their expenditure in favour of capital expenditure.

5.3.2 Normative Approach

i) Availability of Civic Amenities

The Municipal Corporations are expected to provide certain minimum level of civic services to the citizens, in accordance with their obligatory functions and mandates. The availability of civic amenities in a MC could be approximated by the per capita

Table 28: Categorization of Municipal Corporations as per Revenue Expenditure to Total Expenditure Ratio (2003-04)

Parameter	**Municipalities**	**Top 5 Municipalities**
At or Above Average Vishakhapatnam Patna Ahmedabad Jabalpur Pune Ludhiana Coimbatore Lucknow Kanpur Allahabad Meerut Faridabad Kolkata	Hyderabad	Faridabad (100%) Vishakhapatnam (83.69%) Kolkata (73.36%) Kanpur (72.85%) Pune (72.65%)
		Bottom 5 Municipalities
Below Average	Asansol Agra Chennai Greater Mumbai Indore Jaipur Bhopal Madurai Nasik Kochi Bangalore Surat Vijayawada	Kochi (26.65%) Indore (37.68%) Greater Mumbai (38.03%) Jaipur (38.09%) Chennai (39.06%)

Source: Budgets of Municipal Corporations.

expenditure made by the MC on various services. The adequacy of services provided by the MCs is assessed by comparing the expenditure incurred by them on core services, namely, water supply, sewerage, roads and street lighting with Zakaria Committee expenditure norms[7]. Zakaria Committee norms were evolved in 1964. They were adjusted for inflation to arrive at norms for the period of 1999-2000 to 2003-2004. Since service-wise data for all the years have been available only for 11 MCs, average proportion of service-wise expenditure to total expenditure for these MCs was used to arrive at the expenditure incurred by remaining MCs on these services.

[7] Here, the expenditure norm for storm water drainage has not been included, which is not shown in the expenditure on services of the MCs.

The results shown in Table 29 indicate that spending on civic services of all the MCs has been lower than the Zakaria Committee norms. The extent of under-spending varied between 30.78 per cent in the case of Pune to 94.43 per cent in the case of Patna. The average level of under-spending for the 30 MCs under the study works out to 76 per cent.

Table 29: Zakaria Committee Norms and Under-spending of the Municipal Corporations (Averages of 1999-2000 to 2003-2004)

Sl. No.	Municipal Corporation	Average Zakaria Norm (Rupees per capita)	Average Expenditure of the MC on Core Services capita)	Average Under Spending of the MC (As Percentage of Zakaria Norm)
1	Hyderabad	861.71	207.41	-76.01
2	Visakhapatnam	786.21	198.76	-74.73
3	Vijayawada	791.06	147.67	-81.40
4	Patna	856.56	47.56	-94.43
5	Delhi	920.78	137.35	-85.38
6	Surat	986.12	370.61	-62.24
7	Vadodara	804.18	384.21	-50.43
8	Bangalore	983.77	249.24	-74.92
9	Kochi	747.95	277.34	-63.65
10	Indore	843.88	210.63	-75.54
11	Bhopal	823.74	127.53	-84.50
12	Jabalpur	808.08	115.18	-85.79
13	Greater Mumbai	873.37	597.17	-31.64
14	Pune	985.55	684.89	-30.78
15	Nagpur	892.33	289.08	-67.50
16	Nashik	883.52	571.11	-35.52
17	Ludhiana	744.84	281.92	-62.77
18	Jaipur	979.17	114.32	-88.48
19	Chennai	839.69	250.84	-70.11
20	Coimbatore	771.71	146.19	-81.06
21	Madurai	726.77	187.30	-74.75
22	Lucknow	921.07	93.38	-89.88
23	Kanpur	917.65	82.45	-91.01
24	Allahabad	795.23	78.08	-90.17
25	Agra	837.94	72.70	-91.31
26	Varanasi	783.51	76.58	-90.17
27	Meerut	840.60	82.84	-90.15
28	Faridabad	896.00	141.14	-84.25
29	Kolkata	819.73	255.82	-68.75
30	Asansol	788.63	77.26	-90.21

ii) Factors influencing Under-spending

There are a host of factors which influence the level of under-spending by local bodies. These could broadly be categorized as 'exogenous' or 'endogenous' in nature.

Exogenous Factors

The exogenous factors are essentially those factors over which the MCs do not have any control. Since the level of spending depends upon the level of resources available with the MC, the delegation of revenue powers (fiscal decentralization) and grants (inter-governmental transfers), which determine the resources of the local bodies, would be the key exogenous factors influencing the ability of the MC to spend and provide these services. These factors could be captured in the form of 'dependency ratio' and 'decentralization ratio', defined as below:

- *Dependency ratio* refers to the share of grants a MC receives to its total expenditure.

- *Decentralisation ratio* refers to the delegation of autonomy in decision-making with respect to the finances of the MC. Revenue decentralization ratio is measured by ratio of MC's per capita revenue to State per capita revenue receipt.

(a) Dependency and Under-spending

Table 30 juxtaposes the extent of under-spending with the dependency ratio of the MCs.

The rank correlation coefficient between these two series works out to 0.61. The coefficient is statistically significant at 1 per cent level of significance. Figure 6 presents the scatter diagram between under-spending and dependency on grants from higher level of governments. This indicates a significant positive

Table 30: Dependency ratio and Under-spending of the Municipal Corporations

Sl. No.	Municipal Corporation	Under Spending (%)	Dependency Ratio (%)
1	Greater Mumbai	31.64	0.69
2	Delhi	85.38	2.35
3	Kolkata	68.75	46.50
4	Chennai	70.11	3.97
5	Hyderabad	76.01	16.42
6	Kanpur	91.01	72.28
7	Pune	30.78	22.45
8	Surat	62.24	7.69
9	Jaipur	88.48	14.53
10	Lucknow	89.88	61.50
11	Agra	91.31	67.18
12	Nashik	35.52	8.98
13	Meerut	90.15	67.46
14	Faridabad	84.25	7.58
15	Visakhapatnam	74.73	4.03
16	Allahabad	90.17	72.67
17	Jabalpur	85.79	60.43
18	Coimbatore	81.06	8.01
19	Madurai	74.75	9.31
20	Vijayawada	81.40	4.80
21	Kochi	63.65	43.03
22	Asansol	90.21	62.07

relationship, implying that higher dependency would lead to higher under-spending.

Figure 6: Ranking of MCs based on Dependency ratio and Under-spending

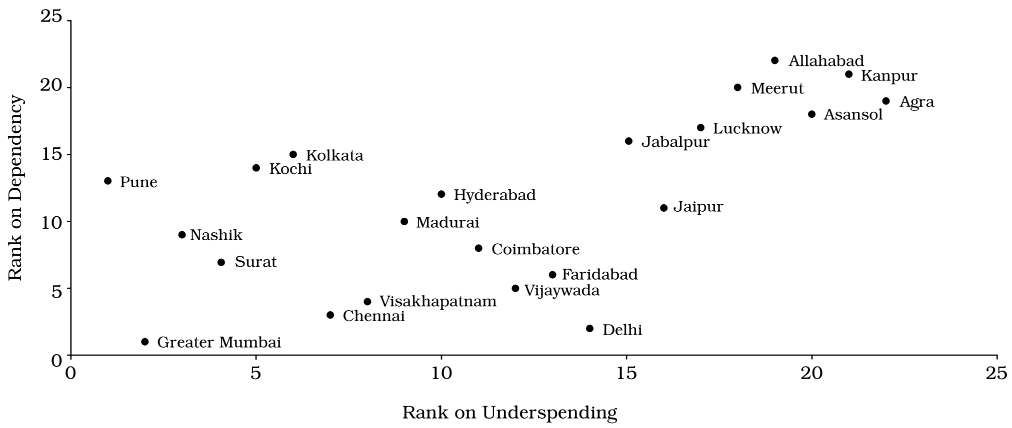


Table 31: Categorization of Municipal Corporations as per Dependency Ratio (Average of 1999-00 to 2003-04)

Parameter	Municipal Corporations	Top 5 Municipal Corporations
At or Above Average (High dependency)	Kolkata Kanpur Pune Lucknow Agra Meerut Jabalpur Kochi Ahmedabad Allahabad Asansol	Kanpur (0.72) Allahabad (0.72) Agra (0.67) Meerut (0.67) Asansol (0.62)
		Bottom 5 Municipal Corporations
Below Average *(Low dependency)*	Greater Mumbai Delhi Chennai Hyderabad Surat Jaipur Vadodara Nashik Faridabad Vishakhapatnam Rajkot Coimbatore Madurai Vijayawada	Greater Mumbai (0.069) Delhi (0.023) Chennai (0.004) Vishakhapatnam (0.04) Vijayawada (0.05)

The MCs falling above and below the group average of the average dependency ratio (over the period 1999-2000 to 2003-2004) are shown in Table 31.

(b) Decentralisation and Under-spending

Table 32 compares the extent of under-spending and decentralization, a measure of delegation of tax powers to the MCs. Here, decentralization ratio has been measured as proportion of the MC's per capita revenue to State per capita revenue, over the time period of 1999-2000 to 2003-2004.

Table 32: Decentralisation and Under-Spending of the Municipal Corporations (Average of 1999-2000 to 2003-2004)

Sl. No.	Municipal Corporation	Under Spending (%)	Revenue Decentralisation Ratio (%)
1	Greater Mumbai	31.64	110.61
2	Delhi	85.38	18.03
3	Kolkata	68.75	67.65
4	Chennai	70.11	45.07
5	Hyderabad	76.01	34.43
6	Kanpur	91.01	24.67
7	Pune	30.78	61.19
8	Surat	62.24	79.92
9	Jaipur	88.48	21.69
10	Lucknow	89.88	23.77
11	Agra	91.31	19.55
12	Nashik	35.52	75.90
13	Meerut	90.15	23.53
14	Faridabad	84.25	19.82
15	Visakhapatnam	74.73	39.02
16	Allahabad	90.17	23.52
17	Jabalpur	85.79	25.67
18	Coimbatore	81.06	24.82
19	Madurai	74.75	20.31
20	Vijayawada	81.40	25.18
21	Kochi	63.65	26.76
22	Asansol	90.21	12.53

The results shown in Table 31 and the scatter diagram in Figure 7 confirm our *a priori* view that higher the revenue

Figure 7: Ranking of MCs based on Revenue Decentralisation and Under-Spending

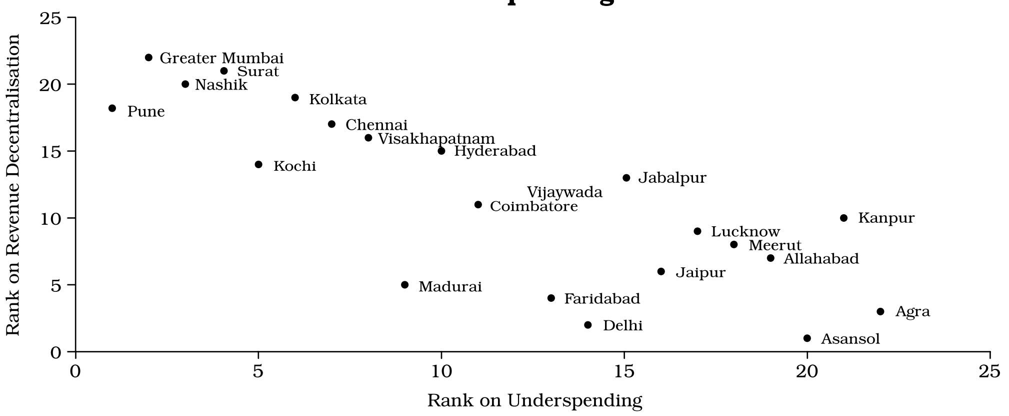


Table 33: Categorization of Municipal Corporations as per Revenue Decentralisation Ratio (Average of 1999-00 to 2003-04)

Parameter	Municipal Corporations	Top 5 Municipal Corporations
At or Above Average (Highly decentralized)	Greater Mumbai Surat Nashik Pune Kolkata Chennai Visakhapatnam	Greater Mumbai (110.61%) Surat (79.92%) Nashik (75.9%) Kolkata (67.65 %) Pune (61.19%) Surat (38.99%)
		Bottom 5 Municipal Corporations
Below Average (Lowly decentralized)	Hyderabad Kanpur Jaipur Lucknow Agra Delhi Kochi Madurai Vijayawada Jabalpur Meerut Coimbatore Faridabad Allahabad Asansol	Asansol (12.53%) Delhi (18.03%) Agra (19.55%) Faridabad (19.82%) Madurai (20.31%)

decentralization, lower the level of under-spending. The rank correlation computed as per Spearman's rank correlation works out to be - 0.81 and has a desired negative sign. It is highly significant at 1 per cent level of significance.

Table 33 provides the list of MCs that fall above or below the group average decentralization ratio.

Endogenous Factors

(a) Revenue Administration

This parameter refers to local body's efficiency in levying and collecting revenues which falls in its jurisdiction i.e, own sources of revenue of the MC. Although not a very accurate measure, it aims at measuring MC's performance with regard to own revenue.

The ratio of per capita own revenue of MC to State GDP (GSDP) per capita could be taken as a close approximation of the efficiency of revenue administration[8]. Table 34 provides a comparative scenario of under-spending and efficiency of revenue administration.

With efficient revenue administration reflected by own revenue as a proportion to GSDP, the availability of resources with the MC improves and level of under-spending is accordingly lower. Rank correlation among the two parameters works out to -0.913, which is statistically significant at 1 per cent level.

