



# 5 | URBAN FINANCE

*Om Prakash Mathur*

Recent years following the Constitution (seventy-fourth) Amendment Act, 1992 (74<sup>th</sup> CAA) have witnessed extraordinary interest in the role of municipal governments in financing urban infrastructure and services and enhancing the quality of India's socioeconomic ethos. Much of the interest owes itself to the two provisions in the Amendment Act, which point towards a larger role for municipalities in the country's developmental affairs, and a corresponding provision that suggests larger fiscal space for them. The former is incorporated in Schedule 12 of the Constitution, which lists out 18 subjects and functions considered appropriate for municipalities (Box 3.1 in Chapter 3). According to Schedule 12, municipalities in India are an appropriate tier for such subjects as urban planning including town planning, planning for economic and social development, urban forestry and protection of the environment and promotion of ecological aspects, slum improvement and upgrading, and urban poverty alleviation. Upon fuller implementation, Schedule 12 will exercise a major impact on the functional profile of municipalities and their role in the country's socioeconomic development.

Issues relating to the fiscal space are embodied in Article 243 Y of the Constitution under which the state governments are required to constitute, once every five years, a Finance Commission (see Annexe 5.1 for Article 243 Y and 280 of the Constitution). The Finance Commissions of states are required to: 'review the financial position of the Municipalities and make recommendations to the Governor as to:

- a) the principles which should govern:
  - (i) the distribution between the State and the Municipalities of the net proceeds of the taxes, duties, tolls and fees leviable by the state, which may be

divided between them under this Part and the allocation between the Municipalities at all levels of their respective shares of such proceeds;

- (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;
- (b) the measures needed to improve the financial position of the Municipalities; and
  - (c) any other matter referred to the Finance Commission by the Governor in the interest of the sound finance of the Municipalities' (74<sup>th</sup> CAA, Government of India).

This provision of the Constitution, which has been incorporated into the state municipal statutes, alters the fiscal relations between the municipalities and state governments. Three features of this provision are worth noting: (a) it provides a review of the financial position of municipalities once every five years; (b) it recognizes the need for and provides for a revenue-sharing arrangement between the municipalities and state governments; and (c) it gives options to municipalities to explore and experiment with measures that would improve their finances.

Yet another change which impacts on the fiscal profile of municipalities lies in the amendment of Article 280 and the insertion of a sub-clause (3)(c) which requires the Finance Commission, set up under the provisions of Article 280, to recommend '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 Commission of the State'. The significance of this provision lies in the fact that the central government which had thus far channelled assistance to municipalities only *via* the centrally sponsored schemes and related development

Views expressed in the chapter are of the author.

programmes and which had rarely made any direct assessment of the finances of municipalities has, under the Constitution, been permitted to provide supplementary assistance for municipalities over and above what the Finance Commission of States might recommend. Pursuant to this provision, the Tenth Finance Commission (TFC) recommended for the period 1996–2001, a sum of Rs 1000 crore for municipalities; the Eleventh Finance Commission (EFC) covering a five year period beginning 2001 recommended an amount of Rs 2000 crore, and allocated the same between states on the basis of a fivefold criteria. The Twelfth Finance Commission (TFC) has likewise provided a sum of Rs 5000 crore for municipalities for a period of five years, beginning 2005.

Over the past decade, these provisions have been implemented in varying degrees by the central and state governments. While a fuller investigation of the impact of the provisions on the finances and functioning of municipalities is called for, this paper focuses on:

1. the ways in which the functional role of municipalities has changed and expanded in recent years;
2. the shifts that have occurred in the fiscal portfolio of municipalities;
3. The way in which Articles 243 Y(a)(i) and (iii) and 280 (3)(c) have affected the scale and nature of transfers to municipalities, and more broadly, changed the vertical relations between the municipalities and higher tiers of government; and
4. fiscal and non-fiscal initiatives that have been taken by municipalities to improve their finances and functioning.

### FUNCTIONAL JURISDICTION OF MUNICIPALITIES

Entry 5 of the State list in the Constitution empowers the state governments to lay down the functions, powers and responsibilities of municipal governments. Accordingly, out of the powers and responsibilities enumerated in the State list (Seventh Schedule), the state governments have assigned certain functions and duties to municipalities. Typically, these have consisted of public health and sanitation (Entry 6), burials and cremations and cremation grounds (Entry 10), libraries, museums and other similar institutions controlled and financed by the state (Entry 12), communications, that is, roads and bridges (Entry 13), water supplies, drainage and embankments subject to the provisions of Entry 56 of the Union list (Entry 17), and markets and fairs (Entry 28)<sup>1</sup>. The main functions with which the municipalities are associated and which are generally, though not uniformly, performed

<sup>1</sup> Provision of water supply and drainage in several states has either been taken over by state governments (for example, Rajasthan) or transferred to parastatal agencies. It is also a shared responsibility in a few states.

by them include services that have the characteristics of *private goods*, for example, water supply, sewerage and drainage, and conservancy and sanitation, and others that are in the nature of *public goods*, for example, street lighting and municipal roads. In addition, the municipalities are vested with a number of regulatory duties, often even with the development of markets, commercial complexes, and the like. Several municipal corporations have a larger functional domain, which consists of running hospitals and dispensaries, electricity generation and distribution, and bus transport services<sup>2</sup>. The key point is that these functions conform to the text book division of functions between the three tiers of government<sup>3</sup>, which says that local authorities are the ‘best to supply local public goods’, and which owes itself, among others, to Adam Smith who on this subject wrote ‘were the streets of London to be lighted and paved at the expense of the treasury (national), is there any probability that these would be so well lighted and paved as they were at present’ (Rattso 1998, p. 24). The domain of municipal functions, however, is neither discrete nor absolute; there is a built-in concurrency between the functional domain of state governments and municipalities. In practice, few municipalities have assumed all these responsibilities, and disparities among jurisdictions are large. The functional domain of municipalities has witnessed periodic shifts and changes, on account of the withdrawal of certain functions (for example, water supply and sewerage), or assumption of new responsibilities such as poverty alleviation.

The incorporation of Schedule 12 into the Constitution has, not infrequently, been understood to mean that the municipal functional domain has acquired some sort of a discrete character, apart from an expansion of its portfolio. Several observations are called for here. First, the functions and duties enumerated in Schedule 12 are *not* in addition to what the municipalities were responsible for in the pre-1992 period. In fact, there is substantial overlap between the functions of municipalities in the pre-1992 period and those that are

<sup>2</sup> The functional domain of municipalities is highly varied and complex, consisting of such subjects and tasks as public administration and establishment which, in the case of larger municipalities, is broken into department of public administration; office of the Secretary, audit; security; public education, food samples; epidemics; births and deaths; gardens; slaughter houses; and a host of others.

<sup>3</sup> The most basic issue associated with expenditure assignment is the division of spending responsibilities. What are the key functions of the government, and which level of government should carry out which functions? There is no best system of expenditure assignment or service decentralization. Local preferences, household mobility, economies of scale, spillover effects, and political considerations suggest what will be feasible for a particular country. International experience shows that stable systems of intergovernmental relations are characterized by clearly stated expenditure assignment rules, rather than by the subjective decisions and murky assignments, that define the intergovernmental system in many countries, Bird et al. (1995).

listed in Schedule 12<sup>4</sup>. Of the 18 functions enumerated in Schedule 12, 11 formed a part of the municipal domain even in the pre-1992 period. These are: regulation of land use and construction of buildings; roads and bridges; water supply for domestic, industrial and commercial purposes; public health, sanitation, conservancy, and solid waste management; fire services; provision of urban amenities and facilities such as parks, gardens and playgrounds; burials and burial grounds; and cremation grounds and electric cremations; cattle ponds, prevention of cruelty to animals; vital statistics including registration of births and deaths; public amenities including street lighting, bus stops, and public conveniences; and regulation of slaughter houses and tanneries. Even the remaining functions incorporated in Schedule 12 are possible to trace either to the State list or as shown later, the Concurrent list in the Constitution.

The significance of Schedule 12 functions for municipalities lies not so much in enlarging the scope of municipal operations as in the fact that many of the functions are drawn from the Concurrent list of the Constitution. At the minimum, it would suggest that there is a group of functions, wherein there is *concurrency* of interests by all the three tiers of government, that is, the central government, state governments and municipal governments. The 1992 Constitutional amendment, however, is vague in that it does not spell out the nature of responsibilities that are required of local governments in respect of such functions as planning for economic and social development (Entry 20), protection of the environment and promotion of ecological aspects (Entry 17 A and B), and safeguarding the interests of weaker sections of the society (Entry 16), and the tasks that are to be performed by the central and state governments.

Many of the functions listed in Schedule 12 have distributional attributes, which on the one hand, represent a major departure from the past, and, on the other, mark a deviation from the typical Musgrave model of fiscal federalism. It is extensively argued in fiscal federalism literature that redistribution in a federal system is a central function (Musgrave 1959). Musgrave, for instance, argued in his seminal book that distributive adjustments at local levels are possible to be nullified by interstate movements, adding further that conflicting goals for redistribution between levels of government could result in a continuous set of adjustments and readjustments without reaching equilibrium<sup>5</sup>. For this

<sup>4</sup> Much of the confusion has arisen on account of the fact that many state governments have incorporated the 12<sup>th</sup> Schedule functions into the state laws—either as they are or in parts, without ascertaining if these formed a part of the state laws operating in the pre-amendment period.

<sup>5</sup> In many Nordic countries, local governments have the responsibility for redistributional functions typical of a welfare state. Such governments use income taxation as their main source of income. In both these respects, fiscal federalism in Nordic countries constitutes a departure where the

reason, functions such as poverty alleviation, environment protection and preservation, and even slum upgradation have continued to remain within the ambit of the central and state governments with a minimal role for municipalities. The Constitutional amendment has altered this position, without any formal or informal suggestion on how these might be financed, with what tax bases, and with what intergovernmental transfer arrangements.

## REVENUE BASE OF MUNICIPALITIES

The Constitution of India does not lay down the revenue base for municipalities. The power to determine their revenue base—be it the tax authority, tax base, tax rate setting, local tax autonomy, or even the grants-in-aid and other forms of transfers rests with the state governments. Within this framework, the state governments have specified the taxes that the municipalities can levy and collect, which historically<sup>6</sup> have comprised taxes on land and buildings (Entry 49); taxes on the entry of goods into a local area for consumption, use or sale therein (Entry 52); taxes on advertisements other than advertisements published in newspapers (Entry 55); taxes on animals and boats (Entry 58); tolls (Entry 59); taxes on professions, trades, callings and employment (Entry 60)<sup>7</sup>, and taxes on entertainment (Entry 62). In addition, there are charges, fees and fines forming the non-tax base of municipalities (Entry 66).

Taxes on property and taxes on the entry of goods into a local area for consumption, use or sale therein (octroi) form the backbone of municipal tax base in India. Between the two, municipal governments have shown a preference for *indirect taxes and levies* like octroi compared to *direct taxes* such as property taxation, even when the latter is rated to be a suitable form of taxation on account of its incidence being localized. At one time property taxation was so important that scholars theorized that the expenses of government could be funded from site rents. Henry George who worked on this subject—his work later come to known as Henry George Theorem (HGT)—concluded that at an optimal population size, the site rents should equal the cost of collective goods<sup>8</sup>.

distributive brand of the budget is reserved for central governments and local governments are assigned a less mobile tax base or restricted to use only benefit taxes.

