Strengthening Finances of Municipal Governments

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NFSSM Alliance

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A paper prepared for the National Faecal Sludge and Septage Management Alliance as an input to the report on 'Strengthening Municipal Governments for Improved Urban Services'.

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Strengthening Finances of Municipal Governments[1]

India's urban areas are considered 'engines of growth' as they contribute to nearly two-thirds of economic growth. However, we have a situation of "rich cities, poor city governments" (Mehta and Mehta, 2011). Municipal governments in India are unable to derive benefits from the economic growth in cities. This is partly due to the fact that despite the 74th Constitutional Amendment Act (CAA), which recognised municipalities as the third sphere of government, they continue to derive their functional and financial powers from the state governments. Thus, while there is political decentralisation due to the 74th CAA, with elected local governments, there has not been appropriate fiscal decentralisation. They also lack functional autonomy in many states.

This chapter looks at the ways in which municipal governments in India can raise their revenue. It argues that for this to happen, it is critical to ensure that they have access to adequate and predictable financial resources. Adequate financing is essential to enable municipal governments to fulfil their mandate of various services and functions assigned to them. It is also important and critical for attracting good and strong political leadership as well as to retain good administrative functionaries.

Unlike for the national and state governments, the Indian Constitution does not specify distinct fiscal resources for local governments. Thus, their resources are dependent on the inter-governmental transfers (IGT) made by both the national and state governments and their own sources assigned to them by the state governments. Compared with the global experience, municipal governments in India lag far behind in, both, the extent of inter-governmental transfers that they receive as well as in their own revenues.

These aspects are explored in this chapter. It outlines a few critical recommendations for policy makers for strengthening urban local governments.

[1] This paper has been prepared for the National Faecal Sludge and Septage Management Alliance by the Centre for Water and Sanitation (CWAS) at CRDF, CEPT University, with inputs from EY and Dasra. It is prepared as an input to the report on 'Strengthening Municipal Governments for Improved Urban Services'. We greatly appreciate feedback on an earlier draft from a number of scholars and practitioners including D. M. Sukthankar, P.K. Mohanty, Ramanath Jha, Om Mathur, Raghu Kesavan, Matt Glasser, Chetan Vaidya, Srinivas Chary, Sujatha Srikumar, Ravikant Joshi, Himani Baxi, Vijaya V. and Darshan Parikh.

1. Inter-governmental Transfers

A key source of revenues for local governments globally is the transfers from national governments, as well as transfers from state governments in federal countries. Such transfers are significant as they account for over half of the resources of urban local governments.

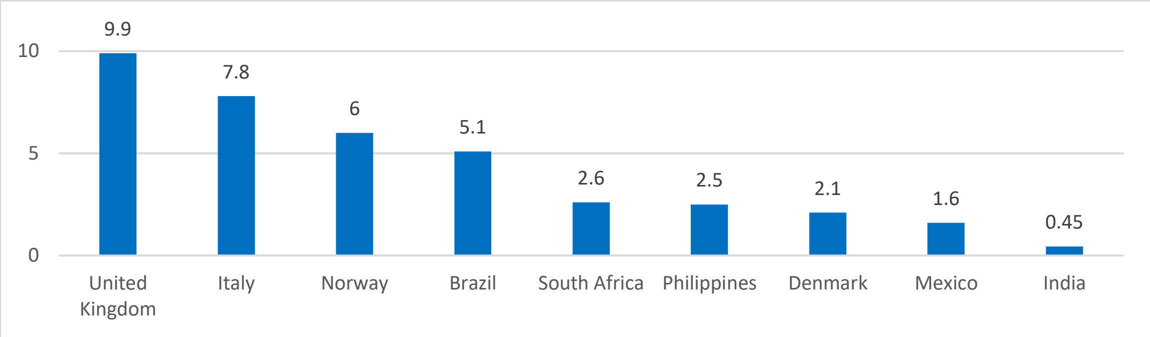
To assess the total finances needed for urban local governments, it is necessary to estimate total expenditures required in relation to the functions assigned to this level of government. In India, the first attempt at setting urban service norms and standards was made in 1963 by the Zakaria Committee, which laid down the physical norms and corresponding expenditure norms for five services: water supply, sewerage, stormwater drainage, urban roads, and street lighting. Mathur et al. (2007) have compiled various estimates that have been made by updating the Zakaria Committee estimates. However, the key challenge has been to ensure that urban local governments have the requisite financial resources to meet the estimated expenditure. It is also necessary to have new 'Zakaria Committee type' estimates to better assess the expenditure requirements for local governments that are in tune with emerging standards for various municipal services.

1.1. The Need to Increase IGTs to Municipal Governments

Some analysts suggest that the share of IGTs has increased over time and the share of municipal own revenues has declined. However, this is misleading due to two facts. First, it is important to assess the extent of grants transferred to municipal governments in relation to total government revenues or total national gross domestic product (GDP). Mathur et al. (2011) suggest that "The share of municipalities in the country's total tax resources too has continued to stagnate (1.7 per cent), despite a country-wide trend towards improved tax to GDP ratio" (p. 7).

The more recent data, as per the High Powered Expert Committee (2011) for India, shows that the share of IGTs to municipal governments is only 0.45 per cent of GDP. The Indian experience fares poorly when compared with the international experience. This is highlighted in Figure 1 which shows that even in developing countries such as the Philippines, the IGT to local governments ranged between 2–2.5 per cent (Diokno-Sicat, 2019); in Brazil, Indonesia and Mexico, the IGTs accounted for 5.1 per cent, 5.4 per cent and 1.6 per cent of its GDP, respectively (Organisation for Economic Co-operation and Development [OECD], 2016).

Figure 1: Inter-governmental transfers to municipal governments as a proportion of GDP



Sources: For the UK, Denmark, Norway, Italy and India: Mohanty (2016) as cited in Ahluwalia et al. (2019) p. 11; for Brazil: Organisation for Economic Co-operation and Development (OECD) (2016a); for Mexico: OECD (2016b); for South Africa: OECD (2016c); for the Philippines: Diokno-Sicat, J. (2019) p. 10.

Figure 1 also shows that developed nations such as the United Kingdom, Italy, Norway and Denmark have a higher proportion of IGTs as a share of their GDPs at 9.9 per cent, 7.8 per cent, 6 per cent and 2.1 per cent, respectively (Mohanty, 2016).

It is necessary to emulate the successful experience of federal countries such as Brazil, where municipalities receive significant transfers called Municipalities' Participation Fund, which are 23.5 per cent of the income taxes and industrialised products taxes (Mehta and Mehta, 2015). Also, in the Philippines, the Local Government Code of 1991 mandates that 40 per cent of internal revenue collections of the third preceding fiscal year be transferred to Local Government Units (Diokno-Sicat, 2019). This experience of other countries with substantially higher level of IGTs suggests that there is considerable increase needed in the level of IGTs to municipal governments.

1.2. Need and Options for Significant Increases in IGTs

The need to increase IGTs is even more important now, in view of the adverse impact of the Goods and Services Tax (GST) on municipal own revenues. It is widely accepted that cities in India contribute to nearly two-thirds of GDP. For example, a recent Ministry of Housing and Urban Affairs (MoHUA) paper suggests that "Urban areas contributed between 52.6 per cent and 64.89 per cent of national output in 2011–12" (Ministry of Housing and Urban Affairs [MoHUA], 2019). However, cities do not benefit from their economic vibrancy as all the buoyant local taxes – such as the octroi, entry tax and local body tax – have been abolished. The most recent shock has come through the imposition of GST. Expert advice on this issue was provided by the Indian Council for Research on International Economic Relations (ICRIER) team in its report (Ahluwalia et al., 2019). It states that "Municipal finances have been the worst hit by this structural reform". It further suggests, "in order to maintain fiscal balance across the three levels of government, the combined revenues from GST ought to have been shared among all the three levels of government. Instead, the sharing has been half and half between centre and states and, in the process, the independent power of local governments to raise their own sources of revenue has been appropriated by the centre and states. GST has subsumed local taxes such as octroi, including accounts-based octroi, in the form of local body tax, entry tax and advertisement tax." (p. 11). To address these issues, the Urban Development Ministry has also "asked for a specific share of revenues from the GST for ULBs" (*Economic Times*, 2020).

It is important to consider the impact of transfer of GST funds from the Government of India (GoI) to the states. The GST (Compensation to States) Bill provides for compensation to states for any loss in revenue due to the implementation of GST. The compensation was supposed to be provided to a state for a period of five years from the date on which the state brings its State GST Act into force, and the compensation payable to a state was to be provisionally calculated and released at the end of every two months. But since GST was introduced in 2017, the states have been facing several difficulties due to delays in payment.

The impact of GST on local finances is well illustrated for Mumbai. Jha (2019) and Udas-Mankikar (2018) estimate that, "In compliance with the new GST regime, the Municipal Corporation of Greater Mumbai (MCGM) has had to abolish octroi, which on average had contributed almost 35 per cent of its annual total revenue" (p. 2). Maharashtra is the only state that has promised a share of GST to urban local bodies (ULBs) in lieu of octroi and local body tax that were abolished while imposing GST. However, the state government has not been very regular about transferring this promised share.

Ahluwalia et al. (2019) suggest that "the long-term solution to correct for the structural fiscal imbalance" which has crept into the system following the GST-related Constitutional amendments in 2016, is for the Constitution to be amended again to provide sharing of the revenues from GST among all three levels of government. Kelkar (2019), in a recent Memorial Lecture, highlighted the vertical imbalance in India's federalist structure and advocated for a greater share of GST resources for the Third Tier by allocating "1/6th of this with the 3rd Tier" (p. 11).

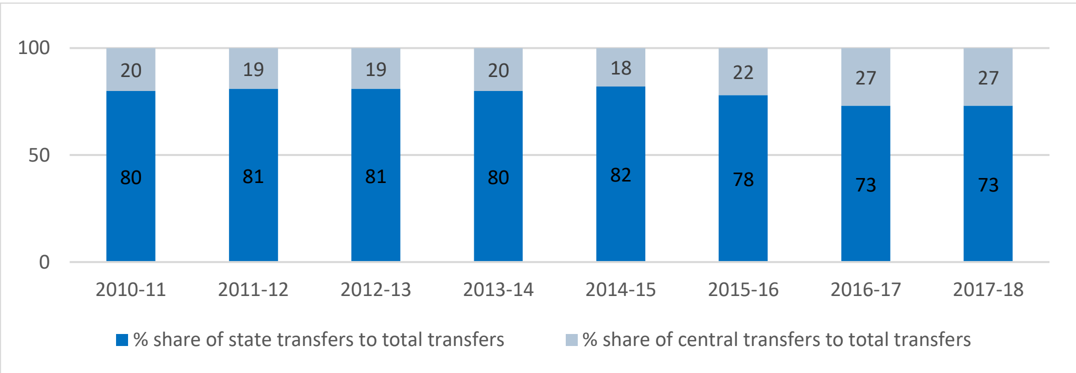
Many scholars have argued for including a separate list of revenue sources for local governments in the Constitution. While the 74th CAA suggested a list of functions for urban local governments in the 12th Schedule, it did not provide a municipal resources list to match the functions. They are dependent on state governments to allocate them such resources from the state list. Unfortunately, the State Finance Commissions (SFCs), which were charged with this have also not been very successful. It was in this background that the High Powered Empowered Committee (HPEC) had recommended "an appropriate amendment of the Constitution/other measures to insert a 'Local Bodies Finance List' (LBFL) along the lines of the Union and State Lists" (p. 129). While this has been discussed often, it needs to now receive priority. In this context, the example of the Philippines is noteworthy as it provides 40 per cent of its internal revenue income as transfers to local governments as per its Local Government Code. In addition, under this code the local governments are also authorised to mobilise debt from bank and financial institutions (Marzan, 2011).