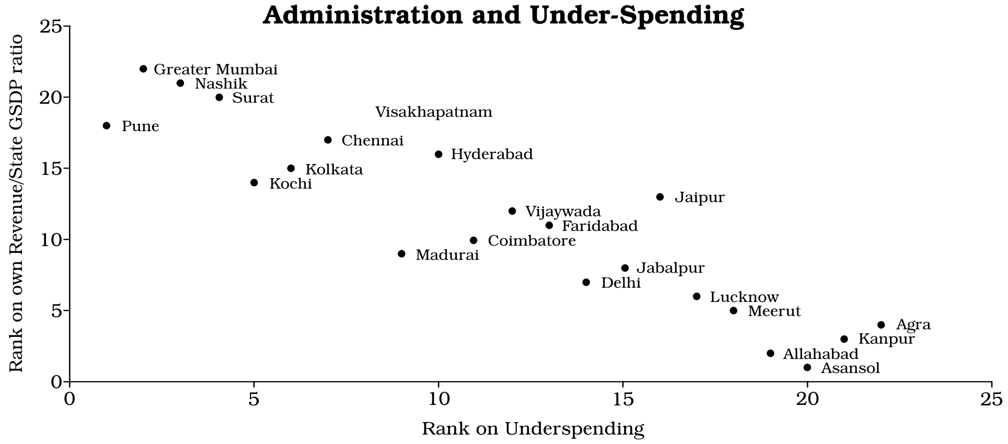
The scatter diagram in Figure 8 clearly reveals a negative relationship between efficiency of revenue administration and level of under-spending.

Table 34: Efficiency of Revenue Administration and Under-Spending of the Municipal Corporations

Sl. No.	Name of the Municipal Corporation	Under Spending (%)	Ratio of Per capita Own Revenue to GSDP per capita (%)
1	Greater Mumbai	31.64	18.45
2	Delhi	85.38	2.30
3	Kolkata	68.75	5.36
4	Chennai	70.11	6.61
5	Hyderabad	76.01	5.75
6	Kanpur	91.01	1.44
7	Pune	30.78	6.66
8	Surat	62.24	9.69
9	Jaipur	88.48	4.43
10	Lucknow	89.88	1.90
11	Agra	91.31	1.50
12	Nashik	35.52	12.26
13	Meerut	90.15	1.55
14	Faridabad	84.25	3.82
15	Visakhapatnam	74.73	7.25
16	Allahabad	90.17	1.27
17	Jabalpur	85.79	2.50
18	Coimbatore	81.06	3.80
19	Madurai	74.75	3.19
20	Vijayawada	81.40	3.91
21	Kochi	63.65	4.81
22	Asansol	90.21	0.73

8 The ability of the local body to collect taxes also depends upon delegation of revenue powers.

Figure 8: Ranking of MCs based on Efficiency of Revenue Administration and Under-Spending



A comparison of the own revenue with performance on individual taxes that are levied and collected by the Municipal Corporations would provide further insight into tax efficiency of the urban local bodies. Table 35 provides a comparative position of

Table 35: Own Revenue-GSDP Ratio and Performance on Individual Taxes

Sl. No.	Municipal Corporation	Own Revenue to GSDP	Property tax	Profession tax	Advertisement tax	Octroi Ratio
High Own Tax						
1	Greater Mumbai	8.63	×		×	√
2	Surat	9.93	√			√
3	Chennai	3.41	√	√	×	
4	Visakhapatnam	8.24	√	√	×	
5	Vijayawada	4.45	√	√		
6	Hyderabad	6.53	√	√	√	
Lower Own Tax						
7	Kochi	1.55	√	√		
8	Jabalpur	1.02	×	×		×
9	Nashik	1.30	×			√
10	Coimbatore	1.38	×	×		
11	Jaipur	.50	×		√	×
12	Madurai	.93	×			
13	Faridabad	1.11	×		×	

Notes :
√ : represents equal or above average performance,
× : represents lower than average performance. In the case of blank cells, no information is available.

different tax sources in order to identify the corporations with potential for improving tax administration

It is pertinent to note that all MCs, barring Mumbai, with above average own tax revenue have performed well in case of property tax and/or profession tax. In case of Mumbai, it has done well in case of Octroi. On the other hand, except Kochi, all MCs falling in the below average category have not done well in either of the major taxes.

(b) Recovery of Cost

Cost recovery of services is an important measure, which is used to assess the health of municipal finances. It can be broadly measured as a ratio of municipal fees and user charges to revenue expenditure incurred by an MC for the provision of respective services *viz.*, water supply, sanitation, health services, education and street lighting. As detailed data on service-wise user charges and fees are not available, the broad indicator of ratio of municipal fees and user charges to aggregate revenue expenditure has been used as a proxy. Table 36 makes a comparison of under-spending and cost recovery of the MCs. None of the MCs, barring Delhi, Visakhapatnam and Bhopal show a high proportion of cost recovery. It is less than 10 per cent in the MCs of Kerala and Tamil Nadu. Cost recovery has to be an integral part of service provision, especially when services can be measured and beneficiaries identified, as in case of water supply, education and health.

The scattered diagram in Figure 9 indicates a negative but relatively weak relationship between under-spending and cost recovery. In case of MCs such as Kanpur, Allahabad and Lucknow, despite higher cost recovery, under-spending has not been lower. Rank correlation for these two series is -0.39, which is significant at 10 per cent level.

(c) Quality of Expenditure

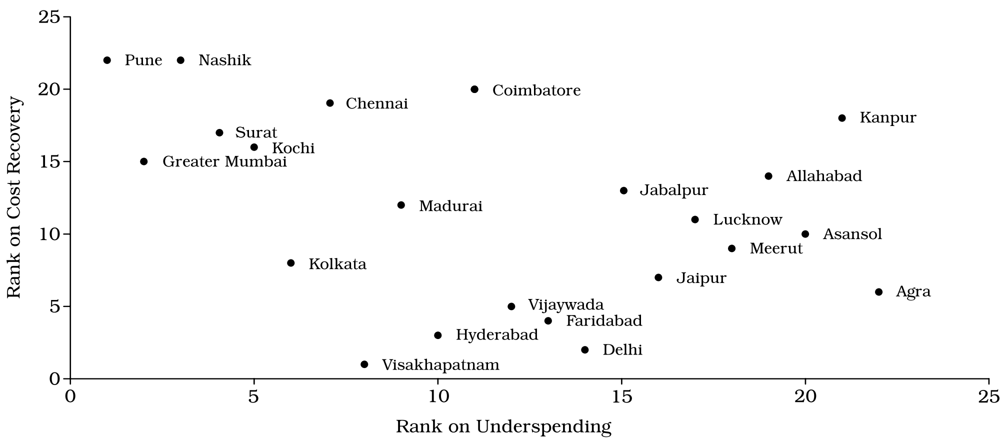
The expenditure structure of Municipal Corporations throws some light on the relative importance assigned to each component in

Table 36: Under-spending and Cost recovery of the Municipal Corporations

Sl. No.	Municipal Corporation	Under Spending of the MC (%)	Average Cost recovery (%)
1	Hyderabad	76.01	38.88
2	Visakhapatnam	74.73	81.91
3	Vijayawada	81.40	37.48
4	Delhi	85.38	94.13
5	Surat	62.24	11.11
6	Bangalore	74.92	14.41
7	Kochi	63.65	7.76
8	Indore	75.54	31.83
9	Bhopal	84.50	62.85
10	Jabalpur	85.79	7.20
11	Greater Mumbai	31.64	11.16
12	Ludhiana	62.77	9.18
13	Jaipur	88.48	33.61
14	Chennai	70.11	7.74
15	Coimbatore	81.06	4.47
16	Madurai	74.75	4.79
17	Lucknow	89.88	9.82
18	Kanpur	91.01	3.90
19	Allahabad	90.17	6.06
20	Agra	91.31	23.25
21	Varanasi	90.17	9.34
22	Meerut	90.15	12.39
23	Faridabad	84.25	28.15
24	Kolkata	68.75	15.17
25	Asansol	90.21	13.08

the total expenditure and it also has a bearing on the financial position and service delivery.

Figure 9: Ranking of MCs based on Under-spending and Cost recovery



Relative shares of Capital, Maintenance and Establishment Expenditures

While a low proportion of spending on establishment is desirable, too low a proportion may hamper the capacity for service delivery. Likewise, expenditure on capital works is important as it provides future sources of revenue; but very high proportion on it would have a bearing on the finances available for provision of services and even necessitate external support, in the form of either grants or borrowings. Table 37 presents the relative shares of various expenditure components of the MCs. It indicates that some of the MCs have an unsustainably high proportion of (more than 50 per cent) total expenditure on establishment and administration, which affects the future of their finance and their service delivery capacity. Likewise, some MCs have an abysmally low capital expenditure (less than 10 per cent to almost zero), which is equally detrimental to the health of civic finance and its long-term sustainability. It is, therefore, desirable to develop certain guidelines/norms for the municipal corporations towards spending on capital and its maintenance works, as well for rationalizing the staffing pattern so as to ensure that excessive amounts are not spent on staff.

Establishment & Administration Expenditure and Under-spending

The revenue expenditure, which comprises expenditures on (i) establishment and administration and (ii) operations and maintenance, assumes critical importance, as it relates to the provision of civic services to the people and their maintenance. However, a very high proportion of expenditure on establishment and administration can be detrimental to both the expansion of capital assets and maintenance of existing facilities. Thus, with a relatively lower proportion of expenditure devoted to establishment and administration, the MCs would be better equipped to provide

Table 37: Relative Share of Expenditure Components of the MCs (Average of the Shares during 1999-2003)

Sl. No.	Municipal Corporation	Share of Establishment & Administration Expenditure in Total Expenditure (%)	Share of Operations & Maintenance Expenditure in Total Expenditure (%)	Share of Capital Expenditure in Total Expenditure (%)
1	Hyderabad	56.95	22.19	19.82
2	Visakhapatnam	46.55	32.38	18.74
3	Vijaywada	46.55	32.38	18.74
4	Patna	53.09	26.46	N.A.
5	Delhi	43.71	2.18	6.08
6	Ahmedabad	0.00	0.00	23.82
7	Surat	37.61	8.01	39.47
8	Vadodara	41.53	20.03	13.48
9	Bangalore	49.00	4.72	N.A.
10	Kochi	16.01	32.94	1.25
11	Indore	28.61	12.15	25.96
12	Bhopal	20.64	11.06	2.85
13	Jabalpur	55.34	7.52	N.A.
14	Greater Mumbai	36.79	8.30	0.06
15	Pune	20.06	58.62	21.32
16	Nagpur	37.98	36.72	25.30
17	Nashik	25.03	20.56	42.29
18	Ludhiana	42.75	13.19	1.37
19	Jaipur	31.53	5.17	36.03
20	Chennai	42.77	4.76	21.61
21	Coimbatore	55.91	15.53	28.56
22	Madurai	53.21	2.34	29.98
23	Lucknow	48.83	14.12	23.96
24	Kanpur	66.89	17.15	1.50
25	Allahabad	51.03	18.89	0.24
26	Agra	50.72	4.16	12.41
27	Varanasi	50.93	6.05	0.11
28	Meerut	58.45	13.03	21.34
29	Faridabad	46.84	53.16	N.A.
30	Kolkata	61.30	7.39	8.72
31	Asansol	32.07	7.92	40.12
	Total	**36.25**	**14.43**	**12.37**

Source: Budgets of Municipal Corporations.

civic amenities. Table 38 compares the establishment and administration expenditure and under-spending of the MCs. The relationship of under-spending with the proportion of expenditure on establishment and administration is shown in the scatter diagram in Figure 10. It indicates a positive relationship conforming to a priori expectations. Rank correlation for these two series is 0.44 which is significant at 5 per cent level.