<sup>6</sup> Multilevel finance is not an old discipline in economics. Prior to the World War II, the subject was treated in connection with taxes on property.

<sup>7</sup> In the early years of the twentieth century, several local bodies in India levied a tax on persons assessed according to circumstances and property. Besides this, there was a tax called the Haisiyat tax. It has been argued that these were in the nature of local income taxes. Gyan Chand (1944).

<sup>8</sup> George Henry (1879)

Taxes on the entry of goods into a local area (octroi) are among the more buoyant and elastic of the local taxes and are currently levied in parts of Gujarat<sup>9</sup> and Maharashtra, and Punjab.

### *Transfers from the Higher to Lower Tiers of Government*

Transfers from the higher to lower tiers of government are an outstanding, and perhaps the most significant feature of public finance and instrumental in making local financial adjustments. Transfers form an important component of the revenue base of municipalities although the importance of transfers varies between states and often between municipalities within the same state. As a proportion of municipal governments revenues, transfers are high or low, depending on the revenue-raising powers of municipalities, the efficiency with which these are used, and of course, the spending responsibilities of municipal governments. A tax on the entry of goods into a local area for consumption, use or sale therein (octroi) makes a phenomenal difference to the role of transfers in the finances of municipalities. Earlier studies on the subject show that transfers to the extent these are possible to be identified, account for 8 per cent to 65 per cent of municipal government revenues. Many of the transfers are not possible to be separately accounted for, as these are absorbed directly into state government expenditures.

An important feature of transfers to municipalities is the discretionary nature. Unlike the Constitutional provisions that lay down the revenue-sharing arrangements between the central and state governments, there exist no statutory provisions in the state municipal laws which define the conditions under which transfers should take place from the state governments to municipalities. Since local government is a state subject and spending responsibilities and taxation powers of municipalities are determined by state governments, it is *assumed* that state governments have the obligation of bridging the gap between what the municipalities are able to raise by way of taxes, charges, levies, etc. and what they need to administer their spending responsibilities, with the proviso that such a gap is worked out on sustainable normative considerations and not attributable to inefficiencies and fiscal profligacy. Transfers are made for other purposes as well.

The revenue base of municipalities in Indian states has shown little signs of change, notwithstanding the 74<sup>th</sup> CAA; indeed, octroi, a major revenue for municipalities, has been abolished without being substituted by any other local source and has substantially shrunk the revenue base of municipalities in such states as Haryana, Orissa, and Rajasthan.

<sup>9</sup> Octroi continues to be levied in the municipal corporations of Gujarat and Maharashtra. The Government of Punjab which permits municipalities to levy octroi is said to have taken a decision to abolish octroi, and is currently exploring the possibility of bringing on the statute a new tax called the Local Area Development Tax.

It is important to point out that while the municipal revenue base in India is controlled and regulated by state governments even though it may fulfil the criteria for the determination of a local tax base, for example, the principles of residence and benefit taxation, low mobility, and stability over the period of the business cycle, and while it may even create a link between service use and tax payment. Rate capping and control over municipal spending and taxation are commonly observed. Most state governments lay down local tax policies, including policies relating to the choice of tax rates or determining who to include or exclude from payment of taxes. Absence of autonomy or low discretion coefficient, in matters relating to tax rate setting, is one of the key features of the functioning of municipal governments<sup>10</sup>.

### SIZE OF THE MUNICIPAL SECTOR

The fiscal role of municipalities in India's macroeconomic framework has rarely been systematically assessed. What the municipalities spend and what they generate from the revenue-raising powers given to them under the state-level statutes, have been historically studied in a narrow, local context. The tax reforms initiated in the post-1991 period involving reduction in income tax rates, rationalization of custom duties and excises, and tax simplification, followed by efforts to shift over to a value-added tax regime, were not extended to the municipal tax regime. Property taxes, for instance, were not even referred to as a constituent of the family of taxes. It is in this context that the fiscal performance of municipalities is assessed here, using municipal own revenues and expenditure as key measures.

In 2001–2, the size of the municipal sector measured in terms of revenues that the municipalities generate by way of levy of taxes, duties, fees and fines was estimated at Rs 12,748 crore<sup>11</sup>. These revenues formed 3.07 per cent of publicly raised resources, the shares of the central government and all state governments combined being 57.5 per cent and 39.5 per cent respectively. As a percentage of the combined gross state domestic product (GSDP), own revenues of municipalities represented 0.63 per cent.

Over the 1997–8 to 2001–2 period, the size of the municipal sector has registered a marginal expansion, both in terms of its share in the total publicly-raised revenues and combined GSDP. Municipal share in the total revenues of the three tiers of government rose from 2.84 per cent in 1997–8 to 3.07 per cent in 2001–2, while relative to GSDP, its share increased from 0.61 to 0.63 per cent during the same period. Municipal own revenues (nominal terms) increased

<sup>10</sup> State limits on local revenue raising authority is, of course, neither new, nor only a feature of India's federal structure. In the USA, property tax limits began in the nineteenth century, originating in Rhode Island (1870).

<sup>11</sup> Adjusted for the total urban population of all states.

## Box 5.1

## International Comparisons of Local Government Revenues

International comparisons of local government revenues are usually hazardous on account of the definitions of local governments that different countries use; however, we present here some figures on the position of local government revenues relative to other tiers of government and relative to the country's GDP.

Table B5.1.1  
Revenue Importance of Three Levels of Government, 1993–6

Country	Local government revenues as per cent of total government revenues	Local government revenues as per cent of GDP
Australia	5.21	0.02
Austria	17.43	0.10
Brazil	4.31	0.05
Canada	12.15	0.10
Germany	13.42	0.10
Mexico	5.58	0.01
South Africa	10.55	0.04
Spain	10.61	0.06
Switzerland	20.72	0.10
USA	15.87	0.09

Source: Ebel (2001)

at an annual average growth rate of 10.32 per cent. The same conclusion emerges when we look at the aggregated expenditure levels of municipalities. As a proportion of the GSDP, municipal expenditures have risen gradually from 0.74 per cent in 1997–8 to 0.75, 0.77 and 0.75 per cent respectively in the successive years (Figure 5.1).



Fig. 5.1 Relative Shares of Municipal Revenues

Source: Om Prakash Mathur and Sandeep Thakur (2004). *India's Municipal Sector*, National Institute of Public Finance and Policy, New Delhi.

Two comments on the aggregate performance seem necessary. First, the municipal sector in India in terms of what the municipalities generate and what they spend is *tiny*, and represents in a sense the inter-governmental allocation of functions and fiscal powers between the three tiers of government under which the municipalities have access to relatively less buoyant and less elastic sources of revenue. This conclusion holds even under the assumption that inefficiencies in tax collection at the municipal level may be higher when compared to the other two levels<sup>12</sup>. At the same time, the fact cannot be denied that the performance of municipalities measured on the basis of municipal own revenues/expenditure relative to the combined GSDP has improved marginally over the five-year period. Second, although municipal revenue expenditures have risen at an annual average growth rate of 10 per cent—a shade lower than the own revenues of municipalities—these are grossly insufficient for maintaining

<sup>12</sup> There is no robust empirical evidence that tax inefficiencies at the level of municipalities are higher. However, the evidence from the USA does indicate that there may at this level be greater inefficiencies; indeed, because of this, reliance on user charges has increased in the USA while the role of taxes in maintaining municipal services has declined (Goetz 1993). A recent study on property taxes in India also shows that property tax collections to tax demanded are 50 to 55 per cent, while taxes collected by states yield a better collection ratio.

services at minimum levels. Compared with the Zakaria Committee norms, the current level of municipal expenditure, placed at Rs 577 per capita in 2001–2, is about 130 per cent lower; one of the key manifestations of the underspending of this magnitude is the low level of services in India's cities and towns. The Zakaria Committee norms, it should be noted, relate to water supply, sewerage and sewage disposal and storm water drainage, roads and footpaths and other services, but excludes garbage collection, which is a major local government expenditure<sup>13</sup>. In estimating the deficit, observed expenditure on garbage collection has been reckoned as a norm (Zakaria 1963).

### REVENUE-BASED PERFORMANCE

Internal resource mobilization is the principal criterion for measuring the performance of municipalities. It represents the combined effect of the fiscal powers and sector's capacity utilization. It is also a measure of the capacity of municipalities to effectively put to use their fiscal powers. Municipalities in India have added Rs 4141.56 crore to their 1997–8 own revenue base; here we analyse the state-wise position to see which states contributed most to the own revenues of municipalities, using per capita own revenues and annual average growth rates. Table 5.1 gives the requisite data.

Table 5.1  
Internal Resource Generation

State	Internally generated resources (Rs lakh) 2001–2	Per capita (Rs) 2001–2	AAGR 1997–8 to 2001–2	As per cent GSDP	
				1997–8	2001–2
Andhra Pradesh	71,745.7	386.8	14.5	0.42	0.48
Assam	3825.8	153.3	9.1	0.12	0.12
Bihar	3408.4	39.5	(–)2.7	0.07	0.07
Chhattisgarh	12,555.3	321.6	11.3 <sup>a</sup>	–	0.41
Goa	1858.7	510.6	15.9	0.20	0.26
Gujarat	1,44,849.2	809.4	5.1	1.30	1.16
Haryana	12,106.9	207.8	3.6	0.27	0.20
Himachal Pradesh	1978.9	335.6	14.5	0.13	0.15 <sup>b</sup>
Jammu & Kashmir	1199.0	48.2	21.5	0.05	0.08 <sup>b</sup>
Jharkhand	1496.2	39.5	10.7 <sup>a</sup>	–	0.05 <sup>b</sup>
Karnataka	56,349.7	322.0	25.2	0.29	0.51
Kerala	22,432.8	371.1	11.2	0.29	0.29
Madhya Pradesh	29,437.0	188.7	(–)4.1	0.44	0.36
Maharashtra	5,87,058.3	1493.3	11.9	1.88	2.16
Manipur	224.0	41.6	(–)3.7	0.12	0.06
Orissa	10,176.8	194.5	3.8	0.27	0.24
Punjab	75,381.2	932.4	20.2	0.69	1.07
Rajasthan	10,339.7	80.7	(–) 27.8	0.49	0.12
Tamil Nadu	92,013.0	355.5	9.9	0.60	0.62
Tripura	217.7	58.9	19.6	0.03	0.04
Uttaranchal	2320.6	113.7	10.0 <sup>a</sup>	–	–
Uttar Pradesh	26,551.0	79.5	11.2	0.12	0.14
West Bengal	42,201.7	215.8	8.1	0.31	0.27
Total	12,09,727.8	482.1	10.5	0.65	0.71 <sup>b</sup>

Notes: <sup>a</sup>Annual average growth rates (AAGR) for these states are for one year, that is, 2000–1 and 2001–2. <sup>b</sup>For 2000–1.

Source: Same as Figure 5.1

<sup>13</sup> The Zakaria Committee average per capita annual norms for maintaining municipal services at 2001–2 prices are Rs 194.69 for water supply; Rs 218.8 for sewerage; Rs 37.63 for roads; and Rs 52.79 for street-lighting. In comparing with the current levels of

municipal expenditures, adjustments have been made to account for expenditure on establishment and such services as garbage disposal, which are otherwise not accounted for in the Zakaria Committee recommendations.