1.3. Making IGTs Predictable, Untied and Focused on Small Cities and the Vulnerable

Based on the data reported by Ahluwalia et al. (2019), Figure 2 shows that the share of the central government in IGTs has increased from 20 to 27 per cent over that past eight years. Despite this, nearly 75 per cent of the IGTs to urban local governments are made by state governments. The high share of state governments, however, is beset with two interrelated problems. The first relates to the irregularities with which the SFCs are set up. The second relates to the lack of predictability of state grants.

Article 243I of the Indian Constitution prescribes that "the Governor of a State shall, as soon as may be within one year from the commencement of the Constitution (73rd Amendment) Act, 1992, and thereafter at the expiration of every 5th year, constitute a Finance Commission." State governments were required to devolve resources to local bodies based on the recommendations of SFCs. In fact, as Mathur (2020) argues the Article 280-(3)-(c) of the Constitution also needs to be relooked at as it requires the Central Finance Commissions to review the SFC Reports to make an assessment of ULB fund requirements.

Figure 2: Share of state versus central transfers over the years (%)



Source: Derived from data available in Ahluwalia et al. (2019), pp. 92–93.

However, the experience has not been good and only 13 states have constituted their 5th SFC. A recent report shows that SFCs have been hampered by inadequate data and lack of staff, and even places to operate from. It highlights that many states have not appointed the SFCs in time and have not provided adequate support. Thus, most SFC reports have seen significant delays (Chakraborty et al., 2018). This is despite the fact that previous Finance Commissions have also tried to comment on, and influence the state governments for, this.

Strong and well-functioning SFCs with adequate support are essential to ensure good quality fiscal decentralisation as envisaged in the 74th CAA. While this has been advocated often by previous Finance Commissions, this has not yielded positive results, as pointed out by

Chakraborty et al. (2018). To overcome this, the 15th Finance Commission should provide some incentives to those states that constitute SFCs regularly and provide a more predictable devolution of resources to local governments. The better experience from some states, such as Kerala and Tamil Nadu, needs to be assessed further and transferred to other states. It is worth highlighting that access to such regular and adequate funding from the SFCs, when linked to an institutional mechanism such as a Municipal Development Fund, can become a basis for strengthening ULBs, inculcate a culture of borrowing and help even small ULBs build a credit history.[2] Kerala is another example of a state with good SFCs, as it has had regular, large and untied transfers to local governments over the past 20 years (Government of Kerala [GoK], 2015a, 2015b).

Besides their low levels, IGTs are often not predictable for municipal governments. This makes it difficult for them to take up any medium-term plans for improving urban services in their jurisdictions. When buoyant municipal resources such as octroi or local body tax were abolished, state governments had promised compensatory grants. The grants were promised with the same annual rate of increase as the abolished tax. However, most state governments have not kept their promise. Their compensatory grants have been ad hoc and nowhere near the amount that the abolished tax would have fetched.

On one hand, the compensatory grants in lieu of octroi are untied, but have reduced significantly. At the same time, a large share of IGTs is tied to programmes or activities determined by national and state governments (see Figure 3a). This also leaves less scope for municipal governments to develop plans to address local priorities. For example, an inquiry into the urban development budgets of four states suggests that programme-related

Figure 3a: Share of programme budget in total urban

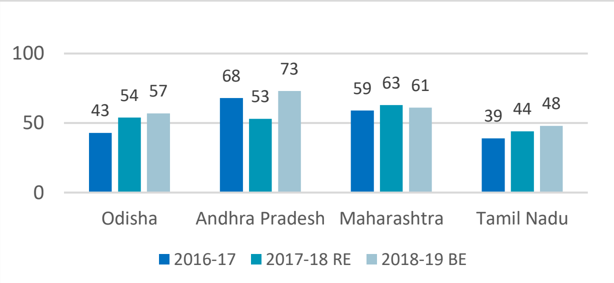
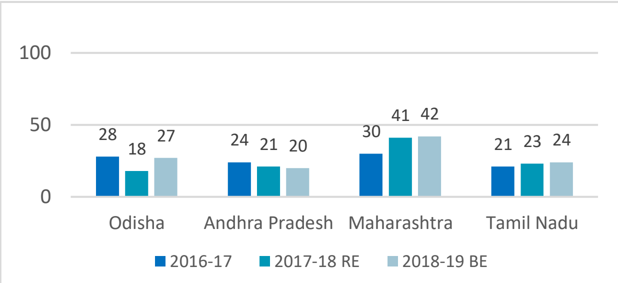


Figure 3b: Extent of influence of central schemes on programme expenditures (%)



Sources: Urban Housing Budget, Odisha, and Urban Development Department Budget, Odisha (2018–19); Municipal Administration and Urban Development Department Budget, Andhra Pradesh (2018–19); Urban Development Department Budget, Maharashtra (2018–19); and Municipal Administration and Water Supply Department Budget, Tamil Nadu (2018–19).

[2] At a recent Round Table on Municipal Strengthening held by the NFSSM Alliance, the previous managing director of the Tamil Nadu Urban Development Fund (TNUDF), pointed out that the TNUDF's success was clearly linked to a good system of regular and predictable transfers by the state government to ULBs. Similar experience was also found in Brazil.

allocations ranged from 43 percent to 68 percent in the states of Maharashtra, Odisha and Andhra Pradesh.

Only Tamil Nadu provided 61 per cent of its transfers to local governments as untied or non-programmatic transfers (see Figure 3a). Even within the programme budgets, a significant proportion was linked to the priorities set by the GoI through Centrally Sponsored Schemes (see Figure 3b). In this regard, Kerala's experience is noteworthy, as it provides a large part of its transfers to local governments as untied. Also, the recommendations of the Kerala SFC are accepted and used to determine the allocations to local governments in the state budget (GoK, 2015a, 2015b, 2020).

A problem with Centrally Sponsored Schemes is that most urban development programmes such as AMRUT and Smart Cities focus on large cities. The Swachh Bharat Mission–Urban is a programme that covers all cities but focuses mainly on solid waste and toilet construction. However, a vital service such as faecal sludge and septage management (FSSM), that is so essential in small towns, is not covered in any central or state programme. A focus on FSSM can be a cost-effective solution to achieve good sanitation and meet Sustainable Development Goal 6.2 at the national level (Mehta and Mehta, 2020). However, under the aegis of ODF++ framework, the focus on FSSM is now being expanded. Hopefully this will be backed by funding from the state governments as well as the finance commission grants.

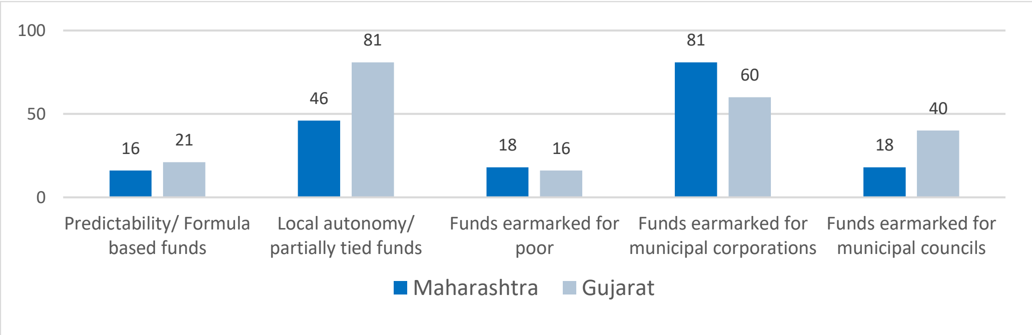
Beliappa et al. (2011a) provide a framework for assessing fiscal decentralisation across four aspects: (a) predictability; (b) local autonomy; (c) earmarking for vulnerable groups; and (d) horizontal equity.

Predictability is measured as a share of formula-based transfer to total funds. These include untied grants from the Central Finance Commission, predefined shares in state taxes (for example, entertainment and professional taxes in Gujarat). As we have argued above, the share of predictable transfers has been declining over the years. Local autonomy is measured as a share of untied funds to total funds. With increasing programme-linked funding, local autonomy has been declining.

A third important aspect is earmarking for vulnerable groups, measured as the share of total funds earmarked for the poor and vulnerable. Many state governments have specific programmes for vulnerable groups such as Scheduled Castes, Scheduled Tribes and Below Poverty Line families. Some state municipal legislations require ULBs to earmark funds for specific groups. While these are tied funds, they are necessary as they are targeted at specific vulnerable groups. These need to be assessed whether they have been used and what their effectiveness has been. However, besides such provisions, it is equally important that key public services, such as sanitation and solid waste management (SWM), are provided to all citizens at affordable prices.

The fourth aspect refers to horizontal equity, as the share of municipal corporations to that of share of municipalities. As we have outlined earlier, many central and state urban programmes are meant for municipal corporations in larger cities. Some central and state grants (for instance, from Finance Commissions) are based on per capita allocations. The smaller towns that are in dire need of grant funding are thus at a disadvantage as they have to rely on their own revenues for capital investments, which are meagre to begin with. Figure 4 illustrates these principles for Gujarat and Maharashtra. We see that the predictability of transfers is low and that significant amounts of funds are earmarked for large cities.

Figure 4: Assessing fiscal decentralisation (% of transferred funds)



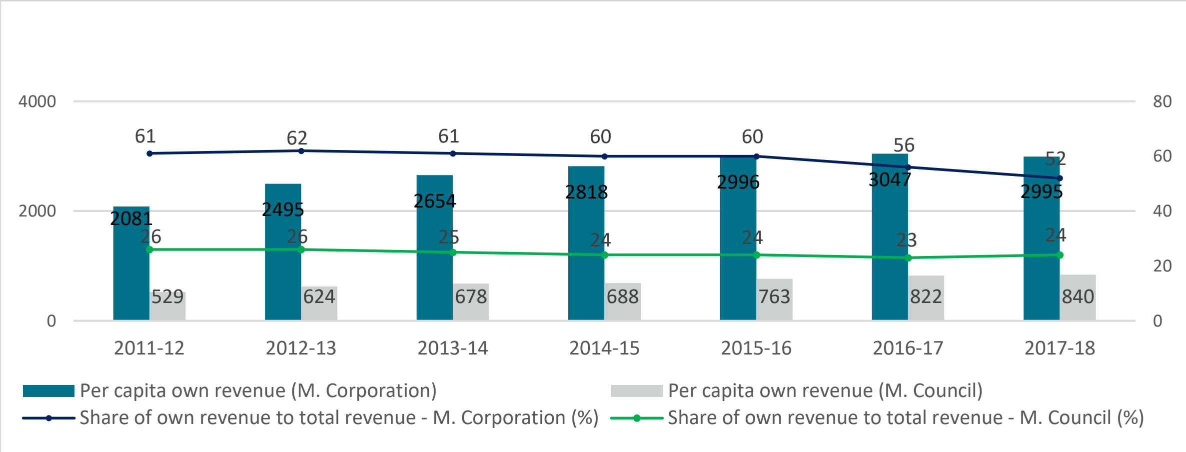
Sources: Beliappa et al. (2011a) p. 15; and Beliappa et al. (2011b) p. 12.