Table 38: Average Establishment and Administration Expenditure of the Municipal Corporations (1999-2000 to 2003-2004)

Sl. No.	Municipal Corporation	Under Spending (%)	Expenditure on Establishment and Administration to Total Expenditure (%)
1	Greater Mumbai	31.64	36.79
2	Delhi	85.38	43.71
3	Kolkata	68.75	61.30
4	Chennai	70.11	42.77
5	Hyderabad	76.01	56.95
6	Kanpur	91.01	66.89
7	Pune	30.78	20.06
8	Surat	62.24	37.61
9	Jaipur	88.48	31.53
10	Lucknow	89.88	48.83
11	Agra	91.31	50.71
12	Nashik	35.52	25.03
13	Meerut	90.15	58.45
14	Faridabad	84.25	46.84
15	Visakhapatnam	74.73	46.55
16	Allahabad	90.17	51.03
17	Jabalpur	85.79	55.34
18	Coimbatore	81.06	55.91
19	Madurai	74.75	53.21
20	Vijayawada	81.40	51.03
21	Kochi	63.65	16.01
22	Asansol	90.21	32.05

Table 39 provides a summary position on relationship of under-spending with other major variables as discussed above. Under-

Figure 10: Ranking of MCs based on Average Establishment and Administration

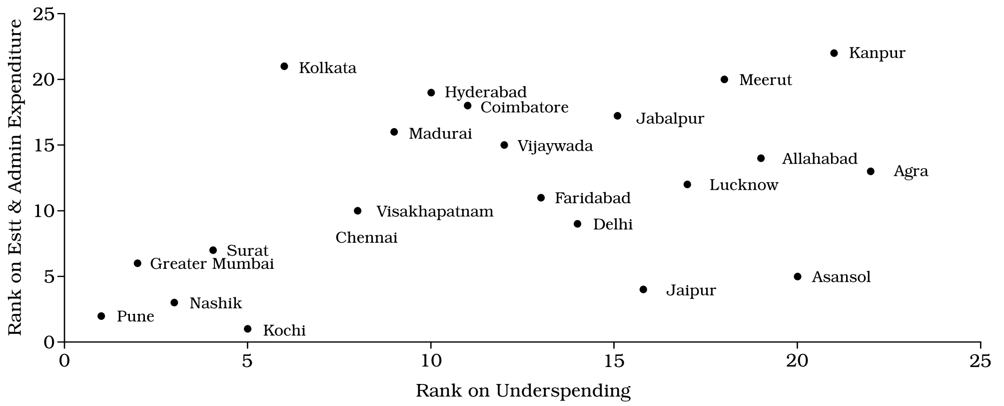


Table 39: Summary of the Assessment of Finances of Municipal Corporations

Sl. No.	Municipal Corporation	Under-spending %	Depend-ency	Decentra-lisation	Revenue (Tax) Adminis-tration	Quality of Expendi-ture	Cost Recovery
1	Pune	30.78	√	√	√	√	
2	Greater Mumbai	31.64	√	√	√	√	×
3	Nazi	35.52	√	√	√	√	
4	Vadodara	50.43	√	√			
5	Surat	62.24	√	√	√	√	×
6	Ludhiana	62.77					×
7	Kochi	63.65	×	×	×		×
8	Nagpur	67.50					
9	Kolkata	68.75	×	√	√	×	×
10	Chennai	70.11	√	√	√	√	×
11	Visakhapatnam	74.73	√	×	√	√	√
12	Madurai	74.75	√	×	×		×
13	Bangalore	74.92					×
14	Indore	75.54					√
15	Hyderabad	76.01	√	×	√	×	√
16	Coimbatore	81.06	√	×	×	×	×
17	Vijayawada	81.40	√	×	×	×	√
18	Faridabad	84.25	√	×	×	×	√
19	Bhopal	84.50					√
20	Jabalpur	85.79	×	×	×	×	×
21	Jaipur	88.48	√	×	×		√
22	Lucknow	89.88	×	×	×	×	×
23	Meerut	90.15	×	×	×	×	×
24	Allahabad	90.17		×	×	×	×
25	Varanasi	90.17					×
26	Asansol	90.21	×	×	×	√	×
27	Kanpur	91.01	×	×	×	×	×
28	Agra	91.31	×	×	×	×	√
29	Patna	94.43					

√ : Above average performance. × : Below average performance.

spending has been shown in the ascending order with the MC on the top being the best performer (with highest per capita spending on core services). Subsequent columns indicate status of individual MCs against various parameters that are expected to influence the level of under-spending. With a majority of the tick marks being concentrated towards the top, the influence of various factors on the level of under-spending is quite apparent.

(d) Debt Position

The debt position of MCs can be assessed in terms of the followings: a) use of debt and b) debt sustainability. The former has been examined by computing debt to capital expenditure ratio and the latter has been ascertained by computing interest coverage and debt coverage ratios.

Use of Debt

Borrowed funds are intended for creation/development of infrastructure by a MC, resulting in asset creation so that the returns generated from the assets can be utilized for servicing the debt (here, it is implicitly assumed that either returns are designed to be adequate or facilities are subsidized by upper tiers). The ratio of borrowings to capital expenditure of the municipalities provides an indication of the extent to which borrowed funds are spent on capital formation. A value of the ratio above one (a proportion greater than 100 per cent) will indicate that a portion of the borrowed funds is utilized for current consumption.

Table 40 indicates that except three MCs belonging to Kochi, Ludhiana & Allahabad no other MC have a borrowing to capital

Table 40: Borrowings to Capital Expenditure Ratio of the MCs (Average of 1999-2003)

Municipal Corporation	Loans (Rs. Lakhs)	Capital Expenditure (Rs. Lakhs)	Borrowings/Capital Expenditure ratio' (%)
Vijaywada	520	1495	34.74
Delhi	1253	4807	26.06
Ahmedabad	12205	17564	69.49
Surat	5653	18169	31.11
Kochi	1562	148	1053.03
Indore	1643	5323	30.86
Bhopal	16	283	5.66
Nagpur	2737	5620	48.69
Ludhiana	715	268	266.92
Jaipur	375	4875	7.69
Chennai	4244	11314	37.51
Coimbatore	763	1898	40.18
Madurai	1118	2666	41.92
Lucknow	2026	2595	78.09
Allahabad	124	37	333.78
Meerut	405	924	43.85
Asansol	26	755	3.38

Source: Budget documents of Municipal Corporations.

expenditure ratio of more than one, suggesting that the borrowed funds have been utilized for capital expenditure only.

Debt Sustainability

Apart from the use of borrowings, debt sustainability of the MCs needs to be assessed, and this can be done in terms of two indicators: ratio of outstanding debt to total revenues and ratio of debt servicing to revenue receipts. As the outstanding debt details of the MCs are not available in the budget documents, the second measure is used in the study. It may be noted that debt repayments include both principal and interest components.

Table 41 sets out the information relating to debt repayment to revenue receipt ratio of the MCs. It reflects that the debt repayment of 18 MCs has not been very high. Excepting the cases of MCs of Chennai, Madurai and Vijayawada, wherein the debt repayment is over and above 10 per cent of their revenue receipts, there is a potential for using debt wisely, by the MCs for capital formation.

Table 41: Debt Repayment to Revenue receipts ratio of the MCs (Average of 1999-2003)

Municipal Corporation	Debt Repayment (Rs. Lakhs)	Revenue Receipts (Rs. Lakhs)	Debt Repayment to Revenue receipts (%)
Hyderabad	307	33882	0.91
Visakhapatnam	217	11007	1.97
Vijaywada	935	6165	15.17
Delhi	309	88030	0.35
Bangalore	2805	36954	7.59
Kochi	60	5168	1.16
Indore	304	17997	1.69
Greater Mumbai	29549	416203	7.10
Pune	216	50716	0.43
Nagpur	1574	24961	6.31
Nashik	2231	26830	8.32
Ludhiana	328	19467	1.68
Jaipur	301	12286	2.45
Chennai	6762	59103	11.44
Coimbatore	124	7210	1.72
Madurai	962	5660	17.00
Kanpur	68	10033	0.68
Kolkata	655	54239	1.21

Source: Budget documents of Municipal Corporations.

However, apart from the measure of debt service in relation to the revenue receipts, debt sustainability should be examined from the point of view of an MC's capacity to service debt. The capacity to service the debt refers to how easily and readily the MC will be able to meet its commitment in respect of the contractual interest payment and the repayment of debt. The MC's ability to service the liabilities can be measured with the help of coverage ratios. The coverage ratios establish relationship between committed liabilities, and the MC's surplus out of which these claims are to be paid. These measures try to relate the MC's surplus to the level of debt repayments with a view to assessing the degree of comfort with which the MC can meet these repayments. The following coverage ratios may used to analyze a MC's ability to service committed liabilities.

Interest Coverage Ratio

This ratio is also called the "times interest earned" ratio and it measures the ability of an MC to pay the interest liability on debts. This is calculated as the ratio of operating surplus to interest payment*. The Interest Coverage (IC) Ratio, therefore, measures how many times the interest liability of the MC is covered with the MC's operating surplus. The ratio gives an idea of how much fall in surplus the MC can sustain, before it defaults or borrows to meet the interest liability. Table 42 shows the performance of the MCs on this measure.

For the MCs whose interest payment details exist, the measure shows that they are on the higher side. The higher the IC ratio, the better it is both for the MC and for the lenders. For the MC, the probability of committing default is reduced and for the lenders, the

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* Operating surplus is defined as current revenue - operating expenditure (operation & maintenance including material as well as staff salaries). Given that the accounts are not segregated in a manner required to measure operating surplus, current expenditure net of interest payments has been used as operating expenditure for computation.

Table 42: Interest Coverage Ratio of the Municipal Corporations (Average of 1999 – 2003)

Sl. No.	Municipal Corporation	Interest repayment (Rs Lakhs)	Operating Surplus (Rs Lakhs)	Times Interest Earned Ratio (%)
1.	Hyderabad	307	6852	22.32
2.	Kochi	20	2604	130.18
3.	Indore	202	10064	49.82
4.	Nagpur	593	5155	8.69
5.	Nashik	1607	14565	9.06
6.	Jaipur	172	7489	43.54
7.	Chennai	1798	36629	20.37

Source : Budgets of Municipal Corporations.

MC is considered to be less risky. A lower IC ratio indicates a low surplus or a deficit of the MC in relation to its interest payment commitments.

Mathur and Ray (2003) provide criteria based on IC ratio as follows: a ratio less than 1.5 is poor, 1.5 to 3 is moderate, 3 to 6 is good and greater than 6 is favourable. Therefore, all the above MCs are on a favourable side of the measure.

Debt Coverage Ratio

The debt coverage ratio shows the relationship between the operating surplus of the MCs and the committed liability in respect of interest and principal. It is calculated as the ratio of operating surplus and debt repayment (interest and principal repayments). Table 43 provides the performance of the MCs on this measure.

A high debt coverage ratio is indicative of the MC's ability to meet its committed payment obligations easily, while a low ratio indicates its difficulty to meet the obligations.

According to Mathur and Ray (2003), the criteria laid down for this measure are as follows: a ratio less than 1 is poor, 1 to 2 is moderate, 2 to 4 is good and greater than 4 is favourable. For the MCs under study whose debt repayment details exist, the measure shows that all MCs except 4 fall in category of 'favourable'. Vijaywada and Madurai fall in 'moderate' category whereas Bangalore and Nagpur could be termed as 'good'.

Table 43: Debt Coverage Ratio to Operating Surplus of the MCs (Average of 1999-2003)

Sl. No.	Municipal Corporation	Debt Payment (Rs Lakhs)	Operating Surplus (Rs Lakhs)	Times Debt Covered (Operating surplus/ Debt payment)
1.	Hyderabad	307	6852	22.3
2.	Visakhapatnam	217	3551	16.4
3.	Vijaywada	935	1715	1.8
4.	Delhi	309	51917	168
5.	Bangalore	2805	7317	2.6
6.	Kochi	60	2604	43.4
7.	Indore	304	10064	33.1
8.	Greater Mumbai	29549	260181	8.8
9.	Pune	216	-19072	Negative
10.	Nagpur	1574	5155	3.3
11.	Nashik	2231	14565	6.5
12.	Ludhiana	328	8524	26
13.	Jaipur	301	7489	24.9
14.	Chennai	6762	36629	5.4
15.	Coimbatore	124	2500	20.2
16.	Madurai	962	1125	1.2
17.	Kanpur	68	1408	20.7
18.	Kolkata	655	15531	23.7

Source : Budgets of Municipal Corporations.

5.4 Projection of Investment Requirement in Urban Areas

This section attempts to project resource requirement for basic civic amenities via, water supply, sewerage, roads, solid waste management and street lighting and for the provision of mass urban transport systems as well as road infrastructure. For making these projections, various norms have been used: Zakaria Committee Norms (Basic amenities), Service cost Norms (Rail/ Road based mass transport) and the Expected Service cost (Inner and Outer ring roads). The details of methodology used for projections are provided below.

5.4.1 Basic Amenities

There would be need for resources for creating new infrastructure for the growing population (including backlog) and for maintenance of current and future assets. Thus, funds would be needed for: i) New infrastructure for backlog, ii) New infrastructure for incremental population and iii) Operation and Maintenance expenditure.

(i) The investment needs for creating new assets for civic amenities *viz.*, water supply, sewerage, roads and street lighting were worked out using Zakaria Committee norms. In the case of solid waste management, the norms were worked out from the estimates made in Arabi (2006). These norms were adjusted for inflation assuming head line inflation of 5 per cent per annum during the projection period.

(ii) It was assumed that there was a service backlog of 33 per cent *i.e.* one third of the population did not have service coverage[9].

(iii) Zakaria Committee norms were used for working out the operation and maintenance expenditure requirement for all the services mentioned at (i) except solid waste management[10].

Thus, the resource requirement for incremental investment and O&M worked out for each year as:

Incremental Investment Need = Zakaria Norm (adj) Incremental Population*

*O&M expenditure Needs = Zakaria Norm (adj) * Population*

Resource requirement for backlog population worked out as:

Backlog Investment Needs = Zakaria Norm (adj) Backlog Population*

The total resource needs for the provision of major civic services can be estimated by adding up:

Incremental Investment Needs + O&M Investment Needs + Backlog Investment Needs

Using the above estimates of total investment needs for the 35 MCs, the corresponding figure for the entire urban population is estimated.

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9 NIUA study (1998) states a 30 per cent backlog in the year 1997-98. Given that the availability of civic amenities has not improved since then and backlog would have increased, a conservative estimate of 33 per cent backlog has been assumed.

10 Norms were worked out from Arabi (2006).

5.4.2 Urban Mass Transport Systems

Urban areas require not only the basic civic amenities but also other services like urban transport and similar public goods and services. An attempt is made to estimate the investment needs of providing (i) mass urban transport systems and (ii) major road infrastructure in the form of inner and outer ring roads for providing faster movement of vehicles. As these services are meant to be provided in metropolitan cities/agglomerations, the 35 MCs with urban agglomeration population more than one million population are considered and categorized into Class AA, A and B based on the prevalent city (MC) population as on 2001.

