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### Municipal Finance in India: Some Critical Issues

Simanti Bandyopadhyay

National Institute of Public Finance and Policy New Delhi, simantib@gmail.com

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**International Center for Public Policy  
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## **Municipal Finance in India: Some Critical Issues**

**Simanti Bandyopadhyay**



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**Municipal Finance in India: Some Critical  
Issues**

**Simanti Bandyopadhyay**

**May 2014**

International Center for Public Policy  
Andrew Young School of Policy Studies  
Georgia State University  
Atlanta, Georgia 30303  
United States of America

Phone: (404) 651-1144  
Fax: (404) 651-4449  
Email: [hseraphin@gsu.edu](mailto:hseraphin@gsu.edu)  
Internet: <http://aysps.gsu.edu/isp/index.html>

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# *Municipal Finance in India: Some Critical Issues*

**Simanti Bandyopadhyay<sup>1</sup>**

National Institute of Public Finance and Policy

## **Abstract**

With the help of the available literature, the paper attempts to assess critically the main problems of municipal finances in India and to bring out the challenges that the municipalities face with respect to revenue generation and expenditure management. The main findings suggest that the urban local bodies in India are confronted with lack of proper decentralization of functions and finances, inadequate revenue generation, expenditure shortfalls leading to poor service delivery. It also analyses the suggestions and recommendations that have been offered in the literature to cope with these critical challenges relating to urban finance.

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## **Introduction**

About 377 million Indians comprising about 31 per cent of the country's population live in urban areas, with an average annual addition of 8 million (Census 2011). As far as the proportion of urban population is concerned, India is behind the other emerging economies like China (45 per cent), Indonesia (54 per cent), Mexico (78 per cent) or Brazil (87 per cent) but is closer to Burma (34 per cent) and Guinea (35 per cent). The share of persons living in urban areas in India rose by 3.4 per cent in the decade 2001 to 2011 while it had risen by only 2.1 per cent in the decade 1991 to 2001. Recent projections show that by 2031, about 600 million Indians will reside in urban areas, an increase of over 200 million in just 20 years (Twelfth Five Year Plan) If we rank the cities in the world by population, Mumbai and Delhi are among the top ten and Kolkata among the top 15 (if population density is the criterion for ranking) all these three Indian megacities are among the top 6 cities in the world (World Urbanization Prospects, 2011 revision, online data UN, Department of Economic and Social Affairs).

Estimates by the Central Statistical Organisation, available for a few years, indicate that the share of the urban sector in Gross Domestic Product (GDP) of India increased from 38 per cent in 1970–71 to 52 per cent in 2004–05. The mid-term appraisal of the Eleventh Five Year Plan projected the urban share of GDP at 62–63 per cent in 2009–10, which is at present around two thirds of the GDP and it is likely to become 75 per cent in 2021 (India 2008).

There is a concentration of the urban population in large cities and existing urban agglomerations. As per census 2011, there are 53 million plus cities accounting for about 43 per cent of India's urban population. Also, the increase in the number of towns in India from 5,161 in 2001 to 7,935 in 2011 can be primarily attributed to the growth of small towns around agglomerations. A recent study by the World Bank also shows that the peri-urban areas in the vicinity of large cities are centres of intense economic activities (India Urbanisation Review: Urbanisation beyond Municipalities 2012). In the Twelfth Five Year Plan, there is a shift of focus in policies with equal importance on small and big towns rather than concentrating on big cities.

A look at the key indicators of the major urban services reveals that there is a failure to achieve even moderate success in service delivery. 70.6 per cent of the urban population has individual water connection with duration of water supply ranging between one to six hours a day. Most Indian cities do not have water metering system for residential establishments. Non revenue water accounts for 50 per cent of water production. Even partial sewerage network is not there in 4,861 cities. 13 per cent of urban households do not have any form of latrine, less than 20 per cent of the road network is covered by storm water drainage, scientific disposal of solid waste is not there in most of the cities (Twelfth Five Year Plan).

The Report of High Powered Expert Committee (HPEC) for Estimating the Investment Requirements for Urban Infrastructure Services estimates Rs 3.92 million crores as the investment needs to provide urban services conforming to national benchmarks for urban infrastructure over a period 2012–31. The operations and maintenance costs would amount to another Rs.2 million crores (Ahluwalia HPEC 2011).

Municipal revenues constitute a minimal share in India's GDP. The Eleventh and Twelfth Finance Commissions data show that the ratio was around 0.7 per cent which according to Thirteenth Finance Commission has gone up to 0.94 per cent in 2007-08. The share of municipal revenues in combined state and central revenues have declined from 3.71 per cent in 1990-91 to 2.43 per cent in 2000-01 (Mohanty et al 2007). Thirteenth finance Commission data reflects that the municipal tax to GDP ratio is a meager 0.5 per cent as compared to central tax to GDP ratio at 12 per cent and states' tax to GDP ratio at 5.6 per cent for 2007-08, while Property tax to GDP ratio is only 0.25 per cent.

The problem of financing infrastructure needs in the Indian cities becomes more relevant in the context of inclusive growth because there is a considerable dependence of the rural sector on urban development. With the urban sector contributing an overwhelming share of growth, an overall sustained growth for the economy places a lot more demand on the performance of the cities (Twelfth Five Year Plan). The efficiency in financial management is the main driver of performance of the cities. In what follows we attempt a detailed literature review on the problems and prospects of urban finances in India.

