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Overview of Municipal Finance in India

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IIHS

Key Questions

- Assumed that a project idea has been finalized, how do we estimate the quantum of money that is required?
- From where are we going to raise the required amount of money?
- How do we justify the amount identified to be invested in the project conceptualized?
- What are therefore; the municipal finance challenges? Can we understand the limitations, opportunities/possibilities?

MoUD submission to 13th CFC

- Urban population: 28% in 2001 and 38% in 2026
- Urban growth accounting for 2/3rd of the aggregate population growth during 2001 – 2026
- This growth poses a number of challenges to civic bodies for meeting the basic needs as well as incremental population needs
- Municipal bodies need to ensure inclusive growth & plan for optimal utilization of urban space & creation
- Ensure creation & maintenance of assets for providing essential services

MoUD submission to 13th CFC

- Fiscal space of municipalities is shrinking: combined expenditure of ULBs shrank from 1.74% of GDP in 1998-99 to 1.54% of GDP in 2007-08
- Internal resources provide for less than half the total expenditure of local bodies
- Octroi abolishment without a viable substitute
- Local bodies unable to exploit property tax as a major source of revenue
- Inter-government transfers not been adequate for local bodies to provide desired level of services
- Significant part of resource transfer is tied & non-discretionary
- Significant increase in expenditure of ULBs due to:
  - 6th Pay Commission
  - Additional O&M costs due to larger investments in civic infrastructure
  - Additional investments necessary for improving governance

Background

- Constitutional responsibility for urban infrastructure to the states
- Separate list of subjects for the municipalities was incorporated into the Constitution in the 1990s, but it was left to the states to decide which of these functions to delegate. Not much delegation has since taken place.
- Municipal bodies depend upon the states for the assignment of taxation powers, and fiscal transfers (including loans), and resort to market borrowing (albeit in a few cases), largely with state guarantee
- The tradition of user charges not yet developed in the country
- Increasing urbanization and income in urban areas, on account of greater service-sector incomes, have raised the demand for larger and better quality infrastructure networks.

What is the resource challenge?

Chart 5.1
Urban Expenditure Projections
(Rs crore)

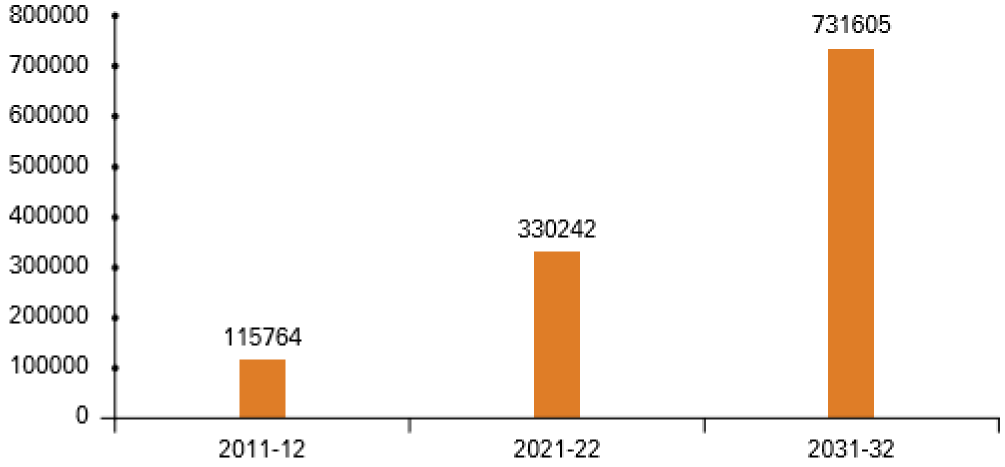
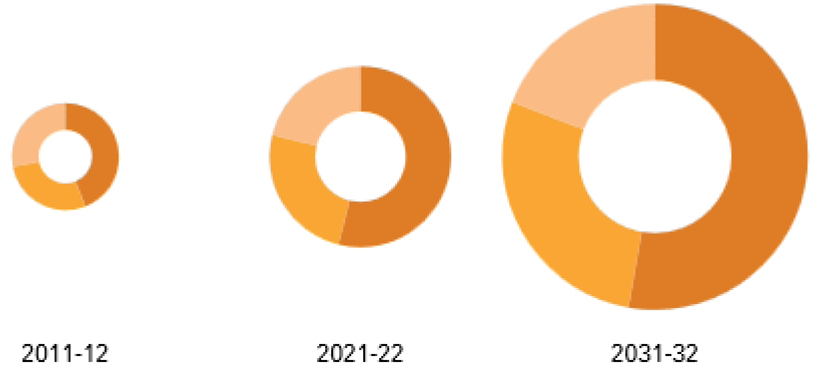