(i) The mass urban transport systems considered include: elevated metro system for class AA and A cities (with service length of 100 and 50 km respectively) and bus rapid transit system for Class B cities (with a service length of 100 km). Therefore, for all the cities, according to their city class, the mass urban transport investment needs are estimated using the capital investment norms provided in Bandai and Coppice (2004) together with the assumed service length.

*Mass Rapid Transport System Investment Needs = Norm * Service length*

(ii) The major road infrastructure needs include: Outer and Inner ring roads for all class AA cities (with a service length of 100 km), Inner ring roads for class A cities (with a service length of 100 km) and Inner ring roads for class B cities (with service length of 50 km). The norms for Outer and Inner investment needs of the roads / expressways per km length in urban areas are formed using the actual cost estimates of their provision in Hyderabad[11]. Using these norms and coverage length, the investment needs of the cities for the provision of road infrastructure/ expressways is estimated.

[11] The Hyderabad Urban Development Authority (HUDA) has undertaken this major project in Hyderabad city and it shared the unit costs information, which form the norms used here.

Table 44: Projection of Investment Requirement in Urban Areas

Sl. No.	Infrastructure Component	Investment Need for Ten Years (2004-05 to 2013-14) (Rs Crore)*
1	Urban basic services	Rs 3,25,010
2	Mass urban transport services	Rs 2,53,700
3	Road infrastructure services	Rs 49,500
4	Total urban services	Rs 6,28,210

*: At 2004-05 prices.

*Road infrastructure Investment Needs = Norm * Service length*

Therefore, the total investment needs of providing urban infrastructure services can be expressed as:

Total Urban Investment Needs =Basic Amenities Investment Needs + Mass Rapid Transport System Investment Needs + Major Road Infrastructure Investment Needs

The estimate given in Table 44 shows that on an average investment requirement is around Rs 62,821 crore per annum at constant prices of 2004-05, which comes to 2.2 per cent of GDP in year 2004-05. Here, it may be noted that total revenues of ULBs remained stable at around 0.75 per cent of GDP, which is much less than the requirement.

5.5 Estimate of Potential for Revenue Mobilisation by ULBs

As mentioned earlier, shortfall in resources is on account of the vertical imbalance as well as the nature of ULBs' own operations. The present section attempts to estimate the potential growth in ULB revenues assuming a status quo in fiscal federal relationship. Thus, it would indicate the size of revenue gap which would necessarily have to be met through major structural reforms in the nature of altering fiscal federal relationship.

i) For working out potential revenue, separate estimates were made for tax and non-tax revenues and grants were assumed to grow at historical growth rate. For working out tax revenue, estimates were made for major taxes *viz.*, property, advertisement and professional tax. For each tax, best performer among the 35 MCs was taken as the benchmark[12] and potential revenue was worked out assuming all ULBs are able to catch up with the benchmark[13,14].

ii) For working non-tax revenue, the optimal performer in terms of proportion of cost recovery was chosen as benchmark[15]. In the previous chapter, cost recovery has been defined as the ratio of user charges to revenue expenditure. Thus, to work out the potential non-tax collections, the proportion of cost recovery of the optimal performer was applied to aggregate revenue expenditures of ULBs in the country.

The sum of all above estimates provides the potential resource mobilization. However, the entire resources cannot be assumed exclusively available for the provision of core urban services or basic infrastructure services. Therefore, we use the proportion of these resources that would reach to these services[16] that give us utilisable

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12 The average of top performer MCs of class AA and A cities has been taken as benchmark.

13 Computation of potential revenue would, however, be quite an involved exercise which needs to take into account myriad number of factors such as tax rate, tax base and tax exemption. Ignoring the tax rate factor, there could be many ways to enhance the tax base and reduce the exemptions granted. There are possibilities such as changing the base of the property tax, trade licensing fee, advertisement fee *etc.*, imposing vacant land tax, premium on Floor Space Index (FSI), rationalization of user charges, formulae for inter-governmental transfers *etc.* Exploring those is beyond the scope of the present study.

14 In an emerging global scenario, sunrise industries such as IT are contributing towards employment and income generation in cities. While income, turnover and services generated through these activities do not fall within the revenue powers of the municipal bodies, there could be some indirect positive contributions in terms of profession and property tax. But these aspects could not be quantified in this study due to lack of detailed data.

15 It may be noted that cost recovery to the tune of 90 per cent of revenue expenditure, as is found in the case of best performer MC (Vijayawada) is ridden with difficulties as it leaves little room for revenue expenditure on establishment and administration for service provision. An optimal performer MC (Bhopal) with a cost recovery of 60 per cent of revenue expenditure is, therefore, taken as an appropriate benchmark.

16 Here, the average proportions of spending on core urban services to total expenditure of average and best performer MC (Kolkata) of the 11 MCs, for which continuous data were available, stood at 35% and 65% respectively. These have been used as proxies.

Table 45: Projection of Potential Revenues of ULBs (2004-05)

Sl. No.	Revenue Source	Projected Revenues (Rs Crores)
1	Property Tax	10,577
2	Profession Tax	2,389
3	Advertisement Tax	510
4	All Major Taxes (1+2+3)	13,476
5	Non Tax (User charges & fees)	9,746
6	Grants in Aid	4,064
7	Total Potential Revenue (4+5+6)	27,285
8	Total Utilisable revenue for Core Service provision (best case – 65%)	17,736
9	Total Utilisable revenue for Core Service provision (conservative case – 35%)	9,550

resources for service provision in the best case and in the average case senerios. The estimates that have been made as per the procedures delineated above for the year 2004-05 are set out in Table 45.

The above Table shows that if current status in fiscal federal relationship continues, ULBs in India together have the potential to raise revenues only up to Rs.27,285 crore in 2004-05. This amounts to about 1.0 per cent of the GDP. Of these funds, in a best case scenario, only 2/3rd would be available for asset creation after meeting the current expenditure. Thus, the utilizable resources of the ULBs only for core service provision even after attaining the benchmark figures of resource mobilization fall short of investment needs (Rs.28,000 crore) to the tune of Rs.10,000 crore in the best scenario and Rs.18,000 crore in the conservative (average) scenario for the year 2004-05, which are substantial amounts that cannot be raised by ULBs assuming status quo in all respects. There is, therefore, urgent need for reforms to mobilize the funds needed for investment in urban infrastructure as estimated in the previous section. Given the magnitude of the problem, it is necessary to have a Centre-State-Local-Private Partnership (CSLPP) for development of urban infrastructure.

5.6 Some Observations

The key conclusions that emerge from the foregoing aggregative and Municipal Corporation-wise analysis of municipal finances are:

- Analysis of the revenue and expenditure of the MCs reveals that most of them are generating revenue surplus and overall resource gaps are not very large. At the same time, assessment of municipal finance reveals that spending by all the municipal bodies is lower than that required for providing a minimum level of civic amenities. The study observes that this apparent contradiction of sound fiscal health and high level of under-spending is due to statutory obligations, whereby ULBs are generally bound to restrict their expenditure to the resources available to them and also are not granted liberal permission by State Governments to incur debt [Mathur and Thakur (2004)].

- In view of the above observation, the study has undertaken an assessment of municipal finance in "normative terms", besides the "standard approach" of revenue or fiscal balance.

- A comparison of per capita spending on core services by MCs in terms of the Zakaria Committee norms indicates that the level of under-spending on an average works out to be about 76 percent. Significantly, MCs belonging to Bihar and Uttar Pradesh are the ones that have highest level of under-spending whereas those belonging to Maharashtra, Gujarat are among the best performers.

- Reasons for under-spending could be traced to MCs' own operations (endogenous) as well as to policy issues related to the upper tiers of Governments (exogenous). Exogenous factors include dependency for resources on upper tiers of the Government and inadequate delegation of revenue powers. Endogenous factors include inefficient revenue (tax) administration, low cost recovery and poor quality of expenditure.

- MCs which have lower level of under-spending levels or better performance have fared well on 4 out of 5 criteria *viz.*, dependency, decentralization, tax administration and expenditure quality. On the other hand, MCs with ranking "below average" on these 4 parameters are also the ones which have been spending less on core civic amenities. Thus, the analysis suggests that restructuring of revenue powers may be given top priority by State Governments if urban amenities are to be improved.

- Though delegation of revenue powers is a key factor, need for efficient revenue (tax) administration cannot be underplayed. Examination of various taxes across the local bodies reveals that property and profession taxes are important sources. (Octroi is the most important source of revenue in municipal corporations belonging to Maharashtra and Gujarat). The local bodies need to adequately tap the existing avenues. Unit area system of computation, based on self-assessment principle, with respect to property tax needs to be extended to all MCs and in the case of MCs where Octroi has been a major source they should be adequately compensated when Octroi is abolished. Other sources like entertainment tax, development charges, betterment levies *etc.* need to be tapped.

- Quality of expenditure, measured as establishment and administrative expenditure as a proportion of total expenditure also turns out to be a major factor in determining the ability of MCs to provide core services. Lower spending on administrative purposes would leave more resources with the MCs to provide for civic amenities. This calls for rationalization of the work force and reduction in spending on establishment and administration.

- There is a very weak link between under-spending and cost recovery. Interestingly, MCs such as Mumbai, Surat and Pune which are among the best performers in terms of other financial parameters, have below average user charges. This is because the municipalities are resorting to lower use of user charges than would be desirable. In fact, on an average the cost recovery is below 1/4th of the expenditure incurred by the MCs. Considering the benefit principle[17], there is a large scope for improvement in levying User Charges.

- It is apparent from the analysis that there is a need to substantially increase the spending by local bodies. Given the constraints faced by State Governments, it is essential that the MCs be granted access to borrowed funds. At least there are two convincing arguments in favour of MCs going for borrowed funds. First, there is a scope for MCs to go in for borrowed funds as their current level of indebtedness is not very large. Secondly, there is a scope to raise the user charges which are abysmally low across the States. Enhancement of user charges would make the new projects undertaken with borrowed funds economically viable and ensure that MCs are debt-sustainable.

- Investment requirement for urban infrastructure has been estimated at about Rs.63,000 crore per annum for the next ten year period (2004-05 to 2013-14), which forms about 2.2 per cent of GDP. Assuming the current status quo in fiscal federal relationship, the study has projected that ULBs together have the potential to raise revenues only up to about 1.0 per cent of the GDP.

- Given the magnitude of the resource gap of the municipal sector as a whole, it is necessary to have a Centre-State-Local-Private Partnership (CSLPP) for development of urban infrastructure. Revisiting revenue assignment is the first task of a partnership.

[17] Benefit principle imply that services that local governments provide should be paid for by those who benefit from them (Bird, 1976).

Chapter 6

CONCLUDING OBSERVATIONS

The study notes that local bodies in India, urban and rural, are yet to be put prominently on the public finance map of the country, which is needed to facilitate inclusive economic growth and equitable development.

The size of the municipal fiscal sector in India is very small compared to that in many developed and developing countries and in relation to the public services that the urban local bodies are mandated to deliver. The total municipal revenue in India account for about 0.75 per cent of the country's GDP as against a figure of 4.5 per cent for Poland, 5 per cent for Brazil and 6 per cent for South Africa. In terms of both revenue and expenditure the urban local bodies account for little above 2 per cent of the combined revenue and expenditure of Central Government, State Governments and ULBs. This is in contrast to the situation obtaining in advanced countries, where local bodies normally account for 20-35 per cent of the total government expenditure and the principle of 'subsidiarity' is regarded as a cornerstone of fiscal federalism. Recent data on municipal finances reveal that the total revenue of ULBs is growing at a lower rate compared to the growth of combined Central and State Government revenues. This is reflecting in a further decline in the existing marginal presence of local public finance in the overall fiscal structure of India.

The backlog, current and growth needs of infrastructure in cities and towns far exceed the resources at the disposal of ULBs. The additional requirement of funds by ULBs to meet the challenges of urbanisation, congestion, service deficiency and environmental degradation and to discharge redistributive functions like poverty alleviation and slum development as envisaged in the Constitution (74^{th} Amendment) Act, is huge. Vertical imbalance, fiscal dependency, borrowing constraints and inefficiency in municipal management are affecting the functioning of urban local bodies. They need to be addressed in a holistic manner through comprehensive reforms.