### **Urban Finance in India: Summary Findings**

Own revenues, consisting of tax (of which the property tax is a major source) and non tax revenues declined to 53 percent of the total revenues of Municipalities in India in 2007-08 from 63 per cent in 2002-03 (Twelfth Five Year Plan). The rest is accounted for by grants, assignment and devolution by State Governments, grants from Central Government and Finance Commissions. Various ways of augmenting the resources of the municipal bodies in the country, including essential reforms in the property tax system and adequate exploitation of user charges and fees for various services delivered as well as ways of strengthening and improving central and state transfers to urban local governments, are explored in Rao and Bird (2010, 2011). With respect to financing urban infrastructure, judicious use of development charges and effective collections from public lands are recommended in general. In addition, development of the municipal bond market is also advocated for financing capital expenditures. Similar recommendations are made in the Twelfth Five Year Plan. The Twelfth Five Year Plan proposes that charges should be levied on the additional floor space index (FSI) provided. Further, the charges on the additional FSI and the land-use conversions should be at least 50 per cent of the actual land value of the area in question. Also, the Twelfth Five Year Plan proposes that apart from the revenues collected from the FSI, urban local bodies (ULBs) collect other "land value based instruments" like development charges, betterment fees etc.

In what follows we would summarise the literature on different sources of municipal revenues in India. In the absence of a Municipal Finance List, we attempt to collect the different tax and non tax sources from Municipal Acts which are listed in section 1 and 2 of the Appendix. We start with property tax which, being identified as a major source of own revenues, has been the main subject of research on urban finance in India. We also cover studies on other taxes, non tax components and user charges. The issues related to intergovernmental transfers and role of Finance Commissions are also discussed in the light of the available literature. Some issues related to municipal borrowing from different sources are also covered.



## **Property Tax**

Studies on property tax focus on a few crucial areas in India like assessment methodology, coverage of properties, collection efficiency and amending the rent control laws to overcome assessment constraints. Jawaharlal Nehru National Urban Renewal Mission (JnNURM) and Urban Infrastructure Development Scheme for Small and Medium Towns (UIDSSMT) gave a lot of emphasis on property tax reforms, particularly the assessment component, stressing upon mapping of properties using the Geographic Information System (GIS), making the system capable of self-assessment, rationalizing exemptions and improve collections to about 85 per cent. As a consequence of this, research and evaluation studies are undertaken assessing the impact of property tax reforms on municipal finances in India. However, even after the first phase of JnNURM is over, the results are not satisfactory (Twelfth Five Year Plan). The main recommendations include improved methods of property tax assessment, accompanied by appropriate administrative reforms. The property surveys and usage of GIS technology should happen as a complete package to ensure full coverage of the properties. Computerization of property taxes, regular revision of rates, more user friendly tax system and making tax enforcement a priority are also proposed.

Assessment of properties is one of the biggest challenges for the ULBs which are plagued with issues like unscientific methods, lack of transparency and issues with incomplete records of properties. There are no formal and standard practices for having the property counts. Apart, from these there are also political interests that prevent the collection of the property taxes leading to low collection efficiency (Gnyaneswar 2009).

The ULBs in India are in different stages of implementation of reforms in valuation of properties ranging between purely Annual Rental Value and Capital Value based on unit area characteristics. There are ULBs who apply a hybrid method of rental valuation based on location and characteristics of the building, and tax is calculated on the basis of this rental value. A review of property tax reforms (National Institute of Urban Affairs (NIUA), 2010) on the basis of 10 selected cities viz. Ahmedabad, Bangalore, Bhubaneswar, Chennai, Hyderabad, Indore, Kolkata, Ludhiana, Patna and Pune shows that cities like Patna, Indore, Chennai, Hyderabad, Bangalore and Ahmedabad have already moved to the “unit area assessment system” while Kolkata and Bhubaneswar are yet to implement the unit area system (although the municipal laws have been amended). Patna and Ludhiana have continued with the system of Annual Ratable Value (ARV). Out of these 10 cities, 6 cities have a collection efficiency of property taxes of more than 70 per cent. Bangalore has experienced a sharp rise in the property tax revenues after moving to the unit area based approach, while Ahmedabad has benefitted through technical advancements like usage of the GIS system which led to the highest number of assessed properties per 1,000 population.

Legal framework plays a prominent role in realizing the gains from a transformation in the valuation methods. Gnaneshwar (2009) in his study based on municipal corporations from Andhra Pradesh, Tamil Nadu and Karnataka established that the gains in Karnataka from moving to a self assessment property tax system has been the maximum because of the fact that in Karnataka, the reform has been executed with a revision in the legal framework whereas in the other two states the existing legal provisions were used. There also have been substantive efforts

on the part of the Government of India (GOI) to bind the states for introducing the reforms by taking e-governance initiative.

Madon et al (2004) looks at the Bangalore City Corporation's (BCC) initiative to reform its property tax system and the interaction between the "local contingencies" and "external influences" in implementing such reforms. Although in nominal terms, property tax revenues have grown by 10.4 per cent from 1988-1994-95, the inflation adjusted figures reflect stagnation. The authors claim that despite there being many initiatives to have better implementation of the property taxes, benefits were only realized when the Self Assessment System was started. The study finds that despite facing constraints in terms of "institutional capacity", the BCC was still able to implement the self assessment system. The feat was achieved by its efforts to mobilize various local and global actors who had diverse interests. The paper emphasizes on the building of such networks.

The administrative aspects to implement reforms in property tax are very important to get desired results. On the basis of a study on Andhra Pradesh, Mohanty (2003) finds that although tax reforms and strategy depends on the "pre conditions" certain factors like close involvement of the tax payer, tax-service linkage, incentives for filing of tax returns, disincentives for non-filing, tax education are very important. The study claims that although it is useful to have uniform slab rates for homogeneous properties, it can be regressive in case of heterogeneous properties. "Correction of inequities" in the tax system could be very useful and could enhance revenues. A greater focus on "compliance" brought in a lot of revenues for Hyderabad.