Chart 5.2
Relative Share in Urban Expenditure
(per cent)



	2011-12	2021-22	2031-32
Capital Expenditure	44	54	53
O&M Expenditure	28	25	28
Establishment Charges	28	21	19

Source: HPEC, 2011

Resource Challenge…

Chart 5.3
Municipal Finances: Declining Share of Own Revenue
2002-03 to 2007-08

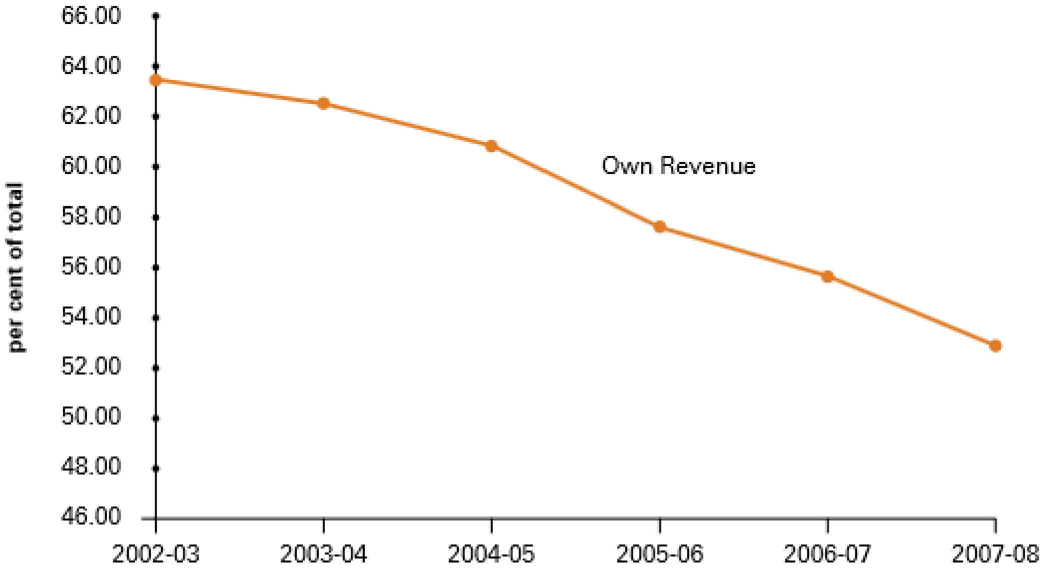
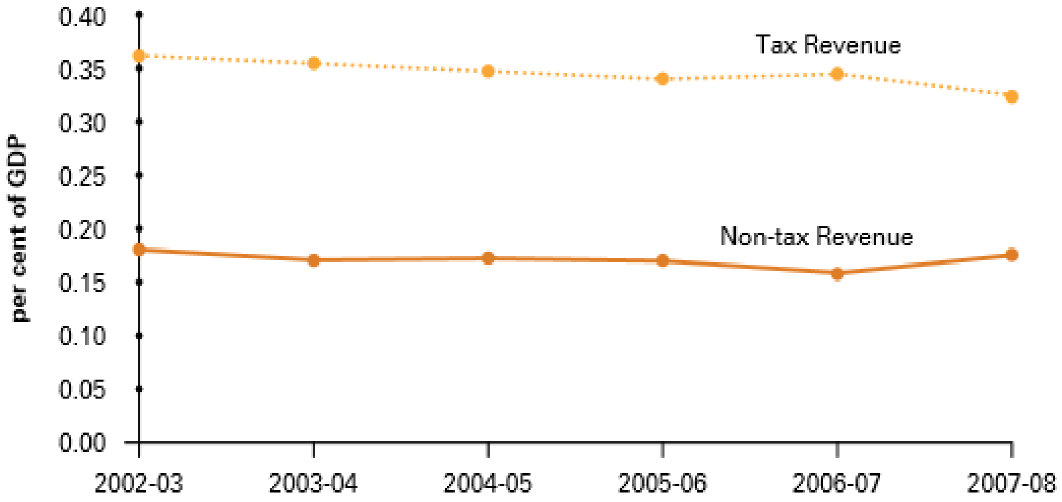