6.1 Major Findings of the Study

Some key findings from the study are as follow:

i) There is mismatch between functions and finances of ULBs, which primarily explains the vertical imbalance. Out of 18 functions to be performed by the municipal bodies in India less than half have a corresponding financing source. The 12^{th} Schedule in the Constitution 74^{th} Amendment Act also envisages that functions like 'safeguarding the interests of weaker sections of society, including the handicapped and the mentally retarded', 'slum improvement and upgradation' and 'urban poverty alleviation' belong to the legitimate functional domain of urban local bodies. However, there are no commensurate resources with these institutions to discharge these functions. Thus, vertical imbalance is constitutionally in-built and correction to the same needs to be achieved through reforms in the structure of fiscal federalism, including revenue assignment and inter-governmental transfers through the Central and State Finance Commissions. There is a need for function-finance mapping to ensure that each function to be performed by the ULBs is backed by a corresponding financing source. The revenue instruments assigned to a tier of government should match, as far as possible, the expenditure requirements to induce fiscal responsibility.

ii) The international experience shows that the range of resources available to urban local bodies in federal countries such as United States, Canada, Brazil, China, *etc.*, is very broad compared to that in India. 'Own' taxes and user charges of ULBs in India is grossly inadequate to meet the expenditure needs of ULBs. Inability of States to assign a buoyant tax to

ULBs in the place of Octroi has seriously affected municipal fiscal autonomy. Besides, elaborate State Government controls on the municipal authority to levy taxes and user charges, set rates, grant exemptions, borrow funds *etc.* and on the design, quantum and timing of inter-governmental transfers are constraining ability of the ULBs in mobilising resources.

iii) The patterns of urban public finance in India are based on the model of Anglo-Saxon countries like United Kingdom and Australia, which have an elaborate system of inter-governmental transfers. In addition to 'own' and 'shared' revenues, grants-in-aid received from the concerned State Governments constitute a major resource of ULBs. However, the fiscal position of the States themselves has been weak with high level of deficits and outstanding liabilities. Hence, the State Governments have not been in a position to provide sufficient funds to their ULBs as per the recommendations of the SFCs. Further, most of them are committed to reducing fiscal deficit, as per their newly enacted Fiscal Responsibility and Budget Management Acts. While there is a need for empowering ULBs with 'own' taxes and non-taxes, the inter-governmental transfer system, especially transfers from States to ULBs, need restructuring. The present system in States is *ad hoc*, with very little incentive to ULBs to prompt efforts for bridging the fiscal gap and rendering performance. Transfers often bail out the incompetent and the irresponsible.

iv) The study highlights deficiencies in the conventional method for assessing municipal finances in terms of analysis of revenue and expenditures of municipalities. ULBs are required to generate revenue surplus due to statutory requirements. Overall resource gaps of ULBs, as seen from municipal budgets, are not very large. However, the spending by all the municipal bodies is lower than that required for providing a minimum level of civic amenities. A comparison of per capita spending on core services by metropolitan municipal corporations in terms of the Zakaria Committee norms indicates that the level of under-spending on an average works out to be about 76 percent. Thus, the assessment of municipal finances in "normative terms", besides the "standard approach" of revenue or fiscal balance is very essential.

v) Under-spending in civic services is evidently linked to certain *exogenous* and *endogenous* factors. Exogenous factors include: delegation of revenue powers (decentralization) and dependency of ULB for resources on upper tier of government (dependency ratio). Endogenous factors include: revenue (tax) administration, cost recovery and quality of expenditure.

vi) ULBs have low outstanding debt and debt sustainability parameters such as interest coverage and debt coverage ratios suggest that these bodies have considerable scope for debt financing of their expenditure needs.

vii) The projected investment requirement of funds for urban infrastructure in the country is estimated at about Rs. 63,000 crore per annum for the next ten year period. This does not include the needs for redistributive functions like urban poverty alleviation. The figure constitutes about 2.2 per cent of the country's GDP and is at present nearly 3 times the revenue of all ULBs together. Assuming a status quo in the federal fiscal relationships in the country, municipal bodies can at best be able to raise upto about Rs.27, 285 crore per annum or about 1.0 per cent of the country's GDP in 2004-05. Within this, the resources available for asset creation after meeting current expenditure would at best be of the order of Rs 17,736 core, implying an annual shortfall of at least Rs 10,000 crore (2004-05 prices) even for providing core urban services.

6.2 Municipal Finance Reforms

The study suggests that to start with, the issues of lack of clarity, consistency and predictability in expenditure assignment and revenue assignment should be addressed. In particular, the system of taxes, user charges, inter-governmental transfers and borrowings in respect of ULBs need to be reviewed for their adequacy and suitability to match the expenditure needs. Resources are required to be aligned with expenditures so that the delivery of services most required by citizens can take place effectively. Reforms need to focus on the basic issues of fiscal federalism, namely, revenue assignment must be clear and revenue assignment must correspond to expenditure assignment. There is also a need to address the issues of service delivery management as in the ultimate analysis outlays will have to translate into outcomes valued by the public.

The study finds that ULBs, which have better delegation of revenue powers and less dependency on upper tiers of Government, perform well in terms of provision of core services or lower under-spending. Thus, the restructuring of revenue powers to ULBs needs to be given top priority by State Governments, if urban services are to be improved. Simultaneously, the quality of expenditure by ULBs needs to be enhanced with a rationalization of the work force and reduction in spending on establishment and administration. There is considerable scope for the ULBs to recourse to borrowed funds for improving civic infrastructure as their current level of indebtedness is perceived to be low. Thus, several ULBs would be in a position to access the capital market if borrowing constraints are eased and tax-free bonds are facilitated. However, strong revenue reforms, covering both general revenues and user charge revenues, are a pre-condition for accessing market funds. There is a significant scope to raise the user charges which are abysmally low across the States.

The study suggests some measures for improving the municipal finances in India as follows:

Expenditure Assignment

The Constitution (74th Amendment) Act 1992 identifies 18 functions in the 12th Schedule as belonging to the legitimate domain of urban local bodies. A study of amendments to municipal acts by the State Governments following the 74th Amendment reveals that there is inadequate clarity regarding the assignment of functions to ULBs. Some municipal acts mention of functions 'as may be assigned from time to time' by the concerned State Governments. In the absence of activity mapping and clarity regarding the levels at which component of functions such as policy-making, planning, formulation of programmes and projects, implementation, monitoring, quality assurance, assessment and evaluation are to be performed in connection with the delivery of particular public services, overlap between the functional domains of ULBs, State and Central Governments will continue. Functions of various tiers of government needs to be clear and without any ambiguity.

Revenue Assignment

Inadequate assignment of tax and non-tax resources including inter-governmental transfers[18], incomplete delegation of revenue-raising powers, inappropriate user charges, inefficiency in tax administration and under-exploitation of assigned revenues are some major factors that have contributed to the resource crunch of ULBs. The ULBs must be made an integral part of revenue mobilization in as much as they share responsibilities. Studies recommend a combination of benefit taxes, user fees, development charges and borrowings for long gestation capital works as appropriate for meeting civic expenditures. User charges should be based on the marginal cost of additional units of services from the infrastructure and development charges on the marginal cost of extending infrastructure to new developments, levied on a development-by-development basis.

Alternative to Octroi

Assigning an alternative in the place of Octroi to ULBs is a critical reform, which is pending since long. The Twelfth Finance

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[18] It has not been possible to address the whole lot of issues raised in the literature relating to inter-governmental transfers which is beyond the scope of this study.

Commission has recommended that a tax, preferably linked to the consumption characteristic of good and hence also buoyant, would be a suitable alternative to Octroi. The search for a substitute for Octroi may perhaps end with a reasonable formulae-based share for the ULBs in the Value Added Tax.

Municipal Finance List

A national consensus needs to evolve on a 'municipal finance schedule' for assignment to the ULBs to match the list of functions included in the 12th Schedule. The context is critical and given the patterns of urban public finance prevailing in States, property tax including vacant land tax and taxation of Central and State Government properties (or service charges in lieu thereof), professional tax, entertainment tax, advertisement tax, business licensing fee or tax, motor vehicle tax or a share from the same, planning permission fee, development impact fee, betterment levy, a surcharge on stamp duty on registration deeds or a share from it and a proportion of the Value Added Tax may be considered as part of the scheme of revenue assignment to ULBs. State Governments need to provide freedom to ULBs in matters relating tax base, tax rate and exemptions. Restrictions, if any, may be only by stipulation of ceilings or maximum rates of levy.

Matching Revenues and Expenditure

The Bahl-Linn (1992) principles of local public finance provide useful guidance for matching local revenue sources with the expenditures needed. They provide directions for determining the types of local public services that could be best financed out of revenues from particular user charges, benefit taxes, generic taxes, administrative fees and borrowings. There is a need for drawing a map showing broad correspondence between expenditure responsibilities to be discharged by ULBs and the most appropriate ways to finance them.

Raising Local Revenue Efforts

While the huge resource gaps of the ULBs require major structural reforms that take time, there are no two opinions that ULBs should exploit the revenue sources already assigned to them more effectively. There is a particular need for focusing on maximization of revenues from property taxes, user charges and the use of urban land as a resource. 'Users pay', 'beneficiaries pay' and 'polluters pay' are the cornerstones of local public finance as suggested by theory as well as practice. They must be fully made use of through scientific ways of identifying tax base.

Capital value taxation is recognized as a desirable way to enhance the yield from property taxes. However, the process to move to such a system is bound to be slow given the view that tax-payers in cities in India are 'property-rich', but 'cash-poor'. Moreover, most ULBs do not have a cadre of trained assessors to evaluate property values and update them regularly. Experiences of cities like Hyderabad and Bangalore suggest that area-based property tax systems, linked to self-assessment schemes, have considerable scope for enhancing property tax revenue. Vacant land tax, which remains one of the most under-exploited taxes in India at the local level, can be a major source of ULB revenues, with a low rate of tax levied on capital value of land based on benchmark values for registration. Reforms in administration of property tax, including assessment, valuation and record-keeping are also called for.

Linking Services with User Charges

Property tax is collected under various Municipal Acts with components such as water tax, drainage tax, lighting tax, conservancy tax and general tax. It is desirable that services like water supply, which can be measured and for which beneficiaries can be identified without incurring a huge cost, are financed through user charges. Linking of services to earmarked user charges and benefit taxes introduces a surrogate market in the provision of the local public goods concerned. Moreover, there is a visible trend in the developed countries towards more effective utilisation of user charges and benefit taxes by local governments due to citizens' preference for them over general taxes. ULBs in India need to be enabled to levy user charges for individual services with the goal of full cost recovery. Benefit taxes should be levied when the levy of user charges is not possible.

Inter-Governmental Transfers

India being a three-tier federal system, inter-governmental fiscal transfers are bound to remain an integral mechanism for solving the problems of vertical imbalance in the assignment of responsibilities and fiscal powers between the Centre, State and local bodies. These transfers could be an effective tool to correct such vertical imbalance, reduce the inequalities amongst ULBs due to a variety of factors including fiscal power, cost disabilities, revenue effort, *etc.* and promote public spending in desired sectors like water supply, education, health *etc.* In addition to the factors of vertical balance, equalization principle and externalities, administrative justification in terms of economies of scale in tax collection at the Central or State level also stands as argument in favour of inter-governmental transfers to local bodies.

The design of inter-governmental transfers from State Governments must be based on the principles of objectivity, transparency and predictability. The following criteria are advocated: (a) the transfers must imply a hard budget constraint for the municipalities and there should be no soft options at the margin; (b) the quantum and frequency of transfers must be predictable; (c) they must be transparent through explicit and identifiable entries in government budgets; (d) they must be pre-determined rather than open-ended and (e) they must have in-built incentives for promoting local resource mobilisation and effective public service delivery. A simple distributive formula that gives due weights to needs, rights to minimum basic services, incentives to performance and inter-jurisdictional equity may be designed.

Easing Borrowing Restrictions

The study reveals that metropolitan municipal corporations in the country have favourable debt sustainability indicators, measured in terms of ratio of debt payments to revenue receipts, interest coverage ratio and debt coverage ratio. Therefore, they have potential for utilizing the debt wisely, discretely and prudently for the purpose of capital formation. A critical issue to be addressed in the context of debt-financing as a key instrument of municipal finance is that practically all Municipal Acts in the country impose restrictions on the power of Municipalities to borrow funds. Examples are: Section 86 of Karnataka Municipalities Act, 1964 as amended by Act No. 24 of 1995; Section 154 of Karnataka Municipal Corporation Act, 1976 as amended by Act No. 25 of 1995; Section 154 of the Uttar Pradesh Municipal Corporations Act 1959 as amended by U.P. Act No.12 of 1994; Section 185 of Delhi Municipal Corporation Act 1957; Section 149 of Hyderabad Municipal Corporation Act 1955 and Section 142 of Madras City Municipal Corporation Act 1919.

All these laws make the previous sanction of the State Government (Central Government in the case of Delhi) mandatory before any borrowing is resorted to by an ULB. While stipulating that such borrowings would be on the basis of security of all or any of the taxes, duties, fees and dues authorised under municipal and other laws, the State Governments prescribe conditions regarding security, rate of interest, repayment of principal and interest, date of floatation and time schedule for loan repayment. They also specify the purposes for which borrowing can be resorted to. These generally include: (a) construction of permanent works, (b) acquisition of lands and buildings, (c) paying off any debt due to government and (d) repaying loan previously raised under municipal and other laws.

It is suggested that borrowing restrictions on ULBs may be relaxed and guided by pre-specified principles and not by case to case examination at the State level.

Financing Urban Infrastructure

Some key options for financing urban infrastructure include: i) specialized banks for municipal lending, ii) municipal bond markets and iii) specialized municipal funds (*e.g.* Tamil Nadu Urban Development Fund). Bank lending model is used in Western Europe while the municipal bond model is adopted in North America. For accessing capital market funds, the municipalities need certain financial, structural, institutional and administrative changes. These include i) availability of buoyant sources of revenue at their disposal, ii) transformation of the urban governance system with limited control by State Governments, iii) changes in the capital market structure, iv) recovery of cost of services and v) escrowing mechanisms to make the urban infrastructure projects commercially viable. In particular, efforts need to be made to broaden and deepen the market for Municipal Bonds in the country, by promoting tax-free and taxable bonds as in USA. For strengthening issuance of municipal bonds, measures such as bond insurance facility and listing of bonds on domestic stock exchanges are required.

Strengthening the creditworthiness of ULBs requires that they be given autonomous authority to set realistic tax-rates and user-charges for the basic services provided by them and also for pursuing right-sizing of staff.