It is clear that both central and state governments need to increase their share of untied grants and increase predictability of their transfers. However, this will need to be balanced by also focusing on the needs of smaller cities and focusing on the vulnerable sections of the population. This is important as these cities, even though they house only 30 per cent of the population, need their appropriate share, as they have less fiscal capacity. Lower land values also put a limit on mobilising additional land-linked resources.

1.4. Using IGTs to Promote Growth in Own Revenues and Municipal Borrowings/Bonds

Another major source of municipal revenue is from 'own sources' such as local taxes, user charges/fees and rental income. One concern of any fiscal decentralisation policy would also be to ensure that any increase in IGTs do not dampen efforts to increase municipal own revenues. Interestingly, Figure 5 shows that for municipal corporations, the share of own revenues has been more or less constant over the past seven years, though there is a small increase in per capita own revenues. For municipal councils, there is a gradual decline in the share of own revenues despite some increase in per capita own source revenues.

Figure 5: Share of own income and per capita own income



Source: Derived from data available in Ahluwalia et al. (2019), pp. 39–47 and pp. 83–90.

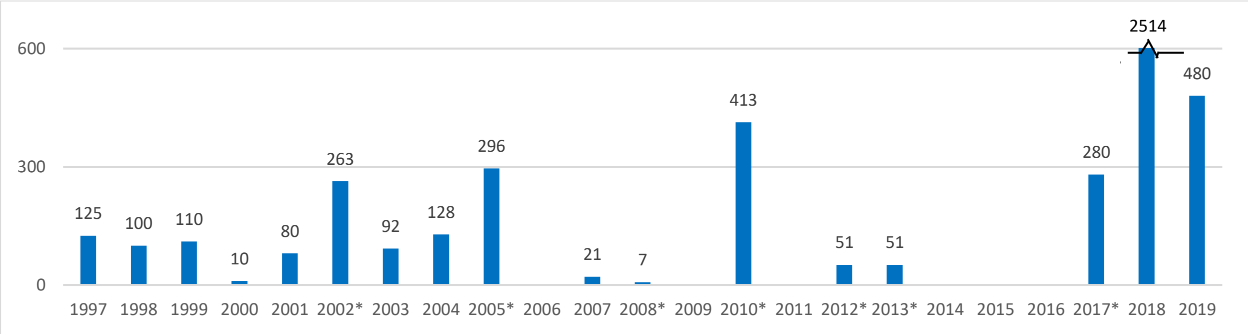
This suggests the need to ensure that growth in IGTs does not dampen the efforts of ULBs to increase their own revenues. This was the logic for the 14th Finance Commission that stipulated growth in own income as one of the requirements for availing performance grants. It would be useful to assess the extent to which urban local governments were able to achieve increased revenues. A well designed performance-linked IGT can provide incentives for increasing own revenues. However, the design of an appropriate metric is critical to ensure that the intended performance is actually achieved as per Goodhart's Law. Koehrsen (2018) highlights this with examples. In case of urban local governments, performance improvement should focus on increase in own revenues as well as in service performance. This necessitates regular and reliable measurements for both revenue and service performance.

Along with own revenues, it is also important that programme-linked IGTs help support use of commercial resources through borrowing by local governments. India has relatively better developed financial systems; during the pre-Jawaharlal Nehru National Urban Reform Mission (JNNURM) phase, many local governments had initiated borrowing from capital markets using the municipal bond route. Most of these bonds were done with credit rating and have delivered very good performances. However, from 2005 to 2017, as Figure 6 suggests, there have been very few issues and the municipal bond route seems to have stopped, except for a few pooled bond issues by the Water Services Trust Fund of the Tamil Nadu Urban Development Fund (TNUDF). This was despite the tax exemption offered by the GoI; 55 ULBs received the least investment grade rating, and 10 municipal corporations received a rating of AA- or higher (MoHUA, 2017).

Mehta and Mehta (2010) have argued earlier that programmatic grants from both central and state governments failed to provide incentives to ULBs to leverage commercial resources. This resulted in crowding out of the municipal bond route by easy access to programme funds under the JNNURM, and later under AMRUT. The share of total funding to be mobilised by ULBs was not really conducive to force them to explore any market-based resources, and the programme designs have not made this a mandatory condition.

Even the new Securities and Exchange Board of India (SEBI) Guidelines issued in 2015 (SEBI, 2015) did not provide a fillip. These new guidelines made credit rating mandatory, though

Figure 6: Issuance of municipal bonds in India from 1997 to 2019 (Rs in crore)



* Pooled bonds issued years marked.

Sources: Chakrabarti (2014); Kapoor and Patil (2017); Tamil Nadu Urban Infrastructure Financial Services Ltd (2019); World Bank (2016); BSE listing of new debt security of Pune (2017, June 21), Andhra Pradesh (2018, August 24), Hyderabad (2018, February 15), Surat (2019, March 5), Visakhapatnam (2019, January 8); *Economic Times* (2019); Press Trust of India (2018); Indore Municipal Corporation (2018); Institute of Chartered Accountants of India (2018); Pathak (2019, January 25).

that was a practice already. Further changes in this were incorporated in 2019 (SEBI, 2019) which included issuer changes as well as audit requirements linked for bond issuers.

However, it is worth pointing out the good results from the market for pooled funds for small ULBs by the TNUDF. The link between a good system of IGTs and the presence of a financial institution focused on local governments has helped to create a situation where market borrowing has been possible through a number of bonds' issues using the pooled fund route even in the years after 2005 (see Figure 6). It would be important to review as to why similar attempts in several other states such as Karnataka, Andhra Pradesh, Telangana, Rajasthan, Bihar and Maharashtra have not yielded good results. In a similar vein, the GoI's Pooled Finance Development scheme was not taken up by any state.

It is also important to discuss the possibility of borrowing from commercial banks, which is the route used often for infrastructure financing in India. The recent addition of sanitation related credit in the priority sector lending requirements for scheduled commercial banks provides another incentive for borrowing from banks. However, this will require considerable support to banks and private service providers to develop viable project proposals.

However, this has not been common in India for ULBs, and most ULBs lack any significant credit history. Even in Tamil Nadu, where ULBs have good history due to the TNUDF, there has been no experience with borrowing from banks. However, a municipal fund can actually help promote such links as was done by FINDETER in Columbia, which provided refinancing to banks for their lending to municipal governments (Mehta, 2003, p. 70; World Bank 2016a).

Since 2018, a further seven municipal bonds were issued. These were spurred mainly by the incentives offered by the GoI. The promise of significant mobilisation of resources for urban infrastructure using this route does exist, as evident from the municipal bond market size of US$3–4 trillion in China and the United States of America (USA) (Patil, 2020, based on data from Bloomberg). However, the central and state government programmes over the past two decades have lacked performance incentives for commercial borrowing built into the programme design.

To capitalise on the promise of municipal borrowing and use of commercial resources, it is essential to improve programme designs that incentivise strong ULBs to mobilise commercial resources. From a review of past efforts, including schemes such as Urban Reform Incentive Funds (URIF) as well as Pooled Development Finance Fund (PFDF), there has not been much success. The answer may lie in better design of performance-linked grants which are linked to results as well as provide incentives for mobilising commercial resources. It should be recognised that access to commercial resources, backed by credit rating, will also help to bring greater transparency.

2. Own Sources of Municipal Revenue

For urban local governments, property tax is one of the most important sources of own revenue. The economic rationale for property tax is that it enables ULBs to capture a part of the 'unearned' increase in property values. The argument is that urban property values rise as a result of infrastructure investments by ULBs (for example, a road-facing property or a park-facing property has higher value than nearby properties in the same location). It is also a 'progressive' tax, as bigger and higher value properties pay higher taxes. It is for these reasons that property tax is a major source of revenue for cities globally.

"However, politicians often prefer to rely on indirect taxes that are less visible. In Brazil property tax comes second in importance after the Tax on Services (ISS). In the past, Indian municipalities relied heavily on octroi (import taxes into urban areas) and neglected property tax. In China, local governments often rely on taxes levied on property transaction rather than on possession." (Salm, 2014, p. 68).

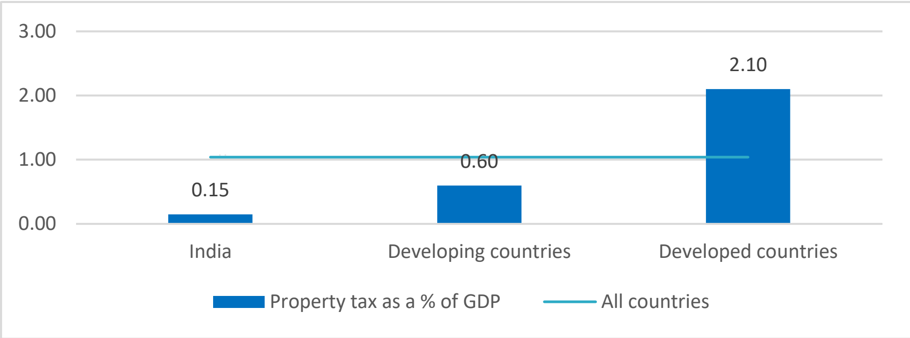
Besides this, user charges for various services also are an important source; they can help to ensure recovery of at least the operation and maintenance costs to ensure sustainability. In recent years, many urban local governments, particularly the lager municipal corporations, have also tapped additional revenue income through land value capture mechanisms.

2.1. There is Significant Untapped Revenue Potential from Property Tax

The 13th Finance Commission said that "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" (Finance Commission (13th), para 10.161). Recognising the importance of property taxes as a key source for local governments, many efforts have been made over the years to undertake a series of reforms under the JNNURM and AMRUT programmes. These have focused mainly on streamlining billing and collection systems. Despite these efforts, Indian cities fare poorly on extent of property tax mobilised as compared to other countries.

Figure 7 shows that "in 2017–18, property tax revenue as a share of GDP in India was 0.15 per cent" (Ahluwalia et al., 2019, p. 9), which compares rather unfavourably with 0.6 per cent for developing countries and 2.1 per cent for developed countries. It also suggests that there is a potential to increase property tax revenues at least four to five times when compared with developing countries, and by as much as 15 times when compared with developed countries.

