



FINANCIALLY EMPOWERING **URBAN** LOCAL BODIES

INTRODUCTION

The Constitution (74th Amendment) Act, 1992, formally recognised urban local governments as the third tier of government and recommended that state governments assign to Urban local bodies (ULBs) a set of 18 legitimate municipal functions such as urban planning including town planning, regulation of land use and construction of buildings, roads and bridge etc. However, ULBs in India have been facing a huge mismatch between their growing responsibilities and deteriorating finances.

With the pace of urbanisation gathering momentum in India, there is clearly a need to position Indian cities as drivers of the structural transformation of the Indian economy. This would require enhancement and massive upgrading of infrastructure that can only be facilitated by the financial empowerment of the urban local governments.

In this scenario, we need to understand- why is it so important to financially strengthen the ULBs? What is the current status of urban finances and what are their major sources of funds? What hurdles do these bodies face in raising and efficiently utilizing these funds? What steps have been taken so far to augment their finances and what more can be done to increase their financial capacity and make them financially self reliant? In this article, we will attempt to answer these questions.

WHY DO WE NEED FINANCIALLY EMPOWERED ULBS IN THE CONTEXT OF URBAN GOVERNANCE?

Urban landscapes in India face unique challenges and present unparalleled opportunities for higher and sustainable growth of National economy. Based on the **principle of 'subsidiarity'**, ULBs can play a significant role in urban planning and national transformation, specifically in terms of:

➤ **Addressing the needs of citizens:** United Nations' projections suggest that India's urban population will increase from about 461 million in 2018 to 877 million in 2050, thereby contributing the largest share of global urban population growth from 2018 to 2050.

- Urban local governments play a significant **role in financing public services** such as providing safe drinking water, affordable housing, public transport, wastewater treatment, solid waste management etc.

➤ **Creation of urban infrastructure for economic growth:** Urban settlements act as engines of growth and generate "agglomeration economies" by supplying requisite infrastructure. Construction and maintenance of such infrastructure **requires adequate capital investment from ULBs.**

➤ **Role in disaster management:** Cities are exposed spati-ally to higher risks from natural and climate change related hazards due to their high population density, increased exposure and vulnerability. Disaster Management Act, 2005 and Sendai Framework for disaster risk reduction both recognize the role played by local government, financially and otherwise, in the disaster preparedness, response, mitigation and recovery.

- Local governments are usually the **first responders** and their **first-hand knowledge of community's social, economic, infrastructure, and environmental needs**, help them to provide support in a disaster and carry out relief, rehabilitation and reconstruction activities.

➤ **Mitigating and adapting to climate change:** Not only urban activities are major contributors to climate change, but also climate change has adverse impacts on urban landscapes ranging from water scarcity to extreme weather events. To efficiently mitigate and adapt to climate change and its impacts, **ULBs need to invest in resilient infrastructure, green technologies, clean energy** etc.

➤ **Social responsibility:** The urban local bodies in India are connected with two major planks of public sector responsibility- allocation and redistribution. The 74th Amendment has envisaged **poverty alleviation and slum development** as legitimate functions of urban local bodies. Fulfillment of these functions is highly dependent on overall fiscal capacities of ULBs.

➤ **Implementation of developmental schemes:** Successful implementation of missions like Smart City Mission, AMRUT, HRIDAY etc. finally rests on ULBs efficacy in resource mobilization and service delivery. Hence, financial empowerment of ULBs when seen from this perspective is no longer of matter of choice but a necessity.

WHAT IS THE PRINCIPLE OF 'SUBSIDIARITY'?

In the theory of fiscal federalism, the principle rests on the foundation that **efficient allocation of public resources** to match public preferences for services is facilitated by factors such as access to **local knowledge, alignment of resources to services, local financial autonomy in planning and delivering services**, scope for achieving cost-effectiveness in service delivery and performance accountability in service provision.