Chart 5.4
Tax and Non-tax Revenues of ULBs
2002-03 to 2007-08

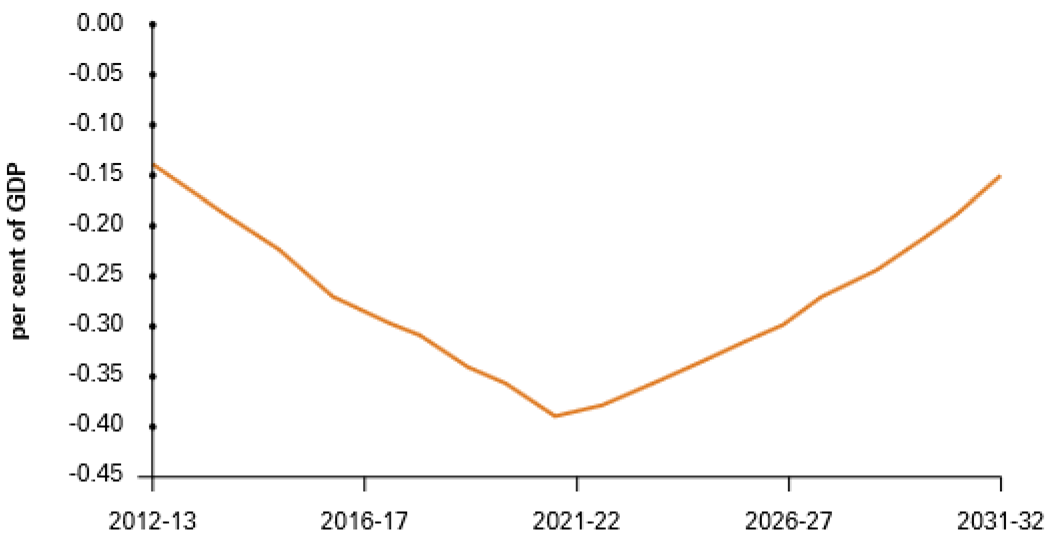


Source: HPEC, 2011

Table 5.3
Municipal Revenue: 2007-08

	Rs crore	Relative share (per cent)	Per cent of GDP
Total	**44429**	**100.0**	**0.94**
Own Revenue	**23522**	**53.0**	**0.50**
'Exclusive Taxes'	15278	34.4	0.32
'Revenue-shared Taxes'	0	0.0	0.00
Non-tax Revenue	8244	18.6	0.18
Other Revenue	**20907**	**47.0**	**0.44**
Transfers from SFC	9171	20.6	0.19
Grants-in-aid from State Government	5676	12.8	0.12
Transfers from CFC	869	2.0	0.02
Grants-in-aid from GoI	2373	5.3	0.05
Other	2818	6.3	0.06

Chart 5.6
Overall Municipal Deficit
(per cent of GDP)

