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# *Coping with Change: The Need to Restructure Urban Governance and Finance in India<sup>1</sup>*

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## **Abstract**

Over 330 million people live in India's 5,165 cities, with 35 cities having a population of over a million. Three (Mumbai, Delhi, and Kolkata) of the 10 largest metropolises in the world are in India. Over two-thirds of GDP originates in urban agglomerations in the country. However, urban governance and finance in India leave much to be desired in terms of providing services to the country's burgeoning urban population and with respect to its flexibility in accommodating different needs and pressures and its lack of resiliency in adapting to shocks, whether natural or manmade. This paper draws on lessons from fiscal federalism theory and experiences of governance institutions and financing systems around the world to identify some key reforms needed to ensure more citizen participation and greater accountability in urban governance, and to augment and strengthen the capacity of Indian cities to deliver more adequate services and provide needed urban infrastructure.

**Keywords:** India; metropolitan areas; governance; finance

**JEL:** R5, H1, H7

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<sup>1</sup> The authors are from the, respectively. This paper is based on a more detailed study issued as *Urban Governance and Finance in India*, Working Paper No. 2010-68 (National Institute of Public Finance and Policy, New Delhi, April 2010).

India's rapid economic expansion over the last few decades since the loosening of the so-called "license raj"—the constricting deadweight of licensing, regulation, and red tape that had long held back private sector development—has been impressive. Moreover, the country has managed to sustain a respectable performance in the face of such major economic crises as the recent financial meltdown. India's private sector is clearly alive, well, and capable of even better things in the future. Unfortunately, it is not so clear that the country's expanding urban public sector is equally able to cope with the economic, demographic, and environmental changes that continue to confront it. This paper considers some aspects of the governance and finance reforms needed to make India's burgeoning cities better places for those who live in them, for those who are going to move into them in the future, and for the country as a whole. To cope adequately with the changes that have already occurred, let alone those that loom ahead, India's cities need to be freed from what might perhaps be called the "urban raj"—the archaic and well-entrenched institutional structure that restricts what they can do and provides few incentives for them to do it well.

Section 1 of the paper outlines why turning India's cities into "engines of growth" is a necessary ingredient of future growth, a feat that requires reforming and strengthening local governance structures. Similarly, local finances must be strengthened to provide adequate finance for the provision of services and to ensure that the money spent results in desired outputs and outcomes. Section 2 sets out some important preconditions for efficient governance systems and finance drawn from the theory of fiscal federalism. Against this background, Section 3 outlines the present inadequate urban governance structure in India, concluding that major efforts are needed to equip India's cities with a governance structure capable of responding flexibly and adequately to the changing realities they face. Section 4 discusses the problems arising from ambiguity and overlap in expenditure assignment and weaknesses in public financial management. The next three sections turn to the revenue side of the budget. Section 5 considers how to make local taxes and user charges more adequate to finance local public services while ensuring efficiency and accountability. Section 6 considers the role of transfers and suggests some reforms. Section 7 turns to the critical issue of infrastructure finance through such means as local borrowing, development charges, land sales, or public-private partnerships. Section 8 offers some concluding remarks.

## **1. The Need for Urban Dynamism**

Cities are the leading edge of economic dynamism in every country. They create agglomeration economies for enterprises, generating externalities that facilitate transactions, production, and distribution activities. They also facilitate productive interaction of people from various walks of life, resulting in the exchange of ideas and a climate for creative activity that leads to both innovation and productivity gains. In particular, large metropolitan areas provide scope to achieve the critical mass required to attain high degrees of specialization in labour, knowledge and businesses, services, infrastructure, institutions, and media, all of which increase economic dynamism and growth (Bird and Slack 2007).

However, the extent to which cities succeed in realizing these potentials depends in large part on whether they provide a properly enabling environment. For example, to give agglomeration economies full scope requires the sustained provision of a wide range of urban public services that promote both private sector activities and the well-being of the urban population, such as water, sewers, garbage collection and disposal, drainage systems, police and fire protection, and transportation. To do this well requires good policies and high-quality public institutions. Similarly, attracting the knowledge workers needed to create and maintain a social environment that facilitates creative social and economic interaction requires policies that accommodate diverse cultures (including outsiders) as well as such quality of life factors as high-quality schools and health care facilities, social and cultural activities, recreational opportunities, and safe and strong neighbourhoods. Cities must accommodate not just such key workers, of course, but all those who make the city work, including new migrants and others working in construction and other essential activities who often need affordable housing and in many cases some social assistance. Underlying all this, a “good” city needs a political and governance system that can respond to the changing requirements and needs of its people swiftly, flexibly, and efficiently.

