Finances of Urban Local Bodies in India: Directions for Reforms

Dr. P. K. Mohanty
Joint Secretary & Mission Director (JNNURM)
Ministry of Housing & Urban Poverty Alleviation, Government of India, New Delhi

30th October 2007
## Urbanization Trends in India 1981-2001

<table>
<thead>
<tr>
<th>Category</th>
<th>Increase/Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in Total Population</td>
<td>684 M to 1027 M</td>
</tr>
<tr>
<td>Decadal Total Population Growth</td>
<td>25%</td>
</tr>
<tr>
<td>Increase in Urban Population</td>
<td>159 M to 285 M</td>
</tr>
<tr>
<td>Decadal Urban Population Growth</td>
<td>40%</td>
</tr>
<tr>
<td>Increase in Million-plus Cities</td>
<td>12 to 35</td>
</tr>
<tr>
<td>Increase in Metropolitan Population</td>
<td>42 M to 108 M</td>
</tr>
<tr>
<td>Decadal Metro-Population Growth</td>
<td>79%</td>
</tr>
<tr>
<td>Increase in Slum Population</td>
<td>26 M to 62 M</td>
</tr>
<tr>
<td>Slum Population Growth</td>
<td>70%</td>
</tr>
</tbody>
</table>
Significance of Cities

- Engines of Economic Growth (Contribute to more than 60% of GDP)
- Reservoirs of Capital & Skilled Labour
- Centres of Service Sector Employment
- Centres of Education, Culture & Innovation
- Destinations of Foreign Direct Investment
- Centres of Information & Communication Technologies, IT-enabled Services & Business Process Outsourcing, Off-shored Services
- Generators of Resources for Development
- Hopes of Millions of Rural Migrants
## Contribution of Urban Areas to National Income

<table>
<thead>
<tr>
<th>Year</th>
<th>Share of Population (%)</th>
<th>Share of National Income (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951</td>
<td>17.3</td>
<td>29.0</td>
</tr>
<tr>
<td>1981</td>
<td>23.3</td>
<td>47.0</td>
</tr>
<tr>
<td>1991</td>
<td>25.7</td>
<td>55.0</td>
</tr>
<tr>
<td>2001</td>
<td>27.8</td>
<td>60.0</td>
</tr>
</tbody>
</table>

*Source: Ministry of Urban Affairs & Employment, Government of India*
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Taxes</td>
<td>58.37</td>
<td>68.73</td>
<td>69.84</td>
<td>72.04</td>
<td>72.85</td>
</tr>
<tr>
<td>Prohibition &amp; Excise Taxes</td>
<td>53.34</td>
<td>53.53</td>
<td>59.20</td>
<td>56.84</td>
<td>63.03</td>
</tr>
<tr>
<td>Registration and Stamps</td>
<td>32.75</td>
<td>33.96</td>
<td>34.88</td>
<td>35.45</td>
<td>36.18</td>
</tr>
<tr>
<td>Transport and Motor Vehicles</td>
<td>27.00</td>
<td>26.80</td>
<td>27.93</td>
<td>28.27</td>
<td>27.80</td>
</tr>
</tbody>
</table>

Source: Centre for Good Governance, Hyderabad
State of Finances of Urban Local Bodies: Rich City – Poor City Govt. Syndrome

- Mismatch between Functions and Finances of Urban Local Bodies – Unfunded Mandates
- Vertical Imbalance: Constitutionally in-built
- High Fiscal Dependency – against the spirit of Decentralisation
- Resolution - through Central and State Finance Commissions
- Plans/Finances of Urban Local Bodies not integrated to National Planning/Public Finance in India
- With Growing Urbanization, it is necessary to consider Central, State & Local Finances in totality
Central Finance Commissions (CFC)

- 10th, 11th and 12th CFCs could not make use of reports of SFCs – mismatch between SFC Report & CFC timings
- Research studies undertaken by academic institutions and estimates made by Government departments/agencies could not provide a realistic picture of service delivery status & fiscal position of local bodies
- CFCs could not arrive at their own estimate of resource gaps – Resorted to ad hoc allocations for local bodies
State Finance Commissions (SFCs)

- First SFCs: 25 states constituted, 23 submitted reports and 20 states submitted the ATRs
- Second SFCs: 19 states constituted, 16 submitted reports and only 6 states submitted ATRs
  - i. several states did not initiate follow up action,
  - ii. recommendations under examination, met with “natural death”,
  - iii. very few states have honored their commitment for the release of additional resources and
  - iv. budgetary provisions have fallen short of commitments.
State Finance Commissions...