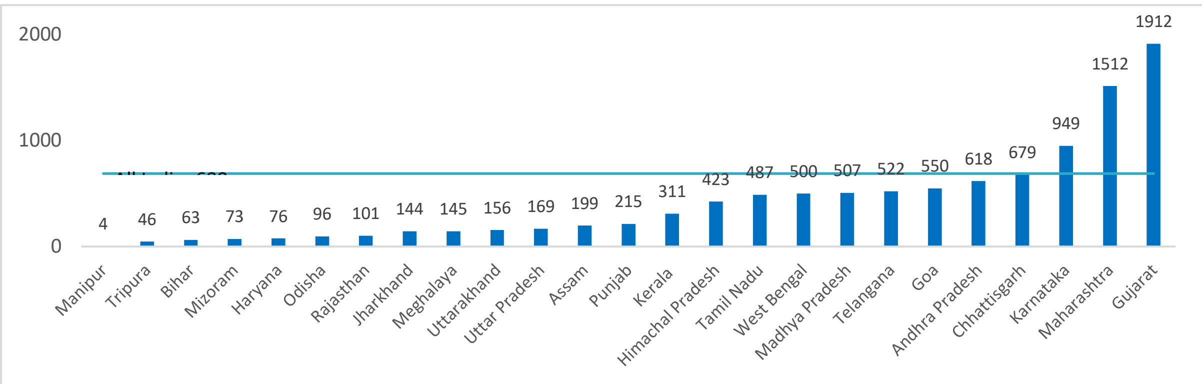
Figure 7: Property tax as a % of GDP across selected countries



Sources: (a) For India 2017-18: Ahluwalia et al. (2019), p. 9; and (b) for Organisation for Economic Co-operation and Development (OECD) and developing countries in the 2000s: Bahl and Martinez (2007), Table 1, p. 16, for 18 OECD and 29 developing countries, based on International Monetary Fund Government Finance Statistics, various years.

Even within India, there are significant variations in per capita property tax revenues (see Figure 8). Across states, Gujarat, Maharashtra and Karnataka have higher per capita property tax levels. It is possible that these states benefit from more regular reassessments of properties. On the other hand, some of the other large states such as Tamil Nadu, Uttar Pradesh and West Bengal have very low levels of per capita taxes, suggesting the possibilities of irregular revision/assessment of property taxes.

Figure 8: Per capita property tax of Indian states, 2017–18 (in Rs)

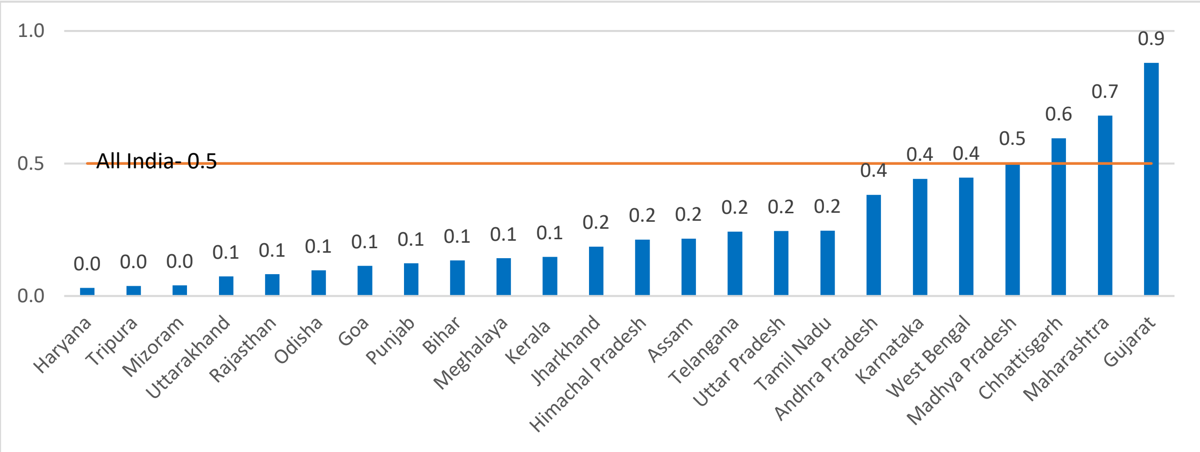


Note: Data is not available for Arunachal Pradesh, Jammu and Kashmir, Nagaland and Sikkim.

Source: State of Municipal Finances in India, ICRIER.

A possible explanation is that property tax revenues are also linked to overall development in the state. Figure 9 shows that while high property tax is linked to Gross State Domestic Product (GSDP) in Gujarat and Maharashtra, there are states such as Punjab and Haryana that have high GSDP but very low property tax yield. So, property tax revenue has more do with its assessment regime (that is, the tax base, tax rate), frequent reassessment and proper administration (billing and collection efficiency).

Figure 9: Per capita property tax as % of per capita GSDP



Sources: Ahluwalia et al. (2019) p. 91; per capita GSDP derived from data available in Ahluwalia et al. (2019) p. 99, Census, 2011 population; for Telangana and Andhra Pradesh population was considered from their state websites.

2.2. Linking Property Tax Base to Market Prices of Property

"In BRICS [Brazil, Russia, India, China and South Africa] countries, the property tax base is predominantly defined by national law (central government), as is the case in Russia, China, and South Africa. In India, the state government has the power to define the tax base. Brazil is the only country where the tax base is defined locally. Regarding the nature of the tax base the BRICS states have decided to make use [of] both methods of taxing land and buildings together, as in Brazil, India, South Africa, and land and buildings separately as in China and Russia" (Salm, 2014, p. 68). "In the United States of America property tax base is a matter of state law and rates are set by local governments, and counties and states usually do the assessments and collection" (Youngman, 2016).

To tap the potential of property taxes as illustrated in Figure 7 fully, the tax base itself will need to be buoyant. Chattopadhyay and Kumar (2019) suggest that the assessed values of properties are only 8–10 per cent of the market values of the properties. So, when property tax base is linked to capital value of property, better information on property values is needed. This will enable cities to better match the base with the prevailing property values in cities.

Currently, in India, most ULBs follow the Annual Rateable Value (ARV) method. This is usually defined as the annual rent which the land and buildings might reasonably be expected to fetch in an open market, from year to year, after allowing deductions for repairs and maintenance. The issue surrounding the ARV approach has always been the definition of a ‘reasonable’ rent. There have been many litigations based on assessment of ARV. The notion of “standard rent” under the Rent Control legislation has further compounded the issue of assessing ARV.

Chattopadhyay and Kumar (2019) point out that “Property tax is characterised as the tax everyone loves to hate because its visibility and other characteristics make people particularly aware of it and, therefore, any reform initiatives entail significant local political challenges and administrative difficulties’’ (p. 3).

To overcome these problems, reforms were initiated under the JNNURM and later continued under the AMRUT programme. With these, most states have shifted to a simpler Unit Area Value (UAV) method for assessing ARV. This was first initiated in Patna in 1993 (Singh, 1996; Vaidya, 2000). Under this system, the price per unit value of the area (built-up/carpet) is fixed and is used to determine the tax returns from a property to take into account aspects such as property type, location and size. This has also helped to minimise arbitrariness in fixing property values and enabled self-assessment of tax by property owners. The recent Telangana Municipalities Act, 2019, mandated all ULBs to undertake self-assessment system (SAS) for property tax. Many cities such as Delhi, Navi Mumbai, Chennai, Pune and Bangalore have also implemented self-assessment, where information on property assessment is provided by property owners. This has helped to free taxpayers from harassment by tax collectors and lower the cost of tax compliance.

Globally, as pointed out by Chattopadhyay and Kumar (2019), property tax is usually levied on the capital value of property. In this system, the tax is levied as a percentage of the market value of the property. Use of capital value method was introduced in Karnataka, starting with Bangalore. The Greater Mumbai Municipal Corporation has also adopted capital value base method for property tax. However, as Ahluwalia et al. (2019) point out, in Mumbai “the shift … has not been smooth. The steep increase in tax levied led to a spurt of litigations against the new system and the Bombay High Court gave an interim order in the year 2014 to levy tax with half the expected increase. Only recently, in year 2019, the Court upheld the capital value system while directing certain changes in the assessment method” (p. 26). The Maharashtra Municipal Councils, Nagar Panchayats and Industrial Townships Act, 1965, in its Section 105 on municipal taxation, states that “the property tax levied on the basis of capital value of any buildings or lands … shall not in any case exceed 40 per centum of the amount of the property tax payable in the year immediately preceding the year of such revision”. It further states that for small properties (500 sq ft or less), the property tax assessed on capital values will not exceed tax payable before revision for five years.

Capital value of property is usually based on the 'ready reckoner rate', which is determined by the state government's revenue department or by the local development authorities. The ready reckoner rate is usually considerably lower than the market rate. A recent survey by the state stamp duty and registration department in Navi Mumbai, Maharashtra, indicates that the ready reckoner rates were lower by 47 per cent to 113 per cent in different locations than the market rates (Kulkarni, 2016). In addition to this, many states do not revise the ready reckoner rates regularly. For example, in Gujarat, the ready reckoner rates were revised nearly 10 years ago in 2011, though as John and Dave (2019) point out, the Gujarat government now plans to do this every year as done in Maharashtra. The lack of updated property values also adversely affects resources from transfer of stamp duty cess and surcharge which are shared with municipal governments.

With a shift to this method of property tax valuation, property tax revenues can increase significantly. However, it is also important to note that its implementation will not be easy due to its political implications.

In a recent announcement by the Finance Minister on May 17, 2020, the limit for a state government's borrowing was increased from 3 per cent of GSDP to 5 per cent of GSDP, subject to certain conditions. One of these conditions, related to urban reform, provides an incentive of 0.25 per cent additional borrowing for state governments. This condition related to notifying floor rates of property tax in urban bodies, in consonance with prevailing circle rates (that is, Guideline rates for property transactions). It also requires states to notify floor rates for user charges for water, drainage, and so on, reflecting current costs and inflation (Financial Express, 2020). The states will also have to undertake periodic increases in both, according to inflation.

Many states, for example, Karnataka and Maharashtra, have already moved to capital value based property taxation, where capital values are linked to circle rates. In most states, the authority to set circle rates is with the state governments. Many states have set up Property Tax Boards for this purpose, as required by the 13th Finance Commission. However, these boards are largely dysfunctional. For example, the memorandum submitted by the Ministry of Urban Development (MoUD) to the 14th Finance Commission states that, "The Property Tax Boards have been constituted by several states. However, the understanding of the subject and its effective implementation is doubtful" (Ministry of Urban Development [MoUD], 2014b, p. 18). A recent SFC report from Maharashtra also states that while "Municipal Property Tax Board Act 2011 came into force in March 2011 ... however, the Board has not been established" (Maharashtra State Finance Commission [MSFC], 2019, p. 6). Similarly, the Tamil Nadu SFC also reported that while a Property Tax Board was established, it had not started functioning (Tamil Nadu State Finance Commission [TN SFC] 2014, p. 114).

Despite the relative non-performance of the Property Tax Boards, there have been recommendations for setting up Municipal Revenue Boards (MRBs). For example, Awasthi and Nagarajan (2020) suggest that MRBs "could be an appropriate institutional structure to administer the fiscal cadastre (property register), such as an autonomous board to be created by an act of the state legislative assembly. The board could serve all urban local governments of the entire state, other than large metropolitan municipal corporations that have already set up independent administrations" (p. 25).

Such proposals need to be assessed properly as they suggest transferring municipal powers to a state entity. While such suggestions are often made by national and international institutions, the experience with such state agencies and property tax boards has not always been good. It is possible that the existing state Directorates of Municipal Administration can support this function, and strengthen capacities of municipal governments, rather than take away municipal autonomy.