Developing Public-Private Partnerships

While a crucial role exists for the private sector to participate in urban infrastructure, the intervention of the state and public policy and the format for such partnerships must be carefully designed. It is also imperative to safeguard the ecological and equity interests of the society and enforce accountability of both public and private actors. The ULBs, especially the smaller ones, have limited capacity to develop public-private partnerships and need to be assisted by specialized state agencies.

Addressing Poverty Alleviation

The functions of urban poverty alleviation and slum development and upgradation are envisaged as legitimate municipal functions under the 12th Schedule of the Constitution, incorporated by the 74th Amendment Act, 1992. If these redistributive functions are to be discharged effectively by the urban local bodies, the sources of financing the same must be clearly spelt out. Unless the ULBs have 'assured' or 'predictable' sources of revenue for these functions, there is little likelihood that they will 'own' them. The municipalities need to be induced to adopt these functions on the assurance of funding from State and Central Governments, which have recourse to more buoyant resources.

Expenditure Management and Disclosure

Many ULBs are seen to incur wasteful expenditure and considerable savings can be achieved through the elimination of the same. This is particularly true of administrative and establishment expenditures. There is a need to review expenditure norms and rationalize them to realistic levels. Procurement reforms, institution of performance measurement and management system for service providers and regulators, enforcement of norms of transparency and accountability and implementation of the Right to Information Act, 2005 are bound to improve the quality of local government expenditures. Budgeting and accounting systems of urban local bodies need to be simplified; accrual-based accounting must be put in place following the National Municipal Accounting Manual. Municipal accounts may be disclosed to the public at regular intervals in simple and easily understandable formats to induce informed debate and enforce vigilance.

Professionalisation of Management

Professional management of urban local bodies is an important reform that is needed to improve civic service delivery in the country. Recruitment, career progression, performance management and incentive systems for municipal personnel need to be designed to warrant efficient performance and accountability in service delivery. Outsourcing of staff and functions may be considered based on cost-benefit analysis. Capacity building and training programmes, including change management need to be undertaken systematically and regularly. Diploma programmes in urban management may be undertaken in association with reputed management institutions to build a cadre of qualified municipal managers.

Role of Central Finance Commission

The 74th Constitution Amendment Act 2002 envisages a key role for the CFC in augmenting the State Consolidated Funds to assist State Governments in the implementation of SFC recommendations. A strong case is required to be made before the 13^{th} Central Finance Commission for recommending wide-ranging measures to correct the problem of vertical imbalance in a holistic manner. The CFC may consider a “normative” approach for assessing the resource requirements of local bodies to decide the quantum of grants to them. This is necessary as the time lag between the submission of reports of SFCs, actions taken by State Governments on SFC recommendations and the constitution of CFCs is bound to continue.

Norms for sub-national expenditures may be evolved and depending on the normative estimates of expenditures to be incurred by State Governments and local bodies, a share in the central divisible pool of resources may be considered for the local bodies in lieu of *ad hoc* grants. As urban poverty issues are going to assume critical proportions, the CFC may consider revenue assignment for ‘redistributive’ functions such as urban poverty alleviation and slum development and linking such functions to a share in ‘redistributive’ taxes like personal income tax, corporation tax and service tax.

Role of State Finance Commissions

The SFCs may follow the suggestions made by the Twelfth Finance Commission regarding approach to be adopted to study the finances of local bodies, identifying problems and making recommendations. The SFCs, which need to have eminent experts with knowledge of local public finance or local administration as members, may make specific recommendations that are implementable. Definite time-frames for implementing the SFC recommendations by State Governments may also be fixed statutorily. SFCs may accord priority to 'measures' for improving municipal finances and financial management to address the fundamental factors leading to vertical imbalance rather than adopting a gap-filling approach.

Promoting Fiscal Responsibility

Key indicators of fiscal health of urban local bodies need to be designed from time to time to facilitate meaningful cross-municipal comparisons, benchmarking, drawing conclusions for measures to augment municipal revenues, cut unnecessary expenditures and enable the access to market funds. Appropriate fiscal responsibility legislations need to be considered by State Governments for the urban local bodies.

Municipal Expenditure Norms

The study has extensively used the Zakaria Committee norms (adjusted to study period) for working out the under-spending by urban local bodies and for projecting resource requirement for 10 years. In this context, it could be indicated that the Zakaria Committee norms, developed during the early 1960s, pertain to only five core services. Moreover, the costs of services may be subject to convexity due to technological changes and lack of natural advantages (*e.g.* on account of over-growth of cities). Therefore, there is a strong case for developing new benchmarks for estimating the costs of municipal services in India by constituting new groups and by undertaking more primary studies.

Best Practices and Innovations

There are many best practices and innovative experiments undertaken by urban local bodies and State Governments in India in areas such as local resource mobilization, expenditure management, capital budgeting, participatory planning *etc.* The same need to be documented and disseminated widely. A national network of resource centres on urban development, urban poverty alleviation and local public finance and a national bank on urban best practices and innovations by urban local bodies in the country and outside may also be developed.

Municipal Finance Database

One serious difficulty encountered while studying the municipal finances in India relates to the lack of a comprehensive and consistent database[18]. The entire discussion in Chapter 8 of the Twelfth Finance Commission's Report brings out the fact that despite several attempts, there is no source of reliable data on finances of all local bodies in India to estimate their resource gaps. The present study of budgets of the 35 metropolitan MCs in the country reveals the lack of uniformity in classification and reporting of data, which do not allow precise comparison on various parameters. There is an imperative need to develop a robust database on municipal finances and the same may be made public on a regular basis. With increasing urbanization, urban public finance is going to have important implications for state and national finances. Reserve Bank of India may consider to steer the building of such a national database on municipal finances. The formats indicated in Appendix 4, based on the National Municipal Accounting Manual may be adopted and e-enabled for developing an online municipal finance information system.

Analytical Research Studies

The local public finance literature in India does not present analytical studies like those brought out by OECD for the developed countries. This study has used measurable indicators relating to revenue balance, fiscal balance, expenditure performance, debt sustainability, dependency, decentralisation, cost recovery, revenue administration and quality of expenditure to make comparative assessment of finances of municipal corporations. There is a need for the regular conduct of similar studies for ULBs, state-wise and group-wise to draw benchmarks and pursue reforms scientifically.

6.3 Framework for Urban Policy

Jane Jacobs (1984) held the view that "Cities, not countries, are the constituent elements of a developing economy and have been so from the dawn of civilisation." This applies to India as well, with cities acting as the engines of national economic growth. Cities enable the clustering of complementary economic activities, capital and skill, entrepreneurial talent and innovation, and scale, scope and agglomeration economies. Cities raise labour productivity and create potential for sustainable economic growth and poverty alleviation. Urbanisation shifts people from low-productivity rural pursuits to high-productivity non-agricultural activities.

It is evident that as the India matures into a modern service sector-dominated developed economy owing to structural transformation, urbanisation will get a push. The positive correlation between income and migration is well-known in the research on rural-urban migration. It is most likely that as rural areas develop, they would eventually release population to cities. Secondly, the agricultural sector still employs about sixty per cent of the country's labour force, although its share in GDP is about eighteen per cent.

In contrast to the picture presented above, in developed countries like USA and UK only about 2-4 per cent of the population is engaged in agriculture. The process of rural-urban migration and in situ transformation of rural habitations into towns and cities cannot be stopped. Further, globalisation, information technology revolution, economic reforms and liberalisation are bound to speed up urbanisation. Cities are already the preferred destinations of domestic and foreign direct investment as well as business process outsourcing. Thus, it would be prudent to work out and pursue urban policy that promotes healthy and orderly urban growth while simultaneously addressing the negative effects accompanying urbanisation. This calls for a national urban policy.

It should be explicitly recognised that urbanisation is a natural consequence of economic development and cities contribute far more to national economic growth than their share in total population. They contribute significantly to the country's national income and exchequer. Urban policy needs to enable cities to contribute to national development through the effective provision of infrastructure and services. This, however, cannot be viewed in isolation from broader economic and social policies. These policies lead to unintended spatial consequences, which may sometimes be far more profound than those intended or envisaged originally. Much of urban policy, as Brian Berry observes, is actually:

"...unconscious, partial, uncoordinated and negative. It is unconscious in the sense that those who effect it are largely unaware of its proportions and features. It is partial in the sense that a few of the points at which governments might act to manage urbanisation and affect its course are in fact utilised. It is

uncoordinated in that national planning tends to be economic and urban planning tends to be physical and the disjunction often produces competing policies. It is negative in that the ideological perspective of the planners leads them to try to divert, retard or stop urban growth and in particular to inhibit the expansion of metropolitan and primate cities..." [quoted in Mohan (1996)].

In view of the above, the approach to urban development and management needs to take account of the likely impacts of multiple sectoral and spatial policies at Central, State and Local Government levels. Municipal finance reforms will have to be undertaken within the ambit of these policies and the structure of fiscal federalism in India. Therefore, the study has suggested measures which are not drastic and which can be implemented in the present Indian context.

Appendix 1
The Trends in Urbanisation and Metropolitan Growth in India

Table 1.1: Number and Population (in Million) of Urban Agglomerations (UAs) and Towns (1901-2001)

Census Year	Number of UAs/Towns	Total Population	Urban Population	Urban Population as % of Total Population
1901	1,830	238,396,327	25,851,873	10.8
1911	1,815	252,093,390	25,941,633	10.3
1921	1,944	251,321,213	28,086,167	11.2
1931	2,066	278,977,238	33,455,989	12.0
1941	2,253	318,660,580	44,153,297	13.9
1951	2,822	361,088,090	62,443,934	17.3
1961	2,334	439,234,771	78,936,603	18.0
1971	2,567	548,159,652	109,113,977	19.9
1981	3,347	683,329,097	159,462,547	23.3
1991	3,769	846,387,888	217,551,812	25.7
2001	4,378	1,028,610,328	286,119,689	27.8

1. Urban Agglomerations, which constitute a number of towns and their outgrowths, have been treated as one unit.
2. The total population and urban population of India for the year 2001 includes estimated population of those areas of Gujarat and Himachal Pradesh where census could not be conducted due to natural calamities.
3. The total population and urban population of India for the year 1991 includes interpolated population of Jammu & Kashmir where census could not be conducted.
4. The total population and urban population of India for the year 1981 includes interpolated population of Assam where census could not be conducted.

Source: Census of India 2001

Appendix 1 *(Contd.)*
The Trends in Urbanisation and Metropolitan Growth in India

Table 1.2: Growth of various Classes of Towns and Percentage of Urban Population to Total Population (1961-2001)

Class of Town	No. of Towns					Percentage of Urban Population to Total Population (%)				
	1961	**1971**	**1981**	**1991**	**2001**	**1961**	**1971**	**1981**	**1991**	**2001**
> 100,000	113	148	216	300	393	9.22	11.38	14.04	16.5	15.50
50,000 to 99,999	138	183	270	345	401	1.97	2.20	3.00	2.80	3.34
20,000 to 49,999	484	582	739	947	1151	2.99	3.23	3.11	3.62	4.43
10,000 to 19,999	748	874	1048	1167	1344	2.26	2.10	2.24	2.02	3.37
5,000 to 9,999	761	678	742	740	888	1.20	0.90	0.80	0.69	1.12
Below 5,000	218	178	230	197	191	0.14	0.09	0.11	0.07	0.04
Unclassified					10					
All classes	2462	2643	3245	3696	4378*	17.78	19.67	23.30	25.70	27.80

* includes 10 unclassified towns
Source: Office of the Registrar General, India.

Table 1.3: Number and Percentage of Urban Population in Million-plus Cities in India (1901-2001)

Census Year	Number	Population (million)	Population per Million Plus City (million)	% to Urban Population
1901	1	1.51	1.51	5.84
1911	2	2.76	1.38	10.65
1921	2	3.13	1.56	11.14
1931	2	3.41	1.70	10.18
1941	2	5.31	2.65	12.23
1951	5	11.75	2.35	18.81
1961	7	18.10	2.58	22.93
1971	9	27.83	3.09	25.51
1981	12	42.12	3.51	26.41
1991	23	70.66	3.07	32.54
2001	35	107.88	3.08	38.60

Source: Census of India 2001.