THE CONSTITUTION (74TH AMENDMENT) ACT, 1992

- It formally recognised urban local governments as the third tier of government.
- The Act recommended that the state governments assign to municipal governments a set of **18 legitimate municipal** functions such as urban planning including town planning, regulation of land use, etc.
 - These functions are listed in the **12th Schedule** of the Constitution of India.
- Article 243X** entrusts to state governments the power to impose taxes, duties, tolls, and fees; it allows state governments to **assign revenues from specific taxes to urban local governments**.
- Article 243Y** leaves to State Finance Commissions (SFCs) the tasks of reviewing and recommending devolution of tax revenues and grants-in-aid to urban local governments.
- In the case of **revenue sources** of urban local governments, the amendment left it entirely to state governments.
- The amendment also inserted a new sub-section to **Article 280** adding to the responsibilities of the **Central Finance Commission (CFC) to 'recommend measures to augment the Consolidated Fund of a State to supplement the resources of its municipalities'**.

WHAT IS THE PRESENT STATUS OF MUNICIPAL FINANCES IN INDIA?



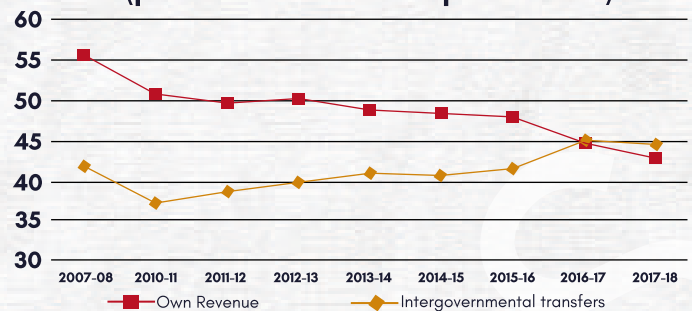
A study commissioned by the 15th Finance Commission highlighted the following concerning trends in Municipal finances:

- Low Municipal revenue to GDP ratio:** Municipal revenue to GDP ratio in India has remained stagnant at around 1 per cent of GDP during the period from 2007-08 to 2017-18.
 - The same ratio was 6.0 per cent for South Africa, 7.4 per cent for Brazil and 13.9 per cent for the United Kingdom in 2010.
- Declining own revenue:** The share of Municipal own revenue (revenue generated through own tax and non tax resources) in total Municipal revenues has declined significantly from approx. 55% in 2007-08 to 43% in 2017-18.
- Low diversification of tax resources:** At present, property tax remains the only major tax in the municipal portfolio in India and it contributed about 60 per cent to municipal tax revenue in India in 2017-18.
 - By contrast, municipalities in other parts of the world have access to a much wider basket of taxes like business taxes, real estate tax, resource taxes, urban land use tax etc.

➤ **Insufficient growth in Property tax:** In 2017-18, property tax revenue as a share of GDP in India was **0.15 per cent which is far below the level of 1 per cent** estimated for recurrent taxes on immovable property in OECD countries.