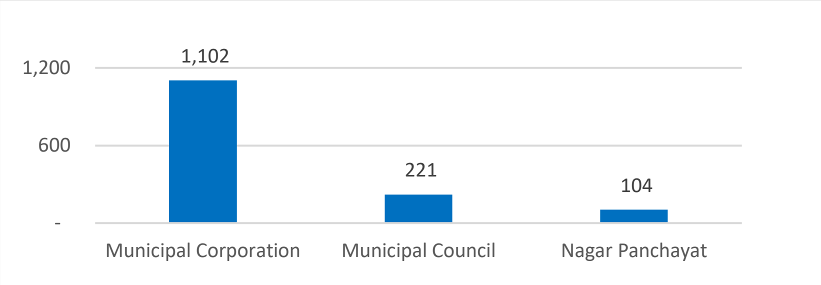
Along with the fair valuation of property, periodic reassessment of the property tax base is also critical to bring assessed values in line with market realities. In Municipal Acts of many states, it is recommended to carry out assessment of properties once in every five (Uttar Pradesh, Andhra Pradesh, Telangana, Tamil Nadu, Karnataka and Odisha) or four (Maharashtra, Gujarat and Rajasthan) years. Similar recommendations have also been made by Awasthi and Nagarajan (2020). It is important to assess the extent to which this happens regularly by local governments in these states. The better performance of Gujarat and Maharashtra in property tax collection may partly reflect regular four-yearly reassessments by most ULBs.

Even when such assessments are done every four or five years as per the relevant Acts, it is likely that the sudden increase in tax payable in the year of reassessment leads to a drop in collection efficiency, as illustrated by Jadhav (2019) for two small cities in Maharashtra. This could be overcome if the tax rates are increased every year as gradual increases will be more acceptable to property owners. This, however, may require amendments in the prevailing Municipal Acts.

2.3. Continued Focus on Reforms to Increase Coverage and Collection Efficiency of Property Tax

Based on the data reported in Ahluwalia et al. (2019), Figure 10 shows that the per capita property tax of municipal corporations is nearly five times that of municipal councils, and 10 times that of nagar panchayats (NP). Interestingly, this is despite the fact that collection efficiency of property taxes for municipal councils and NPs is higher. This may suggest their lower fiscal capacity due to lower property values, and thus the need for higher IGT support from the central and state governments for these councils and NPs.

Figure 10: Per capita property tax by size of ULBs (in Rs)



Source: Based on information reported in Ahluwalia et al. (2019).

Besides under-assessed values, the current property tax systems also face major limitations of inefficiencies in billing and collection systems. Poor billing efficiency is due to the inability of urban local governments to fully cover all taxable properties in the tax net. With cities growing rapidly over space, assessing and taxing the new properties remains a challenge. On the other hand, low collection efficiencies reflect the inability to recover the tax demand, due to inadequate collection systems. Experience in many cities in India, and globally, shows that there is considerable potential to increase billing and collection efficiencies by using digital systems such as geographic information system (GIS) mapping and computerised billing and collection system.

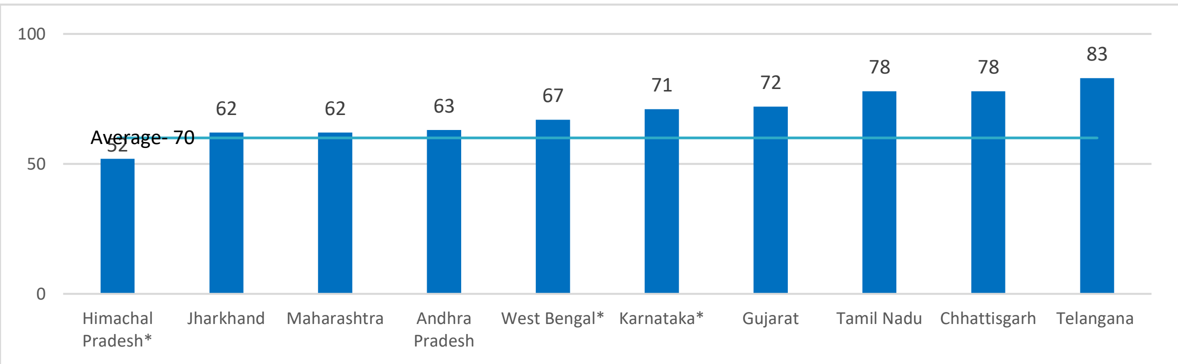
Implementation of e-governance was one of the mandatory reforms under the JNNURM. It was envisaged that cities would establish systems that would bring about transparency and accountability in ULB operations and help improve the reach of the delivery of services to citizens. Under AMRUT reforms, a set of municipal services were listed to be covered with E-MAAS (E-Municipality as a Service). It included computerised billing of property tax, water and sewerage charges, and other fees and taxes.

Studies suggest a coverage of properties ranging from 63 to 80 per cent (Mathur et al., 2009; McKinsey, 2010). Thus, there is a considerable potential to add more properties in the tax net. Bhan (n.d.) suggests several good practices of using GIS to improve billing efficiency. For example, Mirzapur in Uttar Pradesh, using GIS, achieved a 10-fold increase in the number of properties and a tripling of revenues in three years; Kanpur doubled its coverage of properties in four years. Raj (2020) shows that, using spatial analytics, it was possible to double the built-up area reported in property tax database in nine wards in Bangalore. A recent World Bank study states, "But the challenge in using technological solutions does not end with the initial GIS mapping of urban properties. The challenge is in keeping the data dynamic and up to date for additions of property, additions to existing property, and change of ownership" (Awasthi and Nagarajan, 2020, p. 10). While there have been suggestions about the use of GIS-based technologies and outsourcing of tax collection to a central agency or private agencies, their efficacy and usefulness, particularly for small and medium cities, needs to be assessed.

For improving property tax coverage, a simple reform is to match the property records with utility data records from electricity companies. For example, during property tax revaluation, the Indore Municipal Corporation matched property tax records with electricity records and found that “total commercial power connections in a zone were 5,198, while property tax records showed only 2,570, which means 51 per cent of properties did not declare commercial/mixed usage” (Das, 2020, p. 1). It would be also possible to digitise the building permission process and link it to the property tax system. This would mean that a ‘building use certificate’ cannot be issued without the property being assessed by the property tax department. This has been done in Greater Hyderabad Municipal Corporation (GHMC) as many house owners, developers and builders avoided paying property tax to the civic body. To overcome this, the GHMC has synchronised building permissions with the property tax database within 15 to 20 days – an alert is automatically sent to the revenue department to generate property tax receipt based on the constructed plinth area (Singh, 2019).

Property tax reforms under the JNNURM had mandated cities to increase collection efficiency to 90 per cent. Collection efficiency is defined as the amount billed versus the amount collected. This reform has also been pursued under the AMRUT programme. Despite efforts by many cities under such reforms, Figure 11 shows that, on average, collection efficiency of property tax ranged from 47 per cent to 74 per cent across different states during 2016–19.

Figure 11: Average collection efficiency of property taxes across states, 2016 – 2018

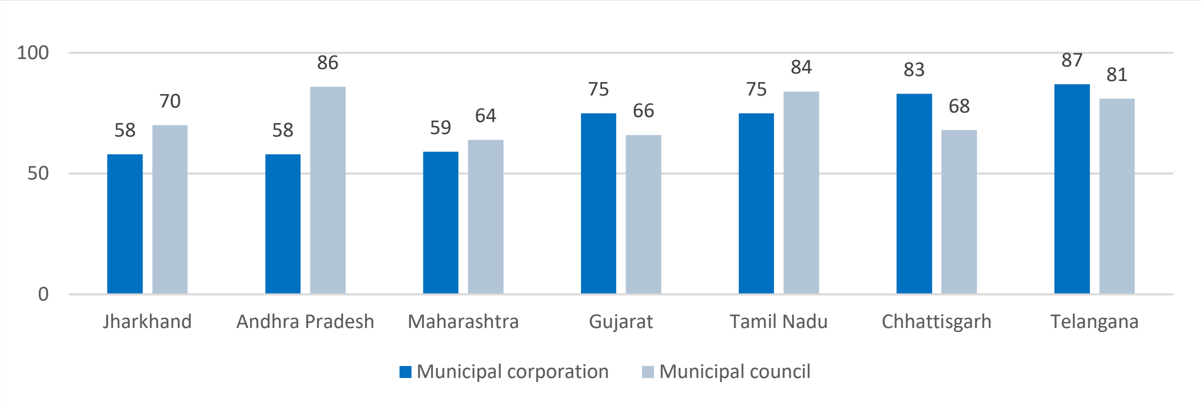


* For these states, the information is only for municipal corporations. For Maharashtra, 12 municipal corporations’ data is not available; for Telangana, Greater Hyderabad data is not available.

Note: Average is a weighted average using 2011 urban population across given states.

Source: Gujarat PAS SLB data (2017–18); Chhattisgarh PAS SLB data (2017–18); Maharashtra PAS SLB data (2017–18); Telangana PAS SLB data (2017–18); Jharkhand PAS SLB data (2017–18); Andhra Pradesh CDMA report (2015–17); Himachal Pradesh CAG report (2013–14); Tamil Nadu SFC report (2014–15); West Bengal CAG report (2011–14); and Karnataka CAG report (2011–16).

Figure 12: Collection efficiency of property tax in municipal corporations versus municipal councils



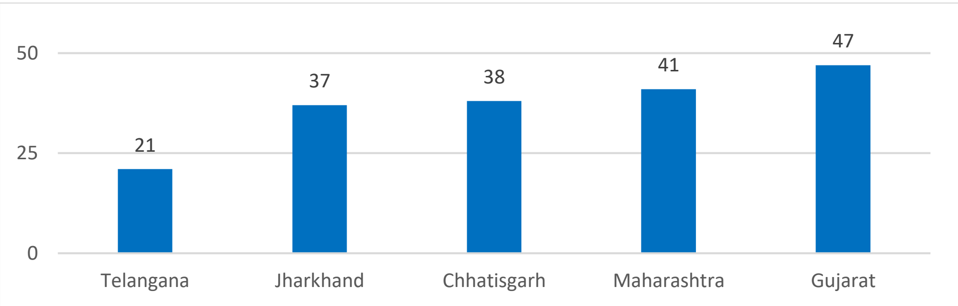
Note: Average % values reported for each state.

Sources: Gujarat PAS SLB data (2017–18); Chhattisgarh PAS SLB data (2017–18); Maharashtra PAS SLB data (2017–18); Telangana PAS SLB data (2017–18); Jharkhand PAS SLB data (2017–18); Tamil Nadu 5th SFC report (2014–15); Andhra Pradesh CDMA report (2015–17); for Maharashtra, 12 municipal corporations' data is not available; for Telangana, Greater Hyderabad data is not available.

However, it also suggests that it is possible to double property tax collections by improving collection efficiency. For improving collection efficiency, many local governments have made efforts to simplify bill generation and payment by introduction of online systems and provide incentives for early payment of dues. Besides incentives, strict enforcement on delays and defaults such as interest payments on outstanding dues, disconnection of water supply, 'naming and shaming' in the local press and issue of warrants have also been used. But since the penalty does not accumulate, the incentive for consumers to settle their arrears quickly is not very powerful.