None of these conditions is easy to satisfy in India, a country in which over 330 million people live in 5,165 urban areas, which has 35 cities with over a million people, as well as three of the largest metropolises in the world (Mumbai, Delhi, and Kolkata). India’s urban population has been growing at an annual rate of 2.7 per cent and, although overall population growth is expected to decelerate, the urban population will continue to grow at about 2.5 per cent over the next two decades (Ramanathan and Dasgupta 2009). The urban sector presently contributes about two-thirds of GDP and this share is likely to increase to 75 per cent by 2021 (India 2008). India’s cities are thus many, large, economically important, and growing. Ensuring that they will be able to meet the challenges they face will not be easy.

Demands for better infrastructure and public services in India’s urban areas are large and growing. However, the resources available to urban local governments are clearly inadequate to serve even their present population. For example, Mohanty et al. (2007) found that, on average, for the period 1999–2000 to 2003–04 actual spending in 30 large municipal corporations<sup>2</sup> in India was only about 24 per cent of the (inflation-adjusted) requirements set almost a half a century ago by the Zakaria Committee (India 1963), with the extent of under-spending by this measure being over 75 per cent in 17 municipal corporations, and over 50 per cent in all of them but three—Pune, Nagpur, and Nasik, where the deficit was only about 30–35 per cent. At the other extreme, spending in the Patna Municipal Corporation was estimated to be less than 6 per cent of the Zakaria norm, with other municipal corporations in Bihar and Uttar Pradesh almost equally badly off. Recent analysis by the Planning Commission shows that 34 per cent of urban households do not have water taps within their premises, 26 per cent of them do not have toilets, 70 per cent of waste is not treated before disposal, and untreated sewerage and unregulated discharge from industries is a major source of water pollution (India 2008). In total, only 63 per cent of the urban population had access to sewerage and sanitation

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<sup>2</sup> According to India (2004), there are 96 municipal corporations, 1494 municipalities and 2092 Nagar Panchayats ( usually in urban areas of 100,000 or less).

facilities in 2004. Urban transportation problems are similarly acute. Public transportation is congested and inefficient; even those who can afford private transportation on average travel only one kilometre in 15 minutes owing to road congestion. Housing too is problematic, with almost 21 per cent of the urban population living in squatter settlements. Indian cities are in bad shape.

With urbanization proceeding at a fast pace, all these problems are likely to worsen in the near future. Ramanathan and Dasgupta (2009) estimate the cumulative capital investment requirements for providing services at 2007 prices for the period 2006–31 at over Rs.71 trillion. When operating expenditures of around Rs.10 trillion are taken into account, the total expenditure required amounts to over Rs.3 trillion, or about 25 per cent of the consolidated revenue of central and state governments. Exponentially growing urban public service requirements simply cannot be financed from the present urban local tax base, which in most cases consists essentially of the property tax. At one time, some states allowed municipal governments to levy a tax on the entry of goods into a local area for consumption, use, or sale (octroi). Although this tax was distortionary and inefficient, it provided a buoyant source of local revenues. Now, however, nearly all states have abolished this tax. Indeed, a few states have gone even further to ensure the inadequacy of urban local public finance by abolishing the residential property tax. Elsewhere, urban local bodies have proved unable (or unwilling) to help themselves by adequately revising property values, thus ensuring stagnancy or even decline in their own revenues. Transfers from the states to municipal governments are of little help, because they are inadequate and ad hoc and poorly designed. The absence of a debt market for local government bonds makes financing infrastructure even more difficult. In the absence of major reforms in both governance and finance, the prospects for Indian cities do not look good

## **2. Lessons from Theory**

The traditional theory of fiscal federalism, assuming a welfare-maximizing government, demonstrates the welfare gains from fiscal decentralization by matching public service provision with the varied preferences of people living in different jurisdictions. In one formulation, people “vote with their feet” by moving to localities providing public service tax mixes that closely matches their preferences (Tiebout 1956). However, the unrealistic nature of this assumption of mobility as well as the information asymmetry relating to public services and tax mix in different localities limits the applicability of this model to real world situations. An alternative formulation is the “decentralization theorem,” which states that “... in the absence of cost savings from the centralized provision of a (local public) good and of inter-jurisdictional externalities, the level of welfare will always be at least as high (and typically higher) if Pareto-efficient levels of consumption are provided in each jurisdiction than if any single, uniform level of consumption is maintained across all jurisdictions” (Oates 1972, 54). The welfare gains from decentralization are larger when variations in demand are greater and where the demand for local services is relatively inelastic. The ability of a centralized system to

cater to diverse preferences is limited by information asymmetry and political constraints (Oates 1999).