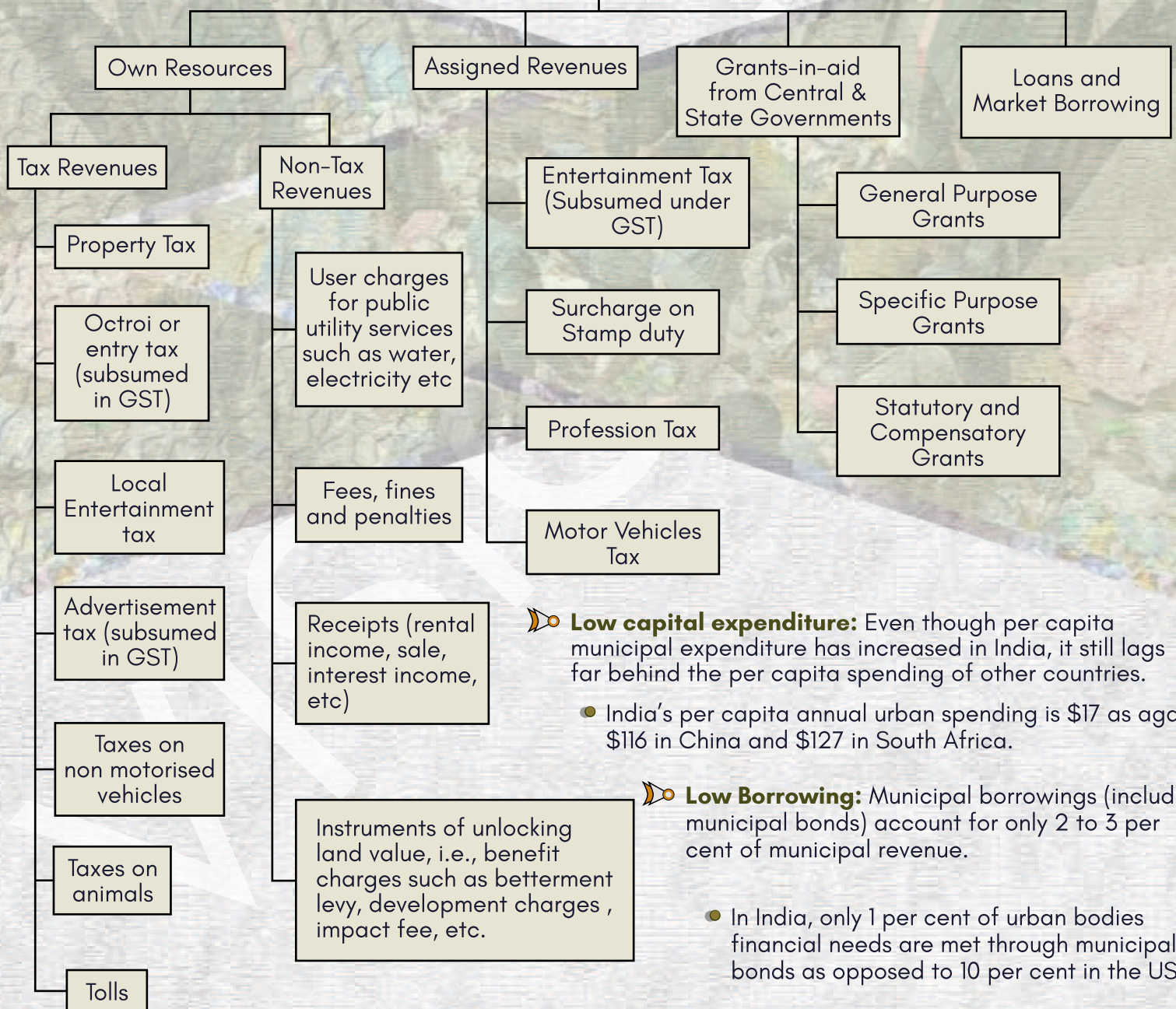
➤ **Inadequate Intergovernmental transfers:** While the share of intergovernmental transfers in municipal revenue has been increasing (refer chart) since 2010-2011, it still remains insufficient.

Municipal Own Revenue and Intergovernmental Transfer (percent of Total Municipal Revenue)



- In comparison with 6.0 per cent in Norway and 9.9 per cent in United Kingdom, such transfers account for a meager 0.45 per cent of GDP in India.

Sources of Finance for Municipal Bodies



➤ **Low capital expenditure:** Even though per capita municipal expenditure has increased in India, it still lags far behind the per capita spending of other countries.

- India's per capita annual urban spending is \$17 as against \$116 in China and \$127 in South Africa.

➤ **Low Borrowing:** Municipal borrowings (including municipal bonds) account for only 2 to 3 per cent of municipal revenue.

- In India, only 1 per cent of urban bodies financial needs are met through municipal bonds as opposed to 10 per cent in the US.

➤ **Poor finances of Smaller Municipalities:** In 2017-18, per capita own revenue of Municipal Corporations was about four times and more than six times that of Municipal Councils and Nagar Panchayats respectively.

WHAT ARE THE CHALLENGES FACED BY URBAN LOCAL BODIES IN ACCESSING FINANCE?

According to the NITI Aayog, India requires Rs. 40-trillion investment until 2030 to overhaul its infrastructure whereas the revenue of all the municipal corporations put together is not more than Rs. 1.2 trillion. Major reasons for stagnation in municipal finances are:

Attitude of state governments:

While State governments had devolved only a limited number of taxes to the ULBs to begin with, in several states, most local taxes, other than property tax, have been taken over by the state governments over the years. This has deteriorated the capacity of ULBs to generate own revenues, impacting their self sufficiency and financial autonomy.

