Municipal Finances in India – Unresolved Issues and Way Forward[1]

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The Context

Since independence, municipal finances in India have shared an insignificant position in the country's public finance, largely characterized by poor resource base, lack of autonomy, low capacity to mobilize revenues and high dependence on central and state level transfers and grants-in-aid coupled with internal inefficiencies for financial management. In 2007, share of municipal expenditure as percentage of GDP was a mere 1.09%, much lower as compared to other countries of the world (Table 1).

Table 1: Municipal expenditures as a percent of GDP in several federal OECD countries (2007)

Country	% of GDP
India	1.09
Australia	2.3
Spain	6.4
Belgium	6.9
Canada	7.2
Austria	7.4
Switzerland	9.7

Source: International Monetary Fund. Government Finance Statistics 2008

However, when India embarked on economic and structural reforms in 1991 and the 74th Constitutional Amendment Act (CAA) came into force in 1993, it was hoped that municipal finances will receive the necessary impetus and municipal governments will gradually become financially self sustainable and efficient. In the past two decades, various strategic initiatives have been taken targeting all tiers of government to streamline municipal finances. The key initiatives are listed below:

[1] *Published in Cities – The 21st Century INDIA – Edited by Satpal Singh – published by Bookwell – Delhi 2015 (ISBN 978-93-80574-72-1)*

- Giving constitutional status to municipal bodies through 74^{th} CAA.
- Providing a constitutional framework for redesigning intergovernmental transfer mechanism for improving the fiscal relationship between central, state and local government in the following ways:

    - Mandating the Central Finance Commissions to look in to needs for municipal finance.
    - Creation of the institution of State Finance Commissions to look into sharing of state resources between state and municipal bodies.

- Successful development of municipal bond system under USAID funded FIRE-D Project. As part of the FIRE-D project, amendment of Income Tax Act 1961 was done to allow municipal bodies to issue Tax Free Municipal Bonds.
- Introduction of Pooled Finance Mechanism.
- Incentive framework for municipal bodies to undertake financial reforms pertaining to property tax, user charges etc under Urban Reform Incentive Fund (URIF) and Jawaharlal Nehru National Urban Renewal Mission (JNNURM).
- Putting in place policy and operational guidelines regarding Public Private Partnership for augmenting and delivering municipal services.

Despite the above interventions, an overview of the finances of India's 3667 municipalities aggregated for 28 states in the Table 2 shows a dismal and declining financial picture of municipal finances in India. In 2007-08, the total municipal revenue income amounted to Rs. 44,429 crore against a total municipal expenditure of Rs. 47,026 crore, which in per capita terms, stood at Rs. 1430 and Rs. 1513 respectively. Own revenues constituted 53 percent[2] of the total revenue whereas it was 63.5 percent in 2002-03. This decline in own revenue by 10.5 percent highlights the fact that despite several initiatives, municipal bodies in India are becoming less self-reliant.

Revenue expenditure constituted 60.5 percent of the total expenditure in 2007-08, declining by 12 percentage points as compared to 2002-03 when it was 72.5 percent. This was mostly on account of increased capital expenditure available under various schemes from Central and State Governments. Between 2002-03 and 2007-07, capital expenditure grew at a CAGR of 25.64 percent as against CAGR of 12.62 percent for revenue expenditure.

The above averages are only a peek into the municipal finance situation in India and do not convey the gravity of the situation in many municipal bodies which are virtually reduced to becoming state government departments since even the salaries are paid by state governments.

[2] *This share of municipal own revenue in all likelihood has gone down as in the year 2007-08 Gujarat State abolished Octroi and municipal governments were given compensatory grant. Also post 2007-08 in the wake of JNNURM quantum of grants have gone up. As a result at present share of municipal own revenue is likely to be around 45%*

Table 2: Municipal Finances in India, All States

Finances	2002-03 Amount Rs. crore	2002-03 Per Capita Rs	2007-08 Amount Rs. crore	2007-08 Per Capita Rs	CAGR %
Revenue Income					
Own tax revenue	8,838.13	311	15,277.72	492	11.57
Own non-tax revenue	4,441.84	156	8,243.66	265	13.16
Total own revenue	13,279.97	466	23,521.38	757	12.11
Assignment and devolution	3,657.06	128	9,171.11	295	20.19
Grants-in-aid	2,259.76	79	5,676.25	183	20.23
Others	1,137.52	40	2,818.32	91	19.90
Transfers from the Central Government	308.86	11	2,372.97	76	50.35
Finance Commission Transfers	276.53	10	869.02	28	25.74
Total revenue income	20,919.69	733	44,429.05	1430	16.26
Expenditure					
Revenue expenditure	15,691.46	550	28,431.45	915	12.62
Capital expenditure	5,938.28	208	18,594.08	598	25.64
Total expenditure	21,629.74	758	47,025.53	1,513	16.80
Gross domestic product (GDP) (India)[45]	22,61,415	21,415	43,20,892	37,969	13.83
Own tax as % of GDP	0.39		0.35		
Own revenue as a % of GDP	0.59		0.54		
Municipal expenditure as % of GDP	0.96		1.09		

Source: ADB - India Municipal Finance Study, February 2013 by NIPFP – Delhi

The macro level picture emerging from Table 2 further highlights the dismal picture of municipal finances in India. It can be observed that during 2002-03 to 2007-08, own municipal tax revenue as percentage of GDP reduced from 0.39 to 0.35; and total own municipal revenue as a percentage of GDP reduced from 0.59 in 2002-03 to 0.54 in 2007-08 while municipal expenditure as percentage of GDP increased from 0.96 in 2002-03 to 1.09 in 2007-08[3]. The data indicates that municipal revenue share in GDP has decreased while expenditure levels are increasing thus widening the gap in overall municipal finances. A large part of this gap has been met through intergovernmental transfers from central and state level, highlighting the continued lack of financial sustainability of municipal institutions in India even after many policy and legislative reforms coupled with programmatic support under FIRE-D, URIF and JNNURM.

In terms of service delivery, municipal governments in India spent Rs. 18,594 crore (0.43 percent of GDP) on creating new infrastructural assets and Rs. 28,431 crore (0.66 percent of GDP) for infrastructure maintenance, establishment charges and salaries. A comparison of these spending levels with the norms recently established by the High-Powered Expert Committee on estimating urban infrastructure investment requirements indicates that municipalities in India under-spent to the tune of 1.04 percent of GDP on infrastructure maintenance. In numerical terms, the under-spending amounted to Rs. 22,649 crore or Rs. 731 per capita – a phenomenal deficit by any measure.

Further, the India Municipal Finance Study – ADB 2013 points out serious problems with the fiscal ability of the municipal sector to realize its revenue generating potential. At all-India aggregate level the fiscal capacity to raise revenue compared to normative expenditure requirements is 58.9 percent while actual revenue realized is just 28 percent. In states of Assam, Bihar, Jharkhand, Madhya Pradesh, Orissa, Uttar Pradesh, and Uttarakhand actual revenues

[3] *India Municipal Finance Study, 2013 by National Institute of Public Finance and Policy for ADB*

account for less than 10 percent of the normative levels of expenditures thus also highlighting the variance in fiscal ability of municipal governments in India.

This paper tries to map these unresolved issues, which are responsible for the present state of municipal finances in India and what needs to be done in the near future to address them. The paper is based on secondary data and analysis aggregated from various recent studies and reports. The key studies which form the basis of this paper are listed below:

1. 13th Central Finance Commission Report (December 2009)
2. High Power Empowered Committee on Urban Development Report (March 2011)
3. Developing a Regulatory Framework for Municipal Borrowing – World Bank (October 2011)
4. India Municipal Finance Study – ADB (February 2013)
5. XII Five Year Plan Document

2. Unresolved Issues

The major unresolved issues and the direct and indirect issues emanating from the major issues are presented below. Also not all the unresolved issues discussed here are directly related to municipal finances but indirectly they are contributing to aggravating the existing situation of municipal finances in India.

2.1 Inadequate Constitutional Status/Structure to Municipal Governments in India even after 74th Constitution Amendment

Local government institutions in India have a long history dating back to before Christ period but existing local government structure is a British creation. The first municipal corporation[4] was formed in Madras in 1687. The current overall framework of municipal bodies in India and their activities are diverse and complex, shaped by years of deliberations on state-local distribution of functional assignments, tax bases, criteria for revenue sharing and grants-in-aid, and responsibilities for service delivery.