The so-called second generation theories (SGT) of fiscal federalism assume that agents within governments (bureaucrats and politicians) attempt to maximize their own welfare function within a constellation of incentives and constraints shaped by the characteristics of the prevailing fiscal and political institutions (Oates 2008). One SGT approach applies industrial organization theories to fiscal federalism and analyses multilevel fiscal arrangements in terms of the principal-agent framework (Seabright 1996). A second approach, motivated partly by the fiscal crisis in several Latin American countries precipitated in part at least by an incentive structure that led to the excessive exploitation of the “fiscal commons” by subnational governments, applies Kornai’s (1986) “soft budget constraint” (Rodden et al. 2003). A third SGT approach employs more formal political economy approaches based, for example, on legislative structure and electoral process to analyse different kinds of fiscal outcomes under centralized and decentralized politics. For example, the outcomes emerging from so-called “yardstick competition” are analysed under the rubric of “competitive federalism” by Breton (1996). All these approaches are not intended to replace the traditional theory of fiscal federalism but to complement and extend it.

An important precondition for efficient provision of public services is clarity in the assignment of functions (expenditure responsibilities) to each level of government. Who does what should depend upon the benefit span of the public service in question, the extent of diversity in demand for the service, the technology available for its efficient provision, and the capacity of the jurisdiction to provide the service. Functions need to be clearly assigned to ensure responsiveness and accountability. In a democratic polity, the elected executive should have the overall decision-making powers for public service provision, and the role of the bureaucracy should be to implement the decisions taken by the executive. Even when the basic assignment system is clear, however, some overlapping is almost inevitable so it is important to establish clear institutional lines of authority.

Assignment of financial powers should be adequate to finance the functions assigned. Accountability of governments to local residents can best be achieved when the residents of the jurisdiction bear the cost of providing the services at least at the margin. Hence, local governments must have powers to raise revenues from the residents to finance the public services consumed by them. Ensuring a strong “Wicksellian” link (Breton 1996) between revenue and expenditure decisions at the margin is critical to ensure that urban governments take rational decisions and are accountable to the residents for their decisions.

Local governments generally provide a mix of private and public goods. In principle, user charges covering the cost of provision should be paid by those who benefit directly from the private goods provided. Similarly, the cost of public services benefiting the people in the jurisdiction as a whole should be collected from taxes on the residents. On the other hand, when service benefits spill over to other jurisdictions, it is often appropriate for them to be partly paid for through transfers. Local governments may obviously levy taxes on immobile bases such as real property. In addition, the benefit principle suggests that they may, to a limited extent, be permitted to impose taxes on

mobile bases, although such powers must be bestowed with care to avoid encouraging shifting the cost of local services to non-residents (Bird and Smart 2010).

Intergovernmental transfers play an important role in local public service provision. In the traditional approach, higher-level governments should levy all broad based redistributive taxes since they have a comparative advantage in carrying out redistributive and stabilization functions. On the other hand, considerable expenditure responsibility is properly assigned to lower-level governments for efficiency reasons. The resulting vertical imbalance between expenditures and revenues at each level is generally corrected through transfers from the higher to lower levels. Within each level of subnational government, some jurisdictions will inevitably suffer some fiscal disability owing to such factors as below average revenue capacity and higher unit costs of providing public services. Differences in these factors create different net fiscal benefits in different jurisdictions and may thus induce inefficient factor movements (Buchanan 1950). This problem may be exacerbated when subnational governments impose origin-based taxes (Boadway and Flatters 1982). The solution to such inefficiencies is, again, usually considered to reside in appropriate intergovernmental fiscal transfers. In principle, such balance-restoring (or gap-closing) transfers are intended to enable every jurisdiction to provide comparable levels of services at comparable tax rates should be unconditional (Bird and Smart 2002). However, there is also often a case for providing specific purpose transfers to ensure minimum standards of public services with significant inter-jurisdictional externalities. In this case, the appropriate transfer design should often require the recipient governments to comply with specific conditions.

In practice, it is difficult to incorporate all these principles in designing the transfer system. There is, for example, no completely objective way to measure the degree of vertical or horizontal imbalance (Bird and Tarasov 2004). Similarly, with respect to specific purpose transfers, it is impossible as a rule to measure the degree of externalities and hence to develop optimal cost-sharing arrangements or matching ratios. Since the economic argument for decentralization is based to some extent on asymmetric information in terms of the inability of the central government to estimate the correct degree of spillovers, it is somewhat ironic that the proper design of specific purpose transfers requires exactly such information. As Inman (2003) shows for the U.S., matching ratios in practice never correspond to the extent of spillovers and the federal share is invariably much higher than spillovers. Finally, even if all the conceptual and empirical problems inherent in designing an economically optimal transfer system could be overcome, invariably non-economic (including political) objectives creep in and ensure that the actual transfer system differs from the ideal.