- Limited resources to generate own revenues has also resulted in the **increasing dependence of the municipal sector on the higher levels of government.**
- Further, **large disparities exist** in different aspects of municipal finances across different states in terms of municipal own revenue, access to market and institutional sources of finance and state transfers to urban local governments.

Unrealized potential of property tax: State governments have neglected property tax as a source of revenue for ULBs because of their inability to fix the administrative challenges of coverage, assessment, valuation and the political difficulty of enforcement.

Poor cost recovery of services by urban local governments: In India user charges and service provision are seem to be caught in a vicious circle with poor quality of services leading to a lack of willingness to pay for these and hence poor collection of user charges and fees.

- There are also cases where the willingness to pay may be there, but there is little willingness to charge because of **competitive populism** (well-established strategy through which political parties signal their intent to voters).

Improper Maintenance of Accounts: CAG reports on local governments point out several lacunae in the preparation of municipal accounts related to lack of budget preparation, accuracy, updating and timely presentation of accounts by urban local governments.

- Some specific issues that were highlighted are - slow adoption of modern accounting systems, lack of distinction between revenue expenditure and capital expenditure and inadequate internal control and lack of monitoring.

Shortcomings of State Finance Commissions: Inefficient functioning of SFCs has affected their ability and that of CFCs to augment financial resources of ULBs. Successive Central Finance Commissions have reported their inability to make use of the reports of SFCs, due to issues like-

- The recommendations made by SFCs are **largely ad hoc** in nature and not based on sound public finance principles.
- The reports are **not available on a timely basis** and their **period is not synchronized** with that of the Central Finance Commission.
- The definition of revenue pool varies across SFCs which complicates the task of the CFCs.

WHY THE MUNICIPAL BOND MARKET IN INDIA HAS FAILED TO GROW AS EXPECTED?

- Municipal bonds are issued when a **government body wants to raise funds for projects** such as infra-related, roads, airports, railway stations, schools, and so on. They have existed in India **since the year 1997** and Bangalore Municipal Corporation was the first urban local body to issue municipal bonds in India.
- However, the municipal bond market in India has not taken off despite several attempts made by governments, due to several factors, namely:
 - **Poor credit ratings**
 - **Perceived as Risky**
 - **Unrealistic planning strategies of ULBs**
 - **Poorly developed government securities market**
 - **Constraints on Institutional investors from participating in Municipal bond market**

- **Lack of Uniform Governance Structure:** Due to complexities involved in defining an urban area and existence of multiple types of governance structures even in a single urban space, the ULBs vary in functioning and administrative setup. This makes it difficult to develop mechanisms for flow of funds and ensure their proper utilization.

- **For example-** There exists multiple definitions for Metropolitan regions in India across the Constitution of India, Census of India and Urban and Regional Development Plan Formulation and Implementation (URDPFI) Guidelines.

- **Hidden Urbanization:** Due to unplanned urbanization in India and a large number of settlements becoming part of urban agglomerations beyond the municipal boundaries in the form of peri-urban or suburban growth, the **financial needs, economic activity & potential revenue of urban regions are not being estimated accurately.**



- **Inability to borrow from market sources:** Most municipal bodies require the state governments' permission to borrow from market sources. Growth in market financial instruments such as **Municipal bonds has largely been inadequate.**
- **Implications of Introduction of Goods and Services Tax (GST) on Municipal finances:** Introduction of the GST has taken away critical sources of tax revenue such as octroi, local body tax, entry tax and advertisement tax for urban local governments without providing any compensation.
- **Existence of Multiple bodies:** There has been little coordination between bureaucrat-led agencies like Development Authorities, parastatals (parallel bodies in operation) etc. at the state level and elected urban local governments who have overlapping functions. This leads to fragmented governance and thus lack of coordination in financing and expenditure.