The fiscal and distributional implications of the existing and the possible future assessment reforms in property tax are worth exploring in the context of Indian cities. Lall and Deichmann (2006) throws some light on the issue for two states Karnataka and Maharashtra, with Bangalore and Pune as the study sample, The authors find that the reforms that get the property tax base closer to the market value have significant and positive implications for revenue generation. Also, these reforms do not have any negative implications for the poor. However, although these reforms are good as a first step intended towards greater efficiency of the property taxes, structural issues like improved valuation, increasing the buoyancy of the taxes etc still need to be looked at. Unless structural issues are resolved, improvements in the administration will do only little to make the property tax a useful revenue option. The paper finds that in Pune and Bangalore where the tax assessment gets linked to the "market rental or capital values", have a very high prospect of augmenting the revenues from property taxes. In fact, in Pune the use of market value is seen to have "redistributive impacts" with lower taxes in areas where services are poorer. Also, the authors find that a one-time move to an area based system from the previous rental-value based system expanded Bangalore's revenues from property taxes by about 62 per cent. If "market rents" were adopted (i.e from an area based approach to market rent approach), then revenues earned from Pune would rise by about 55 per cent while for Bangalore the gains would be about 33 per cent. While studies like Mohanty et al (2007) and various reforms agenda prescribes changing over to valuation based on unit area characteristics, there is a view which challenges the faith in the market based valuation system in India as there is no clear cut definition of a "market value" which might harm the tax yields (Mathur et al 2009).

A recent paper (Bandyopadhyay 2013b) compares the implementation of the property tax reforms in two major metropolitan cities in India, Delhi and Bangalore. Both the cities have implemented the property tax reforms and have shifted to the unit area method of assessment. However, while property tax collection rose for Bangalore after the implementation of the reforms, Delhi experienced a fall in the number of properties assessed and property tax collection after the implementation of the reforms. Further, property tax to GSDP ratio also increased for Bangalore while it fell for Delhi. The paper finds that policy as well as administrative factors was responsible for such contrasting outcomes. Better structuring of the tax rates, better coverage and collection efficiencies achieved through better tax administration, better service delivery and a relatively more stable property market (in Bangalore compared to Delhi), were found to be the major reasons as to why property tax reforms succeeded in Bangalore while they failed in Delhi.

The issue of progressivity is also discussed briefly. After the shift to the unit area method, most areas have a progressive rate structure of property taxes, barring some places who still have a flat rate (like Ludhiana) (Rao 2013). Author (2013b) also points out that a comparatively more progressive rate in Delhi after the unit area method was implemented is also responsible for loss of revenues in Delhi.

As far as revenues from property tax is concerned, there are large variations in Indian Cities. In a study of 35 large corporations, Mathur (2009) finds that there are large inter-city variations with the Mumbai municipal corporation having per capita revenue of Rs.1,334 while the Patna and Dhanbad municipal corporation had only Rs.25 and Rs.40. However, the study does claim that population size has a strong impact on property tax collection (with a correlation of 0.82). The total tax demand over the study period has shown some signs of stagnation reflecting limited inclusion of new properties and revision of rates. However, variables like growth of state's GDP or the ratio of state's tax to GDP have little impact on property taxes. A comparative study of urban finances in Jharkhand and West Bengal finds that per capita property tax in Jharkhand is much lower than in West Bengal (Bandyopadhyay 2011). Bandyopadhyay (2012) indicates to a wide variation in property tax collections in the ULBs within the state of Karnataka. As far as the relation with size of a city is concerned, there is no unique pattern which can be cited from the literature.

Collection Efficiency of property tax is low in Indian cities which is one of the reasons for low collections of property tax (Mohanty et al 2007, Bandyopadhyay and Rao 2009, Rao and Bird 2011). A study on 36 million plus cities in India finds that the average collection rate was only 37 per cent. Higher collection rates are found in Karnataka, Tamil Nadu, Kerala, and Andhra Pradesh. Bihar and Madhya Pradesh have very low collection efficiencies as is the case with Delhi. Corporations of Gujarat and Maharashtra though have higher per capita collections have lower collection efficiency (Mathur et al 2009). For Karnataka, the overall average collection efficiency of property taxes is 62 per cent, with the collection efficiency being the lowest in the smallest size class and the highest (65 per cent) in the medium size class cities (with a population of 25000-50000) with little variation across cities (Bandyopadhyay 2012).

Apart from the usually discussed problems of limited coverage, poor collection efficiency, problems with valuations, Rao (2013) stresses on the exemptions given to various properties. He cites the case of the Municipal Corporation of Delhi and observes that exemptions made to the

lavish buildings of the bureaucrats were a major reason behind the failure of MCD's efforts to reform property taxes.

### **Octroi**

Octroi has been an important source of revenues in Indian cities. The Report of the Committee on Octroi (1985) constituted by the Ministry of Urban Development recommended that it should be replaced by local taxes. The alternatives include surcharge on sales tax, entry tax, terminal tax, road tax, motor vehicles tax, etc. All the states, except Maharashtra, have abolished this local tax because of its distortionary nature. In Maharashtra it is still levied in Corporations. Octroi was abolished in different phases in different states of India and for the cities levying Octroi, it has been the most important source. In most of the cases, it has a higher share than property tax (NIUA 2010, Pethe and Lalvani 2011, Bandyopadhyay and Rao 2009, NIPFP 2007c).