In spite of long and checkered history of local government institutions in India, until passage of the 74th CAA in 1992, the only reference in the constitution to local bodies was in the Directive Principles of State Policy, which stated, ***"The state shall take steps to organize village panchayats and endow them with such powers and authority as may be necessary to enable them to function as units of self-government."*** Before 1992, most local government institutions were either routinely superseded or elections were not held on time, resulting in complete subversion of the system of local governance. The 74th CAA, however, succeeded to do the following:

4 Notwithstanding the constitution of a municipal corporation in Madras in 1687, municipal administration is said to have begun in the country with the passing of the Regulating Act of 1773 and the Charter Act of 1793. The Lord Mayor's resolution of 1870 brought in a measure of self-government at the local level. But it was Lord Ripon's resolution of 1882 that laid the foundation of local and municipal self-government in India.

- Introduced unified three-tier structure of governance.
- Put an end to the state government's discretion in constituting or not constituting local bodies.
- Introduced a specific provision for the representation of women and other disadvantaged groups in governance institutions.
- Created a neutral system to conduct elections in municipal bodies by State Election Commission.
- Created a fiscal devolution framework in the form of State Finance Commissions for reviewing the financial position of municipal bodies and for making recommendations as to the principles that should govern –

    - The distribution between the state and the municipal bodies of the net proceeds of the taxes, duties, tolls and fees leviable by the state;
    - The determination of the taxes, duties, tolls and fees that may be assigned to or appropriated by the municipal bodies; and
    - The grants-in-aid to municipal bodies from the consolidated fund of the state.

But failed to –

- Ensure transfer of functions considered appropriate for the municipal governments which it inserted through Schedule XII (article 243 W).
- Reserve sources of finance exclusively for municipal government.
- Operationalise district planning committees (DPCs) and metropolitan planning committees (MPCs) for purposes of planning and development at the local level.
- Operationalise ward committees for citizens' participation in local governance.
- Resolve issues regarding adequate, transparent, formulae based fiscal devolution from State to municipal bodies through State Finance Commissions.

The above-listed failures of 74th CAA have directly or indirectly led to negative externalities for municipal finance. The specific dimensions of these negative externalities or unchanged position with regard to municipal finances even after constitutional amendments are elaborated in the ensuing sections:

2.1.1 No Exclusive Functional Domain for Municipal Governments Post 74th CAA

Schedule VII (Article 246) of the constitution provides three lists - a Union list, a State list, and a Concurrent list. Prior to 74th CAA in line with Schedule VII, the state governments have assigned certain functions and duties to the municipalities that historically have consisted of public health and sanitation, communications, and infrastructure provisions not specified in the Union list-I, subject to the provisions of Entry 56 of List I (markets and fairs; libraries, museums, and other similar institutions; and burial and cremation grounds). The main services which municipalities generally, though not uniformly perform are water supply, sewerage and drainage, conservancy and sanitation, street lighting, and local roads.

The 74th CAA inserted Schedule XII (Article 243W), which comprise a list of functions considered appropriate for devolution to municipalities but the amendment provided that State "may" transfer these functions to municipal governments. As a result State has absolute prerogative with regard to transfer of functions mentioned in Schedule XII. Currently, a large gap exists between a dejure incorporation and a de-facto transfer of functions to municipalities. As a result, the domain of municipal functions is neither discrete nor absolute; but there is high degree of concurrency of functions between the state government and the municipal bodies which is adversely affecting governance and service delivery.

There is also high degree of inter-state disparity in terms of decentralization of functions in actual practice to the municipal bodies. In many states, larger municipal corporations handle a wide variety of functions including health services, transport and electricity. While in some states the municipal bodies act only as an adjunct to state departments, development agencies or parastatals that provide the core infrastructure service and the municipality administers part-jobs like billing and collection, issuing of permissions or regulation.

In sum, municipal governments have no inherent powers and their functional domain has been limited and controlled by state governments. Progress is visible only in states where there has been an enabling environment for effective decentralization. In such states also there has been contextual variations based on local needs. For instance, in states like Maharashtra, Tamil Nadu and Karnataka, the water supply and sewerage functions have been designated to regional water boards in the interest of covering agglomeration areas beyond the municipal boundaries and pump in larger capital investments for infrastructure improvement. While in many municipal bodies across India, poverty alleviation has been added as a function. This changing functional domain of municipal bodies is often not backed by supporting fiscal empowerment and additional financial instruments to fund the service. This, highly varying and discretionary nature of defining functional domains of municipal bodies in India have created complexity in defining the role of municipal governments as service providers and transferring adequate fiscal domain to municipal governments.

2.1.2 No Exclusive Fiscal Domain for Municipal Governments Post 74th CAA

Fiscal relations among the 28 states and more than 5400 municipalities (as per Census 2011) in India are diverse and complex, much rooted in the constitution itself, which lays down neither an expenditure jurisdiction nor a fiscal domain for municipalities. The fiscal relations are defined by state governments and coded in state laws (Box 1). Schedule VII (Article 246) of the constitution provides three lists, a union list, a state list, and a concurrent list. The legislature of a state is expected by law to endow the municipalities, out of the state list, with such powers and authority as it may consider necessary to enable them to function as institutions of self-government; such law may contain provisions for the devolution of powers upon municipalities.

Although the 74th CAA prescribes the procedures for the constitution of municipalities and provide for certain safeguards against their arbitrary suspension or dissolution, it has not changed the structure of fiscal federalism in the country. It has not even added a schedule or illustrative list of taxes considered appropriate for municipal governments. The state legislature continues to enjoy absolute powers to endow the municipalities with such authority, as it considers necessary "to enable them to function as institutions of self-government." This arrangement implies concurrency of functions between the states and municipalities. It also implies that municipalities do not possess general competency powers permitting them to take actions not explicitly prohibited or assigned elsewhere; they possess the legally delegated powers and functions, under the doctrine of ultra vires (Dillon's Rule), that limits local choice and diversity. They are to take nothing from the general sovereignty except what is expressly granted.[5]

Thus even after 74th CAA, it is the state government which determines the fiscal options of municipal governments. State laws specify the taxes that municipalities can levy and collect. States stipulate the purposes for which funds may be spent, fix salaries, and impose limits on the amount of debt, as well as the purpose for which debt may be incurred, procedures for repayment, and so forth. The lack of autonomy in fixing tax rates: a low discretion coefficient—is one of the most serious handicaps that municipal governments face in managing their finances. In many ways, this has meant increasing dependence of municipalities on the state governments[6].

Box 1: India Municipal Finance Study, 2013 - ADB

Municipal finance system in India has limited autonomy in fixing tax rates, determining the tax exemption policy, accessing capital markets, or restructuring personnel policies. Their taxing and spending powers have existed under the provisions of state laws which often deny municipalities the power either to impose a particular tax or to impose a tax on a particular class of tax payers. The state laws do not provide for the protection of municipal fiscal domain nor do these lay down a policy governing transfers. There exist no performance standards or measures for municipalities; with the result the finance system at this level is extremely "soft".

Although the literature and theory on public finance suggests that finance should follow functions; the fiscal powers of municipal bodies should be allocated in a way that the yields from fiscal powers are consistent with the expenditure assignment which has been a serious lacunae in municipal governance in India. Also, as noted earlier the highly varying and discretionary nature of defining functional domains of municipal bodies in

[5] The Dillon's Rule is not accepted by all judges. However, the U.S. Supreme Court has upheld it and opined that the relationship between state and local government was not contractual in nature (thereby implying equality) but was one of a superior (the creator) and the inferior (the created). For further information, see Advisory Commission on Intergovernmental Relations (1982)

[6] State limits on local revenue-raising authority are neither new nor only a feature of India's federal structure. In the United States, property-tax rate limits began more than 100 years ago, originating in Rhode Island in 1870.

India has resulted into periodic shifts and changes as a result of the withdrawal of functions from municipalities or entrustment of such responsibilities as poverty alleviation. These issues associated with functional domain have a direct impact on the fiscal domain in terms of volume and structure of municipal finances.

2.1.3 Inadequate and Ineffective Fiscal Devolution Mechanism Post 74th CAA

Before the 74th CAA, the intergovernmental transfer system for municipalities was ambiguous. Few state municipal statutes contained any provisions with respect to transfers or the conditions under which state governments would make transfers to municipalities.