It is also important to ensure that pending cases of defaults due to disputes and arrears are taken up in a fast track manner. Data from five states in Figure 13 suggests that most cities face mounting arrears which comprise nearly 30 to 50 per cent of total tax demand. The collection efficiency of these arrears is often poor at 20 to 40 per cent (see Figure 14).

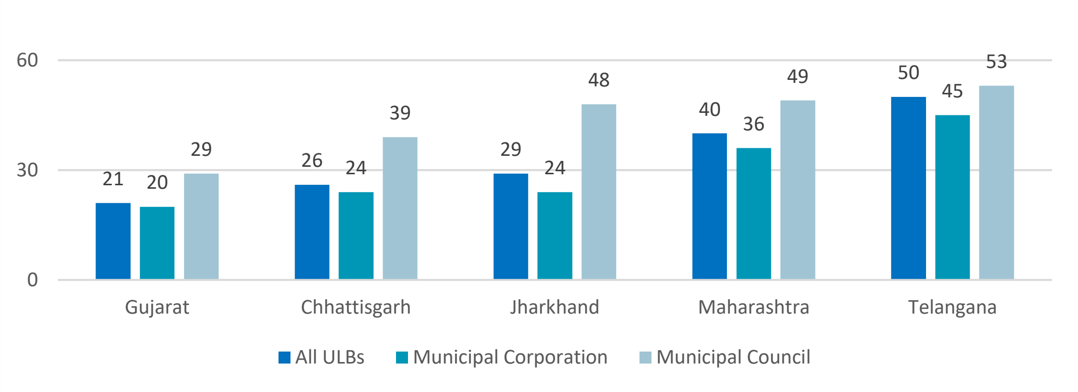
Figure 13: Share of arrears to total demand in percentage, 2018



Note: Data analysis for number of cities: Chhattisgarh – 168; Gujarat – 169; Maharashtra – 376; Jharkhand – 36; and Telangana – 69: for Maharashtra, data is not available for major municipal corporations such as Greater Mumbai, Pune, Nagpur, Pimpri Chinchwad; for Telangana, Greater Hyderabad data is not available.

Source: PAS SLB data (2018).

Figure 14: Collection efficiency of arrears in property tax in percentage, 2018



Notes: Data analysis for number of cities: Chhattisgarh – 168; Gujarat – 169; Maharashtra – 376; Jharkhand – 36; and Telangana – 69. Nagar panchayats are considered under municipal councils; for Maharashtra, data is not available for major municipal corporations – Greater Mumbai, Pune, Nagpur, Pimpri Chinchwad, etc; for Telangana, Greater Hyderabad data is not available.

Source: PAS SLB data (2018).

At times, however, some cities have made special efforts to improve collection of arrears. For example, the Pune Municipal Corporation (PMC), through its 'Amnesty scheme', enabled nearly 1.2 lakh property owners to clear their outstanding payments. The PMC mobilised Rs 225 crore over a short period (PMC, n.d.).

The property tax revenues are also affected by exemptions given to many properties. Chattopadhyay and Kumar (2019) point out that "exempted properties in India constitute approximately 10 per cent of the total urban properties and about 11 per cent of the assessed properties" (p. 3). A recent provision by the Mumbai Municipal Corporation to exempt properties below 500 sq ft led to decline in property taxes in Mumbai (Pinto, 2019). In addition, taxes on vacant land remain unexploited in Indian cities. ''In many countries, especially in Latin America, vacant land is taxed at a rate higher than that for built-up property. This is driven by the desire to curb speculation in land and promote use of land within urban areas. A tax rate of 1 to 2 per cent on the capital value of vacant land appears to be the normal practice in Latin American countries'' (Mohanty, 2003). In Gaborone City in Botswana, land tax rates on underdeveloped plots are four times higher than on developed plots (Collier et al., 2018). There is a wide scope to tap revenue from vacant land tax in Indian cities. Khan et al. (2014) also suggest the use of incentives for tax collectors to improve tax collection and avoid arrears.

Consultation and involvement of the public at various stages of planning, design and implementation of property tax reforms is also critical for its success. The willingness of property owners to pay increased taxes is likely to be higher if they are made aware that their tax rupee is going towards service improvements. For this to happen, there is a need for transparency and greater awareness among the public about costs of services in their cities. This may also help reduce court litigations and increase the collection efficiency of property taxes.

2.4. Achieving Cost Recovery for Basic Services through Local Resources has Received Emphasis through Reforms

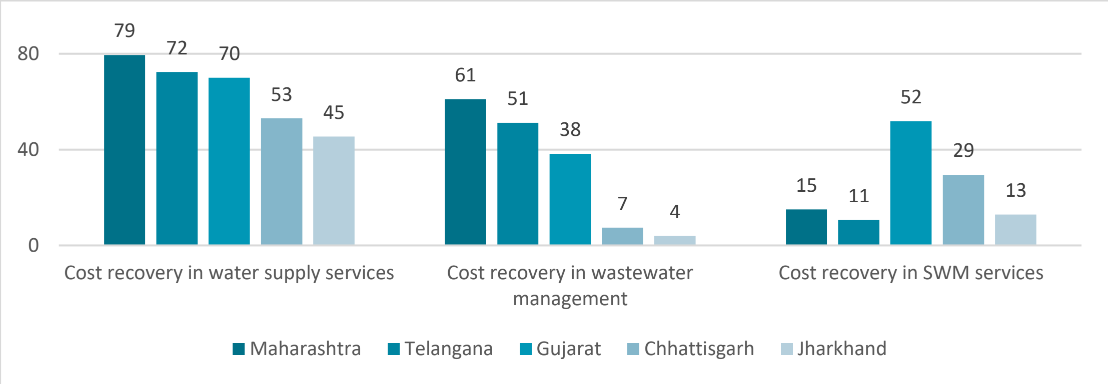
Cost recovery for basic municipal services such as water supply, wastewater management and SWM has received considerable emphasis in India as a part of envisaged reform under various GoI reforms. This has been a key reform measure in central programmes starting with the JNNURM in 2005. It required levy of reasonable user charges, with the objective that the full cost of operation and maintenance is recovered within seven years.

While the main economic reason for levying user charges on the users of services is to make use of resources more efficient, this principle of "allocative efficiency", that is, allocating resources efficiently to meet the demand for services, is the basis of levying user charges. However, the emphasis on cost recovery under the various reforms has been more to ensure availability of adequate 'local resources' with the ULBs and, thus, to ensure sustainability of service provision. However, as we show below, while there is some progress on cost recovery for water supply services, this has not always been possible for sanitation and SWM services.

It is important to distinguish amongst charges for water supply, and sanitation services. Piped water supply services have direct beneficiaries and hence generate more private benefits amongst households as well as enterprises. It is thus an 'excludable' service, that is, the service is provided to those who pay for it. Sanitation and SWM are not easily 'excludable', that is, non-payers cannot be denied services (for example, street cleaning). Sanitation is also considered a public service as it also generates wider environmental and public health benefits.

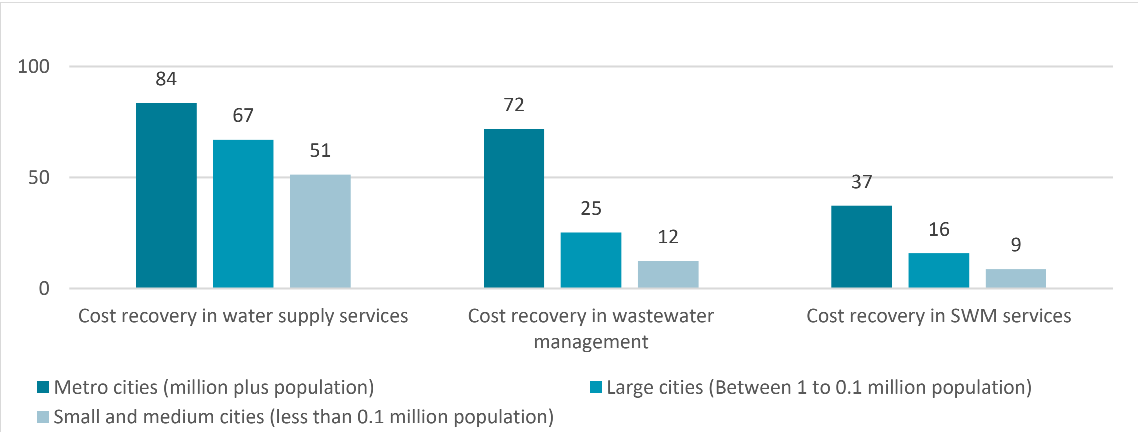
It is in this context that we assess whether Indian cities recover costs of water and sanitation services? In its studies of water supply in major cities, The Energy and Resources Institute (TERI, 2010) suggests that Chennai Metro Water and Bangalore Water Supply Board come close to meeting their operational costs, while all other cities manage to recover only 50 to 75 per cent of their operational costs. This is also similar to the finding from the five states where regular monitoring of urban services has been done for the past six years. It shows that there is better cost recovery for water supply, as compared to SWM (see Figure 15). Also, the metro cities with million plus populations have higher cost recovery than smaller towns (see Figure 16).

Figure 15: Extent of cost recovery in municipal services across five states in India, 2018



Source: PAS SLB data (2018).

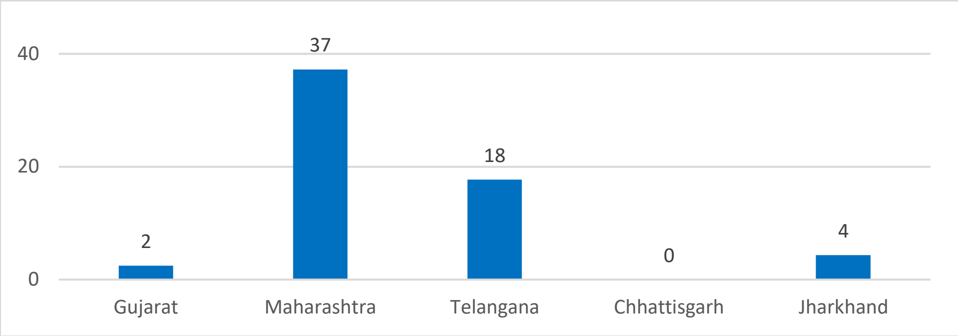
Figure 16: Extent of cost recovery by city size in municipal services in India, 2018



Source: Based on information as reported in annual monitoring through PAS SLB monitoring in the states of Maharashtra, Gujarat, Chhattisgarh, Telangana and Jharkhand.

Maharashtra seems to have done relatively better than other states, because the Government of Maharashtra requires ULBs to regularly revise water charges to ensure full cost recovery. This seems to have yielded positive results. Maharashtra also has a large number of metered connections. This also enables better cost recovery, though the smaller cities typically have less metered water supply (see Figures 16 and 17). Wastewater charges are usually linked to water charges, hence cost recovery for wastewater management is also better in Maharashtra and Telangana.