• Most SFCs failed to emphasize the link between revenue – raising and expenditure responsibilities, a link that is needed to induce fiscal responsibility

• No SFC seems to be worried about fiscal management or the need to impose a hard budget constraint at the local level

• SFCs did not make suggestions to reduce the multiple channels of devolution viz. line departments, State Planning Boards, SFC devolution, MP, MLA programmes, DRDA and the like

• SFCs recommended a number of grants some of which are ad hoc and dependency-promoting
Vertical Imbalances: Links with Central & State Finances

• The vertical imbalance - constitutionally built-in

• Local bodies have only limited powers to raise resources and taxes and duties collected by them are not very elastic or buoyant

• They cannot have deficit in their budgets and are subject to borrowing limits

• Local bodies have to depend on a number of institutions for resources to perform the tasks assigned to them by the Constitution and state legislatures

• The vertical imbalance, fiscal dependency and borrowing constraints and limits affect the functioning of urban local bodies
## Revenue Significance of Municipal Sector in India

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Municipal Revenue (Rs. Crore)</th>
<th>Percentage of GDP</th>
<th>Relative share of Total Municipal Revenue (as per cent of Total Revenue of):</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>State Govt.</td>
</tr>
<tr>
<td>1990-91</td>
<td>3,931</td>
<td>0.73</td>
<td>5.91</td>
</tr>
<tr>
<td>1998-99</td>
<td>11,515</td>
<td>0.73</td>
<td>4.38</td>
</tr>
<tr>
<td>1999-00</td>
<td>13,173</td>
<td>0.75</td>
<td>4.24</td>
</tr>
<tr>
<td>2000-01</td>
<td>14,581</td>
<td>0.77</td>
<td>4.17</td>
</tr>
<tr>
<td>2001-02</td>
<td>15,149</td>
<td>0.73</td>
<td>4.05</td>
</tr>
</tbody>
</table>
## Municipal Revenue Sources: India

<table>
<thead>
<tr>
<th>Revenue Head/Category</th>
<th>Sources of revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax revenue</strong></td>
<td>Property Tax, Octroi, Advertisement Tax, Tax on Animals, Vacant Land Tax, Taxes on Carriages and Carts</td>
</tr>
<tr>
<td><strong>Non-Tax revenue</strong></td>
<td>User Charges, Municipal Fees, Sale &amp; Hire Charges, Lease amounts</td>
</tr>
<tr>
<td><strong>Other receipts</strong></td>
<td>Sundry receipts, Law charges costs recovered, Lapsed deposits, Fees, Fines &amp; Forfeitures, Rent on Tools &amp; Plants, Miscellaneous Sales etc.</td>
</tr>
<tr>
<td><strong>Assigned (Shared) revenue</strong></td>
<td>Entertainment Tax, Surcharge on Stamp duty, Profession Tax, Motor Vehicles Tax</td>
</tr>
</tbody>
</table>
| **Grants-in-aid**            | (i) Plan Grants made available through planned transfers from upper tier of Government under various projects, programmes and schemes  
(ii) Non-Plan Grants made available to compensate against the loss of income and some specific transfers |
| **Loans**                    | Loans borrowed by the local authorities for capital works etc. – HUDCO, LIC, State and Central Governments, Banks and Municipal Bonds           |
Sources of Municipal Revenue: United States of America

• Property tax
• Other Taxes - Local Option Income Taxes, General sales tax, Excise tax, Impact taxes, Special levies
• User fees such as road tolls, park admission fees, and water and sewer charges
• Development Exactions
• Debt Financing
• General Obligation Bonds, Revenue Bonds, Taxable bonds, Bond Banks
• Tax Increment Financing
• Lease-Purchase Contracts
• Revolving Loan Funds
Sources of Municipal Revenues: United Kingdom