The 74th CAA made an important departure in laying down the principles for tax assignment. Instead of providing an illustrative list of taxes considered appropriate for municipalities, it mandated the states to constitute (Articles 243I and Y), a State Finance Commission once in five years and make recommendations to govern the state-municipal fiscal relations by (i) conducting a review of municipalities' finances (ii) estimating municipalities' future financial requirements and (iii) suggesting measures for strengthening municipalities' finances. Thus it altered the fiscal devolution system and framework between states and municipalities through SFCs, which were mandated to prescribe the principles for the following:

- The distribution between the state and the municipal bodies of the net proceeds of the taxes, duties, tolls, and fees levied by the state.
- The determination of the taxes, duties, tolls, and fees that may be assigned to or appropriated by the municipal bodies.
- The grants-in-aid to municipal bodies from the consolidated fund of the state.

This SFC based fiscal devolution system has simultaneously effected a major change in the scope of the tasks of the Central Finance Commission (CFC), which until the insertion of Article 280(3) was confined to the distribution of divisible taxes between the union and the states and of grants-in-aid to states under Article 275 of the constitution. The new fiscal devolution system now requires the CFC to suggest measures needed to augment the consolidated fund of a state to supplement the resources of the municipal bodies on the basis of the recommendations made by the SFC.

However, the problem in this new system lies in the fact that in actual practice, SFCs have typically functioned with inadequate technical and financial expertise and support, and their recommendations have mostly not been complied with. Some states have partially devolved funds, while others have not devolved at all. Kerala and Goa did not accept the SFC recommendations on transfers because the state's resource base was strained. The expected benefits of improved fiscal devolution and enlargement of revenue base for municipal bodies through SFCs has not been realized leading to a failed effort so far in improving municipal finances. As a result municipal taxing authority stands limited to implementing and managing property taxation[7] and a few minor taxes such as advertisement taxes and tax on non-motorized vehicles. The fiscal space of municipalities is dominated by transfers which on average account for 50 percent of municipal revenues[8].

Box 2: Extract from Prime Minister Dr. Manmohan Singh's speech at the JNNURM inaugural address, December 2005

'An honest assessment would show that the 74th Amendment has not yet been effectively translated into improved urban governance. Cities unfortunately with some exceptions, have not been enabled to look inward and build on their inherent capacities, both financial and technical, and instead are still being seen in many states as 'wards' of the State governments. This should and this must change.'

2.1.4 Non Deepening of Democratic Decentralization

The lack of functional and fiscal devolution to municipal bodies has negatively impacted decentralization objectives in making government more responsive to the needs of local residents. The constitutional provisions regarding establishment of ward committees or MPCs and DPCs have not been implemented in letter and spirit, as a result municipal government lacks active participation of citizens in local governance (Box 2).

2.2 Small and Shrinking Share of Municipal Finances in India

Historically, municipal finance constitutes only a small share of India's federal finance structure. It is evident from Tables 3A and 3B that between 1997- 2001, share of municipal revenue hovered around 2.8 percent of the total public revenue raised by three tiers of the government but declined to 2.5 percent in 2002-03 and to 1.7 percent during 2002-07. Thus municipal finance has not shown any improvement; rather it has declined even after the enforcement of 74th CAA.

[7] *Municipal bodies benefit from a mix of taxes. A mix of taxes gives them greater flexibility to local conditions such as changes in the economy, evolving demographics and shifting expenditure needs. Taxes that grow with the economy provide cities with an incentive to make the kind of investment that stimulate growth. Finally, any tax is certain to create local distortions, but a mix could mean that distortions created by one will be offset by the other. See Enid Slack. Ibid.*

[8] *India Municipal Finance Report (2012), for ADB prepared by NIPFP*

Table 3A: Revenue share of different tiers of government

Tiers of government	1997-1998	1998-1999	1999-2000	2000-2001
Central government	63.84	62.78	62.90	**62.01**
State government	33.42	34.35	34.44	**35.17**
Municipalities	**2.74**	**2.87**	**2.66**	**2.82**

Table 3B: Revenue share of different tiers of government

Year	Centre	State	Municipalities	Panchayats
2002-03	44.1	53.2	2.5	0.2
2007-08	50.0	48.1	1.7	0.2

Sources: Indian Public Finance Statistics, Government of India and 13th Finance Commission

Per capita municipal own revenue receipts (MORR) is another good indicator to explain the extremely low level of municipal finance in India. Growth rate of MORRs at the national level was just 6.24 percent from 2001–02 (per capita MORR-Rs. 466) to 2007-08 (per capita MORR- Rs. 757), which is much lower than growth of own revenue receipts at the central and state levels during that period. As a result the share of municipal revenue in total public revenue is dwindling fast and there is a speculative likelihood that the same trend has continued post 2007.

2.3 Increasing Inter-State Municipal Finance Disparity

The state level review of municipal finances by India Municipal Finance Study-ADB (February 2013) clearly indicates that 75 percent of the municipal tax revenue is generated by four states of Andhra Pradesh, Maharashtra, Punjab and Gujarat accounting for 33% of the total urban population of India. On the other hand, the rest of India accounting for 67 percent of urban population contributes only 25 percent of municipal tax revenue. The five states of Orissa, Jharkhand, Uttar Pradesh, Bihar and Madhya Pradesh generate only 3.4 percent of the total municipal revenues while representing 26 percent of urban population.

Maharashtra municipalities generated a per capita annual revenue income of Rs. 2600, in comparison, per capita revenues of municipalities in Orissa, Jharkhand, Uttar Pradesh, Bihar and Madhya Pradesh were Rs. 38, Rs. 86, Rs. 94, Rs. 105 and Rs. 121 respectively, which is a fraction of the revenues generated by municipalities in Maharashtra (Table 4).

Such inter-state disparity in municipal finances and stark differences in per capita annual revenue income terms aggravates the situation and challenges policy-level thinking in dealing with the issue.

Table 4: State level structure of Municipal Revenue and Expenditure (2007-08)

States	Per capita own revenue (Rs.)	CAGR of own revenue 2002-07	% share in total revenue	Per capita revenue expenditure (Rs.)	CAGR of revenue expenditure 2002-07
Andhra Pradesh	748	13.0	58.5	1060	18.5
Assam	143	4.8	38.2	205	10.8
Bihar	105	4.8	14.6	711	48.8
Chattisgarh	376	11.6	14.1	1449	34.1
Goa	282	3.9	57.8	400	8.2
Gujarat	1079	7.7	61.5	1135	10.2
Haryana	281	3.6	33.5	328	2.9
Himachal Pradesh*	595	14.9	47.8	--	--
Jammu & Kashmir	90	21.2	9.9	452	20.1
Jharkhand	86	12.6	20.2	134	15.5
Karnataka	545	6.4	34.2	750	10.5
Kerala	329	3.6	39.5	517	14.4
Madhya Pradesh	121	6.8	11.6	998	16.9
Maharashtra	2600	11.7	76.1	2237	13.8
Orissa	38	14.7	4.5	405	17.6
Punjab	1049	7.2	89.1	925	10.6
Rajasthan	387	16.6	39.5	447	11.0
Tamil Nadu	396	7.4	38.4	665	8.1
Uttar Pradesh	94	2.1	14.8	245	2.1
Uttarakhand	116	0.6	21.8	330	8.6
West Bengal	394	10.4	51.7	574	6.3

Source: India Municipal Finance Study, ADB 2013

The inter-state variations in terms of per capita municipal expenditures were high but not as stark as it was with revenue. Again a municipality of Maharashtra spent as high as Rs 2237 per capita which is ten times compared to per capita expenditure in states like Bihar (Rs 205); Uttar Pradesh (Rs. 245), Haryana (Rs 328) (Table 4). The interstate disparity is much less in expenditure terms because these states make higher transfers to municipalities. The per capita expenditure has a direct implication on the level of infrastructure services that the ULB is able to provide and indicates the efficiency in service delivery.

2.4 Declining Share of Municipal Own Source Revenue or Increasing Dependency on Higher Level Governments

The alarming fact, which emerged from the data collected for 13th Central Finance Commission and reviewed in the ADB Study (Table 2) highlights that despite government's policy, legislative and programmatic emphasis on making municipal bodies financially self sustainable, share of municipal own revenue to total revenue declined from 63 percent to 54 percent between 2002-03 and 2007-08. Within own revenue, the share of tax revenue in total municipal revenue has declined from 42 percent to 34 percent and share of non-tax revenue declined from 21.2 percent to 18.5 percent from 2002-03 to 2007-08 (Box 3).

