Municipal Finance in India: An Assessment

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Chapter 1

INTRODUCTION

1.1 Introduction

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

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

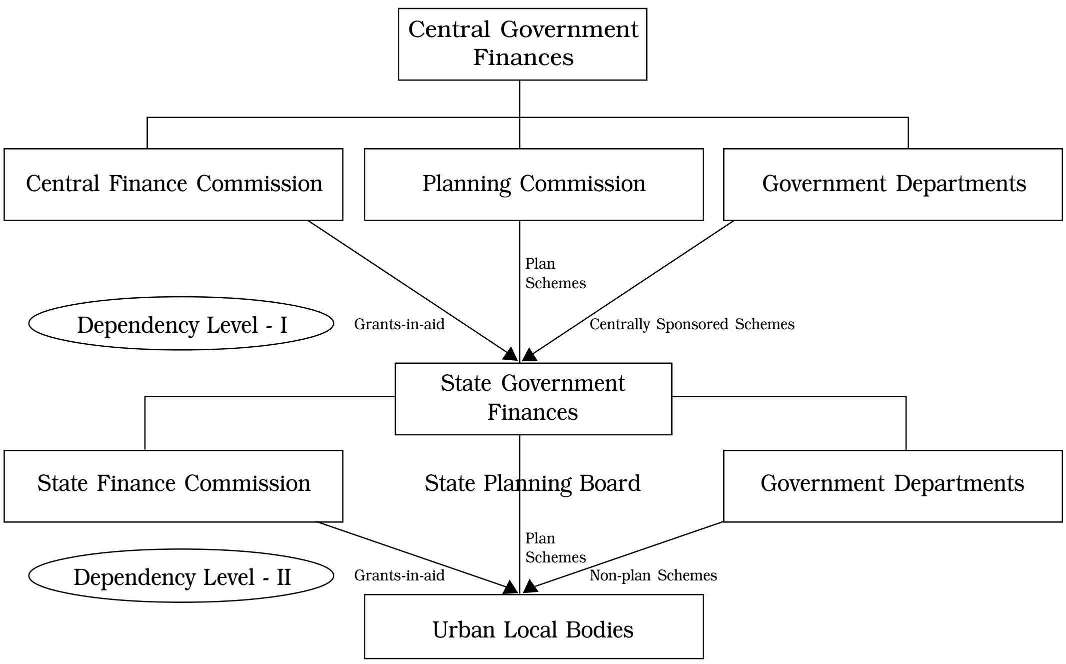
While the Twelfth Schedule of the 74th Amendment Act, 1992 demarcates the functional domain of municipal authorities, the Amendment Act has not provided for a corresponding 'municipal finance list' in the Constitution of India. The assignment of finances has been completely left to the discretion of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

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

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

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

Figure 1: Fiscal Dependency of Local Bodies



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

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

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

1.2 Importance of Local Public Finance

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

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

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

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

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

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

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

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

1.3 Context of the Study

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

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

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

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

Table 2: Share of Urban Areas in National Income

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

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

Table 3: Contribution of Urban Areas to National Income

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

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

1.4 Urbanisation and Economic Growth

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

1.4.1 Cities and Agglomeration Economies

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

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

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

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

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

1.4.2 Cities as Generators of Resources

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

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

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

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

(Per cent Share in State Collection)

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

Source: Centre for Good Governance, Hyderabad.

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

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

1.5 Investment Requirements for Urban Infrastructure

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

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

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

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

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

(Rs. Crore)

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

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

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

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

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

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

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

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

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

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

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

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

1.6 Imperatives of Decentralisation

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

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

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

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

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

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

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

1.7 Objectives of the Study

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

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

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

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

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

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

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

1.8 Analytical Framework, Data Source and Limitations

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

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

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

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

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

1.9 Structure of the Report

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

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

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

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

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

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

Four Appendices are annexed to the Report as follows:

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

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

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

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