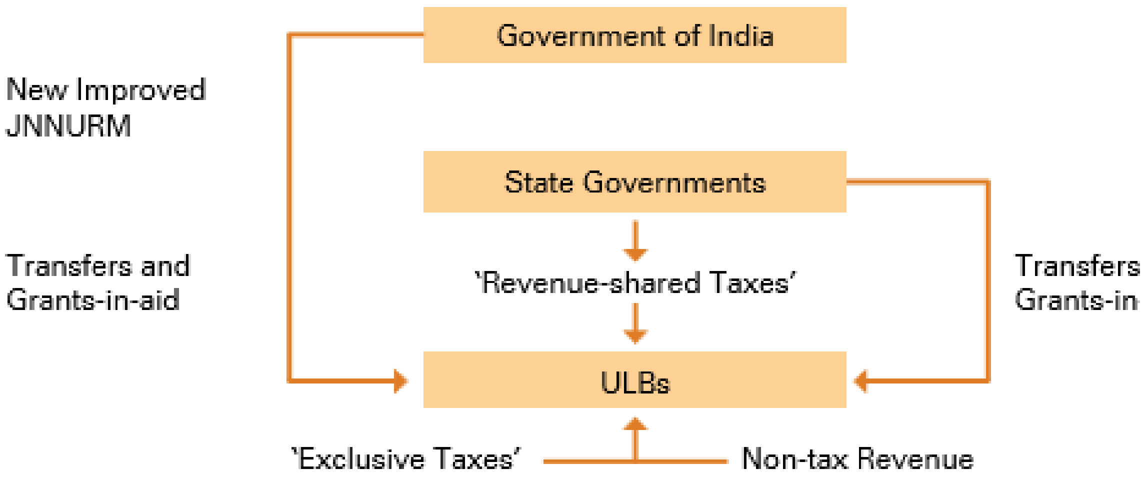


Source: HPEC, 2011

The operational framework

Chart 5.5

Re-engineering the ULB Revenue Model: Key Components



Note: JNNURM stands for the Jawaharlal Nehru National Urban Renewal Mission.

Box 5.3

An Indicative Municipal Finance List

- 'Exclusive taxes'
  - Property tax, including vacant land tax
  - Profession tax
  - Entertainment tax*
  - Advertisement tax*
- 'Revenue-shared taxes'
  - All taxes on goods and services levied by the state government**
- Non-tax revenue
  - User charges
  - Trade licensing fee
  - FSI charge/Betterment charge/Impact fee/Development charge

* if not subsumed under the GST.

** including value added tax (VAT)/sales tax, stamp duty, electricity, purchase tax, luxury tax, taxes on lottery, betting and gambling, entry laxes in lieu of octroi, etc.

Note: FSI stands for floor space index.