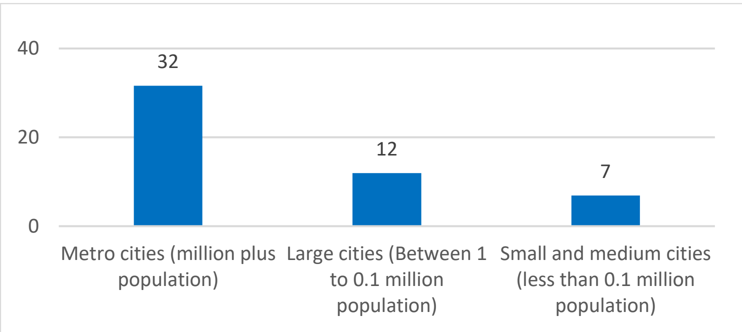
Figure 17: Extent of water metering across states



Source: PAS SLB data (2018).

Unlike electricity tariff that is revised regularly, water tariffs are not revised regularly. This is despite the fact that a large part of water supply expenditure is for electricity charges. In Bangalore, the Bangalore Water Supply and Sewerage Board revises water tariffs every three years, but electricity charges, which account for nearly 60 per cent of operating costs, are passed through to customers (TERI, 2010). This practice can be adopted in other states to ensure that a part of the operating cost of water supply is met.

Figure 18: Extent of water metering, city category-wise



Source: PAS SLB data (2018).

Two other aspects are also important in ensuring adequate cost recovery. The first relates to ensuring efficiency in service provision. For example, in water supply services, an important concern is the extent of non-revenue water (NRW) which increases costs and reduces revenues, and thus affects cost recovery adversely. Under various national programmes, many cities have adopted measures of efficient water management. For example, several municipal corporations in Gujarat have installed Supervisory Control and Data Acquisition (SCADA) systems in transmission networks (from sources to distributions stations), which are computerised systems for gathering and analysing real time data. This enables municipal engineers to check water flows in the system and identify leakages. Rajkot Municipal Corporation has reduced water losses through leakages and illegal connections in the transmission network with the help of real time water loss monitoring systems. Unfortunately, information on NRW is not available for most cities due to a lack of metering in most cities (see Figure 18). However, cities in Maharashtra with good metering and SCADA systems have been able to control their NRW to about 30 per cent. It is important for urban infrastructure programmes to move towards increased metering of water connections. This would help improve efficiency and help with demand management.

Cost recovery is also linked to user satisfaction with respect to improvements in service levels and regular provision. Mehta et al. (2020) find for Gujarat that while service levels in terms of access to municipal supply and quantity of water supply has increased over the past decade, this is not matched by other service improvements. They point out that “the average duration of the water supplied to consumers is two hours per day and the average days of water supplies is 23 days per month. There has been no major change in supply hours over the past nine years” (p. 7).

2.5. Water and Sanitation as Essential Basic Public Services

While cost recovery has received emphasis in municipal reforms, the perspective of water and sanitation as basic services – and thus deserving full coverage – has also influenced policy and practice in urban areas. Drinking water is considered a basic goods and political leaders often feel that people should not be charged for water. “There is wide interest in, and support for, the idea of treating water as an economic good. However, the role of water – as a basic need, a merit good, and a social, economic, financial, and environmental resource – makes the selection of an appropriate set of prices exceptionally difficult” (Perry, et al., 1997, p. v).

“Given the proximity to the population and the predominance of private-good characteristics of many local services, levying user charges is feasible. Often, however, it appears to be politically impossible to levy user charges when the quality of the services rendered is poor. The result is that a vicious circle is set up, with low-quality public services leading to an inability to collect user charges leading to further deterioration in the service levels” (Rao and Bird, 2011, p. 23).

A full-cost recovery approach for pricing of urban services may exclude households that are unable to pay connection and monthly charges, and yet these are precisely the households that need assistance. Differentiated levels of tariffs, including subsidies for the lowest income bracket, could benefit poorer households. They need to be subsidised for access and could gradually move up the water and sanitation ladder rather than face outright exclusion due to their inability to pay high connection charges.

While evaluating the discussion of subsidies, it is critical to assess that a good subsidy has to be based on an assessment of genuine need, and accurately target the intended beneficiaries. It should avoid creating perverse economic incentives that might, for example, encourage customers to waste water, and it can be scaled up to achieve significant coverage levels (Mehta, 2003). These principles were demonstrated by South Africa when it introduced “right to adequate water” in its Constitution in 1996. It introduced the concept of “free basic water” to every household. The water tariff policy stated, “To ensure that every person has an adequate water supply, the national tariff structure must include the following: (a) lifeline tariff to ensure that all South Africans are able to afford water services sufficient for health and hygiene requirements; (b) in urban areas, a progressive block tariff to ensure that the long-term costs of supplying large-volume users are met and that there is a cross-subsidy to promote affordability for the poor” (Muller, 2008, p. 71). It is suggested that, “South Africa’s experience with free basic water thus demonstrates that addressing social and environmental dimensions together with economic dimensions can lead to more effective and sustainable policy” (Muller, 2008, p. 67).

Taking a cue from South Africa, the Government of Delhi in 2015 introduced a similar ‘free basic water’ scheme by: (a) providing free water for all metered connections which consume up to 20 kilolitres of water per month; (b) extending piped water supply to unauthorised colonies over the next three years; and (c) reducing development charges for water connections to enable residents of unauthorised colonies to afford connections (Safe Water Network, 2016). This policy led to the ‘formalisation’ of a large number of ‘illegal’ connections, enabled the extension of piped networks in urban poor communities, increased billing efficiency and reduced water consumption to remain below the free water limits. However, over time, the losses have increased, and the utility has had to increase prices for above the basic water limit.

For sanitation services, in two small cities in Maharashtra, city-wide services are being provided to all residents for scheduled desludging of septic tanks through a public–private partnership model using a performance linked payment approach. Though citizens perceive this as a ‘free service’ as they do not pay any user charge at the time of desludging, it is nevertheless being funded through sanitation tax and property tax revenues by the local governments. This enables city-wide service provision, along with equitable charges as those with higher property values pay higher property taxes, and thereby cross-subsidizing the charges for delivery of services to the poor households in the cities. For sanitation, distributing the burden between households and communities (front-end users) and users of treatment plant outputs (back-end users) can help offset consumer tariffs. This can be done by leveraging demand for the products of treatment plant such as treated wastewater, compost and alternative fuel. This would also be a more environmentally relevant solution.

2.6. Incentivising Local Governments to Increase Own Revenues

It is sometimes argued that increase in IGTs will create disincentives for local governments to increase or even sustain their own revenues. As pointed out by Awasthi and Nagarajan (2020), “While no rigorous analysis has been done to test for a flypaper effect of the impact of grants, it seems the sizable amount of transfers may be crowding out the demand for additional revenues from own sources” (p. 6).

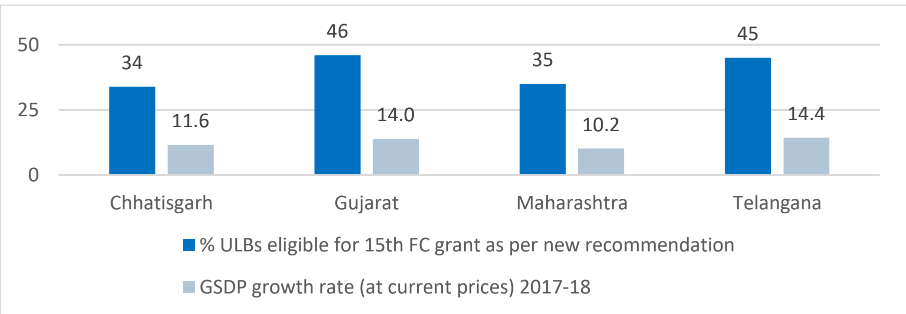
It is, therefore, necessary to design measures to incentivise local governments to improve their own resources, while maintaining and increasing IGTs and keeping them untied and predictable, as argued above. Many finance commissions have been advocating increase in municipal revenue as a condition for grant. More recently, the Finance Minister has also announced this as one of the conditions for increase in states' borrowing limit along with ensuring periodic increases.

Though limited, the Indian experience does demonstrate the use of such incentives. Cities were given incentives to mobilise funds from the capital market, which has led to some revival of the municipal bond issuance. Various finance commissions have made it conditional for municipal governments to raise revenues. For example, the 14th Finance Commission said, "…we are providing performance grants to address the following issues: (i) making available reliable data on local bodies' receipt and expenditure through audited accounts; and (ii) improvement in own revenues. In addition, the urban local bodies will have to measure and publish service level benchmarks for basic services" (Finance Commission (14th), p. 113).

The 15th Finance Commission, in its interim report, goes a step further and states that "to qualify for any grants for urban local bodies in 2021–22, states will have to appropriately notify floor rates and thereafter show consistent improvement in collection in tandem with the growth rate of state's own GSDP" (Finance Commission (15th), p. 53). This is rather stringent as the entire basic grant is linked to this condition. Mehta and Mehta (2020) show that as per available data for 2018–19, only 34 per cent to 46 per cent of ULBs in the four states shown in figure 19 would have qualified for any grant (p. 9) (see Figure 19). This condition is even more surprising as most state governments had earlier indicated to the 14th Finance Commission that "the basic grant by the Finance Commission should be untied" (TN SFC, p. 103).

Unlike the Central Finance Commission, none of the SFCs seem to have provided any incentives for ULBs to increase their own revenues. While the Tamil Nadu SFC did mention that "property tax needs to be increased from 0.2 per cent of state GDP to 0.6 per cent", it did not provide any incentives for this (TN SFC, 2016, p. 105–106).

Figure 19: Estimates of ULBs that would quality for basic grants as per 15th Finance Commission requirements



Note: FC: Finance Commission; GSDP: Gross State Domestic Product.

Source: Based on data reported for the PAS-SLB portal in four states: for Maharashtra, Gujarat and Jharkhand – Year of information (2017–18 and 2018–19); and Telangana – Year of information (2016–17 and 2017–18).

The recent SFCs from Gujarat and Maharashtra had sought and received suggestions for performance grants linked to improvement in ULBs own revenues, particularly for property taxes. The key suggestions were made related to performance-based grants for urban local governments with a few key minimum conditions as well as improvements on selected performance measures (Mehta et al., 2013a, 2013b). While these were recognised in the SFC report of the Maharashtra SFC, no specific recommendations were made (MSFC, 2019, p. 6). For Gujarat, the SFC report was not placed before the legislative assembly (Ahluwalia et al., 2019, p. 100).

Other researchers have raised doubts about such flypaper effects of inter-governmental grants. They argue against more performance-based grans, which in fact reduce the untied funds available for local governments. To address this, a different approach could be to provide additional incentives for improved performance rather than making the grants to local governments based on performance.

This is the approach used by the state governments of Gujarat and Maharashtra. Both these governments have introduced incentives for increase in property tax collection by urban local governments. For example, as per a 2014 resolution of the Government of Maharashtra, two incentives are provided: (a) ULBs whose water tax or charges recovery is more than 90 per cent get a subsidy to cover the costs of salary and pension of their employees; and (b) ULBs that recover 90 per cent of the property tax are to be permitted to use the 13th and 14th Finance Commission grants for processing the salary and pensions of their employees (Government of Maharashtra, 2017). The Government of Gujarat also introduced an incentive for disbursal of basic/salary allowance grants to municipal councils linked to collection efficiency of property tax. Municipal councils receive 50 per cent of approved establishment expenditure of council as grant-in-aid against achieving property tax collection efficiency greater than 80 per cent; this reduces to 40 per cent and 30 per cent if they achieve property tax collection efficiency of 60–80 per cent and <60 per cent, respectively (Government of Gujarat, 2012).