In six states only, own revenues account for over 50 percent of the total revenues – these being Andhra Pradesh (58.5%), Goa (57.8%), Gujarat (61.5%), Maharashtra (76%), Punjab

(89.1%) and West Bengal (51.7%) (Table4). Consequently as noted earlier during the period 2002-03 to 2007-08, own municipal tax revenue as percentage of GDP reduced from 0.39 to 0.35; and total own municipal revenue as a percentage of GDP reduced from 0.59 in 2002-03 to 0.54 in 2007-08 (Table 2).

Similar trend has been observed in terms of municipal own revenue to gross state domestic product (GSDP) (Table 5). Except Maharashtra where municipal own revenue constituted 1.49 percent of GSDP, in all other state it is less than one percent and during the period 2002-03 to 2007-08 share of municipal own revenue has declined.

Box 3: Extracts from India Municipal Finance Study - the ADB, 2013

Declining importance of own revenues in the financial structure of municipalities is an area of concern. It is not only that the share of own revenues has dipped, their growth rates vis-à-vis other revenue constituents have also declined. As a result, municipalities in several states are at a high risk in maintaining their fiscal identity as the third tier of government.

On the other hand, share of fiscal transfers in total municipal revenue income saw a rise from 36.5 percent in 2002-03 to 47.1 percent in 2007-08 with huge transfers from central government under JNNURM[9]. The grants further propelled the total expenditures as a share of GDP from 0.96 to 1.09 in the same period.

Aggregate municipal expenditures as a proportion of the GSDP are, however, substantially higher compared to municipal revenue as along with JNNURM several States have stepped up transfers to fund expenditures of municipal bodies (Table 5).

This highlights that infrastructure project funding under JNNURM was largely fuelled by grants rather than leveraging municipal income, thus defeating the key outcomes of JNNURM to establish ***"financially self-sustaining agencies through reforms to major revenue instrument".*** The only silver lining is that through JNNURM, the central government pumped investments in the urban infrastructure sector and drew attention of multilaterals, financing institutions and private sector to contribute in meeting the huge infrastructure investment needs.

[9] Central government transfers amounted to Rs. 2372 crore in 2007-08 compared to a meagre Rs. 308 crore in 2002-03 registering an annual compound rate of over 50 percent, mainly due to launch of JNNURM in 2005.

Table 5: Measuring Decentralization

State	Own Tax Revenues as a % of GSDP		Municipal Expenditure as a % of GSDP	
	2002-03	2007-08	2002-03	2007-08
Andhra Pradesh	0.26	0.32	0.88	1.18
Assam	0.03	0.05	0.14	0.26
Bihar	0.10	0.06	0.20	0.61
Chhattisgarh	0.20	0.14	1.21	1.76
Goa	0.13	0.07	0.39	0.30
Gujarat	0.91	0.60	1.45	1.40
Haryana	0.10	0.05	0.33	0.40
Himachal Pradesh	0.12	0.14	0.28	0.29
Jammu & Kashmir	0.01	0.01	0.33	0.61
Jharkhand	0.08	0.09	0.36	0.43
Karnataka	0.40	0.26	1.04	1.49
Kerala	0.18	0.10	0.46	0.46
Madhya Pradesh	0.08	0.09	1.21	1.72
Maharashtra	1.48	1.49	2.52	2.94
Orissa	0.02	0.01	0.34	0.46
Punjab	0.65	0.56	0.83	0.76
Rajasthan	0.03	0.01	0.80	0.71
Tamil Nadu	0.37	0.29	1.42	1.29
Uttar Pradesh	0.10	0.07	0.82	0.54
Uttarakhand	0.06	0.04	0.35	0.29
West Bengal	0.18	0.14	0.67	0.76

Source: India Municipal Finance Study, ADB 2013

This decline in share of municipal own revenue in GDP and GSDP (Table 5) is a result of lower annual growth of municipal own revenue due to abolition of octroi in smaller municipal bodies in Maharashtra and Gujarat and anti property tax policies adopted by Punjab, Haryana and Rajasthan. It can be observed from Table 4 that 7 of the 21 states had a CAGR of less than 5% for municipal own revenue and no state has a CAGR above 15% for municipal revenue.

Table 4 also highlights that municipal own revenues are insufficient to meet the revenue expenditures in all but two states, namely, Maharashtra and Punjab. There is a severe problem of structural imbalance in other states like Bihar, Madhya Pradesh and Orissa where municipal own revenue is just 20 percent of expenditure requirements.

2.5 Inferior and Unaugmented Municipal Resource Base Due To Internal Inefficiencies

The above sections have clearly pointed out at the small and shrinking revenue share of municipal bodies in public finances of India. The first root cause of this is very narrow fiscal domain and autonomy given by state governments to municipal governments. The second root cause, but equally pertinent, is the inferior nature of local tax base coupled with inadequate augmentation and internal inefficiencies in leveraging their full potential.

Municipal Governments in India have access to two types of resources for raising revenue, namely:

(i) internal/own sources like tax instruments (property tax being the biggest source); non tax (user charges) and capital receipts from own assets;
(ii) External sources like grants and assignments, loans and borrowings, private sector participation/PPPs.

But these are often either constricted by lack of fiscal autonomy, which although has been incorporated dejure but not de facto or lack of municipal capacity at technical and managerial level to tap these resources efficiently.

Internal (Own) resources: Municipal bodies have control on internal sources but in real practice municipal bodies do not possess full control with regard to administering these resources to their full capacity because of limited fiscal domain of municipal bodies, as discussed in the sections above. State governments have absolute prerogative regarding tax authority, tax base, tax rate, grant-in-aids, forms of transfers etc. Like functional domain, fiscal domain of local bodies is quite diverse and complex from state to state but surprisingly still, it fits or confines to the framework provided by the Lord Rippon's Charter of Municipal bodies of 1882. This is so because not a single additional resource has got reserved or devolved to municipal bodies in spite of changed role of municipal bodies in post independent, post industrialized India. The situation is ironically reverse where state governments have made inroads in local resource base provided by Rippon's Charter and have usurped various local resources from municipal bodies.

Against this backdrop, state governments have in general allowed municipal bodies to levy taxes and use an array of non-tax instruments as listed below in Table 6. As mentioned above, the tax rates are governed by state governments with little or no autonomy available to the municipal bodies to modify/revise/change them in view of local contexts. This is one the reasons why local bodies have been unable to exploit property tax as a major source of revenue apart from their internal inefficiencies to improve coverage and collection efficiency.

The charges levied for the various non-tax resources should also ideally be fully dependent on municipal bodies but that is not the case. In many states municipal bodies are required to take prior approval of the state government to increase or decrease or to change any other conditions regarding user charges. Also municipal bodies are not in a position to charge or introduce any new charge unless they are specifically authorized. In some states municipal bodies are provided a range or bandwidth (minimum and maximum rates) within which they can increase the rates of a charge. Thus the overall autonomy to harness the internal sources of revenue to their full potential is limited by state government interference.

Table 6: Internal Revenue Resources available to Municipal bodies in India

Tax Resources of Municipal bodies	Non-tax Resources of Municipal bodies
Taxes on land and holdings (popularly known as Property Tax)	User Charges with regard to the services like water, sewerage, garbage collection etc
Service related Taxes based or linked to Property assessment value, e.g. – fire tax, streetlight tax, water tax, drainage tax, conservancy tax.	Income from fees and fines;
Taxes on the entry of goods into a local area for consumption, use or sale therein; (known as Octroi but stands abolished in most of the states of India)	Rents from municipal assets;
Special benefit tax e.g. water or sewerage benefit tax	Income from municipal undertaking;
Taxes on advertisements other than published in newspapers;	Income from municipal investments
Tax on Vehicles (taken over and collected by State Government, some amount is shared with Municipal bodies)	
Taxes on animals and boats; (highly unproductive)	
Tolls; (productive but has limited application)	

2.5.1 Inefficient Property Tax Administration

Of all the internal revenue sources of municipal bodies, after abolition of octroi, property tax is the most crucial and dominant tax resource. This fact calls for its efficient and proper usage in the overall municipal resource base. However in India, it is grossly underused and ill-managed. Estimates made in the India Municipal Finance Study –ADB (February 2013) indicate that municipalities have the potential of raising revenues significantly (by about 110 percent) without any fundamental change in the system of property valuation or the design of tax rate structure.