GOVERNANCE STRUCTURE IN URBAN AREAS

- The governance of urban regions in India is based on territorial jurisdictions of **Municipal Corporations, Municipal Councils & Nagar Panchayats.**
 - These elected bodies are the units of local governance and have the constitutional mandate to mobilize/receive funds and deliver public services.
 - The Constitution specifies that:
 - ⊗ **Nagar Panchayats** are meant for areas which are in transition from rural to urban,
 - ⊗ **Municipal Councils** are for smaller urban areas, and
 - ⊗ **Municipal Corporations** for larger urban areas.
 - State governments notify the establishment of these urban local governments based on population, revenue generated for local administration, employment in non-agricultural activities, etc.
- Other institutions involved in urban local governance are:
 - Notified Area Committee.
 - Town Area Committee
 - Cantonment Board
 - Township
 - Port Trust
 - Special Purpose Vehicles

REASONS FOR HIDDEN URBANIZATION

The extent of urbanisation in India is often understated in official data because of following reasons:

- **Restrictive Census definition:** An agglomeration index, developed by the World Bank, put the share of India's population living in areas with "urbanlike" features at 55.3 per cent in 2010 as against the Census of India which puts urban population in India at 31 per cent in 2011. The Census of India designates a settlement as urban in two complementary ways:
 - All places that have a minimum population of 5,000 persons; at least 75 per cent of the male working force engaged in non-agricultural activities; and a density of population of at least 400 persons per sq. km.
 - All settlements which have a statutory recognition.
- **Non Designation of towns by State Government:** There is political resistance to empower towns with a statutory urban local government and often the rural local governments themselves are reluctant to "go urban" because:
 - local politicians are apprehensive that they would not have access to large amounts of funds as for rural development schemes.
 - there is a fear of the regulations that comes with urbanization.

WHAT STEPS HAVE BEEN TAKEN TO ADDRESS THE SITUATION?

- **Recommendations of 15th finance commission:** The total grants recommended for urban local bodies for 2020-21 were enhanced to Rs 29,250 crore against Rs 26,665 crore recommended for the year 2019-20 by the 14th FC. Other recommendations that are aimed at enhancing finances of ULBs are:
 - Grants will also be provided to areas under the Fifth and Sixth Schedule of the Constitution and Cantonment Boards in urban areas.
 - Share of urban local bodies in Finance Commission grants to local bodies should be gradually **increased to 40 per cent** over the medium term.
- **Performance based grants:** Successive FCs have put in conditionalities on the disbursement of grants for improving fiscal position of ULBs. For example—
 - 14th FC provided three conditions for accessing the performance grants. These were - making available more reliable data, improvement in own revenues, and measurement and publication of service level benchmarks.
 - 15th FC has recommended two entry level conditions- notifying the floor or minimum rates of property tax to improve own revenues and timely submission of audited accounts.
- **National Municipal Accounts Manual (NMAM):** The Manual comprehensively provide details to all States/UTs in relation to the accounting policies, procedures and guidelines to ensure correct, complete and timely recording of municipal transactions to produce accurate and relevant financial reports.

- **Allocation of funds through Schemes:** Several schemes of Union **Ministry of Housing and Urban Affairs** provide financial support to ULBs for undertaking projects for development of urban infrastructure and services such as water supply, sewerage, urban transport, housing etc. Some of these schemes are- **Atal Mission for Rejuvenation and Urban Transformation (AMRUT), Smart City Mission, Heritage City Development and Augmentation Yojana (HRIDAY), etc.**
 - Some of these schemes also provide **incentives for fiscal reforms in ULBs. For example- Under Jawaharlal Nehru National Urban Renewal Mission (JNNURM)** release of Additional Central Assistance was made conditional to the State ULBs carrying out certain reforms such as- Accrual based double entry system of accounting, Recovery of User Charge etc.
- **Promotion of Municipal Bonds:** In 2015, Securities and Exchange Board of India (SEBI) had released the **Issue and Listing of Debt Securities by Municipalities (ILD)** Regulations and since then seven municipalities have raised nearly Rs 1,400 crore by issuing their debt securities (commonly known as 'muni bonds').
 - Recently, SEBI **has relaxed norms for 'muni bonds' issuance and has done away with requirements** like appointment of a monitoring agency, filing of viability certificate or Detailed Project Appraisal Report, mandatory backing of state or central government etc.