After the abolition of octroi the main issue is the compensation of Octroi which has been tough for most of the state governments. In fact in Maharashtra one of the reasons why the Corporations still continue to levy octroi is the failure of the state to design a compensation scheme. For example in the city of Mumbai, half the revenues come from Octroi and the amount of octroi received is equivalent to the entire state's excise income which is very difficult to be compensated. Apart from the alternatives mentioned above, local value added tax (VAT), local business tax, professions tax have also been prescribed but faced political resistance on grounds of inter-jurisdictional disparities. However, progress on the implementation of compensatory mechanisms of Octroi in India is not satisfactory.

### **Other Tax, Non tax and User charges**

The non tax revenue collections from cities account for only 0.13 per cent of GDP in India. (Rao and Bird 2011). Non tax and taxes other than the property tax have been neglected as potential revenue sources in Indian cities so far. According to Pethe and Lalvani (2011), in Maharashtra, water charges, license fee, entertainment tax are still an "untapped potential". Although we find that the shares of these components are quite high in many of the cities, no systematic study has been conducted to estimate the potential for these components. The shares of non-tax and tax revenues are almost same, with non-tax revenues having slightly a higher share in the own revenues in the cities of Karnataka (Bandyopadhyay 2012). Non tax revenues have dominated the own revenue collections in Jharkhand and are distributed quite evenly across the population size classes. However, the per capita non tax revenue in West Bengal is about four times as high as in Jharkhand (Bandyopadhyay 2011). The importance of other tax and non tax revenues are also indicated in Rao and Bandyopadhyay (2009), Considerable potential in non tax revenues in all the five major agglomerations are conceived. In the study based on five urban agglomerations viz Delhi, Kolkata, Chennai, Pune, Hyderabad, it was found that for bigger Corporations the shares of non tax revenues in total revenues have a range between 9 to 64 per cent. For smaller cities this variation ranges between 22 to 47 per cent

Even with a considerable share of non tax revenues, and huge untapped potentials in different classes of cities, very little attention has been paid to this component of revenues. There are methodological challenges in estimating the non tax base. Multiplicity of rates and heterogeneous base of non tax revenues are some of the major sources of problems. In most

municipal laws provisions exist for levy of rents/charges for use of shop, stalls, slaughterhouses, burning ghats etc. In Karnataka there are also provisions for charges on public halting places, cart stands, cattle sheds, public bath houses etc. Wherever transport and electricity are provided by municipality, provisions exist for levying charges on the same. In certain cases, a distinction is made for residential and for non residential areas. However most of the items in the provision for tax (other than property tax) and non tax revenues listed are not actually levied by many of the cities in India (Sections 1 and 2, Appendix).

Mohanty et al (2007) recommends that a “Municipal Finance Schedule’ for assignment to the ULBs to match the list of functions included in the 12th Schedule. This list would include property tax including vacant land tax and taxation of Central and State Government properties (or service charges in lieu thereof), professional tax, entertainment tax, advertisement tax, business licensing fee or tax, motor vehicle tax or a share from the same, planning permission fee, development impact fee, betterment levy, a surcharge on stamp duty on registration deeds or a share from it and a proportion of the Value Added Tax. Transfer of a proportion of Value Added Tax has also been proposed in Bandyopadhyay and Rao (2009). The report of the High Powered Expert Committee (HPEC, 2011) also recommends having a Municipal list and transferring a share of goods and services tax (GST) to the local bodies.

One of the important components of non tax revenue is user charge which deserves special mention. User charges are still a recent phenomenon and there are not too many enabling provisions in the municipal laws. In Maharashtra, Karnataka and Andhra Pradesh, there is a provision for levying charges on water and sewerage rather than taxes on these, Mohanty et al (2007) finds that although Mumbai, Surat and Pune are some of the best performing corporations, they underutilize user charges and hence cost recovery is below 25 per cent.

User charges act as signals of the scarcity value to consumers (Bird and Rao, 2011). User charges are useful to the extent that they help in bringing about “efficiency” in revenue collection for the municipalities, helps in “rationing” of services and most importantly help the municipalities with more funds to work with. When it comes to levying a tax or a charge on a particular service, there are mainly two principles-the “ability to pay principle” and the “benefit principle”. The “ability to pay” principle works on the theory that people who have more, should contribute more. On the other hand, the “benefit principle” refers to the theory whereby higher contributions are made by people who enjoy the services more than the others. “User charges” work on the “benefit principle”.

The primary task in determining the pricing strategy is to determine the costs of the service in question. This involves estimating: a) the cost of a particular service; b) the cost of general public services in a locality and c) the general overheads of that municipality. The costs for a given service would vary across municipalities but certain portions (the fixed elements) do not fluctuate too much. Location also impacts costs. Also, the section of the society that the service is catering to has to be kept in mind while estimating costs and then setting up the user charges. For example, if the rich choose to stay away from the city, they should bear the heavy costs of pumping water. But if the poor live in the outskirts due to the urban housing being unaffordable, then it would be unfair to put the burden of charges on them. Further, the authorities also need to analyze if they want to include the capital costs while setting up the user charges. In certain

cases, capital costs are funded by the general public revenues, capital grants etc, while the public pays for the operation and maintenance (O&M) costs. After costs have been ascertained, the feasibility of recovery of such costs is checked. For this, the nature of benefits accruing to the public and the extent of excludability of the service is seen. For example, if the benefit of a service is very direct and private, then the consumer would bear almost the entire costs of provision of such services.

After the costs have been ascertained, the best suited tariff scheme has to be selected. The range of tariff schemes includes flat rate tariff, unit rate charging, variable block pricing, seasonal rate schedule, marginal cost pricing, average cost pricing, two part tariff etc. While choosing a tariff scheme the criteria kept in mind are those of adequacy, fairness, simplicity etc.