According to a study undertaken by the Thirteenth Finance Commission (TFC), property tax revenues in the 36 largest cities of India were estimated at Rs. 4522 crore, yielding a per capita revenue of Rs. 486. In these cities, on an average, property tax revenues constitute 23 per cent of the total municipal revenues and 28.5 per cent of own source revenues. There were large inter-city variations in property tax revenues, with the Mumbai Municipal Corporation registering per capita annual revenue of Rs. 1334 as against Rs. 25 for the Patna Municipal Corporation.[10]

The all-India collection of property tax yield blown up from the 36-city sample is estimated to be between a low Rs. 6,275 crore and Rs, 9,425 crore, or 0.15 percent – 0.23

[10] *Chapter 10 13th Central Finance Commission - GOI*

percent of the country's gross domestic product (GDP)[11], compared with 0.6 percent for developing countries, 0.68 percent for transitional economies, and 1.04 percent for all countries. The Thirteenth Finance Commission report also notes that the main causes for dismal performance with regard to property tax are low coverage, very low collection efficiency and lack of indexation of property value. It noted that percentage of assessed properties actually paying taxes in these 'large city sample' was found to be 63 per cent, and it is estimated that this would amount to 56 per cent of the universe of properties. Even for the properties actually assessed, poor collection efficiency at 37 per cent of demand for the sample, along with non indexation of property values exacerbated the problem.[12] As per TFC figures, municipal bodies were found to realize only about 21% of the potential. Consequently TFC estimated that the property tax revenues could increase to Rs. 22,000-32,000 crore, merely by bringing all cities to an 85 per cent coverage level and 85 per cent collection efficiency, without changing any other variables. Thus property tax in India has a narrow base and highly inefficient in its administration. This situation again has its roots in the common problems of lack of fiscal autonomy of municipal governments in governing policies, tax structures and tax rates with regards to property tax.

The survey of 31 municipalities reported in the India Municipal Finance Study, ADB 2013 has corroborated 13th CFC observation while indicating that in the aggregate;

(i) 28.6 percent of properties were not on the house tax register of the municipalities;
(ii) 8.8 percent of properties were exempted from payment of properties, and
(iii) 53.9 percent of tax demanded was not collected.

The aggregate inefficiency in money terms works out to be 71 percent, meaning that the yields from property taxation will be higher by 71 percent if 85 percent of properties were brought within the tax net and if 85 percent of tax demanded was collected without making any other change. Such is the scale of inefficiency in property tax administration in India with obvious repercussions on municipal body's ability to fund infrastructure investments and improve service delivery.

2.5.2 Underdeveloped User Charge Mechanism

User fees are an essential non-tax source of revenue which is highly underdeveloped in India, given the perceptions to public/government provisioning of basic services like water supply, sewerage, sanitation, housing etc. Literature suggests that on an average, user charges cover less than 50 per cent of the O&M cost of basic infrastructure services in India. Tariffs for water supply and sewerage have remained largely unchanged since 2005. The situation is even worse where solid waste management is concerned[13].

[11] *Chapter 10 13th Central Finance Commission - GOI*
[12] *Chapter 10 13th Central Finance Commission - GOI*
[13] *HEPC on Urban Development Report -2011*

Institutionally, state level and city level parastatals like the public health engineering department or water and sewerage boards play a large role in the provisioning of these services within the municipal area. According to the 74th CAA provision of water supply, sewerage, sanitation, urban planning, and slum improvement are legitimate municipal functions, but state governments have not been able to handhold the municipal bodies to assume these functions and build their capacities in a phased manner to take over from parastatals. As a result, pricing of these services has been difficult given the poor database management at parastatals to assess the capital investment and O&M costs of service provisioning within the municipal area.

Yet again, lack of autonomy to the municipal governments to fix charges without approval from state government mars effective cost recovery from urban infrastructure services through user charges. The pricing at the state government level is often politically motivated and restrictive in terms of prescribing cost efficient charges. Most cities in India prescribe a basic monthly fee for water supply (based on tap connection or as part of property tax) and SWM. Charges for sewerage and drainage are majorly absent across all cities in India.

At the municipal level, inefficient management of user charges in terms of poor coverage and low collection efficiency further reduces revenue generation potential. User charges also have a deep link with property tax coverage to identify the user and administer charges. But this system of cross-check has also failed as property tax management is itself inefficient at the moment.

Thus, inefficient property tax administration and inability to revamp and restructure user charges has further narrowed the revenue resource base of municipal governments partly due to state guided policies and slack action and largely due to internal inefficiencies in improving coverage and collection efficiencies.

The external sources of revenue are discussed in section 2.7 and 2.8.

2.6 Ever Increasing Funding Gap to Meet the Huge Infrastructure Deficit

The above sections have explained the issues faced by municipal finances in India on two paradigms – (i) the lack of fiscal powers and devolution at the municipal level (ii) the plummeting own revenue base of municipal bodies coupled with higher dependence on transfers from center and state. In this background, the municipal bodies are expected to undertake expenditures in improving infrastructure and service delivery. However, the mountainous requirements of urban infrastructure sector clearly denote that municipal finance in its current state cannot meet the deficits. A summary of investment estimates from various authoritative sources will provide appropriate background and perspective on the pressures of municipal finances in India.

2.6.1 Earlier Estimates of Financial Requirements/Investment Gap of Urban Infrastructure Sector

Zakaria Committee norms (1963 updated to 1994-95 prices) placed the estimated financial requirement for operation and maintenance of core municipal services during 2000-2005 at Rs. 56, 622 crores. Against this expenditure requirement the total revenue generation during that period was estimated to be Rs. 38,705 crores leaving a resource gap of Rs. 17,917 crores i.e. an investment gap of 32 percent (Table 7).

The India Infrastructure Report prepared by the Rakesh Mohan Committee in 1996 estimated the total requirement for financing water supply and sanitation at Rs. 2,22,051 crores over the period 1996-2006 i.e. per annum Rs. 22051 crores. As against this, the flow of planned funds was estimated at Rs. 5,000 crores per annum during the period leaving a resource gap of Rs.17, 051 crores per annum. Thus the investment gap was 77 percent[14].

India's Housing and Urban Development Corporation (HUDCO) estimated that the investment needs for core local government services—water supply, sewerage, solid waste disposal, drainage, roads, and street lights—is Rs. 8359 per capita, per annum[15] while capital expenditures in 2007 averaged Rs. 765 per capita: in other words, urban infrastructure investment needs were 11 times compare to the average annual per capita capital expenditure. In other words the investment gap estimated was 90 percent (Table 7).

The XI Five Year Plan of India (2007-2012), estimated that total fund requirement for implementation of the Plan target in respect to urban water supply, sewerage and sanitation, drainage and solid waste management is Rs. 12, 92, 37 crores.[16]

Table 7: Infrastructure Investment Gap Estimations

Report	Estimated Investment Gap
The Zakaria Committee report for O&M of Existing Infrastructure between 2000-2005	32%
The India Infrastructure Report for financing water supply and sanitation per annum between 1996-2006	77%
Housing and Urban Development Corporation for per capita per annum provision of water supply, sewerage, solid waste disposal,	90.8%

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[14] *Ananth Kumar, Minister Urban Development - 2002)*

[15] *Mathur, et al., "Norms and Standards of Municipal Basic Services," New Delhi: National Institute of Urban Affairs, Working Paper 07-01, 2007, p. 13. Also see Shridhar, K. S., O. P. Mathur, and A. Nandy, "Costs of Urban Infrastructure: Evidence from Indian Cities," New Delhi: South Asia Network of Economic Research Institutes, Phase 7 Research, 2006. http://www.saneinetwork.net/research/sanei_VII/abstract1.asp.*

[16] *Source: XIth Five Year Plan of India, 2007-2012, Government of India (Excluding Urban Transport).*

drainage, roads, and street lights in 2007

The Working Group Report on Urban Transport for XI Five Year Plan has estimated an investment requirement of Rs 13, 25, 90 crores (including modern buses) for improving the transport system.

2.6.2. Ministry of Urban Development's Estimate of Funds required (2008)[17]

While submitting memorandum to Thirteenth Finance Commission the Ministry of Urban Development estimates the resource gap of Rs. 1, 25,871 crore for Municipal bodies on the basis of data collected from 19 states, presented in Table 8 as under:

Table 8: Infrastructure Investment Gap Estimations by MOUD (2008)

Particulars	(Rs. crore)
Requirement for all 28 states based on a uniform per capita requirement of Rs. 1578 per annum for provision of core services	63,893
Requirement of O&M for new assets funded under central schemes	20,000
Requirement under state schemes	16,400
Impact of the Sixth Pay Commission	24,288
Capacity building	1,290
Total	**1,25,871**

The Ministry of Urban Development also pointed out further that the aggregate resource requirement of municipal bodies for fulfilling all their functions is significantly larger than then Rs. 125871 core (Table 8). For example with regard to the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) cities, the resource gap was estimated at Rs.2,76,822 crore for 2005-12. Extending same logic, the resource requirement for all urban areas was projected at Rs.7,91,080 crore.