The table shows a large variation across states in the performance of municipalities based on the criterion of own revenues: municipalities in Bihar having an annual per capita revenue generation of Rs 39.5 compared with Rs 1493 generated by municipalities in Maharashtra. There are states—Goa, Gujarat, Maharashtra, and Punjab among them—whose per capita own revenue averages are close to or in excess of the country-wide average of Rs 482 per capita. Many states Andhra Pradesh, Karnataka, Kerala, Maharashtra, Punjab, and Uttar Pradesh have posted high annual growth in own revenues. If we classify the states using the per capita and annual growth rates together, we obtain a configuration which shows that Punjab, Karnataka, Goa, Andhra Pradesh, Maharashtra, Himachal Pradesh, and Kerala are among the better performing states, while others, particularly West Bengal, Orissa, Bihar, Haryana, Madhya Pradesh, Rajasthan, and Manipur have not performed well on these two criteria over the five year period under review. The municipalities in the first category contributed 82.2 per cent of the total accretion that took place in the own revenues of municipalities over the 1997–8 and 2001–2 period; other states contributed the balance with at least four states having contributing negatively to the pool of municipal revenues. The per capita own revenues of municipalities in Bihar, Madhya Pradesh, Manipur, and Rajasthan dipped, although in at least three cases, the decrease was due to reasons exogenous to the municipal system (for example, division of the state, abolition of octroi etc.).

When municipal own revenues are analysed relative to the GSDP, we note that the link between municipalities and states economies is extremely weak, indeed, almost non-existent in Assam, Bihar, Jharkhand, Rajasthan, and even Uttar Pradesh. Only in a few states such as Andhra Pradesh, Gujarat, Karnataka, Maharashtra, Punjab and Tamil Nadu have the own revenues–GSDP ratios in excess of 0.40 per cent. These ratios have shown a marginal improvement in these states over the five-year period (Table 5.2).

Disparities in municipal performance across states are extraordinarily large, and have accentuated over the first, initial phase of decentralization. In 2001–2, municipalities in Maharashtra, for instance, with a share of 14.4 per cent in total urban population accounted for 48.5 per cent of the total revenue resources that are generated by all municipalities in the country. Municipalities in Gujarat account for 12 per cent of the total municipal own revenue, while those in Tamil Nadu, Punjab, Andhra Pradesh, and Karnataka raise 7.61 per cent, 6.23 per cent, 5.93 per cent and 4.66 per cent respectively. The share of the remaining states, which have over 50 per cent of the country's urban population is a meagre 15 per cent of the aggregate revenues raised by all municipalities in the country.

The benefit approach to local government finance implies that the services that they are responsible for and provide,

Table 5.2  
Municipal Own Revenues

State	Share in urban population (per cent), 2001	Share in own revenues (per cent), 2001–2	Share in net addition to own revenues over 1997–8 to 2001–2
Andhra Pradesh	7.39	5.93	7.62
Assam	0.99	0.32	0.28
Bihar	3.44	0.28	-0.10
Chhattisgarh	1.56	1.04	3.03
Goa	0.15	0.15	0.21
Gujarat	7.13	11.97	6.40
Haryana	2.32	1.00	0.39
Himachal Pradesh	0.24	0.16	0.21
Jammu & Kashmir	0.99	0.10	0.17
Jharkhand	1.51	0.12	0.36
Karnataka	6.98	4.66	8.64
Kerala	2.41	1.85	1.96
Madhya Pradesh	6.22	2.43	-1.27
Maharashtra	15.67	48.53	53.74
Manipur	0.21	0.02	-0.01
Orissa	2.08	0.84	0.34
Punjab	3.22	6.23	10.08
Rajasthan	5.11	0.85	-5.08
Tamil Nadu	10.32	7.61	7.29
Tripura	0.15	0.02	0.03
Uttaranchal	0.81	0.19	2.31
Uttar Pradesh	13.30	2.19	0.56
West Bengal	7.80	3.49	2.83
Sample states	100.00	100.00	100.00

Source: Same as Figure 5.1

should be paid for by those who benefit from them (Bird 1976). For reasons of efficiency, charges are levied on those who receive the benefits where it is possible to identify the beneficiaries, unless there is a strong policy argument to the contrary. The importance of charging for municipal services goes beyond the revenues that can be collected from such sources. Notwithstanding its obvious relevance, few municipalities in India make effective use of user charges than would seem necessary and desirable. In 2001–2, the non-tax component was 25 per cent of the total own revenues of municipalities, and although its proportion has risen from 20.95 per cent in 1997–8, it is very low when compared to the large array of the chargeable services that are offered by

municipalities. There is a greater reliance on tax sources whose tax base and rates are almost universally set by the state governments. Examples of a few states are especially relevant here. In Andhra Pradesh and Karnataka, municipal effort in accelerating both tax revenues and non-tax revenues over the 1997–8 and 2001–2 period has been far greater than in other states, and is reflected in the annual average growth rates. In other states such as Assam, Bihar, Madhya Pradesh, Tamil Nadu, Uttar Pradesh, and West Bengal, little effort has been made to make use of charges, fees, etc., and this component has remained stagnant.

Three points deserve to be emphasized. First, interstate disparities in the performance of municipalities are extraordinarily large and have risen over the 1997–8 to 2001–2 period. Improvement in the performance of municipalities is limited to a few states such as Andhra Pradesh, Goa, Gujarat, Karnataka, Maharashtra, and Punjab, and to a minor extent, Kerala and Tamil Nadu. Own revenues of municipalities in other states have either stagnated or experienced deterioration in their revenue-raising capacity. Second, even when there is general acceptance of the relevance of the benefit principle, municipalities in India make far less use of user charges than would seem necessary and desirable; further, many of the charges that are levied bear no relationship with the costs that are incurred on service provision<sup>14</sup>. Finally, municipalities have weak links with the economy of states; it is evident from the ratio of own revenues to the GSDP.

### TRANSFER-BASED PERFORMANCE

State transfers to the municipal governments own revenues of municipalities to constitute the total fund availability. The fund represents municipal revenue-raising effort on the one hand, and on the other, they comprise what the state governments consider necessary to transfer in order to enable municipalities maintain and operate services at some acceptable or normative levels. Transfers have several roles, the foremost being to bridge the gap, since it would be unusual for the revenue-raising capacity of municipalities to be perfectly matched with their expenditure needs. In principle, such vertical gaps are possible to be closed by assigning additional tax powers to municipalities, or reducing service standards. However, most governments prefer transfers, which enable municipalities to provide services at prescribed levels, and also to influence their spending patterns and reduce spatial inequalities in services. Here, we analyse the role of transfers

<sup>14</sup> Several state governments have submitted that weak accounting systems do not permit them to clearly identify the cost incurred on service provision. In part, it may explain why many municipal services are underpriced.

in a limited way: to what extent are the state-transfers able to supplement the resources of municipalities to enable them perform mandated functions and responsibilities?

Note should be taken of the fact that during the period 1997–8 to 2001–2, state transfers to municipalities were characterized by a high degree of fluctuation, partly on account of the acceptance by the Government of India and thereafter by state governments of the recommendations of the fifth pay commission and their gradual extension to local bodies, in part due to abolition or part abolition of octroi, and in part by the implementation of the recommendations of the finance commission of states (SFCs). Transfers to municipalities have in the past been marked by unpredictability and instability, and notwithstanding attempts to bring some stability in the intergovernmental relations, transfers have continued to be characterized by trends that are far from secular (Table 5.3). Ambiguities between the different components of transfers are also noted, for example, the lack of distinction between capital account and revenue account transfers and further confusion that is caused by plan and non-plan transfers on many heads.

We provide above, key statistics that throw light on the role of transfers in the finances of municipalities. There are a number of important features that we note from the Table 5.3. First, transfers are an important constituent of the finances of municipalities in India, their share in the revenues of municipalities being 31.7 per cent (2001–2). This is, however, the average; municipalities in several states are almost entirely transfer-dependent for running of local services. In this category are those that have historically been dependent on state transfers such as Bihar, Himachal Pradesh, Jammu & Kashmir, Uttar Pradesh, West Bengal, and Tripura; and those whose dependency on state transfers has risen in recent years, for example, municipalities in Haryana, Orissa, and Rajasthan. Second, the importance of transfers in the finances of municipalities has risen over the past five years. The expectation that functional devolution will be accompanied by a corresponding transfer of fiscal powers has not been realized. In the octroi-levying states of Gujarat, Maharashtra and Punjab, transfers as a proportion of total municipal revenues are, as would be expected, low compared to other states, although as would be seen, transfers have shown a rising trend in Gujarat and Maharashtra, with the abolition of octroi in parts of the states. Finally, from a macro-perspective, it would be expected that the state governments would supplement the resources of municipalities on grounds of an imbalance between expenditure and revenue assignments, or for reasons of cost disadvantage. Thus, if the aggregate per capita annual own revenue of municipalities in Bihar are a mere Rs 39 or in Rajasthan where it has plummeted from a high of Rs 272 in 1997–8 to Rs 80 in 2001–2, and to the extent such low levels

Table 5.3  
Role of Transfers in Municipal Finances

State	Transfers (Rs lakh), 2001–2	Per cent of total municipal revenues, 2001–2	AAGR per cent 1997–8 to 2001–2	Per capita transfers (Rs), 2001–2
Andhra Pradesh	31,784	30.7	12.4	171.4
Assam	1624	29.7	16.7	65.1
Bihar	5559	62.0	-0.5	64.4
Chhattisgarh	12,624	50.1	-	323.3
Goa	941	33.6	11.0	258.6
Gujarat	31,395	17.8	14.6	175.5
Haryana	7892	39.5	18.6	135.5
Himachal Pradesh	2787	58.5	0.7	472.6
Jammu & Kashmir	6162	83.7	16.2	247.6
Jharkhand	2440	62.0	-	64.4
Karnataka	60,859	51.9	14.5	347.7
Kerala	17,949	44.5	3.4	296.9
Madhya Pradesh	37,663	54.8	-2.1	241.4
Maharashtra	94,177	13.8	22.8	239.6
Manipur	195	46.5	33.1	36.1
Orissa	8047	44.2	22.4	153.8
Punjab	8489	10.1	9.7	105.1
Rajasthan	51,703	83.3	38.6	403.5
Tamil Nadu	46,770	33.7	-2.8	180.7
Tripura	1,100	83.5	5.6	297.8
Uttanchal	5,105	63.7	-	250.1
Uttar Pradesh	77,488	74.5	14.4	232.1
West Bengal	50,203	54.3	14.1	256.7
Sample states	5,62,958	31.7	13.5	224.4

Source: Same as Figure 5.1

are attributable to factors that are exogenous to the municipal system, there would seem to be a justification for inter-governmental transfers.

### SCALE AND STRUCTURE OF MUNICIPAL EXPENDITURE

Revenue expenditure is a proxy for service levels. The higher the expenditure, it is assumed, the higher are the levels of services. We look at the expenditure levels of municipalities in terms of size and trends, and also in terms of composition in an attempt to distinguish between expenditure on establishment and wages and salaries, that is, the non-discretionary component from other discretionary expenditures consisting of expenditures on the operation and maintenance of services. Table 5.4 provides the key data in this respect.

