

Chapter 2

FISCAL FEDERALISM: THEORY & PRACTICE

2.1 Approach to Review

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

2.2 International Studies

2.2.1 Fiscal Decentralization - Theoretical Aspects

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

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

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

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

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

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

- i) The central government, while remaining more concerned with the functions like economic stabilization, income distribution and resource allocation that have macro implications, often neglects the activities relating to provision of basic services. Most central governments are primarily concerned with managing macroeconomic policies and maintaining national political stability. They are often less concerned with the provision of civic services, except to the extent that these involve large-scale capital-intensive investments (Rondinelli, 1990).
- ii) Decentralisation of political, financial and administrative authority to the lower levels of government increases the efficiency in provision of various services due to the lesser jurisdiction and focused attention of the lower levels of government.

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

- i) Deconcentration of authority to field offices, lower echelons, *etc.*, *i.e.*, to officials within same organisational hierarchy;
- ii) Delegation to separate legal persons, but ultimately under the same political direction; and
- iii) Devolution to a representative body, such as a provincial government or local authority, *i.e.*, with independent political accountability.

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

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

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

- i) macroeconomic stabilization;
- ii) income redistribution; and
- iii) resource allocation.

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

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

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

- ii) Where charging is impracticable, sub-national governments should finance such services from taxes borne by local residents, except to the extent that the central government is, for whatever reasons, willing to pay for them through transfers and
- iii) Where the central government does pay, sub-national governments should be accountable to the central government, at least to some extent. This is one way to ensure accountability. But in the context of decentralised democratic governance, it may be noted that, the concept means much more than ‘answerability.’ Actually, democratic decentralisation is expected to correct not only the distortions caused by the abuse of power of public agencies (the answerability aspect), but also to make them more responsive, participative and transparent. Transparency facilitates participation, and participation makes a public agency really responsive to people’s needs.

2.2.2 Structure of Local Bodies

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

2.2.3 Resources of Local Bodies

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

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

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

Source: Fjeldstad (2001).

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

The literature on public finance addresses the issue of the suitability of types of taxes for various levels of government. Though there is no ideal assignment of taxes between central and lower levels of government, one can find a set of tax-assignment rules in the traditional theory of fiscal federalism. These principles are in accordance with the respective responsibilities of central and lower

tiers of governments. Thus, taxes on international transactions (customs duties) and a considerable share of income and excise taxes should be assigned to central government. To perform the function of income redistribution, it is appropriate for the central government to collect corporate income and wealth taxes. Local bodies require relatively stable sources of revenues.

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

- i) Taxes suitable for economic stabilization should be levied by the central government;
- ii) Progressive re-distributional taxes should be assigned to central government;
- iii) Personal taxes with progressive rates should be levied by the jurisdictions most capable of implementing a tax on a global base;
- iv) Lower-level governments should tax revenue bases with low mobility between jurisdictions;
- v) Tax bases distributed highly unequally between jurisdictions should be centralized and
- vi) Benefit taxes and user charges may be appropriately used at all levels.

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

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

Table 7: Tax Assignment: Who should tax what?

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

N=National (or, Central); P=Provincial (or, State); L=Local

Source: Boadway, *et al* (2000).

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

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

Table 8: Criteria for Choice of a Local Tax

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

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

Source : Bird (1994).

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

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

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

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

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

Economy: Local taxes should be collected with least expenses.

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

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

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

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

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

- (i) Wherever possible, user charges may be levied for the services provided as the first resort;
- (ii) For achieving efficiency, user charges should be levied on the direct recipients of benefits;
- (iii) The poor may be subsidised directly, if needed, rather than through reduced prices and distortions in the entire market for services;
- (iv) Where charging is impracticable, specific benefit taxes should be levied on local residents; and

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

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

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

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

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

In the case of ‘collective’ services where beneficiaries are not identifiable or services are not measurable and levying user charges is not possible, researchers regard benefit taxes as the appropriate

instruments of financing local expenditures. It is argued that when clear linkages exist between the taxes levied and the expenditures financed, earmarked benefit taxes constitute indirect user charges or surrogate prices for services. Earmarking then facilitates the rational choice by tax payers.