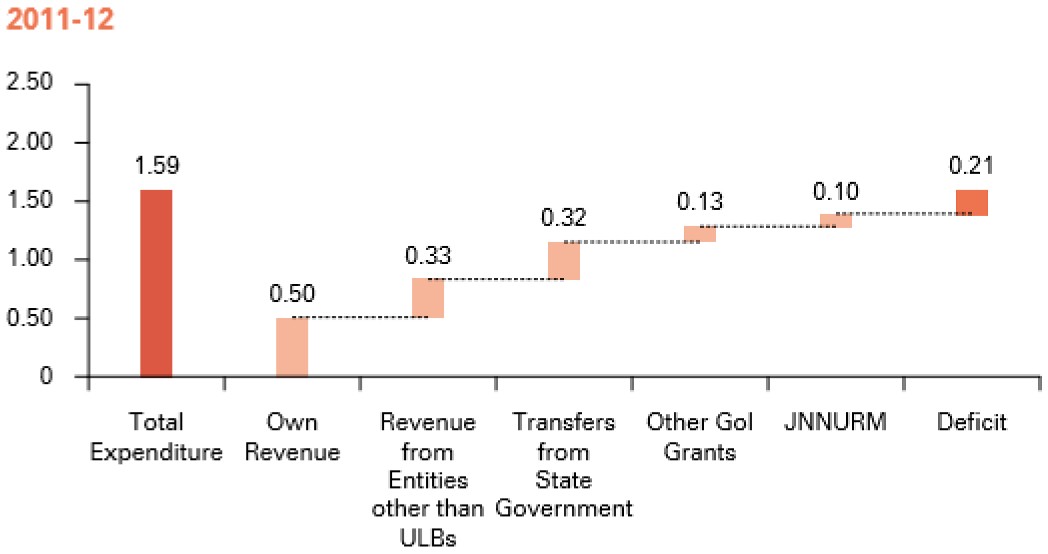
Source: HPEC, 2011

The Goal

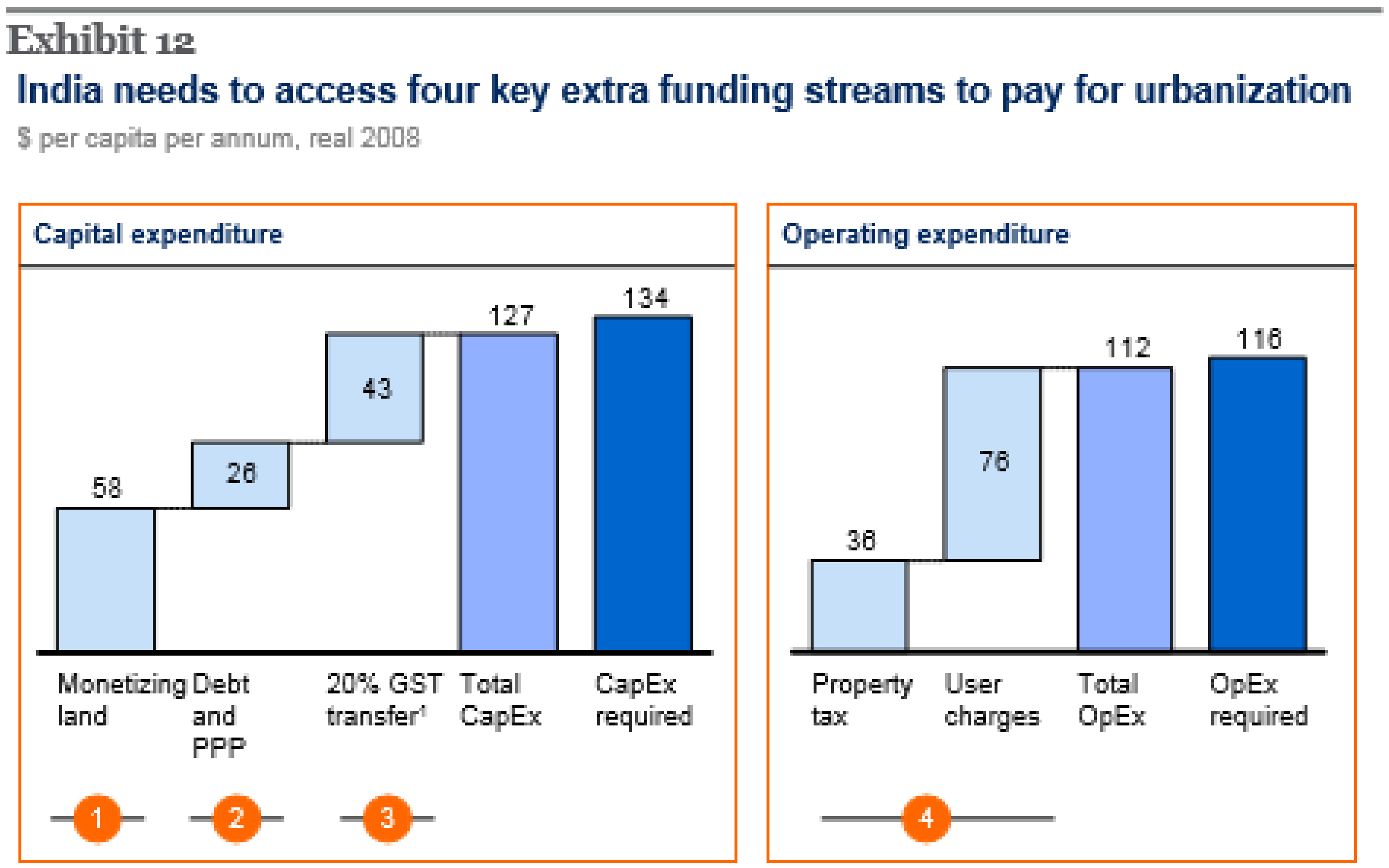
Summary of Service Norms			
Water Supply	• 100 per cent individual piped water supply for all households including informal settlements for all cities • Continuity of supply: 24x7 water supply for all cities • Per capita consumption norm: 135 lpcd for all cities		
Sewerage	Underground sewerage system for all cities and 100 per cent collection and treatment of waste water		
Solid Waste	100 per cent of solid waste collected, transported, and treated for all cities as per Municipal Solid Waste 2000 Rules		
Urban Roads	City Size Class	Area under Roads (per cent)	Road Density (km per sq. km)
	Class IA	11	12.25
	Class IB	11	12.25
	Class IC	11	12.25
	Class II-IV+	7	7.00
Storm Water Drains	Drain network covering 100 per cent road length on both sides of the road for all cities		
Urban Transport	Rail-based and road-based mass rapid transit system (MRTS) for Class IA and IB cities, and city bus service for other city classes		
Traffic Support Infrastructure	Intelligent transport systems and area traffic control	For Class IA cities	
	Vehicular and pedestrian underpasses	For Class I cities	
	Parking systems	For Class I cities	
	Terminals	For Class I and II cities	
	Depots	For Class I, II, and III cities	
Street Lighting	• Illuminance: 35 Lux (35 lumens per sq. km) for all road categories in all cities • Spacing between street lights: 40 m for major roads, 45 m for collector roads, and 50 m for access road spaces		