WHAT MORE CAN BE DONE TO FISCALLY STRENGTHEN URBAN LOCAL BODIES?



For fiscal decentralization to be effective, finance should match expenditure assignments related to the transferred activities. This requires the demarcation of fiscal domain of local bodies to tap resources directly from both tax and non-tax

revenue and enhanced devolution of funds from the Union and state governments to local bodies. Some measures that can be taken in this regard are:

- **Enhanced Devolution by States:** Municipal bodies can be given access to **Profession Tax, Local Body Entertainment Tax**, motor vehicles tax, stamp duty, mining royalty, property tax payment for properties of state government and their undertakings etc.
- **Unlocking land value:** Land value can be monetized by ULBs using Benefit charges such as **impact fees**, betterment levy, vacant land tax etc.
 - Benefit charges are payments for the indirect benefits received by individuals or groups of individuals on account of public investments. For example- Impact fee is a one-time charge levied at the time of granting building permission and is designed to recover the cost of infrastructure development.
- **Property Tax Reforms:** Certain measures that help in enhancing revenue from property tax are-
 - **Property Tax Boards**, as recommended by the 13th Finance Commission, can be set up in each state and create conditions for buoyancy in property tax revenue.
 - **Use of GIS** for extending coverage and tracking demand and collection must be promoted.
 - More frequent **property revaluations** must be done to reflect the impact of rising prices including through methods such as indexing to inflation.

- **Online and mobile based payments** can be used to **improve compliance and encourage transparency**.
- **Strengthening Municipal Bonds:** Local capacity building, financial empowerment, rationalization of the state-local fiscal relationship and further legislative changes are critical in developing a viable and vibrant municipal bond system in the country.
- **Reforms for State Finance Commissions:** The states should timely constitute SFCs with members of eminence and competence and provide them with technical support. Also synchronizing the time period of SFC with CFC should be ensured.
- **Creating a Municipal Finance Database:** Reserve Bank of India can be asked to publish a **Study of Municipal Finances** every year to should provide municipal finance data.
- **Compensating for losses induced by GST:** In short term, State transfers can initiate additional devolution towards urban local governments who have been deprived of access to several taxes in the GST regime, etc.
 - In the long run, suitable laws can be passed by state legislatures for a formula-based sharing of state GST with urban local governments.
- **Capacity building of ULBs:** Technical assistance and training can enhance capacity of ULBs in various aspects of financial planning such as **identifying internal and external sources** of mobilizing funds for capital investments, **improving accounting standards** etc.
- **Other Measures:**
 - **Strengthening urban institutions and clarifying roles of different organizations.**
 - **Explore innovative financing mechanisms** like PPP, venture capital financing, crowd source financing etc.

SOME BEST PRACTICES THAT CAN HELP ULBs TO IMPROVE THEIR FISCAL CONDITION

Domestic

- **Pune Municipal Corporation** has seen a steady increase in property tax collections by introducing a series of **reforms to simplify billing and collection** like- Door-to-door collection, increased number of collection centres, a wide range of digital payment platforms, Amnesty Scheme etc.
- **Chennai** is mapping its properties **using drones** and has conducted trials of a **dynamic pricing model for Parking** fee from which the Corporation expects to better manage road traffic and collect revenues to the tune of Rs 350 crore.
- **Chennai and Ahmedabad** have started levying **local entertainment tax** as an alternative to Entertainment tax which is subsumed under GST.

International Best Practices

- **Wider basket of taxes for municipalities:** Municipal revenue sources in China include business taxes, real estate tax, urban land use tax, land appreciation tax, urban maintenance tax etc.
- **Autonomous functioning:** Some cities in Canada have the authority to levy additional taxes and also determine the base rates, method of administration and enforcement mechanisms for such a tax.
- **Uniform local taxation structure and benchmarks for service delivery:** South Africa has built a single-tier unified structure to undertake the provision of services to entire metropolitan areas.