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

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

Local public finance provides broad guidance for matching revenues with expenditure responsibilities. Bahl and Linn (1992) suggests the following general principles for identifying the revenue

sources appropriate to financing particular types of local expenditures:

- i) Where the benefits of public services are measurable and accrue to readily identified individuals in a jurisdiction, user charges are the appropriate financing instruments;
- ii) Local public services such as administration, traffic control, street lighting and security, which are services to the general public in the sense that identification of beneficiaries and measurement of benefits and costs to individuals are difficult, are most appropriately financed by taxes on local residents;
- iii) The cost of services for which significant spillovers to neighbouring jurisdictions occur (e.g., health, education and welfare), should be financed substantially by state or national inter-governmental transfers and
- iv) Borrowing is an appropriate source to finance capital outlays on infrastructure services, particularly, public utilities and roads.

2.2.4 Imbalance of Revenues and Responsibilities

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

Table 9: Vertical Imbalances in Selected Countries

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

Source: Fjeldstad (2001).

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

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

2.2.5 Inter-Governmental Fiscal Transfers

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

programmes sponsored and funded by the central government are required to be implemented by local governments.

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

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

While matching grants, particularly of the open-ended variety, have greater stimulating effect on grant-receiving institutions because of both income and substitution effects, there are empirical studies indicating that closed ended grants stimulate greater expenditure than open-ended ones [Gramlich (1977), Shah (1979) and Shah (1989)]. The chief weakness of this type of grants is that it may distort

local priorities besides widening spatial disparities as richer governments can attract more resources especially in an open-ended grant programme. This has very serious implications for countries like India where reducing spatial disparities has been an avowed development objective of the Government.

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

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

- i) Sub-national governments must be made an integral part of the revenue mobilization as much as it has shared responsibilities;
- ii) Objectivity, transparency and predictability may be built into sub-national budgeting;
- iii) Transfers should not perform a “gap filling” function as far as possible. (Any transfer from a higher to a lower government will help to close the fiscal gap and the objectives to be served therefore assume importance here). Needs, rights and incentives are key criteria of inter-governmental transfers. A simple distributive formula that gives due weights to needs, rights to minimum basic services, incentives to performance, inter-jurisdictional equity *etc.* is important;
- iv) Medium-term expenditure and revenue framework may be put in place;

- v) Efficiency and inter-jurisdictional equity have to be ensured. Efficiency requires that those responsible for any service should have adequate resources (assuming the best own revenue effort) and sufficient flexibility to make decisions, while being held accountable for results. Unless increased transfers are matched by a local contribution, however small that contribution may be in the poorest communities, the full efficiency benefits of decentralisation are unlikely to be realized;
- vi) Transfers should not bail out the incompetent and the irresponsible. Hard budget constraints should be the rule and soft options need to be avoided;
- vii) Fiscal autonomy cannot be built in a regime of grants, but the sub-national governments will have to progressively rely on tax effort and innovative revenue mobilisation including project-tied loans, public donation and the like and
- viii) Sub-national governments should have defined responsibility including expenditure and performance conditionality and accountability.

2.2.6 Municipal Finance and Economic Development

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

and development charges on the marginal cost of extending infrastructure to new developments. The study suggested that municipal financial tools should not work against planning objectives and tools.

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

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

2.3 International Experience

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

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

There is a visible trend in the OECD countries towards more effective utilisation of user charges and benefit taxes by local

governments. This is attributed partly to citizens' preference for user charges over general taxes. In contrast, user charges in India remain a grossly under-exploited source till today.

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

United Kingdom

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

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

student nurses, apprentices, youth trainees, those on income support and the severely mentally handicapped.

United States

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

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

Property Tax

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

Local Option Income Tax

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

General Sales Tax

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

Excise Taxes

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

Impact Taxes

These taxes, notably levied in California, aim at generating resources from new developments to finance their infrastructure requirements. These taxes are imposed under the 'tax' powers of

local authorities and not under their 'police' powers. These are comparable to excise taxes.