User charges and the required hikes in them for cost recovery are likely to face strong resistance initially, but over time people appreciate such moves once the better service delivery from these revenues are realized. In Amravati though people initially opposed the hike in the water tariffs, 24X7 water supply has ensured that they pay the tariffs regularly (Ahluwalia 2012a). Also, proper user charges based on accurate meters (with proper billing procedures) can be beneficial for consumers. For example, the pilot project in Karnataka showed that with meters, people were paying lesser (with a consumption based payment system in place), than the fixed rate system in the absence of meters (Ahluwalia 2010).

Empirical evidence, though inadequate, shows that cost recovery in Indian cities is quite low. According to Mohanty et al (2007) 10 large corporations in their sample could recover less than 10 per cent of the cost of providing services through fees. In the other six corporations cost recovery was around 10 to 20 per cent. Only in 2 out of 25 corporations in the sample, cost recovery was more than 75 per cent.

Measures to augment local revenues, particularly user charges and non tax components), are evaluated in Bandyopadhyay and Bagchi (2013) with the case of Municipal Corporation of Delhi, the capital city of India. Introduction of congestion and conservancy charges and revision of rates for existing parking fees, one time parking charges, fees from mobile towers and property taxes were recommended but could not be implemented due to political and social resistance. Through a simulation based analysis, the authors find that with the implementation of these recommendations, increases in the own revenues could range between 10 per cent and 21 per cent while total revenue increases could range between 7 per cent and 15 per cent. The authors also find that own revenues would be able to cover about 77 per cent to 85 per cent of the revenue expenditure and total revenues would be able to account for about 74 per cent to 80 per cent of the total expenditure. Major share of gains would come from 'one time parking charges' followed by property taxes and other components.

### **Own Revenue Potential**

Estimating the revenue capacity is very important to assess the financial strength of cities. There are methodological challenges as well as constraints in data for these estimations in Indian cities (National Institute of Public Finance and Policy (NIPFP) 2007 a,b,c,2008 a,b).However, studies have attempted to provide empirical estimations of underutilization of revenue potentials. Bandyopadhyay and Rao (2009) in their study on five major agglomerations in India viz.

Kolkata, Delhi, Chennai, Pune and Hyderabad which constitutes 15 per cent of India's total urban population finds that all the agglomerations have unutilized potential for revenue generation. The potential for the central cities of the agglomerations are estimated to be 79 per cent more than the actual while the smaller ULBs in the agglomerations are estimated to have 25 per cent more. Author (2011) estimates the total revenue potential for ULBs in the state of Jharkhand to be 77 per cent more than what is actually generated in the ULBs of the state.

Mathur et al, (2009) aims at estimating the property tax potential in India and also suggests the measures to tap that potential. The study estimates property tax revenues from 36 million plus cities (which accounts for about 35 per cent of the total population) in India. The study estimates property taxes to be somewhat around 0.16 per cent-0.24 per cent of GDP. The main recommendations suggest broadening of the tax base, establishment of the Central Valuation Board, indexation of property tax values, improving the collection efficiency by setting up a mechanism that helps to identify tax evasion and use of guidance values in assessing property values. The study pointed out that there remains huge untapped revenues on account of property tax in the country and to improve the situation, states should focus on improving coverage and collection efficiency. Property tax revenues could increase to an extent of three times as high as the present collections by bringing all cities to an 85 per cent coverage level from an average coverage ratio of 56 per cent and 85 per cent collection efficiency from an average collection efficiency of 37 per cent.

## **Transfers**

Transfers consist of shared taxes between the municipality and the state government and grants from upper tiers of the government. Shared taxes are revenues based on Tax Assignment Rules. Entertainment Tax, Motor Vehicles tax, Stamp Duty/Surcharge are some of the common shared revenue sources which are not uniform across states. On an average, almost half of the total revenues of the cities come from transfers. While grants are more important sources for smaller cities, for bigger corporations, the proportion of shared taxes are higher (Bandyopadhyay and Rao 2009). Another study (NIUA 2011) reports that 66 per cent of the revenues for the ULBs of Bhopal, Ujjain, Bhubaneswar and Puri came from "non plan transfers". However, ULBs of Ahmadabad and Rajkot were fairly "self sufficient" while dependence on state funds has increased for Guwahati.

After 74<sup>th</sup> Constitutional Amendment, the 10<sup>th</sup>, 11<sup>th</sup> and 12<sup>th</sup> finance commissions provided "ad-hoc grants" to the ULBs of India. However, the 13<sup>th</sup> finance commission made provisions for a "devolution package" whereby the grants would be now linked to the central revenues. Also, the 13<sup>th</sup> finance commission had introduced the "performance based grants". There were also other features like the proper budgeting, having a better system of proper administration at the local body level, having an electronic transfer system at the local body level etc. However, the ULBs have a long way to go in trying to exploit the performance based grants as these need certain conditions to be fulfilled (like empowering all ULBs to levy property taxes without any exemptions, having a State Property tax Board which would assist the ULBs in assessing property tax, having a Local Body Ombudsman who would look after complaint being addressed etc) and there is a need for proper guidance to the ULBs for the fulfillment of these conditions.