Appendix 1 *(Concld.)*
The Trends in Urbanisation and Metropolitan Growth in India

Table 1.4: Population of Million-plus Urban Agglomerations/Cities (2001)

Rank	Urban Agglomeration/City	Population (Million)	Population Growth			
			1981-1991	1991-2001	1981-1991	1991-2001
1.	Greater Mumbai	16.37	33.7	29.9	20.4	20.0
2.	Kolkata	13.22	19.9	19.9	6.6	4.1
3.	Delhi	12.79	46.9	51.9	43.2	36.2
4.	Chennai	6.42	26.4	18.5	28.9	9.7
5.	Bangalore	5.69	41.3	37.8	7.4	61.3
6.	Hyderabad	5.53	66.5	27.4	39.2	12.8
7.	Ahmedabad	4.52	29.5	36.4	22.9	18.9
8.	Pune	3.75	44.8	50.6	30.2	38.3
9.	Surat	2.81	64.4	85.1	62.2	62.3
10.	Kanpur	2.69	23.8	32.5	25.8	35.0
11.	Jaipur	2.32	49.6	53.1	49.2	59.4
12.	Lucknow	2.27	65.7	35.8	70.8	36.3
13.	Nagpur	2.12	36.4	27.6	33.2	26.2
14.	Patna	1.71	19.7	55.3	18.1	33.4
15.	Indore	1.64	33.7	47.8	31.6	46.3
16.	Vadodara	1.49	44.0	32.4	40.4	26.6
17.	Bhopal	1.45	58.4	36.9	58.3	34.9
18.	Coimbatore	1.45	19.6	31.4	15.9	13.1
19.	Ludhiana	1.40	71.8	33.7	71.7	33.7
20.	Kochi	1.35	38.3	18.8	13.5	2.4
21.	Visakhapatnam	1.33	75.1	25.7	33.0	28.9
22.	Agra	1.32	26.9	39.4	28.5	29.2
23.	Varanasi	1.21	29.3	17.5	29.6	18.4
24.	Madurai	1.19	19.7	10.0	14.6	1.9
25.	Meerut	1.17	56.5	37.4	67.9	42.5
26.	Nashik	1.15	63.7	58.8	80.6	63.9
27.	Jabalpur	1.12	17.4	25.7	20.8	22.0
28.	Jamshedpur	1.10	21.9	32.9	5.1	23.8
29.	Asansol	1.09	52.0	42.7	42.9	85.4
30.	Dhanbad	1.06	18.9	30.5	26.2	31.1
31.	Faridabad	1.05	86.7	70.8	86.7	70.8
32.	Allahabad	1.05	29.9	24.3	28.7	24.9
33.	Amritsar	1.01	19.2	42.6	19.2	27.3
34.	Vijayawada	1.01	37.8	19.6	32.9	17.6
35.	Rajkot	1.00	47.1	53.1	25.7	72.8
	Total	**107.88**				

Source : Census of India 1971, 1981, 1991 and 2001.

Appendix 2
International Experience in Municipal Finances

Table 2.1: Pattern of Local Taxation in OECD Countries 1988

Country	Local Taxes as % of		As % of Local Taxes		
	Total Taxes	Local Revenues	Income Tax	Sales Tax	Property Tax
Australia	3.3%	43.2%	0.0%	0.0%	99.6
Austria	10.8	52.7	50.6	33.2	9.2
Belgium	5.0	37.4	76.8	0.0	0.0
Canada	9.1	39.1	0.0	0.3	84.5
Denmark	30.0	49.6	92.1	0.1	7.8
Finland	25.6	45.0	99.1	0.1	0.9
France	8.9	44.3	14.7	4.9	34.2
Germany	8.7	36.7	81.9	0.3	17.1
Greece	9.9	n.a.	0.0	33.2	0.0
Ireland	2.2	6.2	0.0	0.0	100.0
Italy	1.8	3.6	41.7	22.3	0.0
Japan	25.9	n.a.	61.0	11.5	22.4
Luxembourg	11.9	55.4	80.5	15.1	3.7
Netherlands	2.2	5.9	0.0	1.3	73.5
New Zealand	5.5	n.a.	0.0	1.4	92.4
Norway	20.9	n.a.	88.9	0.0	7.6
Portugal	5.4	n.a.	43.6	29.4	23.7
Spain	11.3	57.3	31.7	29.6	27.1
Sweden	27.6	61.1	99.6	0.4	0.0
Switzerland	15.8	n.a.	86.3	0.4	13.3
Turkey	10.1	n.a.	41.0	37.4	3.4
U.K.	10.5	32.6	0.0	0.0	100.0
U.S.A.	12.2	40.0	6.0	15.3	74.2

Source : Calculated from OECD (1990, 1991)

Appendix 2 *(Concld.)*
International Experience in Municipal Finances

Table 2.2: Relative Importance of Local Taxes in Selected OECD Countries (2001)

Countries	Tax sources as a percent of total local tax revenues				Local taxes as a percent of GDP	Local taxes as a percent of all taxes[5]
	Income[1]	Sales[2]	Property[3]	Other[4]		
Federal:						
Australia	0.0	0.0	100.0	0.0	1.0	3.0
Austria	55.3	29.7	9.9	5.1	4.4	10.1
Belgium	86.5	13.2	0.0	0.3	2.1	4.7
Canada	0.0	1.9	91.3	6.8	2.9	8.1
Germany	78.0	6.0	15.8	0.2	2.6	7.5
Mexico	0.0	2.6	86.7	10.8	0.1	0.8
Switzerland	84.4	0.3	15.3	0.0	5.0	14.0
United States	6.5	21.8	71.8	0.0	3.5	11.5
Unweighted average Unitary:	**38.8**	**9.3**	**48.8**	**2.9**	**2.9**	**7.5**
Czech Republic	90.8	4.2	4.6	0.4	4.8	12.4
Denmark	93.4	0.1	6.5	0.0	15.9	32.9
Finland	95.4	0.0	4.4	0.1	9.9	21.2
France	0.0	11.5	48.2	40.4	4.4	9.7
Greece	0.0	46.3	0.0	53.8	0.4	1.0
Hungary	0.8	76.2	22.5	0.4	2.0	5.2
Iceland	78.0	7.6	14.3	0.0	8.3	22.4
Ireland	0.0	0.0	100.0	0.0	0.6	1.8
Italy	12.2	8.6	18.6	60.6	4.8	11.4
Japan	47.4	20.7	30.9	1.0	7.0	25.6
Korea	16.6	26.5	53.3	3.6	3.9	15.1
Luxembourg	92.9	1.3	5.6	0.3	2.4	5.9
Netherlands	0.0	44.0	56.0	0.0	1.4	3.4
New Zealand	0.0	9.7	90.3	0.0	1.8	5.8
Norway	89.9	2.2	7.9	0.0	6.5	16.3
Poland	78.4	1.8	19.8	0.0	5.7	16.3
Portugal	21.6	33.7	44.5	0.2	2.3	6.3
Slovak Republic	59.9	11.8	28.2	0.1	1.5	4.0
Spain	25.2	36.1	37.3	1.4	5.9	16.9
Sweden	100.0	0.0	0.0	0.0	16.0	29.8
Turkey	24.7	31.5	6.5	37.3	4.3	13.0
United Kingdom	0.0	0.0	99.5	0.5	1.5	4.1
Unweighted average	**38.0**	**16.8**	**31.6**	**9.1**	**4.8**	**12.7**

1. Includes individual and corporate income tax plus payroll tax.
2. Includes general consumption taxes, taxes on goods and services (fuel taxes, hotel and motel occupancy) and taxes on use on goods or on permission to use goods or perform activities.
3. Taxes on property including recurring taxes on net wealth.
4. Includes social security contributions in Austria and some residual taxes mainly on business (Austria, Canada, and Germany) and miscellaneous taxes everywhere.
5. Total includes central government, state government, local government and social security funds.

Source : OECD, *Revenue Statistics 1965-2001* (Paris: OECD, 2002), Tables 135 to 168.

Appendix 3
Details of State Finance Commissions

Table 3.1: First SFC Reports: Dates of Constitution, Report Submission & Action Taken

State	Date of Constitution of SFC	Date of Submission of SFC report	Date of Submission of ATR	Period covered By SFC
Andhra Pradesh	22.6.1994	31.5.1997	29.11.1997	1997-98 to1999-2000
Arunachal Pradesh	21.5.2003	6.6.2003	3.7.2003	2003-04 to 2005-06
Assam	23.6.1995	29.2.1996	18.3.1996	1996-97 to 2000-01
Bihar	23.4.1994/ 2.6.1999*	Not submitted	Not submitted	–
Chattisgarh	22.8.2003	Not submitted	–	–
Goa	1.4.1999	5.6.1999	12.11.2001	2000-01 to 2004-05
Gujarat	15.9.1994	RLBs-13.7.1998, ULBs Oct., 1998	Submitted	1996-97 to 2000-01
Haryana	31.5.1994	31.3.1997	1.9.2000	1997-98 to 2000-01
Himachal Pradesh	23.4.1994	30.11.96	5.2.1997	1996-97 to 2000-01
Jammu & Kashmir	24.4.2001	May, 2003	Not submitted	2004-2005 (Interim)
Jharkhand	28.1.2004	Not submitted		Not specified
Karnataka	10.6.1994	RLBs-5.8.1996, ULBs 30.1.1996	31.3.1997	1997 -98 to 2001-02
Kerala	23.4.1994	29.2.1996	13.3.1997	1996-97 to 2000-01
Madhya Pradesh	17.8.1994	20.7.1996	20.7.1996	1996-97 to 2000-01
Maharashtra	23.4.1994	31.1.1997	5.3.1999	1996-97 to 2000-01 #
Manipur	22.4.1994/ 31.5.1996	December, 1996	28.7.1997	1996-97 to 2000-01
Meghalaya	SFC not yet constituted	73rd Amendment not applicable as traditional Local Institution of Self Government exists in these States		
Mizoram	SFC not yet constituted			
Nagaland	SFC not yet constituted			
Orissa	21.11.1996/ 24.8.1998*	30.12.1998	9.7.1999	1998-99 to 2004-05 $
Punjab	July, 1994	31.12.1995	13.9.1996	1996-97 to 2000-01
Rajasthan	23.4.1994	31.12.1995	16.3.1996	1995-96 to 1999-2000
Sikkim	23.4.1997/ 22.7.1998*	16.08.1999	June, 2000	2000-01 to 2004-05
Tamil Nadu	23.4.1994	29.11.1996	28.4.1997	1997-98 to 2001-02
Tripura	RLBs-23.4.1994, ULBs-19.8.1996	RLBs-12.1.1996, ULBs-17.9.1999	RLBs-O 1.4.1997 ULBs-27.11.2000	RLBs-Jan.1996. Jan.2001 ULBs-1999-00 to 2003-04
Uttar Pradesh	22.10.1994	26.12.1996	20.1.1998	1996-97 to 2000-01
Uttaranchal	31.1.2001	2002	3.7.2004	2001-02 to 2005-06
West Bengal	30.5.1994	27.11.1995	22.7.1996	1996-97 to 2000-01

* : Date of reconstitution. In case of Gujarat, the SFC report on RLBs was submitted prior to the reconstitution of the SFC.
# : As per the ATR, the SFC recommendations shall be effective from 1.4.1999.
$: Though SFC was asked to submit the report covering a period of five years w.e.f. 1.4.1998, its report covers the period from 1998-99 to 2004-05.
Source : Report of the Twelfth Finance Commission, Government of India, 2004.

Appendix 3 *(Concld.)*
Details of State Finance Commissions

Table 3.2: Second SFC Reports: Details of Constitution, Report Submission & Action Taken

Sl. No	State	Date of Constitution of SFC	Date of submission of SFC report	Date of submission of ATR	Period covered by SFC
1.	Andhra Pradesh	8.12.1998	19.08.2002	31.3.2003	2000-01 to 2004-05
2.	Arunachal Pradesh	Not constituted			
3.	Assam	18.4.2001	18.08.2003	Not submitted	2001-02 to 2005-06
4.	Bihar	June,1999	RLB-September, 2001	Not submitted	
			ULB- January, 2003	Not submitted	
5.	Chattisgarh	Not constituted			
6.	Goa	Not constituted			
7.	Gujarat	19.11.2003	Not submitted		2005-06 to 2009-10
8.	Haryana	6.9.2000	Not submitted		2001-02 to 2005-06
9.	Himachal Pradesh	25.5.1998	24.10.2002	24.06.2003	2002-03 to 2006-07
10.	Jammu & Kashmir	Not constituted			
11.	Jharkhand	Not constituted			
12.	Karnataka	October, 2000	December, 2002	Not submitted	2003-04 to 2007-08
13.	Kerala	23.06.1999	January, 2001	Not submitted	2000-01 to 2005-06
14.	Madhya Pradesh	17.06.1999	July, 2003	Not submitted	2001-02 to 2005-06
15.	Maharashtra	22.06.1999	30.3.2002	Not submitted	2001-02 to 2005-06
16.	Manipur	03.01.2003	Submitted	Not submitted	2001-02 to 2005-06
17.	Meghalaya				
18.	Mizoram				
19.	Nagaland				
20.	Orissa	5.6.2003	25.10.2003	Not submitted	2005-06 to 2009-10
21.	Punjab	Sep., 2000	15.2.2002	08.06.2002	2001-02 to 2005-06
22.	Rajasthan	07.05.1999	30.08.200 I	26.03.2002	2000-01 to 2004-05
23.	Sikkim	July, 2003	Not submitted		*
24.	Tamil Nadu	2.12.1999	21.5.2001	8.5.2002	2002-03 to 2006-07
25.	Tripura	29.10.1999	10.4.2003	Not submitted	2003-04 to 2007-08
26.	Uttar Pradesh	February, 2000	June, 2002	30.04.2004	2001-02 to 2005-06
27.	Uttaranchal	Not constituted			
28.	West Bengal	14.7.2000	6.2.2002	Not submitted	2001-02 to 2005-06
Constitution of Third SFCs					
1.	Andhra Pradesh	16-01-2003	Not Submitted	–	2005-06 to 2009-10
2.	Kerala	20-09-2004	Not Submitted	–	2006-07 to 2011-12
3.	Punjab	20-09-2004	Not Submitted	–	2006-07 to 2011-12

* : No specific period of coverage has been prescribed.
Source : Report of the Twelfth Finance Commission, Government of India, 2004.