The performance of municipalities on the criterion of expenditures runs along the same track as that of own revenues

or even total municipal revenues. Maharashtra, Punjab, Gujarat and Goa post relatively high per capita expenditures and higher expenditure ratios to the gross domestic product of states. Other states that show medium levels of expenditures comprise Andhra Pradesh, Kerala, West Bengal, and Tamil Nadu. Further examination of the per capita municipal revenue expenditures shows that the expenditure levels are low and depressed in such states as Manipur, Bihar, Jharkhand, Assam, and Uttar Pradesh, and are lower compared to the Zakaria Committee norms even in such states as Himachal Pradesh, Gujarat, Punjab, and Goa. On average, underspending in relation to the Zakaria Committee norm is 130 per cent, which is one factor that explains the extremely low level of services and consequently, the deplorable living conditions in cities and towns (see footnote 13).

We analyse below the performance of municipalities on the basis of two supplementary criteria, namely: (i) expenditure on establishment and salaries, and (ii) operations and

Table 5.4  
Per Capita Revenue Expenditure

State	Per capita revenue expenditure 2001–2	Annual growth rate (per cent), 1997–8 to 2001–2	per cent of GSDP, 2001–2
Maharashtra	1253.71	6.51	1.82
Punjab	1008.12	17.22	1.15
Himachal Pradesh	955.45	13.02	0.38 <sup>a</sup>
Gujarat	865.12	7.11	1.24
Goa	604.18	13.24	0.31
Andhra Pradesh	508.88	14.47	0.63
Kerala	493.17	10.65	0.39
West Bengal	487.49	10.33	0.61
Tamil Nadu	481.79	0.96	0.84
Madhya Pradesh	427.66	-2.59	0.82
Karnataka	418.29	11.32	0.67
Uttaranchal	399.77	–	–
Jammu & Kashmir	392.69	19.86	0.52 <sup>a</sup>
Rajasthan	390.36	7.30	0.56
Chhattisgarh	376.07	–	0.49
Tripura	356.75	7.09	0.37
Orissa	355.06	13.87	0.43
Uttar Pradesh	275.18	9.54	0.49
Haryana	255.23	1.45	0.25
Assam	211.79	5.21	0.16
Jharkhand	87.20	–	0.11 <sup>a</sup>
Bihar	87.20	5.53	0.15
Manipur	81.03	4.90	0.22
Sample states	576.71	7.36	0.85 <sup>a</sup>

Note: <sup>a</sup>The figures are for 2000–1.

Source: Same as Figure 5.1

maintenance expenditure. Note should be made of the staff-intensive nature of municipal operations. For instance, solid waste collection and management is vastly labour intensive, with the exception of a few large cities where mechanized collection has replaced manual lifting of garbage. Therefore, high proportion of expenditure on establishment is commonly observed among municipalities in most states.

Expenditure on establishment (salaries and wages) accounts for 54.2 per cent of the total municipal expenditure. In several states, however, it is as high as 80.4 per cent (Madhya Pradesh), Haryana (69.7 per cent), Orissa (50.6 per cent), West Bengal (65.0 per cent), Rajasthan (63.2 per cent), and Uttar Pradesh (60 per cent). Bihar stands at only 43 per cent because of unpaid salaries. There exist no norms with respect to the division of expenditure between establishment and operations and

maintenance, and therefore, it is not possible to ascertain if these proportions are, in any way, excessive.

Expenditure on establishment and wages and salaries in several states is in excess of what the municipalities collect by way of taxes, levies, duties, etc. These states are unable to recover even the establishment cost, let alone able to maintain services. Inability to recover from taxes and rates and charges even the establishment costs is one of the key failings of municipalities in India. This is the case with Himachal Pradesh, Madhya Pradesh, Rajasthan, Uttaranchal, Uttar Pradesh, West Bengal, Manipur, and Tripura. They depend on state governments for meeting the establishment costs as may be seen below.

An important consideration in assessing the performance of municipalities is the revenue surplus after accounting for establishment costs, that is, wages and salaries. The higher the surplus, the greater is the flexibility and discretion with municipalities for operating and maintaining services. Establishment costs average 54–5 per cent of the total municipal expenditure. However, several states are able to post a higher surplus, and are evidently able to use these surpluses for operation and maintenance of services.

Operations and maintenance of services such as water supply and sewerage systems, management of solid waste, street lights, roads and the like are key functions of municipalities in India as these are in other countries. The level of expenditure on operations and maintenance is an important indicator of the quality of services. On average, operations and maintenance expenditure accounts for 39.93 per cent of the total municipal expenditure. Several states, Andhra Pradesh, Goa, Gujarat, Himachal Pradesh, Maharashtra, and Punjab among them, however, spend substantially higher amounts than the average per capita. At the other end are states where municipal spending on operations and maintenance is low, both in per capita terms as also as a percentage of total expenditure. These include Assam, Chhattisgarh, Manipur, Rajasthan, Tripura, Uttaranchal, and West Bengal. In per capita terms, the operation and maintenance expenditures are abysmally low in Bihar, Jammu and Kashmir, Jharkhand, Manipur, Tripura, and Uttar Pradesh, and manifest themselves in poor level of municipal services.

## REVENUE–EXPENDITURE BALANCE

Municipalities in India are statutorily required to maintain a balanced budget, even a surplus in several states. However, an accurate accounting of municipal finance accounts stands hampered by a cash-based accounting, which makes it difficult to track and incorporate outstanding payments, and absence of distinction between capital account and revenue account receipts and expenditures. A number of municipalities in several states do not remit dues to the state governments, which enable them to post large surpluses over expenditure. It is important to point out that even when the finances of municipalities are

in shambles, their accounts show accounting surpluses. Observations of the State Finance Commission, Rajasthan on this subject are pertinent:

A comparison of the income and expenditure for 1993–4 for individual category of ULBs, though shows a surplus, the reality is different. The ULBs have devised a system for financing these activities by diverting employees' PF/Pension amount to other heads of expenditure. It is clear that the apparent category-wise surplus position reflected by the ULBs do not reflect the truth and in reality, the municipalities at all levels have deficit because of their default on deposition of PF/Pension amount<sup>15</sup>.

Report of the First State Finance Commission,  
Rajasthan (1995–2000)

Most states would fall in this category. Given these limitations, the key conclusions that emerge are:

1. Expenditure levels on services provided by municipalities across states are low when these are compared with the norms established by the Zakaria Committee in 1963. Even independent of norms, average per capita expenditures (daily) ranging between Rs 0.20 and Rs 2.25 cannot by any standards, be expected to deliver services that would satisfy the needs of either the urban households or other non-domestic consumers. Although the costs of inadequate services in the Indian context are not estimated, these are, from all accounts, high.
2. Own revenues of municipalities are insufficient to meet the revenue account expenditures. With the exception of Maharashtra and Gujarat, there is no state where municipalities are able to raise revenues that are adequate for meeting expenditures. The expenditure–revenue gap is particularly high in such states as Madhya Pradesh, Rajasthan, Uttar Pradesh, and West Bengal.
3. While the overall per capita expenditure–revenue gap (expenditure–own revenues) has declined over the period 1997–8 and 2001–2—per capita expenditure has risen at an annual average growth of 7.36 per cent as compared to a growth rate of 8.60 per cent for revenue receipts—increasing pressures are noted in several states where deficits are large and have simultaneously shown increasing trends, for example, Rajasthan, West Bengal, Madhya Pradesh, and special states such as Himachal Pradesh, Jammu & Kashmir, and Tripura.
4. When we analyse the revenue–expenditure balance by incorporating the state transfers, then, in the aggregate, municipalities show a surplus of Rs 132.72 per capita.

<sup>15</sup> Report of the First State Finance Commission, Rajasthan (1995–2000), December 1995, Jaipur (p.227).

However, whichever criterion is applied to assess the performance, better performance is observed in the municipalities of Gujarat, Maharashtra, and Punjab, and to some extent of Andhra Pradesh, Karnataka, and Kerala. Municipalities in other states have either stagnated or deteriorated on most fiscal criteria.

Somewhat crudely, municipalities would seem to fall into three groups: (a) those that have a comparatively larger functional role and an equally large fiscal domain; (b) those that have a comparatively larger functional domain, but a narrower fiscal base; and (c) those that have a larger fiscal domain but a narrower functional jurisdiction. This fact would explain, in a significant way, why the levels of revenue incomes and expenditures are high in Gujarat and Maharashtra and low in other states. Municipalities in Gujarat and Maharashtra are responsible for water supply and sewerage system; they run hospitals, transport services and other higher order services. Likewise, they have access to octroi, which provides large revenues, enabling them to run these services.

Octroi levies are a major determinant of the level of revenue incomes. In the municipal corporations of Gujarat and Maharashtra and municipality of Punjab, octroi levies constitute the main revenue source for municipalities. Abolition of octroi over the past five years without assigning to municipalities a substitute has shrunk the revenue base of municipalities in Haryana, Orissa, Rajasthan, and seriously affected the revenue profile of municipalities in Gujarat and Maharashtra. An indication of the shrinkage is possible by looking at the octroi compensation of municipalities in some of these states (Table 5.5). The municipal performance in these states stands adversely affected by the abolition of octroi. Evidently, on own revenue account, their performance ranking would be different if octroi receipts were included<sup>16</sup>.

If we were to explore the other factors that might influence the revenue performance of municipalities we would come

Table 5.5  
Octroi in the Finances of Municipalities, 2001–2

State	Octroi compensation (Rs lakh)	Impact of octroi on municipal own revenue base (per cent)
Haryana	6479.6	53.5
Orissa	9482.6	93.2
Rajasthan	37,036.1	358.2

Source: Same as Figure 5.1

<sup>16</sup> It was suggested to us that octroi compensation should be treated as a part of own revenues of municipalities. However, for purposes of this study, we have maintained it as a part of transfers under the category of compensatory grants.

up with interesting findings. We hypothesize here that the scale of urbanization and GSDP have a vital impact on the finances and financial performance of municipalities. The more urbanized a state, higher would be the level of municipal incomes and consequently the expenditures; similarly, a higher GSDP is a function of the quality and quantity of municipal and urban infrastructure. We have run correlations between own revenues of municipalities, levels of urbanization (also the proportion of urban population in cities having one lakh plus population), and gross domestic product of states, for the initial year 1997–8 and the terminal year of the study, that is, 2001–2. Results of correlations suggest that these do indeed cast an influence on the fiscal and financial health of municipalities, measured in terms of incomes and expenditures (Table 5.6).

Table 5.6  
Correlation Coefficients

Correlation between	1997–8	2000–1
Per capita own revenues of ULBs and level of urbanization	–	0.61
Per capita own revenues of ULBs and share of class I cities in total population	–	0.63
Per capita own revenues of ULBs and per capita GSDP (current)	0.50	0.51

Source: Same as Figure 5.1

## URBAN INITIATIVES AND MUNICIPAL PERFORMANCE

How do the three tiers of government respond to municipal fiscal crises and the problems of service delivery and management? How do they address issues of stagnating tax revenues at municipal levels, growing service deficits, and indifference on the part of users to municipal, publicly-provided services?

The past 6 to 7 years have witnessed in India an extraordinarily large number of initiatives that are aimed at improving the finances and functioning of municipal governments. Indeed, at no time in recent decades have so many initiatives been taken by the different levels of government for reforming the municipal system and attempting to bring them into the country's development mainstream. In 2001, for example, the central government inserted a new clause (vii) to Section 10(5) of the Income Tax Act, 1961 under which bonds issued by the local authorities were exempted from income tax.