- Property tax levied on industrial and commercial property
- Exchequer grants to local authorities - Revenue Support Grant (RSG)
- A capital finance system (grants and loans) through partnerships with the private sector
- Local domestic taxation known as the Council Tax

Government grants constitute more than 50 per cent of the total revenue expenditures
Sources of Municipal Revenues: Canada

- Property tax
- Business tax
- Local improvement taxes in the form of betterment levies
- Special taxes to raise revenue to pay for a specific service or purpose such as:
  - waterworks tax; sewer tax; boulevard tax; dust treatment tax; paving tax - to cover the cost of repair and maintenance of roads, boulevards, sewer facilities and water facilities;
  - ambulance service tax - tax to enable the Municipality to provide incentives to health professionals to reside and practice in the Municipality;
  - fire protection area tax; drainage ditch tax; recreational services tax.
Patterns of Local Taxation in OECD Countries 2001

- Income taxation (corporate and personal) - most important source of local tax revenues in 14 countries.

  - Denmark, Finland, Norway, Sweden, Luxembourg, and the Czech Republic - Income Tax accounts for more than 90 per cent of local revenues.

  - Australia, Canada, Mexico, France, Greece, Hungary, Ireland, Netherlands, New Zealand and the United Kingdom - local governments do not have direct access to income tax revenues.

- Local sales taxes - 20 to 76 per cent of total tax revenue in 10 countries. At the other extreme, local sales taxes are non-existent in 5 countries and produce less than 10 per cent of local revenue in another 12 countries.

- Property taxes - more than 90 per cent of all local tax revenue in 5 countries (Australia, Canada, Ireland, New Zealand, and the United Kingdom). By contrast, local governments in 10 countries get less than 10 per cent of their tax revenue from the property tax.

- Business taxes - Local governments in France, Italy, Greece, and Turkey rely fairly heavily on other local taxes, mainly on business.
Addressing Municipal Tax Reform

\[ T = e \times t \times (B - L) \]

- \( T = \text{Total Tax Collection} \)
- \( e = \text{Collection Efficiency} \)
- \( t = \text{Tax Rate} \)
- \( B = \text{Potential Tax Base} = f(\text{Income, Population}) \)
- \( L = \text{Leakages on Base} \)

Address all Issues
Issues of Fiscal Federalism

Central Government

- Rectify the constitutionally in-built imbalances between revenue raising powers and expenditure responsibilities of ULBs – create “municipal finance list” in Constitution
- Sharing of revenues from the fast-growing service sector through Service Tax and from Corporation Income Tax could be considered
- Taxation of Central Government Property – Service Charges
- Viability gap funding in case of financially very weak local bodies by Central-State-Local partnerships
- Tax Increment Financing with Central-State-Local Partnerships
- Dedicated resource centres at State/Local levels/special research cells in institutes of excellence for local finance studies.
Revenue Assignment: Bahl-Linn Principles

Benefits Identifiable - User
Beneficiaries Identifiable - Charges

Benefits broadly Identifiable - Benefit
Identification of Beneficiaries - Taxes
Costly or Difficult

Neither Benefits nor Benefit
Neither Beneficiaries nor Taxes

Administrative Expenses - Fees & Charges

Long-gestation Capital - Borrowings/Bonds
Projects and Works
State Governments

- States may amend the acts relating to local bodies to accord powers to them to decide sources of revenues and their rates subject to legal safeguards and not executive discretion.
- Local bodies may be given sufficient powers to fix the property tax, professional tax, user charge rates etc. - ceilings and floors may be fixed by law.
- Alternative to Octroi – Share in Value Added Tax?
- State Government properties to pay property and other taxes to local bodies.
- Unit Areas Method for Residential Property Tax; Non-residential Property Tax for high end properties may be assessed on case-by-case basis.
- Vacant Land Tax and Planning Permission Betterment; Tax Increment Financing
- States may set up financial intermediaries/urban development fund like the Tamil Nadu Urban Development Fund/Karnataka Urban Infrastructure Development & Finance Corporation
State Governments Contd.