Moreover, some have even questioned whether intergovernmental transfers are a good idea in any case. Transfers inevitably soften the budget constraint and have been argued to undermine fiscal discipline and promote fiscal irresponsibility and macroeconomic instability (Prud'homme 1995). Equalising transfers given to offset fiscal disadvantages can interfere with the normal process of income convergence which occurs in the process of economic growth as labour and capital move from places with lower productivity to those with higher productivity. Specific purpose transfers may not effectively encourage local expenditures on the desired function owing to the fungibility

of funds. For these and other reasons, transfers may harm rather than further the achievement of efficiency and even equity goals.

Nonetheless, substantial transfers exist in every multilevel fiscal system. It is not possible to perfectly match revenue powers with expenditure responsibilities, so an appropriate design principle is for transfers to be neither so large as to turn local governments into simple agents of higher-level governments or make them unduly transfer-dependent and hence fiscally irresponsible, nor so small as to render them incapable of providing minimal local services to their residents. One key way to set a hard budget constraint is to ensure that richer local governments are as self-financing as possible and that even the poorest local governments have sufficient revenue flexibility so that revenue and expenditure decisions are matched at the margin in the sense that any local decision to expand expenditure must be financed through additional local taxation (Bird and Vaillancourt 1998). Further, both central and state governments must be careful not to bail out bad local decisions by expanding transfers. The system of grants must be transparent, predictable, and essentially “infra-marginal” for any particular budgetary period so that local governments do not have incentives to free-ride.

To satisfy the conditions of what Weingast (1995, 2009) calls “market-preserving federalism” (in the sense of maintaining an open national market), local governments must face a hard budget constraint as a result of properly designed and implemented expenditure and revenue systems. In addition, efforts must be made to strengthen and deepen markets, particularly land and capital markets, by removing impediments to mobility and trade in factors and products such as laws restricting markets and institutional rigidities. Similarly, efficient credit and debt markets and a well-developed banking system along with credible credit rating institutions are important preconditions to avoid bail outs. If intergovernmental competition is to result in gains in terms of efficient service delivery let alone innovation and productivity gains, it is important to institute proper checks against destabilizing (predatory) competition as well as against restrictive and protectionist policies. All these issues become particularly important in the context of globalization because localities with better linkage to markets and infrastructure can reap higher benefits from access to domestic and international markets and grow faster than those less well off in these respects. Finally, in case something goes badly wrong in some locality it is also essential to develop institutions that can handle local fiscal crises and even, in the extreme, bankruptcy. None of the tasks assigned to policy makers by the fiscal federalism literature is easy and few, if any, are facilitated by India’s current structure of urban governance and finance.

### **3. Urban Governance in India**

Economically dynamic cities need governance structures that elicit preferences for public services, ensure responsiveness in the provision of such services, provide accessibility to citizens, and achieve cost savings by adopting an appropriate scale of operation. Bird and Slack (2007) discuss several alternative models for governing large metropolitan areas and conclude that no unique model of governance fits all municipalities or even the same municipality at different times. In fact, in recent years, a number of major cities have

changed their governance model. Toronto (Canada) moved from a fragmented one-tier structure to a two-tier structure and then to a consolidated single-tier structure. On the other hand, London (UK) moved from a two-tier structure to a one-tier structure and then back to a two-tier structure. Cape Town (South Africa) moved from having no metro government at all to a two-tier and then a consolidated one-tier metropolitan structure. What is right for any city is seldom clear, and may change over time. In larger metropolitan areas, however, the real choice is usually between one-tier or two-tier governance structures perhaps supplemented by some voluntary inter-municipal cooperative agreements or specialized agencies to provide particular public services.

An important governance issue in India concerns the need to distinguish large metropolitan cities from smaller municipalities. In metropolitan cities, the concentration of a variety of economic activities, the cosmopolitan composition of population, and large-scale migration requires a system of public service provision that not only facilitates economic activities but also promotes the social interaction and cohesion necessary to facilitate innovation and impart dynamism. However, how large metropolitan cities are actually governed may deviate substantially from this mandate in response to the compulsions of local politics, especially when they are state capitals. Restrictive protectionist policies responding to pressures to provide employment to local population, preferences for local population in business dealings and contracts, and preferences based on linguistic, ethnic, and other considerations may rob cities of their metropolitan character. A possible way to free large cities from such state political pressures may be to remove them from the control of the state governments and create separate city-states as China has done for several very large cities, most recently Chongqing. Germany, for example, has three such city-states, including Berlin. Other countries—the United States, Australia, Mexico, and Brazil, for example—have created special capital city districts, as has India. However, as Indian experience with New Delhi shows, being special and separate provides at best only a partial answer to the financial and governance problems facing large, rapidly growing cities in India (Mathur 2009), so we do not discuss such approaches further here.