The grants provided by the Central Finance Commission (CFC) were mostly conditional and heavily relied upon the utilization certificates furnished by the ULBs. The State Finance Commission (SFC) grants were more unconditional in nature and were to be used for regular expenses. There have been delays in setting up of the SFCs and other administrative delays like delays in submitting reports to the SFCs, delays in submission of the Action Taken Report. Non-availability of data is a constraint in the selected states (Madhya Pradesh (M.P), Gujrat, Tamil Nadu Orissa and Assam) and consequently surveys were required for collecting data (NIUA 2011). Further, the systems of grant in aid in the selected states were quite diverse in terms of the “non-plan transfers”. For example, in certain cases the octroi compensation was considered as a part of the SFC’s devolution package while others kept it outside the SFC’s grants. For Gujrat the share of the SFC grants in the “non-plan transfers” were low while there were about 30 types of specific purpose grants. Apart from the CFC and the SFC grants, there are other grants that are received by the ULBs from the upper tiers. However, in some states SFC funds were released without having the utilization certificates from the previous years (NIUA 2011).

Performance of the SFCs and the devolution of the powers to the ULBs are related. The Constitutional amendment provides that the SFCs should recommend on issues like distribution of the net proceeds from taxes, duties etc. between the state and the local bodies, the determination of taxes, tolls, duties, fees that could be assigned to the ULBs, the grant-in aid and the measures required to improve the financial position of the ULBs. Although the mandates are fairly broad, most states have struggled to provide the required guidance. However, Kerala and Tamil Nadu have mandated their SFCs to explore “the potential for borrowing by the ULBs, develop the criteria for sharing of costs of assets and institutions transferred to ULBs, and provide guidance for more effective local financial management and accountability as well as state incentives that can support higher local resource mobilization”. There is this belief that the SFCs have not been able to play the “leadership role” in supporting decentralization. The report of the HPEC (2011) recommends in line of the Thirteenth Finance Commission to strengthen the SFCs by improving their capacity.

However, Mathur and Peterson (2006) find that in certain cases the SFCs’ recommendations have not been heard by the state governments and if at all they have been heard, implementation has been poor. Also, despite the 74<sup>th</sup> Amendment providing for transfer of functions to the ULBs, they have only happened in a very limited manner and no proper “mechanism” has been put in place whereby the developing authorities and the ULBs can coordinate the future development activities of the cities. Further, the SFCs have failed to recommend the required changes in the fiscal powers of the ULBs but have emphasized a lot on the revenue sharing arrangements between the state and the ULBs by estimating what the ULBs would gain from the shared revenues and how much would they need to spend for even the minimum level of service delivery. Finally, the paper recommends setting up a workshop for assessing the SFC’s reforms, undertaking an analysis for better structuring of the grant-in-aid, modernizing states’ resource gap analysis etc.



## **Municipal Borrowing**

Borrowing is considered to be a practical option for financing large infrastructure projects (Rao and Bird, 2011). Municipal borrowing is mainly confined to public institutions like Life Insurance Corporation of India (LIC) and Housing and Urban Development Corporation Limited (HUDCO).

Market based borrowing is not very common in Indian cities. Tamil Nadu provides a good example. The Tamil Nadu government has actively been involved in implementing the Tamil Nadu Urban Development Project since 1988. The International Development Agency (IDA) of World Bank was the main financier of this project and the Municipal Urban Development Fund (MUDF) was an important component of this fund. The MUDF performed well and its scope was broadened to have some private participation. This led to the formation of the Tamil Nadu Urban Development Fund (TNUDF) in 1996 under the Indian Trust Act. The MUDF was converted with the state government's contribution of around 72 per cent and private players' (like Industrial Credit and Investment Corporation of India (ICICI), Housing Development Finance Corporation (HDFC) etc) pooled in funds to have a contribution of about 28 per cent to create the TNUDF. Tamil Nadu Urban Infrastructure Trustee Company Limited (TNUITCL) manages TNUDF while Tamil Nadu Urban Infrastructure Financial Services Limited (TNUIFSL) is the fund manager.

TNUDF uses mainly three lines of credit-world bank, Japan International Cooperation Agency (JICA) and Kreditanstalt für Wiederaufbau (KfW). They specify how much they would provide in terms of loans and how much in terms of grants. These lines of credit finance a part of the project while the remaining amount can come from the state government or through market borrowings. Funding agencies provide funds to the GOI which are then transferred to the Tamil Nadu (TN) government. The TN government can transfer these as loans (by TNUDF) or by grants (these are capital grants where a part of the grant may also come from the international donors).

However, funds to the ULBs can also be made available through the Special Purpose Vehicles (SPVs). The Water and Sanitation Pooled Fund (WSPF) is an example of such SPVs. This was created as a debt fund through issuing bonds. These were unsecured in nature and were issued for 15 years. The funds were raised by TNUIFSL. The proceeds were given to the ULBs. Although they were unsecured bonds, there were certain guarantees that were provided. Firstly, the ULBs needed to contribute to an escrow account through their revenue sources. Secondly, a separate fund was kept aside by the state for repayment known as the Debt Service Reserve Fund (DSRF). Thirdly, U.S Agency for International Development (USAID) guaranteed for 50 per cent of the total amount to be paid as principal and interest and the remaining part would be paid by the state government (by repaying the shortfall through the Bond Service Reserve Fund and deducting this amount from the respective ULB's share in the funds from the State Finance Commission). Also, the TNUIFSL would monitor the whole process and ensure timely repayment of the dues to the investors.

The TNUDF are used for a range of purposes for urban development, mainly focusing on urban infrastructure. TNUDF also aims at private participation in urban infrastructure, improving the

finance management of ULBs enabling them to access markets and having grant funds for addressing urban poverty. The borrowers can be the ULBs or private institutions that provide for urban infrastructure and the eligibility criteria are well defined. Strong emphasis on escrow funds etc ensure timely repayment of borrowings leading to almost full repayment of loans.