2.6.3 High Power Expert Committee (HPEC) Estimate of Urban Infrastructure Needs[18]

The Committee has made projections for the period from the Twelfth Five Year Plan to the Fifteenth Five Year Plan, i.e. 2012-31. Given the volatility of land prices, the estimates do not include the cost of land acquisition. The investment for urban infrastructure over the 20-year period is estimated at Rs 39.2 lakh crore at 2009-10 prices. Of this, Rs 17.3 lakh crore (or 44 percent) is accounted for by urban roads. The backlog for this sector is very large, ranging from 50 per cent to 80 per cent

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[17] *Chapter 10 of the report of the Thirteen Central Finance Commission*

[18] *Report on Indian Urban Infrastructure and Services (March 2011) – High Power Empowered Committee for estimating the investment requirements for Urban Infrastructure Services – Ministry of Urban Development, Government of India*

across the cities of India. Sectors delivering urban services such as water supply, sewerage, solid waste management, and storm water drains will need Rs 8 lakh crore (or 20 per cent). The Committee has made explicit provision of Rs 4 lakh crore towards investment in renewal and redevelopment including slums. Recognizing that the focus of policy should be on provision of public services, which flow from infrastructure assets, and not merely on creating the assets, the Committee has highlighted the importance of operations and maintenance (O&M) for the upkeep of the assets. The O&M requirements for new and old assets are projected at Rs 19.9 lakh crore over the 20-year period.

2.7 Increasing but Inadequate and Tied Devolution of Funds to Municipal Governments

As noted earlier external resources are the most important part of municipal finances (forming 60 to 90 per cent of total receipts) because – (i) the state governments have not empowered municipal bodies with adequate resources and powers to levy existing and new taxes and user charges; (ii) the municipal bodies have not administered efficiently the resources which they have, thus, leaving a huge fiscal deficit in urban infrastructure financing. Consequently devolutions of funds from central and state level have a crucial role to play.

Of the key heads of external resources ***assigned taxes*** are levied and collected by the state governments and proceeds are passed on to the municipal bodies, implying it is again at the behest of the state government; ***government grants*** are the most important external resource and can be of revenue or capital nature, or specific/tied or general/untied nature, formulae based or of an adhoc nature. Grants can be of incentive nature, for matching purpose or performance linked as in case of JNNURM. The huge dependence on grants and its widening nature as a policy instrument to fund the infrastructure deficit in the country has adversely affected the municipal bodies which are often complacent to substitute its operational deficit through grant money. The India Municipal Finance Study – ADB (February 2013) acknowledges that *"In 2007-08, transfers comprising assignment and devolution, grants-in-aid, Central government grants, and finance commission dispensations accounted for 95 percent of the total revenue income in Orissa, 88 percent in Madhya Pradesh, and 85 percent in Uttar Pradesh. There is a trade-off between own revenues and transfers, with the latter serving as a substitute for declining own revenues."*

The data has conclusively indicated that the overall devolution of funds to municipal governments is growing but at a much lower rate than the state government revenues. A significant part of resource transfer is tied, project specific and non-discretionary thus defeating the purpose of fiscal decentralization and limiting the abilities of the municipal bodies to match resources to locally felt needs.

The HPEC on Urban Development has projected investment requirements of Rs 39.2 lakh crore for urban infrastructure to be financed over the 20-year period from 2012-13 to 2031-32. To meet this, municipal finances need to be well supplemented by the central government and through a revenue sharing model between the state government and municipal bodies as prescribed by the respective SFCs. In this context 13th Central Finance Commission has taken steps in the right direction in recommending that funds be automatically transferred to municipal bodies through a percentage of the divisible pool of taxes being converted into a grant-in-aid. Under this system, state governments should make an unconditional, consolidated, and formula-driven basic grant available to all municipal bodies. In addition, a conditional, consolidated, formula-driven performance grant is proposed on the fulfillment of certain governance and financing reforms. Predictability of the basic grant will encourage financial planning at the municipal level, while performance-linked grants will provide an incentive to improve governance through reforms.

2.8 Inadequate Access to External Resources (Borrowing and Market Based Financing)

Generating external resource through ***loans and borrowings*** has not been able to make a dent in municipal bodies in India because municipal acts provide very limited borrowing powers to municipal bodies (in some state only municipal corporations have the powers). This external source conventionally was confined to government loans to municipal bodies or government institutional (Life Insurance Corporation, Housing and Urban Development Corporation) or multilateral loans flowing through central and state government. In recent years this source is acquiring non-conventional status because of advent of market based borrowing (municipal bonds, loans from commercial banks, project finance etc). The incidences of municipal borrowings from market are not plenty because borrowing is a resource contingent on repayment capacity of a municipal body, which is generally weak. Credit ratings are also poor. Municipal bodies, which have repayment capacity often lack mindset and ability to deal with the market. HPEC Report rightly summarized the situation by stating, “Municipal bodies can borrow from the market only within limits and with explicit approval of the state government. However, this has mostly not been a binding constraint since the real challenge in accessing external finance has been the precarious state of their own finances and poor governance”.[19]

Because of poor or no credit ratings and lack of repayment capacity, funding through ***Private Sector Participation (PSP) or Public Private Partnership (PPP)*** has also not been substantially successful although it is an emerging external source. Also PSP or PPP requires enabling policy and regulatory framework to manage various types of risks. ***Community Participation or Peoples’ Participation*** can be another external source if not remarkable but of noticeable proportion and some municipal bodies. State Governments have started involving civil society, community at large in development and management of urban services for example initiatives like Janambhoomi in Andhra Pradesh, Lok Bhagidari in Delhi.

2.9 Absence of Fiscal Responsibility and Budgetary Management Accountability

[19] *HEPC on Urban Development Report 2011*

The single most important factor which is directly or indirectly responsible for the various unresolved issues of municipal finances in India particularly with respect to internal efficiency and performance of municipal bodies is absence of performance accountability including absence of fiscal responsibility and budgetary management accountability. ADB study also observed that there are no performance standards for municipalities with the result that they have accumulated huge inefficiencies in the internal mobilisation and management of resources and are hardly ever confronted with a hard budget constraint.[20] Absence of accountability structure for municipal bodies emanates from an absence or inadequate or unaugmented -

1. Accrual Based Double Entry Municipal Accounting System (DEAS)
2. Municipal Audit System including Efficiency and Performance Audit System
3. Municipal Budgetary System
4. Municipal Financial Management System (FMS)
5. Municipal Cost Accounting System
6. Municipal Public Disclosure System (PDS)
7. Municipal Fiscal Responsibility and Budgetary Management System (FRBM)

Reforms with regard to some of the above missing accountability frameworks have been initiated under JNNURM and 13th Central Finance Commission performance conditionalities and are at various stages of implementation but at a very slow pace.

FRBM is of specific importance in the context of municipal finances in India as it aims to assign responsibility to ensure long-term fiscal sustainability and stability by achieving sufficient revenue surplus and removing fiscal deficits, which are common to municipal finances in India. Adoption of FRBM will ensure preparation of a Medium Term Fiscal Plan, which would set forth a five year rolling target for the municipal-level fiscal indicators, along with a clear target of the physical and financial targets, and adherence to performance codes/standards, thus building in accountability and transparency in the system. Legalizing responsibility for prudent debt management through FRBM will shift the onus of effective conduct of fiscal management on municipal bodies and (i) weed out internal inefficiencies as discussed in the sections above; (ii) ensure improved revenue coverage and collection in order to fund the expenditure streams designated in the budget and medium term plan and (iii) regulate high expenditures on establishment and administration.

2.10 Absence of Necessary Capabilities in Municipal Management

Although some of the observations presented above will not find respite till the fiscal autonomy and devolution is impinged by state governments but internally the municipal bodies need to make serious adjustments in changing their overall mindset towards organizational functioning and instill a culture of operational efficiency and proactive management.