- States may follow suggestions made by the Twelfth Finance Commission regarding constitution of State Finance Commission, follow up of recommendations etc.
- Bring more clarity in respect of the assignment of powers, authority and responsibility of the local bodies
- Overhaul Inter-governmental Transfer system – Formulae-based Transfers – Incentive System
- Objective limits on borrowing by ULBs – set by law
- Functional/cost centre Budgeting and Accrual-based Accounting – Standardization of budgets & accounts
- E-enabled Municipal Finance Information System
- E-Governance for process simplification and transparent and accountable service delivery – subject to Social Audit & Right to Information
- Appoint persons of eminence to SFCs
Basket of Local Taxes

- Property Tax
- Vacant Land Tax
- Profession Tax
- Entertainment Tax
- Motor Vehicle Tax
- Surcharge on Stamp Duty
- Business Licensing Tax
- Advertisement Tax
- Planning Permission Fee
- FSI as Resource
- Polluters Pay, Users Pay, Beneficiaries Pay
- Share in VAT
- Formula-based Devolution via Central Finance Commission
Local Governments

- Local bodies need to devote more attention for revenue generation.
- To increase both tax and non-tax revenue local bodies may follow the principles of ‘Users Pay’, ‘Beneficiaries Pay’ and ‘Polluters Pay’.
- All common property resources of the local bodies may be identified, listed and made use so that revenue from these can be increased.
- Local bodies may follow accrual based accounting instead of the cash based accounting followed now.
- Local bodies may encourage public-private partnership to enhance service delivery.
- Promote community based projects to ensure people’s involvement in the projects and its maintenance.
Central Finance Commission

- Normative approach may be followed for accessing the resource requirements of local bodies to decide the quantum of grants to local bodies.

- Concrete measures may be considered for augmenting consolidated funds of state governments to improve local finances – formula-linked transfer rather than ad hoc lumpsum grant.

- Purpose-specific grants may be provided to rectify the acute shortage of certain vital civic facilities and undertake poverty alleviation.
State Finance Commissions

• Follow the suggestions made by the Twelfth Finance Commission regarding the approach to be adopted by the State Finance Commission in studying the finances of local bodies, identifying the problems and making the recommendations

• The recommendations may be made very specific and implementable. Definite time-frame may also be fixed so that there will not be any delay in implementing the recommendations by the State Government

• Emphasis may be placed on measures for improving municipal finances by local efforts and financial management - provide best practices
Local Resource Mobilisation

a. Property Tax Reforms
b. Vacant Land Tax
c. Profession Tax
d. Entertainment Tax
e. Motor Vehicles Tax
f. Betterment Levies
g. Planning Permission as a Resource
h. Impact Fees
i. Polluters pay, Users pay, Beneficiaries pay charges
j. Use of Land as a resource
k. Productive utilisation of assets
Local Resource Mobilization: Tapping Conventional & Non-Conventional Sources

- Property Related
  - Conventional – Composite Property Tax
  - Non-Conventional – Vacant Land Tax, Service Taxes, Surcharge on Land Registration Duty

- Water Supply Related
  - Conventional – Water Charges

- Sewerage Related
  - Conventional – Sewerage Charges
  - Non-Conventional – Sewerage Donations, Sewerage Connection Charges, Sewerage Benefit Tax, Sewerage Betterment Charges
Mobilising Municipal Resources: Conventional & Non-Conventional Sources

- **Solid Waste Management Related**
  - Conventional – Conservancy Charges
  - Non-Conventional – Bulk Garbage Collection Charges

- **Town Planning Related**
  - Conventional – Building Permit Fee, Development Charges
  - Non-Conventional – Betterment Charges; External Betterment Charges; Open Space Contribution; Impact fee; Transferable Development Right; Premium FSI, Sub-division charges; Planning Permission Betterment

- **Engineering Related**
  - Conventional – No Sources
  - Non-Conventional – Road Cutting Charges, Street Tax, Frontage Tax, Cess on Infrastructure, Motor Vehicle Tax/Surcharge on Tax on Petrol and Diesel

Contd…
Mobilising Municipal Resources: Conventional & Non-Conventional Sources

Contd...