Many state governments have changed the system of property taxation and are in the process of shifting from a single entry, cash based system to an accrual based accounting

system. At least nine city corporations have raised funds in the capital market for financing city-based infrastructure activities, by using credit enhancement instruments. Many of them have entered into partnerships with the private sector with the primary objective of improving service delivery and management. It is a long menu of initiatives that have been documented to register what city governments have done in recent years to respond to the problems that they are faced with. Indore Municipal Corporation, which took active initiative in this direction was able to increase its revenue in excess of 100 per cent over five year period (Box 5.2).

In this section, we look at some of the major steps. These are discussed under three heads, that is, (a) those that are meant to enhance the revenue base of municipalities, mainly the property tax, (b) those that have taken steps to enter the capital market, and (c) those that are concerned with institutional changes for improving service delivery and management.

### Property Taxation

Recognizing that proper management of the property tax system is crucial for improving revenue generation, several state governments have introduced important changes in the legal and policy framework of municipalities in order to de-link property taxes from standard rent and rent controls. The Government of Andhra Pradesh has replaced the concept of reasonable rent with an area-based system that takes into account the location, construction type, plinth area, age and use of property. The Government of Gujarat has amended the Bombay Provincial Municipal Corporation (BPMS) Act, and changed the basis of property tax assessment from annual rateable value (ARV) to a per square metre rate, applicable on the carpet area of buildings and land. Rate of tax depends on the location, use, the age of the building, type of building, and type of occupancy. The Government of Karnataka has modified the municipal acts to bring in capital valuation in place of ARV, wherein land is to be assessed as per the market value notified by the Government under the Stamp Duty Act, and the constructed part is to be valued on the basis of cost of construction. Other states that have undertaken property tax reforms include Uttar Pradesh and Tamil Nadu, and Patna Municipal Corporation.

An important feature of the unit area system now applicable in Andhra Pradesh, Gujarat, Tamil Nadu, and Uttar Pradesh and under consideration in other states is that it has reduced the discretion of municipalities in assessing property values. The focus of this measure is thus on reducing rent-seeking components and not entirely on revenue mobilization. In most states, these changes have meant higher property tax revenues; however, since the higher property tax revenues are the result of the unit area system as well as tax revenues earned from

## Box 5.2

## Increasing Municipal Revenues: Case of Indore

Chetan Vaidya

Indore, with a population of 1.6 million, is the largest city in the state of Madhya Pradesh. Six years ago the corporation embarked upon a modernization plan, developed with extensive citizen participation, to increase revenues and improve urban services. The IMC entered into an agreement with the FIRE-D project in 2000 to help it mobilize resources needed to meet them. The measures described below increased revenue from its own sources from Rs 34 crore in 1999–00 to Rs 75 crore in 2003–4. Total revenue increased correspondingly from Rs 101 crore to Rs 184 crore, thus, reducing its dependence on state transfers to provide municipal services.

*Increasing Revenues*

The IMC's own sources of revenue are primarily property taxes and water tariffs, with smaller amounts from business licences, shop rents, and advertisement taxes.

*Property tax improvements:* To reform its property taxes, which average almost 50 per cent of the city's own source income, the IMC shifted to a simpler, mass assessment method and introduced self-assessment of properties by taxpayers in 1997. Taxpayers provide information about their property, such as its location, size, age, and use, into a formula-based program that calculates what they owe.

The IMC contracted with a private firm in 2001–2 to conduct a physical survey of properties in all wards to identify unregistered properties and add them to the property database. The surveyors also helped owners fill out their self-assessment forms. The number of properties registered nearly doubled in four years, from 135,000 before the survey to 236,000 in 2003. Revenues increased due to simplified and more equitable assessments, better administration, increased coverage and billing, and more efficient collections and enforcement (described below). Complementary measures, such as verifying tax records at registration when properties were sold, and requiring that payments be made by 31 December helped. In addition, assessment rates, especially of commercial properties, were revised after a considerable period.

*Water charges improvements:* It was estimated that there were approximately 80,000 illegal water connections, compared to 120,000 legal connections. The IMC identified legal/illegal water connections during its physical survey of properties. It compared its water charges and property databases to identify residences that were not receiving or paying water bills. And it calculated arrears owed. The IMC improved collections and enforcement.

The following steps played important role in turning around the municipal finances.

*Leadership:* Strong and sustained commitment of political and executive leaders was the critical element of Indore's success. The city's first directly elected mayor, demonstrated leadership by starting the citywide visioning process that resulted in a modernization plan supported by the citizens. The municipal commissioners, demonstrated leadership by initiating the reform process and working through the comprehensive administrative changes required to make the tax administration process efficient and transparent.

*Computerizing and comparing databases:* Making progress requires accurate baseline data and consistent tracking. The IMC contracted with a private data operator of Indore in 1998–9 to make the technology changes to improve tax administration quickly and effectively. The firm, under a type of build-own-operate-transfer agreement, set up new computer systems and created taxpayer and property databases. Databases were designed in compatible format so they could eventually be linked to each other. Cross-checking data from different sources helped strengthen billing and collection. The system was designed to facilitate collections; taxpayer information could be accessed in zonal offices.

*Restructuring the Revenue Department:* To strengthen its collection efforts, the IMC brought all billing and collection together in one department, removing them from the functional departments, in 2002. The city then reorganized the Revenue Department into two new departments: the Assessment Department and the Recovery Department. A Vigilance Team was constituted under the Recovery Department. Three smaller departments, Survey, Encroachment and Markets, were also created.

At the same time, the IMC decentralized collections by introducing cash collection counters in the 11 zonal offices and strengthened collection by staff in the field. People-friendly collection systems helped motivate citizens to pay taxes.

*Training staff and building capacity of local officials:* The IMC, developed a training programme for elected representatives and all staff of the Assessment and Recovery Departments. The course covered the role and functions of the Revenue Department, duties and behaviour of staff, the property tax assessment system, an online computer exercise on tax assessment, legal issues in assessment, and control and coordination.

*Improving accounting, budgeting, and financial management:* The corporation adopted a double entry, accrual system of accounting in 1999–2000 and is computerizing accounting activities. These changes will enable the IMC—and potential investors—to assess its financial position more accurately.

*Carrying out a communications strategy:* The corporation, under its first directly elected mayor, realized that the success of its efforts depended on citizen cooperation and willingness to pay for improved urban services. Officials conducted intensive outreach to citizens, meeting with resident associations. They also used multiple media channels, including newspapers, radio, cable television, short messaging service (through mobile phones), billboards along major roads, its website, and email to spread their messages. These campaigns helped bring about attitudinal change and paved the way for the reforms' acceptance.

*Note:* Views expressed here are of the author of the box.

new properties, the share of the new property tax system is not possible to be separately identified (Mathur 1996).

### Accounting System

Many state governments have begun to change their accounting systems. Municipalities in India have historically used a single entry cash based system, which is nothing but a statement of income and expenditure. It fails to capture the receivables and payables, and denies an accurate assessment of the financial position of municipalities as well of their assets and liabilities. Beginning with Tamil Nadu where a double entry system has been universally applied to all municipalities, states such as Andhra Pradesh, Gujarat, Karnataka, Madhya Pradesh, and Rajasthan have begun to improve the municipal accounting system in specific locations, for example, Hyderabad, Ahmedabad, Anand, Vadodra, Bangalore, Indore, and Jaipur. These reforms are diverse, and involve standardization of budgeting formats, inventory of assets, preparation of budget manuals, classification of accounts into different funds, zero-based budgeting, and the like (see Box 3.3).

### Accessing the Capital Market

The most notable initiative in the municipal sphere has been the emergence of a municipal bond market. Propelled by the report of the Expert Group of Commercialization of Infrastructure Projects in 1996, which proposed adoption of a commercial approach to municipal infrastructure and the follow-up groundwork, the Ahmedabad Municipal Corporation became the first municipality in the country to issue bonds of Rs 100 crore at 14 per cent interest payable semi-annually. Following this example, a number of municipal entities and parastatals have since accessed capital market funds, with the back-up of CRISIL and two credit rating agencies, namely ICRA Ltd. and CARE, who have developed systems for evaluating the creditworthiness of municipalities. The nine municipalities, which have accessed the capital market

have thus far been able to raise Rs 618.5 crore, by issuing bonds. An important feature of municipal bonds is that with the exception of bonds issued by the Bangalore Municipal Corporation and Indore Municipal Corporation, other bonds have been issued without a state government or a bank guarantee. Traditionally, lenders to municipal entities in the infrastructure sector have sought a state or a sovereign guarantee as an important security mechanism. The fact that municipal entities have begun to raise resources in the capital market on the strength of their own credit standing and credit enhancements based on the escrowing of the cash flows indicates a growing acceptance in India of municipal bonds as an instrument for raising resources for financing infrastructure projects (Table 5.7). Municipal bonds in India are securitized debt instruments, providing future revenue flows from the projects as collateral (Mathur and Ray 2003)<sup>17</sup>.

### Institutional Reform

Public–private partnership has emerged as an effective mode of delivering and managing municipal services. It owes itself in part, to the worldwide trends towards downsizing and restructuring of the public sector, and in part, to the locally evolving environment wherein the municipal governments have begun to look beyond their administrative apparatus for discharging the numerous functions they are responsible for. Municipal governments in India which are endowed with statutory powers to provide many services have reached a point where they are unable to deliver services for reasons that are traceable to their narrow revenue base, institutional and procedural deficiencies, and limited staff capacities. It is in

<sup>17</sup> Note should be made of the new ways for municipal borrowing. Cities can now borrow large sums on short terms that continue for years. Enhancements can reduce interest rates. Derivatives are a more recent development that can involve combination of transactions such as swapping long term fixed rate payments for short term variable payments. Derivatives allow city governments to create a wide variety of bond structures, which are not possible with a single instrument.

Table 5.7  
Municipal Bonds

City	Amount (in Rs million)	Placement	Guarantee	Interest (per cent)	Escrow	Purpose	Rating
Ahmedabad	1000	Public and Private	No	14	Octroi from 10 octroi collection points	Water supply and sanitation project	AA-(SO)
Bangalore	1250	Private	State government	13	State government grants and property tax	City roads, street drains	A-(SO)
Ludhiana	100	Private	No	13.5 to 14	Water and sewerage taxes and charges	Water supply and sanitation project	LAA-(SO)
Nagpur	500	Private	No	13	Property tax and water charges	Water supply project	LAA-(SO)
Nashik	1000	Private	No	14.75	Octroi from four octroi collection points	A (SO)	AA-(SO)
Indore	100	Private	Yes	NA	Improvement of city roads	City road project	
Madurai	300	Private	No	12.25	Toll tax collection	Water supply and sanitation project	LA+(SO)
Ahmedabad (tax free)	1000	Private	No	9	Property taxes of two zones	Road construction and widening	AA (SO)
Hyderabad (tax free)	825	Private	No	8.5	Non-residential property taxes, advertisement tax, profession tax, etc.	Water supply and sanitation projects in 14 ULBs	LAA+(SO) AA+(SO)
Tamil Nadu (pooled financing)	110	Private	*	9.20 per cent	Monthly payments equal to one-ninth of their annual payments.		

*Note:* \*The USAID provided a backup guarantee of 50 per cent of the bond's principal through its Development Credit Authority.