[20] *India Municipal Finance Study – ADB 2013*

2.10.1 Low Technical Competence in Municipal bodies

Generally, most municipal bodies in India have a concentration of non-technical staff vis a vis technical staff which makes the municipal body bottom heavy and erodes a large part of the revenue on meeting establishment expenditures including wages vis a vis O&M expenditures on infrastructure. Table 9 shows a redeeming trend where O&M expenditures are on the rise and establishment expenditures are reducing but the latter still dominates municipal finance.

Table 9: Composition of Revenue Expenditure in Municipal bodies

Composition	Percent	
	2003-04	2007-08
Establishment	57.8	44.9
Operations and Maintenance	19.6	27.2
Others	22.6	20.9
Total	100.0	100.0

Source: ADB Study on India Municipal Finance Study, 2013

State policies on recruitment of municipal staff are also to blame in this regard. In many states although the functional domain of the municipal body has been expanded but a supporting organizational structure with new posts and recruitment has not been initiated, thus leaving the municipal body to deliver larger roles with limited staff having inadequate capacity. The survey of 31 municipal bodies under India Municipal Finance Study – ADB (February 2013) indicated that municipalities are made up of staff, which has little technical and managerial capacities. This survey also showed that supervisory and managerial staff constituted less than 10 percent of the total staff, the balance being clerical and service staff.

The lack of autonomy of the municipal bodies to design and revise their own organization structure in pursuance to their changing needs; revamp HR strategies and undertake recruitments with specified job descriptions has also been a major restricting factor in enhancing municipal capacity. In most states, initiatives on revising organizational structure and infusing fresh competent technical staff is happening under large multilateral funded technical assistance or capacity building programs under state government guidance. However the onus of such initiatives should have rested with municipal officials whose decision-making powers are mostly clipped through unhealthy policies at the state level.

2.10.2 Low Capacity for Accessing Funds and their Utilization at the Municipal Level

Absence of adequate capacity to reform or to undertake infrastructure development or to improve performance with the municipal bodies is clearly evident from the fact that even when funds were made available to municipal bodies under JNNURM, they have not been able to take advantage of it and show improvements in infrastructure delivery. As actual expenditure figures under JNNURM are not available if amount released by Government of India is taken as proxy then as of December 2013, (after eight years of launch of JNNURM) is around 69 per cent which is much less. Another set of data shows that out of 553 sanctioned projects under the UIG component (Table 10) only 212 have been completed i. e. 39 percent. Hence non-availability of funds in project account is not the reason for low project implementation but lack of capacity at state and municipal level in terms of project planning, designing and DPR preparation, consultant management, procurement and tendering, project implementation, monitoring and evaluation etc.

Capacities for PPP and accessing ways for innovative financing have also been weak amongst state governments and Municipal bodies. By end of 2010 around 50 projects of Rs. 5458 crore (less than 10 percent in terms of numbers and project outlay) had PPP structure in which Rs. 1066 crore only have been leveraged through private sector partner. Similarly not much fund leveraging has been done through accessing of capital/debt market in JNNURM projects.

Table 10: JNNURM Progress at the End of December 2013 (Rs. In Billion)

Progress December 2013	Sub Mission for Urban Infrastructure and Governance	Urban Infrastructure Development for Small and Medium Towns	Sub-Mission for Basic Services to the Urban Poor	Integrated Housing and Slum Development Program	Total
Total Allocation	315.00	114.00	163.56	68.28	660.00
Envisaged Cost of Projects approved	625.51	141.21	297.70	119.36	1183.78
ACA committed in ` and %	285.23 (90.55%)	113.19 (99.29%)	147.00 (90.00%)	76.45 (112.00%)	621.87 (94.20%)
Funds released	187.04 (59.38)	94.65 (83.00%)	97.09 (59.00%)	57.05 (74.06)	435.83 (66.03%)
Funds spent	Not Available	Not Available	Not Available	Not Available	
Projects Approved	553	807	525	1083	2968
States/UTs covered	30	30	30		
Cities/Towns covers	62	640	62		

Total Released	432.00 (69.00%)	115.23 (81.60%)	183.45 (61.60%)	82.21 (68.90%)	812.89 (68.70%)

Source: MoUD website www.jnnurm.nic.in

In the light of these issues HPEC observed that progress in implementing reforms under the JNNURM has been slow, and it has been difficult to enforce conditionality of overall reforms in a project-based financing approach for a variety of reasons. JNNURM has more generally exposed the lack of capacity at local government level to prepare and implement projects in urban infrastructure.[21]

2.10.3 Slack Reform Implementation under JNNURM

Reform implementation under JNNURM has also been lukewarm in terms of building capacities at the municipal level, as external consultants (especially for enabling double entry accounting systems and e-governance reforms) have done most of the reform implementation work. Training, although has been imparted at central, state and municipal level to municipal staff but transference of skills in actual practice is in serious doubt. Many municipal bodies have been unable to take forward the accounting reforms through their own accounting department after exit of consultants and have gone in for fresh tendering to hire CA firms to take the system forward. Similar kind of incomplete completion is observed with other reforms. For example property tax and user charge performance has not improved or public disclosure or earmarking of funds for urban poor in budget is not happening etc.

3. Way Forward

The main unresolved issues with their sub-layers discussed above are well known to a large extent in the municipal sector. Some of the issues are unresolved for many decades and have been documented in various studies and reports. The change, in the recent past has been in the urgency or intensity being felt to address these unresolved issues at various levels of governance. India has now reached a stage where these unresolved issues need to be addressed immediately to fuel infrastructure development and ensure double-digit economic growth rates. Fortunately, the HPEC Report on Urban Development; the 12th Five Year Plan documents and other study reports have come out with a comprehensive and well-articulated 'way forward' to overcome these unresolved issues. Some of these have been summarized below with added insights.

3.1 Broad-Basing Municipal Resource Base With or Without Constitutional Mandate

The discussion above have factually articulated and summarized that the Indian municipal bodies have very narrow resource base coupled with low fiscal and functional autonomy. In

[21] *HPEC on Urban Development Report – 2011*

this context, the HPEC Report recommended to introduce a Local Bodies Finance List' in the Constitution and to empower municipal bodies with exclusive' taxes (to overcome observed behaviour of the States to withdraw tax authority from municipalities or to dilute their tax powers, thereby weakening their revenue base) to bring stability and uniformity municipal fiscal structure.

Constitutional mandate in the form of exclusive taxes and resources for municipal bodies will certainly be the ultimate solution but there are many federal countries in the world where constitutions have not provided for exclusive resources for municipal bodies but political ideology, belief in fiscal decentralization and political and executive will have provided broad-based resources to municipal bodies. Also constitutional amendment may be time consuming and in the interim what is required more urgently is to follow the public finance principles to restore at least those municipal taxes that fulfill the criterion of immobility – namely, non-commercial motor vehicles registered within the jurisdictional limits of municipalities; and stamp duty on sale and purchase of properties located within municipal limits. At present these taxes are with state governments and needs to be devolved to the municipal bodies immediately.

Broad basing municipal resource base also has another angle of reducing exemptions imposed by state laws with regards to municipal taxes and charges and reducing subsidies in the provisioning of the municipal services, implying that there is a need to give fiscal and functional autonomy to municipal bodies with regard to taxes/charges devolved to them. Various studies have proved that absence of a fuller correspondence between the cost and price of services results in large gap between the cost of providing services and the price fixed for cost recovery. The India Municipal Finance Study - ADB (February 2013) rightly observes that, "a sound municipal finance system is unsustainable with such large subsidies. The study suggests reducing the subsidies to be no more than 15 percent of the cost of delivering the services".

Broad basing municipal resource base to meet challenges of 21st century cannot be achieved by giving taxes which meet immobility condition (traditional fiscal federalism) and by reducing exemptions or subsidies. There is a need to create link between municipal resource base and local and national economy which can be achieved by allowing municipal bodies to impose local income tax and local expenditure tax. In this context, the TFC has proposed that the proposed Goods and Services Tax (GST) be shared with local bodies. The India Municipal Finance Study - ADB (February 2013) also has reinforced the suggestion and proposed that the method of GST sharing and the share of GST to be assigned to municipalities should be worked out by an Expert Group.

Besides, the above, TFC has also suggested the following to broad base municipal resource base:

- All local bodies should be fully enabled to levy property tax (including tax for all types of residential and commercial properties) and any hindrances in this regard must be removed.