Special Assessments

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

User Charges & Fees

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

Development Exactions

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

Debt Financing

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

General Obligation Bonds

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

Revenue Bonds

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

Taxable Bonds

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

Tax Increment Financing

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

Lease-Purchase Contracts

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

Revolving Loan Funds

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

Bond Banks

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

Impact Fees

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

mandating developers either to dedicate land or infrastructure for public use or to contribute cash for provision of facilities needed to serve a proposed development. Impact fees have a demonstrated potential for raising revenues to support new development.

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

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

Canada

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

Box 1 : Lessons from Impact Fee Legislations in USA

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

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

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

Australia

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

Brazil

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

The main municipal taxes in Brazil are those on services (ISS) and urban property (IPTU). ISS rates are set by the municipalities, subject to ceilings introduced by the federal government. IPTU is levied

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

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

China

China's fiscal system is highly decentralized among the 31 provincial, 331 prefecture, 2,109 county and 44,741 township-level units. Nearly 70 per cent of total public expenditure in China takes

place at the sub-national (*i.e.* provincial, prefecture, county, and township) level, of which more than 55 percent takes place at sub-provincial levels. Key sub-national expenditure responsibilities in China include sub-national administration, local capital construction, basic local services, maintenance, repair and operation of urban infrastructure, primary and secondary schooling, health and hospitals, support for agricultural production, price subsidies, poverty alleviation, cultural and heritage protection, environmental conservation, local and regional development and physical planning.

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

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

revenues include VATs (75 per cent central and 25 percent, sub-national governments), stamp taxes on security exchange (50: 50 sharing) and resource taxes.

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

2.4 Indian Studies

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

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

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

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

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

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

decentralisation initiative has almost remained ineffective in improving the resource generation out of the non-tax sources for the ULBs.

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

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

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

- (i) An alternate approach to the traditional mode of financing is public-private partnership (PPP). However, presently, the objective

of public-private partnership relates much to attracting capital and curtailing public sector employment rather than increasing the efficiency and effectiveness of service delivery. The basic reason for the failure of PPP model is the lack of customer approach in it and the extensive focus on technical and commercial aspects of infrastructure.

- (ii) Just two sources, namely, Octroi and property tax, have been the major sources of revenue. Basically, Octroi is the only tax within the jurisdiction of city governments that has the potential to grow over time with the growth of economic activities. However, Octroi is on the verge of being abolished. Therefore, there is an urgent need for the State Governments to devolve some major tax sources to the municipalities which have their growth potential derived from the economic growth in cities.
- (iii) Municipalities have not succeeded in realising the potential of the property tax, though property values are on rise. A major problem with the property tax system in India lies in the process of tax computation. The linking of the property tax – based on annual rental value (ARV) - with the rent control law has hindered the growth of collection.
- (iv) For accessing capital market funds, municipalities need financial, structural, institutional and administrative changes. These include: i) placing certain buoyant revenue sources at their disposal, ii) transforming the urban governance system with limited control by the state, iii) changing the capital market structure and iv) recovering the cost of services to make infrastructure projects commercially viable.

Vaidya and Johnson (2001) gives a vivid account of how the Ahmedabad Municipal Corporation (AMC) issued municipal bonds worth Rs.1,000 million in early 1998, the first such instrument issued in India without a State guarantee and it marked the first step towards a market-based system of local government finance. Before the issue of the bonds, AMC introduced reforms to improve revenue collection

so as to make up for the loss it had been incurring. Other preparatory steps taken by the AMC included preparing a five-year capital investment or corporate plan and credit rating by the CRISIL. For debt servicing, revenues from 10 Octroi collection centres were placed in an escrow account-structured debt obligation (SDO). Other credit enhancing measures adopted by the AMC were fixing minimum average debt service coverage ratio of 1.5 and having a sinking fund for repayment of principal and mortgage equal to 1.2 times the par value of the bonds. The authors suggested that the technical framework developed for the AMC bonds can act as a blueprint for future development initiatives in this area.

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

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

Mathur and Thakur (2004) examined the fiscal performance of municipalities and assessed the load on state finances on account of the implementation of the State Finance Commission recommendations. The study found that the size of the municipal sector, in terms of revenues, was only 3.07 per cent of publicly raised resources (by municipalities, States and Central Government taken together). The study further found that the expenditure levels on services provided by municipalities across states were low when

compared to the norms established by the Zakaria Committee. Another finding of the study was that per capita expenditure-revenue gap declined over the period of 1997-98 to 2001-02. Fiscal transfers to municipalities formed 3.85 per cent of the combined own resources of states.