*Source:* Compiled from Bond Issuance Brochures.

this context that public–private partnerships have emerged as a new institutional arrangement for improving service delivery. Although these are not well documented, such partnerships are most often observed in the following spheres:

- contracting out of solid waste management projects by making agreements on a BOT basis (see Chapter 8);
- contracting out of garbage collection, treatment and disposal (see Chapter 8);
- contracting out of the operation and maintenance of tube wells for water supply (see Chapter 7);
- Maintenance of traffic islands and parks and maintenance of street lights in lieu of advertisement rights;
- Contracting out of municipal tax collection like octroi and water charges (see Chapter 7); and
- Developing townships with facilities in the fringe areas of metropolitan cities.

This provides a menu of the initiatives taken in recent years to effect improvements in the finances and functioning of municipalities. We provide here some observations on these initiatives. First, the coverage of these initiatives (state and

city level) is limited to a few states and municipalities. Among those which have been in the forefront of initiatives are Gujarat, Maharashtra, Andhra Pradesh, Karnataka, Tamil Nadu, and in a limited way, Madhya Pradesh and Rajasthan. Interestingly, the property tax reform that began in Patna has not been introduced in other cities of Bihar; in Uttar Pradesh where it was introduced on the Patna model, property tax reforms have stagnated and have not led to any improvement in tax revenues or simplification of the procedures. Second, the amendment of the Income Tax Act for issuance of tax-free bonds has been taken advantage of by only a few municipalities, located in the relatively reform-oriented states. Finally, public sector participation in urban services, notwithstanding its spread, is insignificant in the bigger picture. As a proportion of municipal budgets, the private sector component is small. Barring two water supply projects in Tirrupur and Vishakhapatnam where private sector investments are estimated to be substantial, other activities are characterized by low scale operations, low investment (mostly working capital) and low levels of technology, owing essentially to the absence of a proper

framework for private sector participation in municipal services. The contracts between municipalities and the private sector entrepreneurs are, in most cases, drawn up for one year, which acts as a disincentive for them to make capital investments in improving delivery systems. No procedures have yet developed for determining appropriate concessions to the private sector or their obligations in return for concessions. The result is that private sector participation in municipal service delivery when aggregated is negligible, and has made little impact, except in specific locations, on municipal delivery and their finances.

There are many other micro initiatives towards the improvement of the interface between municipalities and the users of their services, for example, setting up redressal cells and systems, introduction of e-Governance, new monitoring systems for measuring performance in service delivery, or even providing incentives to citizens for payment of taxes and charges. Questions are often asked as to what prompted the states and cities to take on the initiatives. To what extent do the initiatives represent the need to improve resource mobilization and the procedures and systems and to what extent are these crises-

driven? In the case of property tax reform, at least three factors are said to have contributed to a shift to the unit area system: (i) stagnating property tax revenues with substantial leakages and other associated abuses, (ii) determination of the leadership at the state and city levels to plug the leakages and make the system transparent, and (iii) judicial support to the new system. Likewise, the conditions under which the Ahmedabad Municipal Corporation (AMC) issues the bonds in 1997 are related to (i) poor fiscal health of the Ahmedabad Municipal Corporation (AMC), (ii) resource compression at the level of state, and its inability to finance AMC's infrastructure, (iii) strong administrative and local political leadership. The issuance of municipal bonds was made possible by the USAID under its housing guarantee assistance programme. Market-based financing for smaller and medium sizes ULBs has been pioneered using the pooled finance mechanism (Box 5.3). Clearly for change to be initiated and for the reform measures to work, the need for the change must be compelling and the leadership must be inspired and motivated enough to carry it forward and determined enough to see it through.

#### Box 5.3

##### Market-based Financing for Smaller- and Medium-sized ULBs: The Cases of Tamil Nadu and Karnataka

*Lee Baker and N. Bhattacharjee*

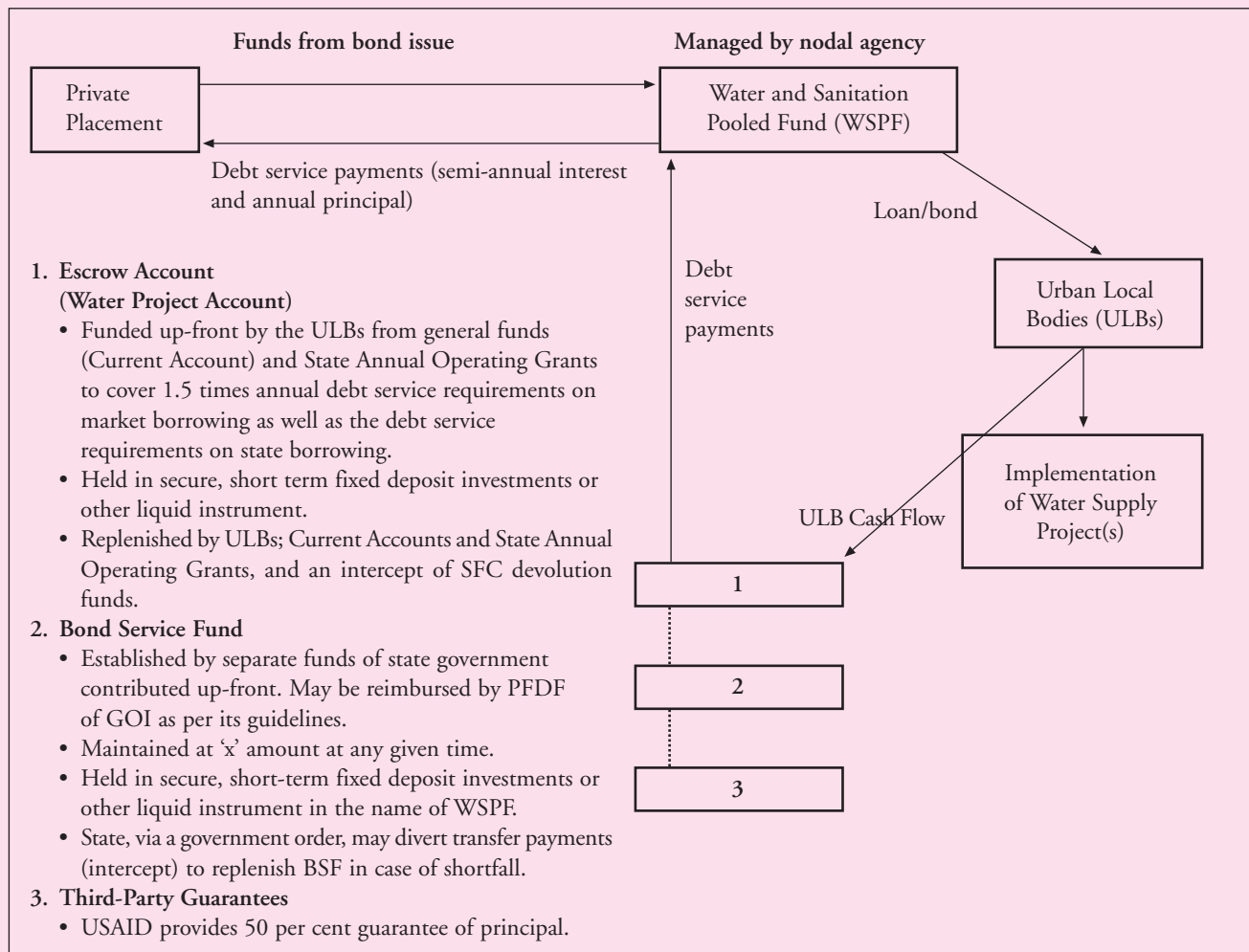
The declining viability of subsidized funds from state governments and semi-public financial institutions has limited the flow of funds to ULBs for infrastructure projects and compelled them to explore alternate sources and methods of finance. One such source, direct access to domestic capital markets, pioneered under the USAID FIRE (D) project, is now an accepted option for larger, financially viable ULBs. Since 1996, at least 30 ULBs have received credit ratings and 14 successfully issued municipal bonds for urban infrastructure totaling more than Rs 900 crore (US\$ 200 million).

Smaller- and medium-sized ULBs, however, do not have the capacity to directly access domestic capital markets nor is direct access cost-effective for them. Another constraint to the expansion of the municipal bond market has been lack of investor appetite for long-term debt. Until the introduction of the pooled finance framework, modelled on the U.S. bond bank concept, the term of municipal bonds did not exceed seven years because longer-term bonds were seen by investors as too risky and priced too high for municipalities to afford. The USAID FIRE (D) project has supported the states of Tamil Nadu and Karnataka to introduce the concept of pooled financing as a mechanism for smaller- and medium-sized ULBs to access the capital markets to finance urban infrastructure.

The state of Tamil Nadu, with FIRE (D) support, developed a Rs 30.41 crore (US\$ 6.4 million) pooled bond issue with USAID Development Credit Authority (DCA) guarantee whose proceeds would fund water and sewerage projects in 14 small and medium-sized towns in the Chennai Metro Area. The bond has a 9.20 per cent annual interest rate, 15-year maturity, with redemption in 15 equal annual installments and is puttable/callable at the end of 10 years. The bonds were assigned a credit rating of Ind AA (SO) by Fitch and LAA (SO) by ICRA. While the bonds were unsecured, a multi-layered credit enhancement mechanism (see below) was set up. The bond was privately placed with five domestic investors in December 2002. The small water and sewerage projects in the 14 ULBs are complete and repayment is proceeding as per the pooled finance structure.

The FIRE (D) project supported the Government of Karnataka in the financial structuring of a Rs 659 crore (US\$ 150 million) water and sewerage project that utilizes the pooled finance mechanism. The project will bring potable water and waterborne sewerage for the first time to 1.2 million inhabitants living in eight smaller ULBs surrounding Bangalore city. These rapidly growing areas are home to Bangalore's burgeoning information technology and, more recently, biotechnology and genetic engineering industry. The GoK mobilized Rs 100 crore (US\$ 22 million) from the domestic capital markets in June 2005 to partially fund the water component of the project. A USAID DCA agreement (US\$ 11.5 million, 50 per cent guarantee of principal) with built-in credit enhancement will reduce the cost of borrowing for the eight ULBs compared to traditional sources of institutional finance. The tax-free bond has a

tenure of 15 years, three-year moratorium on principal with repayment from years four to 15, and an annual interest rate of 5.95 per cent. The bond was rated LAA (SO) by ICRA. The bond was placed privately with 13 investors subscribing. As with the case of the GoTN pooled bond, a multi-layered credit enhancement mechanism was set up as follows:



The successful cases of pooled finance in Tamil Nadu and Karnataka show that this mechanism offers a viable option for the financing of urban infrastructure in India's smaller- and medium-sized ULBs.

*Note:* Views expressed here are of the authors of the box.

## MUNICIPAL FINANCES IN THE CONTEXT OF SFCs

The amendment of Article 243 provides for the Constitution of a finance commission in every state every five years to review the financial position of municipalities and recommend which taxes, duties, tolls and fees be assigned to municipalities, and which of them be shared between the state and municipalities, and the principles for determining the grants-in-aid for them. It is fundamental to reshaping the fiscal relations between municipalities and

the state governments. In its barest sense, it is interpreted to mean that:

1. revenue base of municipalities should have some stability and predictability; the recommendations made by the finance commission of states (SFCs) and accepted by the state governments, it is implied, should remain undisturbed for a period of 5 years;
2. there should be provision for redrawing the fiscal arrangement between the states and municipalities, or else a quinquennial review of the finances of municipalities as

provided for under Article 243 Y may not be justifiable; and

3. revenue base of municipalities should consist of (a) assigned taxes, duties, tolls, and fees; (b) shared taxes, duties, tolls, and fees; (c) grants-in-aid. This provision is basic to the emerging fiscal federalism in India. While other provisions deal with the place of municipalities within the Constitution, this provision refers to fiscal structures—that is, division of fiscal powers between municipalities and the state.