- The Government of India and the State Governments should issue executive instructions that all their respective departments pay appropriate service charges to local bodies (Para 10.178).
- Given the increasing income of State Governments from royalties, they should share a portion of this income with those local bodies in whose jurisdiction such income arises (Para 10.179).

3.2 Restructuring Intergovernmental Fiscal Transfer System and Reinventing Role of SFCs and CFCs.

As noted earlier, institution of SFC has not fulfilled the role envisaged by the 74th CAA. Successive finance commission reports and other studies have elaborated on this aspect. Even after twenty years, intergovernmental fiscal transfer system has remained almost as it was prior to constitutional amendment. There is a need to reinvent the role of SFCs and in a manner that the fiscal transfer system is restructured. In this context TFC has made the following recommendations:

- State Governments should ensure that the recommendations of SFCs are implemented without delay and that the Action Taken Report is promptly placed before the legislature (Para 10.129).

HPEC Report has also recommended the following:

- Constitutionally ensure sharing by the state governments of a pre-specified percentage of their revenues from all taxes on goods and services with municipal bodies.
- Provide for formula-based transfers and grants-in-aid to municipal bodies from the divisible pool.

3.3 Improving Municipal Financial Management

Giving additional resources and fiscal devolution/transfers will not be sufficient in itself as municipal bodies are equally responsible for the present state of municipal finance given their low capacities and poor management which has led to inefficient administration of existing revenue sources (property tax and user charges). In other words municipal bodies need to improve municipal financial management. As noted earlier, municipal bodies are recovering only 20 to 25% of the property tax potential. The case of user charges is similar. If municipal bodies are allowed to continue with poor resource augmentation capacity then provision of additional resources will not solve the problem, rather aggravate the situation as municipal bodies will continue to use newly given resources with low efficiency. Thus, there is a need to create positive and negative incentive and accountability framework to incentivize, penalize and regulate municipal bodies. In the same light, TFC also observes the following:

- Though our recommendations provide enhanced support to local bodies, we recognize that there is no substitute for local bodies raising their own tax and non-tax revenues (Para 10.173)
- The state governments should incentivize revenue collection by local bodies through methods such as mandating some or all local taxes as obligatory at non-zero rates of levy; by deducting deemed own revenue collection from transfer entitlements of local bodies or through a system of matching grants (Para 10.173).

3.4 Building Necessary Capacity of Municipal Bodies

JNNURM implementation experience clearly points that making funds available is not sufficient; creating adequate capacity to plan, implement and run urban services efficiently is most important. HPEC has recommended creation of a separate Mission for capacity building of municipal bodies in the second generation JNNURM. Besides this, it has made following recommendations regarding capacity building of municipal bodies.

3.4.1 Institutional Capacity Building

- Set up five Indian Institutes of Urban Management through partnership between the Government of India, state governments and the private sector, either anchored in existing IIMs or as standalone institutions of excellence.
- Infuse funds and new talent into existing Schools of Urban Planning.
- Promote think tank initiatives in urban policy through Centres of Excellence / Innovation in existing institutions
- Create a Reform and Performance Management Cell (RPMC) in the Government of India (and at state level and in large cities) with a multidisciplinary team undertaking activities such as:

    - Providing technical assistance to state governments, regulators, and Municipal bodies in planning, finance, operations, and monitoring of urban programmes
    - Encouraging projects under PPPs through model concession agreements, database, knowledge sharing, etc.
    - Creating a dedicated Municipal Information Unit to collect, collate, and analyse comparable data on municipal services and finances on an annual basis
    - Providing assistance to State Finance Commissions
    - Developing a Performance Management System for evaluating cities and towns

TFC has also made some suggestions with regard to institutional capacity building as below:

- While the C&AG will provide technical guidance and supervision, the major portion of the work will have to be undertaken by the local fund audit department. State Governments should appropriately strengthen their local fund audit departments through capacity building as well as personnel augmentation (Para 10.167).

3.4.2 Human Resource Capacity Building

- Train 300 officers from the Indian Administrative Services (IAS) and other central services annually as urban specialists and place them systematically through deputation in cities and towns.
- Build/Reform Municipal cadres in all states with recruitment into the cadre at entry level through a competitive examination.
- Provide flexibility in lateral hiring of professionals with special skills into the cadre.
- Put in place a transparent search-cum-selection process in the appointment of the Municipal Commissioner.
- Tenure of the management team to be a minimum of three years.
- Develop dedicated IT cadre with a Chief Information Officer for the larger cities

3.5 Creating Frameworks for Adherence to Performance Standards and Overall Accountability at the Municipal Level.

The crux of all unresolved issues is absence of any form of performance standards (revenue realization, expenditure efficiency or service delivery) and accountability in the municipal system. All the recent reports on municipal governance and finances listed above have made recommendations in this regard. The beginning in this direction was made by JNNURM by prescribing public disclosure law as one of the mandatory reforms.

TFC has tried to take forward objects of performance assessment, transparency and accountability by including the following three conditions in the nine conditions to be fulfilled by the state governments and municipal bodies to get performance grant

- State Governments must put in place an audit system for all local bodies. The C&AG must be given TG&S over the audit of all the local bodies in a State at every tier/category and his Annual Technical Inspection Report as well as the Annual Report of the Director of Local Fund Audit must be placed before the State legislature.
- Putting in place a system of independent local body ombudsmen who will look into complaints of corruption and maladministration against the functionaries of local bodies, both elected members and officials, and recommend suitable action.
- Putting in place (gradually) standards for delivery of all essential services (water supply, sewerage, storm water drainage, and solid waste management) provided by local bodies.
- The State Government must put in place a supplement to the budget documents for local bodies (separately for PRIs and Municipal bodies) furnishing the details (other than those relating to Finance Accounts) indicated in Para 10.110

HPEC Report has also recommended several ways to create missing accountability mechanism in the following ways:

- Urban Utility Regulator, beginning with water and sewerage.
- Local Body Ombudsman for dispute resolution.
- Local Fund Audit Commission for independent and professional audit.
- Implementation of Public Disclosure Law.
- Preparing Citizen Report Cards and Social Audits.
- Preparing Market Worthiness Disclosure Statements by municipal bodies.

India Municipal Finance Study- ADB (February 2013) suggests that an appropriate legislation on Fiscal Responsibility for Municipalities, be brought in to gradually bring them into a system that requires them to adhere to a minimum performance standards. Such an Act should provide for the following:

- Preparation of a Medium Term Fiscal Plan, which would set forth a five year rolling target for the municipal-level fiscal indicators, along with a clear target of the physical and financial targets, and adherence to performance codes/standards.
- Creation of an expenditure stream only against a matching revenue stream, and managing expenditure consistent with the level of revenue generated.
- Fixation of ceiling on expenditure on administration.
- Ensure proper procedure for preparation, submission and audit of accounts, and proper scrutiny and adherence to the audit reports.
- No credit operations without the authorization of Municipal Councils.
- Publication of an annual report on the impact of tax exemptions and price subsidies in the municipal budget.
- Laying down measures to enforce compliance to the provisions of the Act.

Twelfth Five Year Plan Document has also recommended putting in place a Fiscal Responsibility Framework for municipal bodies through an appropriate legislation.

4. Summing Up

After independence, municipal bodies in India lost the classical theoretical autonomy of a self-governing institution as a result of increasing financial dependence on higher-level governments and inroads by higher-level governments in the functional domain of municipal bodies because of centralization.

The 74th CAA provided municipal bodies with the right to exist but upheld the prerogative of state governments to decide the functional and financial domains of municipal bodies. As a result, even after the constitutional amendments, municipal bodies have remained marginalized both functionally and financially in the Indian federal structure and continued to suffer from several unresolved issues. The analysis presented in this paper clearly establishes the feeble condition of municipal finances in India. This dismal scenario of municipal finance needs urgent attention and the following corrective actions:

- Broad basing Municipal Resource Base with or without Constitutional Mandate.

- Restructuring Intergovernmental Fiscal Transfer System and reinventing role of SFCs and CFCs.
- Improving municipal financial management comprising of improved resource augmentation and cost efficiency / expenditure management.
- Building necessary capacity of municipal bodies.
- Creating frameworks for adherence to performance standards and overall accountability at the municipal level.

In recent years various official policy documents like 12th Five Year Plan, Central Finance Commission Reports etc. have started giving heightened attention to the issues of Municipal Finance which gives hope that various issues which have remained unresolved will get addressed and Indian Municipal Bodies will acquire the status they deserve to have in the 21st century India.

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