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

India Infrastructure Report 2004 (3i Network, 2004), *inter alia*, discusses the issues relating to creating local financial systems for infrastructure development, accessing capital markets by ULBs and reforming the property tax. In this Report, Jha (2004) lists a range of options and models available to developing countries on how to finance infrastructure projects locally. These options include i) specialized banks for municipal lending, ii) municipal bond markets, and iii) specialized municipal funds. The paper reviews the initiatives for issue of municipal bonds and the experience of Tamil Nadu Urban Development Fund. For strengthening the creditworthiness of local bodies, the paper suggests that they should be given autonomous authority to set realistic tax-rates and user-charges for the basic

services provided by them and also for pursuing hiring-firing policies. Measures needed for strengthening Municipal Bond issuance, such as bond insurance facility, facilitating the listing of bonds on domestic stock exchanges, *etc.* are also discussed in the paper.

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

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

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

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

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

Table 10: Details of Bonds Issued by Municipal Corporations

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

Source: Mathur (2006)

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

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

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

and further legislative changes are critical in developing a viable and vibrant municipal bond system in the country.

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

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

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

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

An obvious shortcoming in the literature of local public finance in India is the inability to locate a suitable alternative to Octroi. Traditionally Octroi has been the most important source of municipal taxes in the country. Being regarded as an obnoxious tax, Octroi has been on its way out and all but a limited number of States like Maharashtra and Gujarat have already abolished Octroi. However, the States which abolished Octroi have not been able to find an alternative for their ULBs as buoyant as Octroi. Several States have

gone for experiments. Karnataka levied entry tax. Tamil Nadu permitted a surcharge on sales tax for the Chennai Municipal Corporation. States like Uttar Pradesh and Andhra Pradesh have not attempted instituting any major tax in the place of Octroi. The compensations to Municipalities in lieu of Octroi have been kept at abysmally low levels in the States that abolished it. Although in the interest of economic growth and free trade within the country there can be no case for Octroi, the need for assigning a substitute 'own' tax to ULBs as buoyant as Octroi continues to be strong.

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

- (a) Octroi might be retained in Municipal Corporations covering a population of three lakhs or more; the tax could be abolished in the smaller local bodies.
- (b) Octroi should be replaced with taxes the incidence of which would be on the transport sector. The alternatives in the case of smaller Municipalities include surcharge on sales tax, entry tax, terminal tax, road tax, tax on motor vehicles, *etc.* If the revenue realised on account of these taxes was inadequate, augmentation measures through property tax, entertainment tax, professional tax, *etc.* might be considered. If the revenue still remains inadequate even after the imposition of these taxes, only then special grants-in-aid should be provided. Grants-in-aid should not be considered in isolation without augmentation of the tax base of the local bodies as this would take away their initiative and autonomy.
- (c) The procedure for payment of grants to the Municipalities should be revised in so far as it related to the loss of Octroi revenue. They should be paid as a direct advance to the Municipalities by the Planning Commission at the time of plan allocation and should be adjusted against the revenues due to the State Governments.

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

The Eleventh Finance Commission also noted the following:

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

2.5 Summary Observations

2.5.1 International Literature

The rationale for fiscal decentralization is well-grounded in theory and it is gaining momentum in many countries. The identified role of local bodies, in the public finance literature, is resource

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

2.5.2 Indian Literature

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

bodies in India is far narrower than that in most developed countries and several developing countries, mandated to discharge similar responsibilities.

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

2.5.3 Some Issues for ULBs in India

While the national expectations from the ULBs are too high, however laudable they may be, the fiscal arrangements for meeting these expectations are highly unsatisfactory. The expenditure levels on services provided by municipalities across the country, especially on infrastructure and poverty alleviation, are low when compared to the norms established by the Zakaria Committee. The devolution of funds to ULBs through the State and Central Finance Commissions

has been on an *ad hoc* basis in the absence of normative estimates of their resource gap. In the above circumstances the local authorities are in need of major 'own' tax and non-tax sources, proceeds of which should grow along with the growth of the cities concerned and their economies.

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

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