Appendix 4
Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.1: Statement Showing Summary of Financial Performance

ULB Name: (Rupees in Lakh)

Sl No	Particulars	Years											
		1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	
1	Opening Balance												
2	Revenue Income												
3	Revenue Expenditure												
4	Revenue Surplus/(Deficit)												
5	Capital Receipts												
6	Capital Expenditure												
7	Capital Surplus/(Deficit)												
8	Loan Repayment												
9	Disposal of Fixed Assets												
10	Closing Balance												
11.a	Depreciation												
11.b	Provisions												
11.c	Increase/Decrease in Current Assets												
11.d	Increase/Decrease in Current Liabilities												
12	Closing Cash Balance												

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.2: Statement Showing Liquidity Position

ULB Name: (Rupees in Lakh)

Major Head	**Head Description**	**Years**											
		1995-96	**1996-97**	**1997-98**	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	
1	**Opening Balance**												
450	Cash Balance												
	Balance in Current A/cs*												
	Balance in S.B A/cs*												
	Fixed Deposits												
	Post Office												
a	**Total**												
2	**Closing Balance**												
450	Cash Balance												
	Balance in Current A/cs												
	Balance in S.B A/cs												
	Fixed Deposits												
	Post Office												
a	**Total**												
3	**Statutory Minimum Balance**												
4	**Surplus/(Deficit) over SMB (2.a - 3)**												

* Banks include Nationalized Banks, Scheduled Banks & Scheduled Co-operative Banks

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.3: Statement Showing Revenue Income of Major Heads

ULB Name: (Rupees in Lakh)

Major Head	Head Description	Years											
		1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	
110	Tax Revenue												
120	Assigned Revenue & Compensations												
130	Rental Income From Municipal Properties												
140	Fee & User Charges												
150	Sale & Hire Charges												
160	Revenue Grants, Contributions and Subsidies												
170	Income from Investments												
171	Interest Earned												
180	Other Income												
	Total Revenue Income												
	Statutory Minimum Balance of 5% Revenue Income excluding Major Head 160												

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.4: Statement Showing Revenue Income of Minor Heads

ULB Name: (Rupees in Lakh)

Minor Head	Head Description	Years											
		1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	
110	Tax Revenue												
1	Property Tax												
2	Water Tax												
3	Sewerage Tax												
4	Conservancy Tax												
5	Lighting Tax												
6	Education Tax												
7	Vehicle Tax												
8	Tax On Animals												
9	Electricity Tax												
10	Profession Tax												
11	Advertisement Tax												
12	Pilgrimage Tax												
51	Octroi & Toll												
52	Cess												
80	Other Taxes												
	Total Tax Revenue Income												
120	Assigned Revenue & Compensations												
10	Tax and Duties Collected By others												
20	Compensation in Lieu of Tax and Duties												
30	Compensation in Lieu of Concessions												
	Total Assigned Revenue Income												

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.4: Statement Showing Revenue Income of Minor Heads

ULB Name: (Rupees in Lakh)

Minor Head	**Head Description**	**Years**											
		1995-96	**1996-97**	**1997-98**	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	
130	Rental Income From Municipal Properties												
10	Rent from Civic Amenities												
20	Rent from Office Buildings												
30	Rent From Guest Houses												
40	Lease of Land												
80	Other Rents												
	Total Rental Income												

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.4: Statement Showing Revenue Income of Minor Heads

ULB Name: (Rupees in Lakh)

Minor Head	Head Description	Years											
		1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	
140	Fee & User Charges												
10	Empanelment & Registration Charges												
11	Licensing Fee												
12	Fee for grant of permission												
13	Fee for Certification or Extracts												
14	Development Charges												
15	Regularization Fee												
20	Penalties & Fines												
40	Other Fees												
50	User Charges												
60	Entry Fees												
70	Service & Administrative Charges												
80	Other Charges												
	Total Fee & User Charges Income												
150	Sale & Hire Charges												
10	Sale of Products												
11	Sale of Forms & Publications												
12	Sale of Stores & Scrap												
30	Sale of Others												
40	Hire Charges for Vehicles												
41	Hire Charges for Equipment												
	Total Sale & Hire Charges Income												

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.4: Statement Showing Revenue Income of Minor Heads

ULB Name: (Rupees in Lakh)

Minor Head	Head Description	Years											
		1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	
160	Revenue Grants, Contributions and Subsidies												
10	Revenue Grants												
20	Reimbursement of Expenses												
30	Contribution Towards Schemes												
	Total Revenue Grants Income	-											
170	Income From Investments												
10	Interest												
20	Dividend												
30	Income from Commercial Projects												
40	Profit On Sale of Investments												
80	Others												
	Total Income from Investments												
171	Interest Earned												
10	Interest On Bank Deposits												
20	Interest On Employee Loans												
30	Interest On Other Loans												
40	Other Interest												
	Total Interest Earned												

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.4: Statement Showing Revenue Income of Minor Heads

ULB Name: (Rupees in Lakh)

Minor Head	Head Description	Years											
		1995-96	**1996-97**	**1997-98**	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	
180	Other Income												
10	Deposits Forfeited												
11	Lapsed Deposits												
20	Insurance Claim Recovery												
30	Profit On Disposal of Fixed Assets												
40	Recovery From Employees												
50	Unclaimed Refunds Payable/Liabilities Written Back												
60	Excess Provision Written Back												
80	Miscellaneous Income												
	Total Other Income												

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.5: Statement Showing Revenue Expenditure of Major Heads

ULB Name: (Rupees in Lakh)

Major Head	**Head Description**	**Years**											
		1995-96	**1996-97**	**1997-98**	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	
210	Establishment Expenses												
220	Administrative Expenses												
230	Operations & Maintenance												
240	Interest & Financial Charges												
250	Programme Expenses												
260	Revenue Grants, Contributions and Subsidies												
a	**Total Revenue Expenditure before Deprecation & Provisions *etc.***												
270	Provisions & Write Offs												
271	Miscellaneous Expenses												
272	Depreciation												
280	Prior Period Items												
290	Revenue Transfers												
b	**Total Depreciation & Provisions *etc.***												
	Total Revenue Expenditure (a+b)												

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.6: Statement Showing Revenue Expenditure of Minor Heads

ULB Name: (Rupees in Lakh)

Minor Head	Head Description	Years											
		1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	
210	Establishment Expenses												
10	Salaries, Wages and Bonus												
20	Benefits and Allowances												
30	Pension												
40	Other Terminal Benefits												
	Total Establishment Expenses												
220	Administrative Expenses												
10	Rent, Rates and Taxes												
11	Office Maintenance												
12	Communication Expenses												
20	Books & Periodicals												
21	Printing and Stationery												
30	Traveling & Conveyance												
40	Insurance												
50	Audit Fees												
51	Legal Expenses												
52	Professional and other Fees												
60	Advertisement and Publicity												
61	Membership & subscriptions												
80	Others												
	Total Administrative Expenses												

Appendix 4 *(Contd.)*
Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.6: Statement Showing Revenue Expenditure of Minor Heads

ULB Name: (Rupees in Lakh)

Minor Head	Head Description	Years											
		1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	
230	Operations & Maintenance												
10	Power & Fuel												
20	Bulk Purchases												
30	Consumption of Stores												
40	Hire Charges												
50	Repairs & maintenance Infrastructure Assets												
51	Repairs & maintenance - Civic Amenities												
52	Repairs & maintenance - Buildings												
53	Repairs & maintenance - Vehicles												
59	Repairs & maintenance - Others												
80	Other operating & maintenance expenses												
	Total Operations & Maintenance												
240	Interest & Financial Charges												
10	Interest on Loans from Central Government												
20	Interest on Loans from State Government												
30	Interest on Loans from Government Bodies & associations												

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.6: Statement Showing Revenue Expenditure of Minor Heads

ULB Name: (Rupees in Lakh)

Minor Head	Head Description	Years											
		1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	
40	Interest on Loans from International Agencies												
50	Interest on Loans from Banks & Other Financial Institutions												
60	Other Interest												
70	Bank Charges												
80	Other Finance Expenses												
	Total Interest & Financial Charges												
250	Programme Expenses												
10	Election Expenses												
20	Own Programmes												
30	Share in Programme of others												
	Total Programme Expenses												
260	Revenue Grants, Contributions and Subsidies												
10	Grants												
20	Contributions												
30	Subsidies												
	Total Revenue Grants Expenditure												

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.6: Statement Showing Revenue Expenditure of Minor Heads

ULB Name: (Rupees in Lakh)

Minor Head	Head Description	Years											
		1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	
270	Provisions & Write Offs												
10	Provisions for Doubtful receivables												
20	Provision for other Assets												
30	Revenues written off												
40	Assets written off												
50	Miscellaneous Expense written off												
	Total Provisions & Write Offs												
271	Miscellaneous Expenses												
10	Loss on disposal of Assets												
20	Loss on disposal of Investments												
30	Decline in Value of Investments												
	Total Miscellaneous Expenses												

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.6: Statement Showing Revenue Expenditure of Minor Heads

ULB Name: (Rupees in Lakh)

Minor Head	Head Description	Years											
		1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	
272	Depreciation												
20	Buildings												
30	Roads & Bridges												
31	Sewerage and Drainage												
32	Waterways												
33	Public Lighting												
40	Plant & machinery												
50	Vehicles												
60	Office & Other Equipments												
70	Furniture, Fixtures, Fittings and Electrical Appliances												
80	Other Fixed Assets												
	Total Depreciation												
280	Prior Period Items												
	Incomes												
10	Taxes												
20	Other – Revenues												
30	Recovery of revenues written off												
40	Other Income												
	Expenses												
50	Refund of Taxes												
60	Refund of Other-Revenues												
80	Other Expenses												
	Total Prior Period Items												
290	Revenue Transfers												
10	Transfer to Capital Funds												
20	Transfer to Earmarked Funds												
30	Revenue Surplus												
	Total Revenue Transfers												

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.7: Statement Showing Capital Receipts & Loan Position

ULB Name: (Rupees in Lakh)

Major Head	Head Description	Years											
		1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	
320	**Grants/Contributions**												
	Opening Balance of Un-utilized Grants												
	Grants Received During the Year												
10	Central Government												
20	State Government												
30	Other Government Agencies												
40	Financial Institutions												
50	Welfare bodies												
60	International Agencies												
80	Others												
	Grants Utilized During the Year												
	Closing Balance of Un-utilized Grants												
330	**Secured Loans**												
	Opening Balance of Secured Loans												
	Secured Loans Raised During the Year												
10	Central Government												
20	State Government												
30	Other Government Agencies												
40	International Agencies												
50	Banks and Financial Institutions												

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.7: Statement Showing Capital Receipts & Loan Position

ULB Name: (Rupees in Lakh)

Major Head	**Head Description**	**Years**											
		1995-96	**1996-97**	**1997-98**	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	
60	Other Term loans												
70	Bonds & Debentures												
80	Others												
	Secured Loans Re-paid During the Year												
	Closing Balance of Secured Loans												
331	**Unsecured Loans**												
	Opening Balance of Un-secured Loans												
	Un-secured Loans Raised During the Year												
10	Central Government												
20	State Government												
30	Other Government Agencies												
40	International Agencies												
50	Banks and Financial Institutions												
60	Other Term loans												
70	Bonds & Debentures												
80	Others												
	Un-secured Loans Re-paid During the Year												
	Closing Balance of Un-secured Loans												
a	**Capital Receipts**												
b	**Loan Re-payment**												

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.8: Statement Showing Capital Expenditure & Asset Creation

ULB Name: (Rupees in Lakh)

Major Head	Head Description	Years											
		1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	
410	Opening Fixed Assets												
	New Assets Created and Put to Use During the Year												
	Assets Disposed During the Year												
	Assets Transferred to Other Organizations												
	Closing Fixed Assets												
412	Opening Capital Work In Progress												
	Capital Expenditure Incurred During the Year												
	Works Completed and Transferred to Fixed Assets												
	CWIP written Off During the year												
	Closing Balance of Capital Work In Progress												
a	**Capital Expenditure**												
b	**Assets Disposed**												

Appendix 4 *(Contd.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.9: Statement Showing Change in Current Liabilities

ULB Name: (Rupees in Lakh)

Major Head	**Head Description**	**Years**											
		1995-96	**1996-97**	**1997-98**	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	
1	Opening Balance												
340	Deposits												
341	Deposit Works												
350	Other Liabilities												
a	**Total**												
2	Closing Balance												
340	Deposits												
341	Deposit Works												
350	Other Liabilities												
a	**Total**												
3	Increase/(Decrease) in Current Assets												

Appendix 4 *(Concld.)*

Proposed Formats for National Municipal Finance Information System (MFIS)

Table 4.10: Statement Showing Change in Current Assets

ULB Name: (Rupees in Lakh)

Major Head	**Head Description**	**Years**											
		1995-96	**1996-97**	**1997-98**	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	
1	Opening Balance												
420	Investments – General Fund												
421	Investments – Other Funds												
430	Stock in Hand												
431	Sundry Debtors												
432	Provision against Debtors												
440	Pre-paid Expenses												
460	Loans, Advances & Deposits												
461	Provision against Loans, Advances & Deposits												
470	Other Assets												
480	Miscellaneous Expense to be written Off												
a	**Total**												
2	Closing Balance												
420	Investments – General Fund												
421	Investments – Other Funds												
430	Stock in Hand												
431	Sundry Debtors												
432	Provision against Debtors												
440	Pre-paid Expenses												
460	Loans, Advances & Deposits												
461	Provision against Loans, Advances & Deposits												
470	Other Assets												
480	Miscellaneous Expense to be written Off												
a	**Total**												
3	Increase/(Decrease) in Current Assets												

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