An elaborate discussion on the evolution of municipal bond market in India is given in Vaidya and Vaidya (2010). Since 1994, the Indo-US Financial Institution Reform and Expansion (FIRE\_D) project has been actively working towards developing an active bond based finances for the ULBs which has enabled the local ULBs to mobilize funds worth more than Rs12 million. This started with the taxable municipal bonds with the Ahmadabad Municipal Corporation (AMC) issuing bonds of Rs. 1000 million for financing a water and sewerage project of Rs. 4390 million. AMC was partially helped by its earlier steps towards improving its efficiency through better tax collection measures, having computerized accounting systems etc which in a way did some groundwork before the bond financing. These initiatives helped the AMC to have a cash surplus of Rs. 2,140 million by March 1999, from a deficit earlier.

Following AMC's example other cities (Nashik, Nagpur, Ludhiana and Madurai) have also floated such bonds. A remarkable feature of these bonds has been that they were not backed by any kind of guarantee by the state. (State guaranteed bonds were first issued by the Bangalore Municipal Corporation in 1997) However, the subscription depended largely on credit ratings and ULBs had to prove that they had sound financial positions with a strong revenue base, high collection efficiency etc.

Next came the tax free municipal bonds. The GOI had constantly been trying to give tax concessions on bond interests but that met with limited success. So, in 1999-00, the then Finance Minister announced that ULBs can float tax free bonds and in 2000 the central government amended the Income Tax Act (vide the Finance Act 2000) whereby the interest earned from bonds would be entirely tax free. The AMC was the first municipality to float these tax free bonds in April 2002, where bonds were issued for Rs.1000 million for water and sewerage projects.

However, access to capital markets is fairly limited for smaller local bodies. Also, there is a high transaction cost in accessing the capital markets. This led to the pooled finance system whereby small ULBs pooled in resources and then issued bonds. The first initiative in this line was WSFPF in 2002-03 where 14 municipalities came together and floated bonds worth Rs.304 million and was backed by the credit enhancement system where the state and USAID guaranteed repayment. This was followed by the Government of Karnataka's initiative whereby eight municipalities came together and floated bonds worth Rs 1,000 million in 2005. The fund was called Karnataka Water and Sanitation Pooled Fund (KWSPF) and was supported by USAID guarantee.

Looking at the success of the pooled finance system in Tamil Nadu and Karnataka, the Pooled Finance Development Fund (PFDF) guidelines were introduced by the GOI and the FIRE-D project so that the ULBs could access the market funds for creation of urban infrastructure and also undertake the required reforms to create efficient urban centers. The JNNURM, a flagship urban investment program of GOI encourages ULBs to link the projects with market-based financing. Also, the Central Finance Commission (CFC) along with the support of the State

Finance Commission is supposed to provide important recommendations on how to augment the resource base of the municipalities. One of such important recommendations came from the 13<sup>th</sup> CFC report where the grants would be linked to the “divisible pool” rather than the “ad-hoc grants” provided earlier. Also, although the total grants would be increased by four-times, part of the grant would be linked to the performance of the municipalities.

### **Expenditure Management and Fiscal Gaps**

Karnataka was the first to have a system of measuring and monitoring of the urban services by setting up the Municipal Reform Cell (MRC) in 2004. This was the first initiative by any state government to introduce service level benchmarking. The main feature of this was the use of information technology(IT) for monitoring and governance with fundamental administrative reforms at the local government level (Ahluwalia 2012b). Subsequently, the Ministry of Urban Development also came up with Service Level Benchmarking framework. Once the extent of adequacy of services in physical terms is determined, expenditure requirements on them can be analysed.

Composition of expenditures is not uniform across Indian cities. Also, expenditure per se does not mean much unless we can assess the extent of misuse component in it. Pethe and Lalvani (2011) finds that corporations in Maharashtra are more inclined towards the “core service” than on the local public goods, with a 39 per cent share of core services in the total expenditure in 1999-00. The highest expenditure component has been “general administration”, pensions etc, although the trend has seen a decline. On the other categories, the expenditure on education has declined while the expenditure on public health has remained at about 5 per cent for some time. According to Bandyopadhyay (2012) bigger cities in Karnataka have higher proportions of O&M expenditures while both salary and establishment components show higher proportions in smaller cities. This indicates that bigger cities are incurring more productive expenses than the smaller ones. We find that the ULBs on an average can reduce 27 per cent of their expenditures on O&M, labor and establishment to provide the same levels of services provided currently by them. The study also finds that there can be additional savings particularly on establishment and labor expenditures to operate at the maximum efficiency levels. Further the paper finds that the extent of problem of unproductive spending and under-provision of services is more pronounced in smaller cities.

Estimations of expenditure requirements are useful to guide the cities in expenditure management. Fiscal gaps measured as the difference between the expenditure needs and revenue capacities can act as the indicators to quantify transfers from upper tiers of the government. The daunting data requirements and methodological challenges restrict the number of studies in this area.

