EXECUTIVE SUMMARY

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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