In what way has the revenue base of municipalities changed in the post 1992 period, and in what way has it affected the finances of state governments?

Straight answers to these questions are not available, mainly for reasons of ambiguities that surround the implementation of the recommendations of the finance commission of states (SFCs). Information on what parts of SFCs' recommendations have been accepted and implemented and for what periods is sparse. It needs to be pointed out that issues relating to the impact of transfers to municipalities on the finances of state governments were rarely examined in the pre-1992 period. Perusal of municipal finance studies of the earlier periods as also the reports of the commissions and committees that examined the subject of local government finance shows heightened concern for the unsatisfactory state of the finances of municipalities as also for the irregularity in the grants-in-aid and other transfers. However, neither the studies nor the commission reports referred to the pressures that the transfers to municipalities exerted on the finances of state governments. Municipalities were the subject of the states, and it was assumed to be an obligation on their part to make periodic assessment of municipal demand for resources—drawn from their spending responsibilities—and to design appropriate supply strategies. The state budgets carried one single budget head that is, compensation and assignment to local bodies to reflect all transfers to the panchayats and municipalities. Transfers other than shown under this budget head formed a part of sector spending.

The 1992 amendment has changed this perspective. While states may expand the expenditure portfolio of municipalities without effecting a corresponding change in their fiscal powers, the role of transfers and consequently their impact on the finances of state governments assumes importance. We review here the approach to devolution proposed by the SFCs for municipalities. This part is qualitative and, at best, provides some general features of the approaches recommended by the SFCs for augmenting the revenue base of municipalities.

### *Devolution by State Finance Commissions*

The SFCs have approached their constitutional mandate in the specific context and condition of the states, without any

commonly-accepted or nation-wide guidelines or norms either for expenditures or revenues. Further, SFCs have formulated fiscal packages without access to a clear directive on the functional jurisdiction of municipalities, particularly with reference to the functions enumerated in Schedule 12 of the Constitution. Absence of clarity in respect of the functional domain of municipalities constitutes a serious gap in the functioning of the SFCs, and speaks simultaneously of the tardiness on the part of the states in implementing the 74<sup>th</sup> CAA<sup>18</sup>.

We give below, in a summary form, the devolution packages as recommended by the first finance commissions of states (SFCs I) and the second finance commissions of states (SFCs II) (Table 5.8):

The table shows a wide variation in the approach to devolution to municipalities. Service approaches are noted from the recommendations of the SFCs.

The table shows a large variation in the recommended shares for municipalities. Many of these constitute marginal adjustments to the shares or amounts recommended by the SFCs I, and do not display any fresh review of the finances of municipalities<sup>19</sup>. In Andhra Pradesh, for example, the share of local bodies has been enhanced from 39.24 per cent of state tax and non-tax revenue to 40.92 per cent; in Himachal Pradesh, the amount has been raised from Rs 17.9 crore to Rs 19.7 crore. In West Bengal, the share of 16 per cent remains unchanged between the two successive SFCs. In Punjab, however, the system of revenue sharing recommended by the first finance commission has been changed under which the state government, instead of sharing individual taxes, will now share the net tax proceeds of all state taxes. We would highlight here the fact that even when the state governments accept the devolution packages recommended by the finance commission of states, the actual transfers, which are registered in the finance accounts may vary.

<sup>18</sup> Clarity in respect of the functional jurisdiction of municipalities is an essential first step in deciding upon the principles for tax assignment, revenue-sharing, and grants-in-aid. Only after their functions are known could any decision be taken with regard to how these could be financed. In fact, the structure of the financing mechanism—the mix of taxes, user charges, and transfers, that is appropriate in a given context depends on the functions assigned to municipal governments (Chelliah and Mathur 1996).

<sup>19</sup> This report is not the platform for making a critical review of the reports of the SFCs. Two points, may however, be made. First, there are serious drawbacks in many of the reports in that they have not even estimated the revenue gap faced by municipalities. It is not evident as to how a devolution package could be formulated without any reference to the gap in resources. Second, the reports of the second SFCs appear, in most cases, as updated versions of the first reports, without a fresh review of the finances of municipalities.

Table 5.8  
Devolution System and Recommendations by State Finance Commissions

Divisible Pool of the State	State and share (per cent) of ULB as per first SFC	State and share of ULB as per second SFC
Gross tax and non tax revenue	AP-1.74 <sup>a</sup>	AP-3.63
Non-loan gross own revenue <sup>b</sup>	Karnataka-5.4	Karnataka-8
Gross tax revenue + share in central taxes	Goa-9	
Net tax and non tax revenue	MP-1.3 (recommended) 0.514 (accepted) <sup>c</sup>	MP-1.07 (recommended)
Net tax revenue	Rajasthan-0.5 Assam <sup>e</sup> UP-7 per cent	Punjab-1.3 Rajasthan-0.53 <sup>d</sup> Uttaranchal-6.35 <sup>f</sup> UP-7.5 Kerala <sup>g</sup>
Net tax revenue except certain taxes	Tamil Nadu-2.72 to 4.08 <sup>h</sup> Kerala-0.15 <sup>i</sup> West Bengal <sup>j</sup>	Tamil Nadu-2.9 to 3.65
<i>Other cases</i>		
Individual Taxes	Maharashtra, Orissa, Haryana, Gujarat and Punjab	
Lumpsum Grants	HP, Manipur	HP

*Notes:* Certain states have been omitted in the analysis due to non-availability of their SFC reports.

- The commission has recommended that 39.24 per cent of state tax and non-tax revenue be devolved to all local bodies. This includes the plan fund, excluding which the additional devolution is 10.93 per cent of the total tax and non-tax revenue. This has been distributed to ULBs and RLBs in a ratio of 1.74:9.14.
- Non loan gross own revenue receipts of the state government include the gross yield from taxes and non taxes levied and collected by the state. It also includes interest receipts.
- The commission recommended 8.67 per cent for local bodies in the proportion of 85:15 for rural and urban local bodies. However, the state has agreed to devolve 2.91 per cent in the same proportion.
- The net tax pool does not include entertainment tax, which has been separately shared with ULBs as 15 per cent of the receipts.
- The devolution consists of 2 per cent of state tax for local bodies. The share of urban local bodies has not been specified.
- 11 per cent of the net state tax revenue to be distributed among all local bodies. The ULBs are assigned 57.77 per cent of the 11 per cent.
- The commission has recommended 5.5 per cent and 3.5 per cent of the annual own tax revenue as 'maintenance grants' and 'general purpose grants' respectively. The share of ULBs is based on a detailed formula.
- The devolution from the net tax receipts (excluding entertainment tax) varies from 8 per cent to 12 per cent during 1997-98 to 2001-2002. After deducting 15 per cent for 'Equalization and Incentive Funds', 85 per cent is shared by PRIs and ULBs in the ratio of 60:40 respectively.
- Share from the 1 per cent of state revenues (excluding from certain sources) has been distributed between the rural and urban local bodies in proportion to their population (85:15 as per Census 1991) and transferred to them as non-statutory, non-plan grants.
- The devolution constitutes 16 per cent of the net revenue receipts from taxes (except urban land revenue, entertainment tax and irrigation charges) to be allocated to districts within which the share of panchayats, municipalities, and special areas is based of their respective total populations.

*Source:* SFC Reports of the states

### DEVOLUTION BY CENTRAL FINANCE COMMISSIONS

The Tenth Finance Commission made an ad-hoc provision of Rs 1000 crore for municipalities, anticipating that the resources of municipalities will need to be augmented to meet the new functional responsibilities assigned to them under Schedule 12 of the Constitution. The Commission stipulated that (a) the amount of Rs 1000 crore which it allocated on the basis of 1971 slum population should be in addition to the funds that flow to municipalities from state governments, (b) municipalities should provide matching contributions by

raising resources, and (c) this amount should not be used on wages and salaries.

The Eleventh Finance Commission (EFC) was mandated, in accordance with the amended Article 280 (3)(c) to make recommendations on 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 Commission of the State'. The terms of reference provided that in the event of the non-availability of the recommendations of the SFCs, the Commission could make its own assessment of the

resource requirements of municipalities for making its recommendations. The Commission considered the mandate in its entirety. Taking the position that the SFC recommendations could not form an adequate basis for determining either the extent of augmentation or even a general approach to the finances and functioning of municipalities, it formulated a set of principles and cast its recommendations accordingly. The recommendations can be categorized as follows:

1. those that relate to the provision of supplementary support to municipalities together with the criteria for its allocation between states, and also between municipalities of individual states;
2. those that comprise suggestions for improving resource mobilization by municipalities, referring especially to property tax reform, fixation of appropriate user charges, and in a few cases, even the creation of competitive environment and engagement of the private sector;
3. those that relate to the support for the creation of appropriate databases and standardization of the budget and accounting formats and auditing systems at local levels;
4. those that are generally concerned with the implementation of the *intent* underlying the 74<sup>th</sup> CAA.

The EFC recommended a grant of Rs 2000 crore for municipalities and allocated it to states on the basis of a five-fold criteria (Figure 5.2).

The Twelfth Finance Commission (TFC) has recommended for the 2005–10 period, a sum of Rs 5000 crore for municipalities. This is an ad-hoc amount, bearing no relationship with either the municipal requirement of funds for raising the service levels, or the gap, which the finance commissions of states are unable to bridge. Continuing ad-hocism in determining the supplementary grant for municipalities constitutes a major lacuna in the decentralization process contained in the 74<sup>th</sup> CAA and the corresponding amendment of Article 280, which also points to the inability of the central and state finance commissions

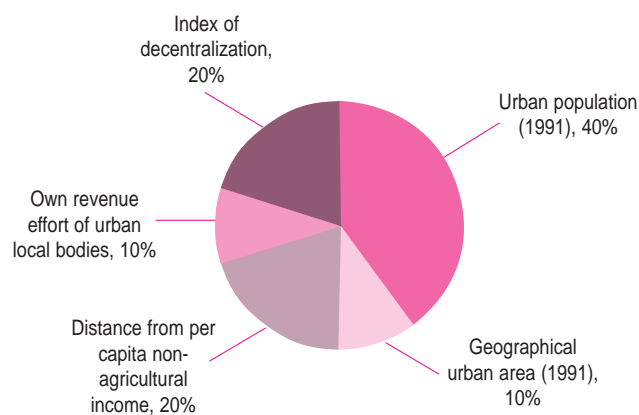


Fig. 5.2 EFC Criteria for Allocation to States for Municipalities

to forge links, and function in a coordinated fashion. In fact, the exercises conducted by the central finance commission and SFC run parallel, failing to recognize the implicit link that exists between them *via* the two key Articles namely 243 Y and 280 (3)(c)<sup>20</sup>.

The TFC refined the criteria for allocating the recommended amount between states (Figure 5.3).

The TFC has made it obligatory upon states that at least 50 per cent of the grants-in-aid should be earmarked for solid waste management through public–private partnership<sup>21</sup>. The municipalities should concentrate on collection, segregation and transportation of solid waste. It has reiterated the need for better information at municipal levels.