Source: HPEC, 2011

The Challenge: Finance (% of GDP)



Some other assessment (McKinsey, 2010)



Some Issues: the Municipal Political Framework

- No uniform model of empowerment.
- Some states restrict municipalities to birth and death records, street cleanliness and lighting, without any fiscal empowerment
- Some states, such as Tamil Nadu, Maharashtra and Gujarat, entrust certain municipal infrastructure and urban services such as water supply, primary education, bus services and electricity to municipal bodies.
- Almost all states have separate institutional arrangements for area development within municipal limits, or wider urban agglomeration limits for a city.

Some National & Local Financing Agency

- HUDCO has primarily financed state government agencies such as the housing boards and municipalities on the strength of state government guarantees.
- IDFC and ILFS Identify Urban Infrastructure as their Principal Infrastructure Financing Area
- Karnataka Urban Infrastructure Development and Finance Corporation (KUIDFC)
- Tamil Nadu Urban Infrastructure Financial Services Limited (TNUIFSL)
- The World Bank and Some Other External Assistance Agencies

New emerging Financing Mechanisms

- Municipal Bond Issues
- Pool Finance Structures at Municipal Level
- Loan Financing from Banks Directly without State Government Guarantee
- Community-based Urban Infrastructure Financing

Summarizing Major Issues

- Can State Governments Invest Adequately to meet the Growing and Large Need of Urban Infrastructure?
- Can Cities become Major Drivers of Economic Growth and Better Local Governance?
- Should the Central Government Be Very Proactive in Nudging States to Delegate Powers to Municipalities?
- Is Privatisation of Urban Infrastructure and Increased Resort to Public–Private Partnership the Answer?
- Should Municipalities Be Empowered to Use TDRs for Urban Infrastructure Development?

Principles of Local Finance: the Benefit Model

- According to the benefit model of local government finance, local government services, wherever possible, should be paid for on the basis of the benefits received from those services
- The extent to which municipalities will be able to apply the benefits-received principle, however, depends on the nature and characteristics of the services they provide

Public Finance Principles

- ***Economic efficiency*** is concerned with the allocation of resources to the production of goods and services where society gets the largest possible bundle of goods and services.
- Economic efficiency is achieved when the user fee or tax per unit of output of the service received equals the marginal cost
- The tax or fee indicates what consumers are willing to pay for the service and the marginal cost measures the cost of resources in producing that service.

- ***Fairness (equity)*** based on benefits-received is achieved when those who consume public services pay for them, just as someone who benefits from a private good pays for it.
- Fairness based on ability to pay suggests that those with similar ability should pay similar amounts in taxes and user charges (horizontal equity) and those with different ability should pay different amounts (vertical equity).