It is worth exploring the role played by these incentives provided by the state governments, as both Maharashtra and Gujarat show higher per capita property collections compared with other states, even when compared with Karnataka which has done significant reforms for improving billing and collection efficiency (see Figure 9).

2.7. Exploring the Potential of Other Non-Tax Sources and Land Value Capture to Enhance Local Resources

Besides property taxes, and user charges linked to basic services reviewed above, several other sources also contribute to own income of municipal governments in India. These mainly include taxes on business and entertainment (profession tax, advertisement tax and theatre tax) as well as various fees that local governments charge for licencing, parking, and so on. Rental income from their own properties is also an important source for many local governments.

Some taxes, such as stamp duties levied on transfer of properties as well as entertainment tax, profession tax and motor vehicles tax, were collected by state governments and shared with municipal governments (Mohanty, 2016; MoUD, 2014b). An important source of municipal revenue used to be octroi, which was later replaced with local body tax in Maharashtra. However, these were abolished, and state governments had agreed to pay compensation to local governments.

While the information on property taxes and for taxes/charges for municipal services is available, the information on municipal revenues from other sources is not readily available. The 14th Finance Commission had recommended that the books of accounts of local bodies should capture these details. However, this has not been heeded. It had also included these aspects, along with publishing service level benchmarks, as a part of their performance grants. Unless effort is made to address these suggestions, it is difficult to assess comparative trends in municipal revenues beyond property taxes and cost recovery on selected services for which data is available.

In recent years, there has been emphasis on exploring ways for local governments to mobilise resources through land value capture. For example, Mohanty (2019) suggests a toolbox of land-based instruments including taxes, development financing and land value capture methods. To some extent, local governments use their own land and property assets to mobilise revenue such as rental income. However, other measures of land value capture, such as "land value increment tax, impact fees, sale of development rights, regularising unauthorised developments, incentive FSI [floor space index] and unlocking value of public land" are also being practised in some cities (Indian Council for Research on International Economic Relations [ICRIER], 2014, p. 7). Essentially, these methods represent ways "to raise finances by leveraging the increasing urban land values using different mechanisms" (Gandhi and Phatak, 2016, p. 31).

Gandhi and Phatak (2016) point out that there has not been much research in India on land value capture. However, there is considerable evidence from other parts of the world, particularly from Latin America, where such approaches have been used. Transfer of Development Rights, where landowners pay a government entity a fee to transfer the density potential – for example, FSI or floor area ratio (FAR) – of one tract of land to a non-contiguous parcel of land that is better suited to greater densities. The fee generates revenue for public investment, and the transfer of density can also further urban planning objectives. For example, in Brazil, CEPACs (*Certificados de Potencial Adicional de Construção*) are a form of charges for building rights that are sold on a securities exchange. The City of São Paolo has generated nearly US$2 billion from CEPACs to fund infrastructure and planning programmes within a designated redevelopment area (Germán and Bernstein, 2018).

In India, a similar concept is used in the form of transfer of development rights. Karnataka, Gujarat and Maharashtra have made provisions for enabling Transfer of Development Rights to buy additional FSI/FAR. In Mumbai, charges for premium FSI are levied from developers who wish to build more than permissible floor space.

Betterment levies, known as valorisation charges in Columbia, have been used to defray, in whole or in part, the cost of a specific improvement or services that is presumed to be of general benefit to the public and of special benefit to the owners of such properties" Ochoa (2011, p. 1). It is quite successful in Columbia as "Bogotá currently has about $1 billion worth of investment in public works from this levy, and eight other smaller cities combined have another $1 billion". In Indian cities, betterment levies have not yielded significant revenues. In Gujarat, the betterment levy is linked to Town Planning Schemes. However, little effort by the local governments is made to collect this levy regularly.

Impact fees are common in many states of the USA. Developers pay the municipality a one-time charge designed to cover the costs associated with a development's impact on certain public services and infrastructure, and the municipality invests this revenue in public services and infrastructure. In India some cities have adopted impact fees, but not of the type used in the USA. Hyderabad levies a city-level impact fee on all buildings above 15 metres or above five floors (Gandhi and Phatak, 2016, p. 39). In Ahmedabad, a fee to 'regularise' all illegal constructions was termed as 'impact fee'.

The Mumbai Metropolitan Region Development Authority (MMRDA) and City and Industrial Development Corporation Limited (CIDCO) have used different value capture methods including betterment levies, to finance infrastructure development in the urbanising areas. However, the funds that development authorities such as MMRDA, CIDCO, DDA, etc, generate from land development do not accrue to the ULBs in which they are located. Tamil Nadu and Maharashtra have made land value tax applicable to urban areas too, under which increase in land value is tapped through increased revenue tax. However, in Gujarat, vacant urban land tax has often been proposed but never imposed. West Bengal has formulated a system to capture gains from land use conversion (MoHUA, 2017).

As one can see from the above, land value capture financing is often a one-off activity. For example, both Hyderabad and Ahmedabad generated significant revenues from impact fees, but it was only for a few years. Building permissions, rental from municipal properties, parking fees, etc, are recurring revenues but the amount is often too small compared to property tax and water and sanitation charges. Hence less attention is paid to such non-tax revenues by state and local governments.

2.8. Own revenues of the small and medium cities have been adversely affected by the COVID-19 pandemic

COVID-19 pandemic has affected revenue of all levels of government. However, cities have borne a major brunt of this pandemic. City officials, especially health and sanitation workers, are at the forefront of the battle against Covid-19. The pandemic has spread from larger cities to small and medium cities. Prolonged lockdown has affected municipal revenues significantly as suggested by a municipal finance assessment study for a small town in Maharashtra. The collection from property tax and rental income in this town dropped by nearly 40% as compared to the previous year. For cities to remain at the forefront of the battle against Covid-19, it is critical to ensure that they have access to adequate and predictable financial resources. Adequate financing is also essential to enable municipal governments to fulfil their mandate of various services and functions assigned to them.

3. Conclusions

Strengthening municipal finance has been on the government agenda for a long time. In India, the first attempt at setting urban service norms and standards was made in 1963 by the Zakaria Committee, which laid down the physical norms and corresponding expenditure norms. It is now time to have new estimates to assess expenditure requirements in line with emerging standards and options for various municipal functions.

IGTs have been a major source of municipal finance globally. Compared with global practices, in India the IGTs are very low at 0.45 per cent of GDP. It is suggested that this should increase to match global practice, ranging from 1.5 to 5 per cent even for developing and BRIC countries. IGTs in India are also largely tied, as they are linked to central and state programmes, and often conditional on fulfilling certain requirements. While some central and state programmes based on national and state priorities are necessary, they reduce the untied component of the grant. It is suggested that the share of untied IGTs from the centre through the finance commissions and GoI should be increased. This may also require Constitutional changes to have a separate list for municipal resources as well as a local government share in the GST.

Transfers from state to local governments face even more problems. These were often promised in lieu of withdrawn local taxes such as octroi, local body tax and, more recently, due to GST. However, states have often reneged on their promise to local governments. As a consequence, grants to ULBs often become unpredictable and ad hoc. Even more importantly, it is crucial to ensure that state governments regularly set up and adopt the recommendations of their SFCs as mandated by the Constitution. The use of transparent and formula-based allocations by SFCs would make transfers more regular and predictable.

There have been a few attempts in the past to promote borrowing by ULBs. But it is a Catch 22 situation. ULBs need to be financially strong to be able to borrow from the market or from banks. Given that very few cities have managed to get a credit rating of A and above, which is required for attracting investors, there is not much scope for using this route to finance municipal investments without first strengthening their finances. Thus, central and state transfers will be needed to fund their capital investments. However, the IGTs should be designed to avoid crowding out, and encourage strong municipal governments to use commercial resources for urban infrastructure, using the municipal bond route or borrowing from commercial banks. The success of TNUDF in creating a credit history has lessons, as does the success of FINDETER in Colombia to link local governments with banks (World Bank, 2016a, 2016b).

ULBs are usually advised to mobilise own resources by various central and state finance commissions and property tax is cited as a source with great potential. Compared with international experience, property tax mobilised by Indian cities has been very low. Many efforts have been made to change the basis of property tax from ARV to capital value, use digital technology, and improve billing and collection efficiency. However, despite this, the level of property tax in relation to GDP has not matched international experience. To achieve this improvement, concerted efforts will be needed to move to capital value as a base for property tax, backed by more realistic and regular assessment of property values. However, it should also be recognised that, for small and medium towns with generally lower property values, there will be limits to raising revenue from property tax as well as other measures of land value capture.

Local taxes and user charges are advocated to recover the operational costs of service provision. Experience from five states for which information is available suggests that ULBs have increased their cost recovery for water services, though this has not been common for sanitation and SWM. While cost recovery deserves emphasis in municipal reforms, the perspective of sanitation as a basic service with wider public health benefits – and thus deserving full coverage at 'affordable costs' – is also important in policy and practice. Similarly, it is important have well designed subsidies to ensure that the poor and vulnerable groups have 'affordable access' to all public services for water and sanitation.

For both property tax and user charges, the state governments decide the framework and rates. Thus, while the third tier of government is recognised by the Constitution, ULBs have still remained under the clutches of the state governments. Their inability to raise their own revenues is partly a result of lack of empowerment of ULBs by the state governments. This requires considerable increase in intergovernmental grants from the union and state governments, and to build capacities of local governments to maximise the potential of own revenues. It is important to also ensure regular annual increases in both property taxes and other user charges by ULBs. This will help steady increases to keep pace with price increases and avoid sudden jumps in charges, which result in public opposition and reduction in collection efficiency.

This paper has not discussed the need for proper financial management at the local level. But it must be borne in mind that appropriate and well managed use of local finances, and good financial management will be needed to ensure fiscal discipline, including proper accounting and reporting. Equally, additional municipal resources should lead to better service delivery. Regular monitoring of service delivery through measures such as Service Level Benchmarking (SLB) through a Performance Assessment System (PAS), as being currently done across nearly 1,000 ULBs across many states, will be needed for this purpose.

It is only a recognition of this **two-fold approach** – that combines a significant increase in IGTs along with incentivising and supporting local governments to enhance their own revenues – that will enable local governments to become financially strong. This requires the upper echelons of government, both political and administrative, to recognise and support the cities and urban development, through adequate funding, capacity building support and encouragement. Major reforms will be needed to achieve this agenda. For this, political support for local governments is critical to ensure that the urban potential in economic development of the country is realised.

While pursuing these approaches, it will also be important to recognise that small and medium local governments will need greater attention. Efforts will also be needed to achieve universal access to basic municipal services in a sustainable and equitable manner. On one hand, this will require major transformational changes, such as recognition of local government resources in the Constitution and a share for them in GST collections. At the same time, measures are also needed to increase municipal own revenues by reforms and capacity building for property tax and other own sources. By focusing on both approaches simultaneously, it will be possible to achieve the vision of strong municipal governments and sustainable delivery of inclusive and equitable services.

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