There have been some attempts to assess the adequacy of municipal finances to provide services conforming to norms. Comparisons of actual expenditures on a particular service with the financial norm for that service can give an idea on the extent of under-spending. Taking Zakaria Committee norms, which was determined in the 1960s, a study for the period 1999-2000 to 2003-04 shows that in 30 municipal corporations in India, on an average, actual spending is only about 24 percent of the requirements, or the extent of under-spending is as high as 76 percent (Mohanty et.al, 2007). The study also shows that of the 30 municipal corporations, the extent of

under-spending was over 75 percent in 17 municipal corporations, and over 50 percent in all of them except in three which are Pune (31.6 percent), Nagpur (30.8 percent) and Nasik (35.5 percent). Patna Municipal Corporation actually spends only about 5.6 percent of the requirement and the shortfall was 90 percent in almost all municipal corporations in UP and Bihar. The study also attempts to establish a direct relation between cost recovery ratio and extent of under-spending. It was found that in their sample the cities with better cost recovery rate are the ones with lesser extent of under-spending on services. A higher cost recovery in user charges can help the cities to fulfill their expenditure requirements. Another study on the urban local bodies of Jharkhand (Bandyopadhyay 2011) based on Ramanathan and Dasgupta (2009) norms estimates that the actual revenue expenditures can cover only 41 per cent of the revenue expenditures requirements. Actual capital expenditures can cover 3 per cent of the capital expenditure requirements on urban services. Bandyopadhyay (2012) shows that comparing the services in a particular size class of city with the norms suggested by HPEC report (2011), in the smaller cities in Karnataka, it is water supply which has the minimum shortfall from norms, in the medium sized cities it is road density which is closest to the norms and in the largest city size class it is the solid waste management which performs the best with zero shortfall from norms. On an average for all the services there is a shortage of 57 per cent of the O&M expenditure norms, the shortage being the highest (64 per cent) in the biggest size class of cities.

Comparison of the growth of expenditures with that of revenues can give an idea about how the city can cope up with growing needs. If we compare the growth of revenues with expenditure, generally growth in the latter is higher than the former. Mathur et al (2009) finds that revenue productivity of the property taxes is low, with a growth rate much below the growth rate of expenditure.

Another way of looking at the adequacy of revenues is by comparison of the revenues (or the potential estimates, if available) with expenditures (or the requirements). According to Mathur et al (2009) property taxes can only fund about 28 per cent of the revenue expenditure. Bandyopadhyay (2012) finds that for the cities in Karnataka, only 27.5 per cent of the O&M expenditure requirements can be fulfilled by the own revenues once the potential for the latter is fully realised. This proportion is higher in bigger cities with moderately high variation across cities. As far as the O&M cost coverage is concerned the paper finds that on an average the ULBs in Karnataka can finance 50 per cent of the O&M costs on basic services through their own revenues with a very high variation in the proportions across cities.

Bandyopadhyay and Rao (2009) estimates the fiscal gaps for five major agglomerations in India. The main findings suggest that, except for five small urban local bodies in Hyderabad, the others are not in a position to cover their expenditure needs by their present revenue collections. All the agglomerations have unutilized potential for revenue generation; however, with the exception of Hyderabad, they would fail to cover their expenditure needs even if they realize their revenue potential. Excepting Chennai, larger corporations are more constrained than smaller urban local bodies.

The main problem in assessing the fiscal health of Indian cities is the absence of a rigorous methodology in estimating expenditure needs and revenue capacity. Bandyopadhyay(2013a) considers big urban agglomerations and smaller cities in India to propose a two stage

methodology which explains the variations in fiscal health across cities. In the first stage the expenditure need and revenue capacities are estimated. In the second stage an econometric analysis is attempted to identify the determinants of fiscal health. The nature of relationship between the determinants and the fiscal health indicator is defined by the relative strength of the 'revenue effect' and the 'expenditure effect'. We find that the role of the higher tiers of the government is important in bigger and smaller cities in their financial management. For bigger cities, own revenues can also play an important role in improving fiscal health. In smaller cities the role of the demand indicators is not that prominent but the cost indicators are found to be more effective while in case of bigger agglomerations, the demand indicators can play a role.

## **Conclusions**

This paper has attempted to review the state of municipal finance in India. With the help of the available literature, we find a wide diversity in the functions and thus revenue handles of cities. The extent of decetralisation is not uniform across states. The compositions of revenues are diverse, with differing trends in the growth patterns of revenues. Expenditures in general fall short of their requirements. Most of the cities generate revenues much lower than their potentials. Assignments of revenues are not uniform, nor are grants transferred in the same way on the same heads. The size of the city is an important factor in explaining these differences, but we are yet to have any unique relation between size of the city and their quality of management from empirical literature. The stage of the development in which the city is in, whether it is a part of an agglomeration or has an independent identity also affects the performance.

Performance in revenue generation and expenditure management is at the core of competitiveness for a city. A good performance in municipal resource management could be the key to attract educated mass which in turn can bring about more revenues to the city. Given the industrial performance of the city, population growth, employability, a good performance in municipal resource utilization and management can bring about a huge change in the city.

## **Appendix**

### **Section 1: Tax Sources in Indian Cities from Municipal Acts**

1. Property tax
2. Profession tax
3. Sanitation/ Conservancy Tax
4. Scavenging tax
5. Latrine tax
6. Drainage tax
7. Education tax
8. Entry/Terminal tax
9. Taxes on vehicles
10. Advertisement tax
11. Entertainment tax
12. Pilgrim tax
13. Environment tax/Land Revenue
14. Betterment/Development tax
15. Passengers & Goods Tax
16. Timber tax
17. Tax/toll on animals
18. Cable Operator Tax
19. Toll/Tax on bridges/Vehicles
20. Octroi

### **Section 2 Non Tax Sources /Use Charges in Indian Cities from Municipal Acts**

1. Sanitation/ Conservancy Charge
2. Water charges
3. Surcharge on Sales Tax
4. Birth/Death Registration fees
5. Betterment fees
6. Mutation fees
7. Dangerous and Offensive Trade License Fees
8. Slaughter house fees
9. Market fee
10. Fee for fire services
11. Fees on dogs
12. Fees for Registration of animals etc.
13. Parking fees
14. Fee on building application
15. Duty on transfer of immovable property
16. Penalty for late tax payment
17. Stamp Duty
18. Rent from Municipal Properties
19. Receipts from Fines
20. Receipts from Interest

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