Public Finance Principles

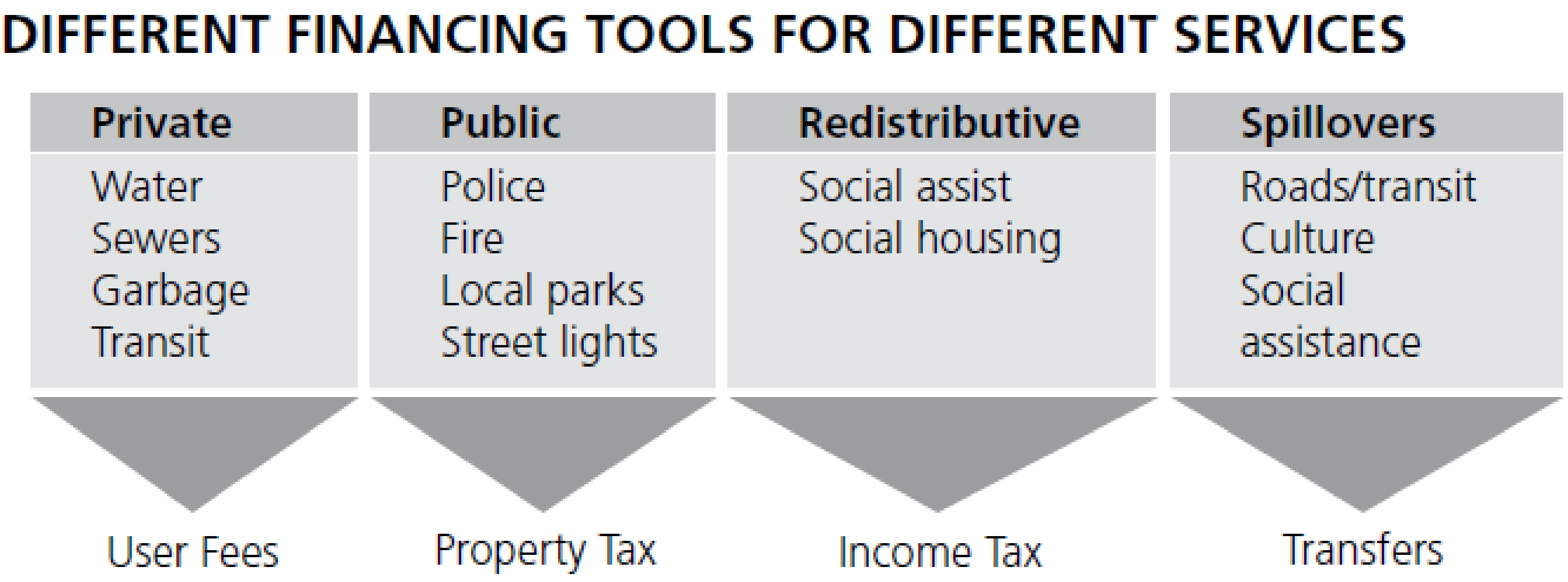
- ***Accountability*** means that taxes (charges) and expenditures should be designed in ways that are clear to taxpayers so that policymakers can be made accountable to the taxpayers for the services they deliver and the costs they incur.
- The more direct the relationship between the beneficiaries of a government service and payment for that service and the less the complexity of the revenue system, the greater is the degree of accountability.

- ***Adequacy and Stability*** requires that revenues provide governments with sufficient funds to finance services on a regular and continuing basis.
- Revenues should be stable and predictable so that municipalities can budget and plan for future expenditures.

Public Finance Principles

- ***Autonomy*** means that municipal governments have autonomy and flexibility to set their own priorities.
- To do this, they should minimize their dependence on revenues from other levels of government.
- ***Ease and cost of administration*** means that the time and resources devoted to assess, collect, and account for revenues should be minimized.
- Moreover, costs of compliance on the part of taxpayers should be minimized.

Financing Typology: a Guide



Source: UnHabitat, 2009