In making these recommendations, the TFC has made two important departures from that of the EFC. First, it has earmarked 50 per cent of the grants-in-aid for solid waste management. Second, it has replaced the criterion of ‘index of decentralization’ with an ‘index of deprivation’. The points of departures are puzzling, to say the least. For one, earmarking of central funds for solid waste management is assumed to mean that the central government agrees to share the cost of delivering this service even when it is an obligatory duty of municipal governments. Assumption of this role by the central government has important ramifications, and may pre-empt the flexibility of the future finance commissions in making recommendations. Similarly, the substitution of the index of decentralization by an index of deprivation does not carry forward the intent and the objectives of the 74<sup>th</sup> CAA.

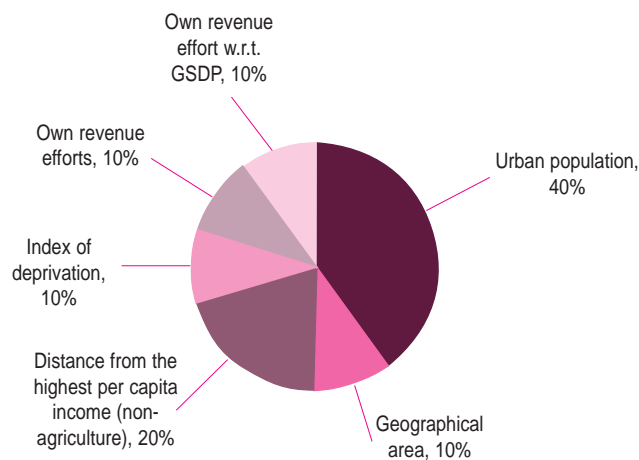


Fig. 5.3 TFC Criteria for Allocation to States for Municipalities

<sup>20</sup> See, for example, lack of synchronization in the award periods of the central finance commission and the SFCs; or the inability of the system to regularly collect, and compile the status of finances etc. See Table A1.1—List of Identified Cities. See, Reports of the Eleventh and Twelfth Finance Commission.

<sup>21</sup> See Table 8.10 for the TFC allocation to municipalities and panchayats in 2005–10 for SWM.

**WAY FORWARD**

In sum, the finances of municipalities are in a grossly unsatisfactory state, with little overall impact of the 74<sup>th</sup> CAA. On a per capita basis, the spending levels of municipalities are about 130 per cent lower compared with the established norms and standards. Moreover, the accounting systems do not permit a proper assessment of their finances, since these do not take into account the receivables and payables. Data systems at municipal levels have shown no improvement, notwithstanding a separate allocation made for this purpose by the EFC.

The positive performance of municipalities is represented by the recent initiatives of many state governments and municipalities for a variety of purposes including resource mobilization. To these which are discussed above must be added the recent reform measure of the central government, called the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) wherein 60 cities<sup>22</sup> will be eligible to access central government funds for such sectors as water supply, wastewater disposal, roads and bridges and the like, upon committing themselves to a slew of reforms comprising reform of property taxation; better and fuller application of user charges; adoption of accrual-based accounting systems; introduction of a public disclosure and a community participation law; repeal of Urban Land (Ceiling and Regulation Act) 1976, reform of rent control laws and the like. The rationale

underlying these reforms is that investment in urban infrastructure and services stands impeded on account of the continuation of laws and procedures, and their inability to adjust with the changing socioeconomic policies and environment. The central government expects the following outcomes from the proposed urban reform agenda.

- modern, transparent budgeting, accounting, financial management systems designed and adopted for all urban services and governance functions;
- city-wide framework for planning and governance established and operational;
- all urban residents obtain access to a basic level of urban services;
- financially self-sustaining agencies for urban governance and service delivery established, through reforms to major revenue instruments;
- development of a well-functioning, efficient and equitable urban land market;
- local services and governance conducted in a manner that is transparent and accountable to citizens; and
- e-Governance applications introduced in core functions of ULBs resulting in reduced cost and time of service delivery processes.

Aimed at creating economically productive, efficient, equitable and responsive cities, this initiative is expected to enhance the role of cities in the national economic system.

<sup>22</sup> The Jawaharlal Nehru National Urban Renewal Mission (JNNURM) is applicable in the first phase to about 60 cities. These cities comprise all cities with a population of over 1 million, state capitals, and a few cities of religious and tourist importance.

## ANNEXE

Table A5.1  
Revenue Significance of Municipalities

Year	Municipalities own revenue (Rs crore)	Per cent of GDP	Relative shares of own revenues (per cent)		
			Municipalities	State governments	Central governments
1997–8	8434.9	0.61	2.84	33.4	63.8
1998–9	9451.7	0.59	2.97	34.3	62.7
1999–00	10372.7	0.59	2.80	34.4	62.8
2000–1	12018.4	0.63	2.98	35.1	61.9
2001–2	12748.1	–	3.07	39.5	57.5

Note: Figure for municipal own revenues are adjusted to reflect the revenues for all statutory towns and cities.

Source: Same as Figure 5.1

Table A5.2  
Criteria for Determining the Allocation to States for Municipalities (EFC)

Criterion	Weight (per cent)
Urban population (1991)	40
Geographical urban area (1991)	10
Distance from per capita non-agricultural income <sup>a</sup>	20
Own revenue effort of urban local bodies	10
Index of decentralization <sup>b</sup>	20

Source: Report of the Eleventh Finance Commission (EFC).

Table A5.3  
Criteria for Determining the Allocation for Municipalities (TFC)

Criterion	Weight (per cent)
Urban population	40
Geographical area	10
Distance from the highest per capita income (non-agriculture)	20
Index of deprivation	10
Revenue Effort	
Of which	
(a) with respect to own revenue of states	10
(b) with respect to GSDP	10

Source: Report of the Twelfth Finance Commission (TFC).

<sup>a</sup> Average per capita GSDP (excluding the primary sector) has been arrived at by using the GSDP figures for 1994–5, 1995–6, and 1996–7 and the population figures for these years as published by the Registrar General of India.

<sup>b</sup> Index of decentralization is constructed on the basis of ten indicators which include such indices as enactment of state municipal legislation in conformity with the Constitution (seventy-fourth) Amendment Act, 1992, *de jure* and *de facto* assignment of functions to municipalities and taxation powers, election to municipalities, and Constitution of the District Planning Committees.

## ANNEXE 5.1 ARTICLE 243 Y AND 280 OF THE CONSTITUTION OF INDIA

### 243 Y. Finance Commission

- (1) The Finance Commission constituted under Article 243—I shall also review the financial position of the Municipalities and make recommendations to the Governor as to:
- (a) the principles which should govern:
- the distribution between the state and the Municipalities of the net proceeds of the taxes, duties tolls and fees leviable by the state, which may be divided between them under this Part and the allocation between the Municipalities of all levels of their respective shares of such proceeds;
  - the determination of the taxes, duties, tolls and fees which may be assigned to, or appropriated by, Municipalities;
  - the grants-in-aid to the Municipalities from the Consolidated Fund of the State;
- (b) the measures needed to improve the financial position of the Municipalities;
- (c) any other matter referred to the Finance Commission by the Governor in the interests of sound finance of the Municipalities.
- (2) The Governor shall cause every recommendation made by the Commission under this article together with an explanatory memorandum as to the action taken thereon to be laid before the Legislature of the State.

### 280. Finance Commission

- (1) The President shall, within two years from the commencement of this Constitution and thereafter at the expiration of every fifth year or at such earlier time as the President considers necessary, by order constitute a Finance Commission which shall consist of a Chairman and four other members to be appointed by the President.
- (2) Parliament by law may determine the qualifications which shall be requisite for appointment as members of the Commission and the manner in which they shall be selected.

- (3) It shall be the duty of the Commission to make recommendations to the President as to—
- (a) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under this Chapter and the allocation between the States if the respective shares of such proceeds;
- (b) the principles which should govern the grants-in aid of the revenues of the States out of the Consolidated Fund of India;
- \*[(bb) the measures needed to augment the consolidated Fund of a State to supplement the resources of the Panchayats in the State on the basis of the recommendations made by the Finance Commission of the State;]
- †[(c) 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 Commission of the State;]
- \*[(d) any other matter referred to the Commission by the President in the interest of the sound finance.]
- (4) The Commission shall determine their procedure and shall have such powers in the performance of their functions as Parliament may by law confer on them.

\* Sub-clause (bb) inserted by the Constitution (Seventy-third Amendment) Act, 1992, sec. 3 (w.e.f. 20-4-1993).

† Sub-clause (c) inserted by the Constitution (Seventy-fourth Amendment) Act, 1992, sec. 3 (w.e.f. 20-4-1993), previously sub-clause (c) was omitted by the Constitution (Seventh Amendment) Act, 1956, sec. 29 and sch.

‡ Sub-clause (c) re-lettered as sub-clause (d) by the Constitution (Seventy-fourth Amendment) Act, 1992, sec. 3 (w.e.f. 20-4-1993); previously sub-clause (d) was re-lettered as sub-clause (c) the Constitution (Seventh Amendment) Act, 1956, sec. 29 and sch.

## REFERENCES

- Bird, Richard (1976). *Charging for Public Services: A New Look at the New Idea*, Canadian Tax Foundation, Toronto.
- Bird Richard, Robert D. Ebel and Christine I. Wallich (1995). *Decentralization of the Socialist State*, World Bank, Washington D.C.
- Chelliah, Raja J. and Om Prakash Mathur (1996). *Implications for the Constitution (Seventy-fourth) Amendment, 1992*, National Institute of Public Finance and Policy, New Delhi.
- Ebel, Robert and François Vaillancourt (2001). 'Fiscal Decentralization and Financing Urban Governments: Framing the Problems', in Freire Mila and Richard Stren (eds), *The Challenging of Urban Government: Policies and Practices*, World Bank Institute, Washington D.C.
- EGCIP (1996). *The India Infrastructure Report. Policy Imperatives for Growth and Welfare*. Expert Group of Commercialization of Infrastructure Projects, Ministry of Finance, Government of India, New Delhi.
- George, Henry (1879). *Progress and Poverty*, Robert Schalkenbach Foundation, San Francisco.
- Goetz, Edward G. and Susan E. Clarke (eds) (1993). *The New Localism: Comparative Urban Politics in a Global Era*, Sage Publications, Newbury Park, CA.
- GOI (2000). *Report of the Eleventh Finance Commission (2000–05)*, Government of India, New Delhi.
- \_\_\_\_ (2004). *Report of the Twelfth Finance Commission (2005–10)*, Government of India, New Delhi.
- Gyan, Chand (1944). *Local Finance in India*, Kitabistan, Allahabad.
- Mathur, Om Prakash (1996). 'Property Tax Policy and Local Governance', in Parthasarathi Shome (ed.). *Fiscal Policy, Public Policy and Governance*, National Institute of Public Finance and Policy, New Delhi.
- Mathur, Om Prakash and Sanjukta Ray (2003). *Financing Municipal Services: Reaching out to Capital Markets*, National Institute of Public Finance and Policy, New Delhi.
- Mathur, Om Prakash and Sandeep Thakur (2004). *India's Municipal Sector*, National Institute of Public Finance and Policy, New Delhi.
- Musgrave, R. A. (1959). *The Theory of Public Finance*, McGraw-Hill, New York.
- Rattso, Jorn (1998). *Fiscal Federalism and State-Local Finances. The Scandinavian Perspective*, Edgar Elgar, Cheltenham, UK.
- Zakaria, Rafiq (1963). *Report of the Committee of Ministers constituted by the Central Council of Local Self Government on Augmentation of Financial Resources for Urban Local Bodies*. Government of India, New Delhi.