• Trade Licensing Related
  ▪ Conventional – Trade Licensing Fee
  ▪ Non-Conventional – Business License Fee

• Advertisement Related
  ▪ Conventional – Advertisement Tax
  ▪ Non-Conventional – Hoarding Charges, Advertisement Placement Fees, Cable TV Fee, TV Advertisement Charges

• Shops and Establishment Related
  ▪ Conventional – Shop Room Rent
  ▪ Non-Conventional – Royalty on Auctions

• General Principles
  ▪ Users Pay, Beneficiaries Pay, Polluters Pay
Municipal Corporation of Hyderabad

Rs. in Crores

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>24.5</td>
<td>27.6</td>
<td>30.18</td>
<td>29.16</td>
<td>36.39</td>
<td>46.88</td>
<td>56.95</td>
<td>58.47</td>
<td>83.32</td>
<td>92.71</td>
<td>130.12</td>
<td>153.25</td>
</tr>
</tbody>
</table>
Municipal Corporation of Hyderabad
Advertisement Fee Collected: 1991-92 - 2001-02


Rs. in Lakhs: 44.18 53.99 55.51 114.18 173.83 174.91 300.73 536.62 701.27 793.27
Municipal Corporation of Hyderabad
Parks & Plantation Charges: 1994-95 - 2002-03

Rs. in Lakhs

Year

1994 - 95
1995 - 96
1996 - 97
1997 - 98
1998 - 99
1999 - 00
2000 - 01
2001 - 02
2002 - 03

4.67
3.68
4.07
4.51
3.31
47.85
64.83
91.60
90.63
Municipal Corporation of Hyderabad
Town Planning Charges: 1992-93 - 2002-03

Year
1992-1993
1993-1994
1994-1995
1995-1996
1996-1997
1997-1998
1998-1999
1999-2000
2000-2001
2001-2002
2002-2003

Rs. in Crores

4.8
5.21
5.71
8.26
12.28
11.69
9.4
19.19
21.9
24.57
26.78

0
5
10
15
20
25
30
Municipal Corporation of Hyderabad
Betterment (including External Betterment) Charges 1992-93 - 2002-03

Year | Rs. In Crores
--- | ---
1992-93 | 1.65
1993-94 | 1.53
1994-95 | 1.9
1995-96 | 2.45
1996-97 | 1.77
1997-98 | 1.6
1998-99 | 1.54
1999-2000 | 5.55
2000-01 | 9.4
2001-02 | 10.9
2002-03 | 12.83
City Planning as a Resource: Planning-related Fees & Charges

- Building permit fee
- Sub-division/Layout charges
- Development charges
- Betterment charges
- External betterment charges
- Open space/Parking contribution
- Impact fee
- FSI as a resource
- Users Pay, Beneficiaries Pay, Polluters Pay
City Planning as a Resource: Planning-related Fees & Charges

- Road cutting charges
- Storm-water drainage charges
- Parking contribution
- Use of planning permission as a resource (Road-widening scheme)
- Transferable Development Right
- Advertisement charges

Contd....
Forfeiture of security deposit
Penal amounts for violation
Demolition charges
Projection charges
Building regularisation fee
Empanelment of licensed personnel
Sale of bits & pieces of land
Leasehold to freehold (proposed)
Directions for Municipal Reforms

• Functions of local bodies – expenditure assignment – must be clear;

• Finances of local bodies – revenue assignment – must be clear;

• Finances must be commensurate with functions assigned;

• Functions discharged or services delivered must be commensurate with funds provided;

• Accountability channels, performance/outcome measurement framework and reporting lines must be clear;

• Professional civic management and effective leadership are critically important for outcomes.
Municipal Reforms: A Lesson from Hyderabad Experience 1999-2003

“Vast schemes, grandiose theories can never achieve the same benefits as the accumulation of smaller, consistent, attainable goals. Hyderabad is one example of what the sum looks like when the many smaller parts that actually work are added up”.

‘Hyderabad, India: the next Silicon Valley?’ National Geographic, November 2002
Thank You