CONCLUSION

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

TOPIC AT A GLANCE

Need of financially empowered ULBs

- ▶ To address the **needs of growing urban population**
- ▶ For **construction and maintenance of urban infrastructure**, enabling urban settlements to act as engines of economic growth
- ▶ To **fulfill its role in disaster management** in urban areas
- ▶ To **efficiently mitigate and adapt to climate change**
- ▶ To **fulfill social responsibilities** envisaged by 74th Amendment
- ▶ For **successful implementation of developmental schemes**

- ▶ **Low Municipal revenue to GDP** ratio which has been stagnant at around 1 per cent of GDP from 2007-08 to 2017-18 (6.0 per cent for South Africa, 7.4 per cent for Brazil).
- ▶ **Decline in share of own revenue** in total Municipal revenues from approx. 55% in 2007-08 to 43% in 2017-18.
- ▶ **Low diversification of tax resources:** Property tax alone contributed about 60 per cent to municipal tax revenue in 2017-18.
- ▶ **Insufficient growth in Property tax:** In 2017-18, property tax revenue as a share of GDP in India was 0.15 per cent (far below the level of 1 per cent in OECD countries).
- ▶ **Inadequate Intergovernmental transfers** which account for a meager 0.45 per cent of GDP in India (6.0 per cent in Norway and 9.9 per cent in United Kingdom).
- ▶ **Low Municipal borrowings** (including municipal bonds): accounting to only 2 to 3 per cent of municipal revenue.
- ▶ **Other trends- Low capital expenditure** and comparatively **poor state of finances of Smaller Municipalities.**

Trends related to Municipal Finances

Challenges faced by ULBs in accessing finance

- ▶ **Attitude of state governments: Devolution of only a limited number of taxes and encroachment of local taxes by State Governments** leading to increasing dependence of the municipal sector on the higher levels of government.
- ▶ **Unrealized potential of property tax and Poor cost recovery of services** by urban local governments.
- ▶ **Improper Maintenance of Municipal Accounts-** slow adoption of modern accounting systems, lack of distinction between revenue and capital expenditure etc.
- ▶ **Inefficient functioning of State Finance Commissions- Problems like ad hoc recommendations,** delayed reports etc.
- ▶ **Inability to borrow from market sources and poor growth of Municipal Bond Market.**
- ▶ **Critical sources of municipal tax revenue subsumed under GST** without any compensation
- ▶ **Existence of Multiple bodies** leading to fragmented governance and lack of coordination in financing.
- ▶ **Lack of Uniform Governance Structure** effecting flow of funds and their utilization.
- ▶ **Hidden Urbanization** leading to inaccurate estimation of financial needs, economic activity and potential revenue of urban areas.

Recommendations of 15th finance commission:

- **Enhancement in total grants** recommended for urban local bodies.
- Grants **extended to areas under the Fifth and Sixth Schedule of the Constitution and Cantonment Boards** in urban areas.
- Gradual **increase of share of urban local bodies in Finance Commission grants** to 40 per cent.
- ▶ **Performance based grants** which put in conditionalities on the disbursement of grants for improving fiscal position of ULBs.
- ▶ Creation of **National Municipal Accounts Manual (NMAM)** to act as a guide for maintenance of Municipal accounts.
- ▶ **Allocation of funds through Schemes** like AMRUT, Smart City Mission, HRIDAY etc.
- ▶ **Promotion of Municipal Bonds:** SEBI specified regulations pertaining to Municipal bonds and recently relaxed certain norms for their issuance.

Steps taken

- ▶ **Enhanced Devolution by States** by giving access to more tax/non-tax resources to Municipal bodies.
- ▶ **Monetization of Land value** using Benefit charges.
- ▶ **Property Tax Reforms-** Creating Property Tax Boards, use of GIS, frequent property revaluations, Online and mobile based payments.
- ▶ **Strengthening Municipal Bonds** through local capacity building, financial empowerment, rationalization of the state-local fiscal relationship and legislative changes.
- ▶ **Compensating ULBs for losses induced by GST.**
- ▶ **Reforms for State Finance Commissions-** timely constitution, technical support etc.
- ▶ **Capacity building of ULBs** through technical assistance and training.
- ▶ **Other steps-**
 - Creating a Municipal Finance Database
 - Strengthening urban institutions
 - Clarifying roles of different organizations
 - Exploring innovative financing mechanisms

More that can be done