Even within a *one-tier* structure, of course, governance in large cities is far from simple. In Shanghai, for instance, there are three levels of management—municipal, district, and sub-district. In Mumbai, which has been characterized as a “fragmented one-tier structure” (Slack 2007, 15), matters are more complicated. Mumbai has seven wards, each with its own municipal officials, and the surrounding eastern and western suburbs are also divided into wards. Within the Mumbai urban agglomeration, in addition to the municipal corporations of Mumbai, Kalyan, and New Mumbai, there are many other governing bodies, including the Mumbai Regional Development Authority, 16 municipal towns, 7 non-municipal urban areas, and 995 villages. In addition, management of urban services in Mumbai is divided further still among the Municipal Corporation of Greater Mumbai, the state of Maharashtra, and the Government of India. For example, the urban rail network is run by Indian Railways.

In a *two-tier* model, the lower tier is responsible for providing services having smaller geographical spread while the upper tier provides services with a larger

geographical spread as well as those involving significant economies of scale. This model has some characteristics that make it suitable for large metropolitan regions. Examples may be found, for instance, in Madrid (Spain), Santiago (Chile), and Manila (Philippines). Two-tier structures already exist in many Indian cities. For example, Hyderabad Municipal Corporation has 11 municipalities, Chennai Municipal Corporation has 36 municipalities, and Kolkata has 41 municipalities within its area (Bandyopadhyay and Rao 2009). In principle, the two-tier model may have potential advantages over the one-tier model owing to its greater responsiveness, efficiency, and accountability. Some redistribution is also possible in this structure through a combination of tax and spending decisions. On the other hand, there may be overlap and duplication in the provision of services. Moreover, since the structure is less transparent, residents may be confused as to who is actually responsible for which services.

In addition, in India as in other countries, a number of specialized agencies for providing water supply, waste management, and transportation across a number of municipalities exist. This approach has a number of advantages. For example, specialized agencies can reap economies of scale and address the issue of spillovers, can be professionally managed to ensure efficiency and can, to at least some extent, establish and collect user charges without political considerations. On the other hand, there are disadvantages. There may, for instance, be problems of coordination when a number of specialized agencies providing different services are involved. In addition, these agencies may have no local political accountability unless their decisions are subject to the approval by the municipal executive. Furthermore, if municipal taxes go to support such agencies without a clear linkage between the expenditure decisions of the specialized agencies and the taxes collected by the municipalities, the absence of the “Wicksellian connection” between revenues and expenditures further reduces accountability. Specialized agencies can certainly improve efficiency in the delivery of some services, but if they are not locally accountable, it is far from clear that they will supply the right services in the right places.

Effective fiscal decentralization requires that not only must appropriate functions and adequate finances be devolved to the local governments, but so must control over those they employ. In Indian cities, the primary responsibilities are vested in an executive mayor chosen by elected representatives, and local officials are charged with implementing the decisions taken by the executive. In practice, however, the role of the mayor (or chairperson) as the executive head of the municipality is often confused with that of the Municipal Commissioner—an official appointed by the state government who is supposed to implement the policies approved by the executive. Since the local government has no role whatsoever in the appointment, promotion, or transfer of the Municipal Commissioner, it is hardly surprising that this official is, in reality, primarily accountable to the state government rather than to the elected local representatives. In addition to this confusion at the top, governance in most smaller municipalities also suffers from inadequate administrative capacity to plan, effectively regulate, raise revenues, and implement spending decisions. Moreover, both state and central politicians, in varying degrees in different regions, often interfere in the functioning of municipalities.

The Expert Committee on the Governance in Bangalore Metropolitan Region (Report of the Expert Committee 2004) recommended that the Commissioner of the Greater Bangalore Municipal Corporation should be selected by a committee constituted by the state in consultation with the mayor and, more importantly, that the commissioner's role should be legislatively redefined to make him/her clearly responsible and accountable to the mayor and the corporation. If India's larger cities are to have effective urban governance structures, similar steps need to be taken by all state governments to make the commissioners in municipal corporations and municipalities primarily responsible and accountable to the respective municipal bodies. Of course, so long as the commissioner's career path remains essentially in the state bureaucracy, some problem of "dual subordination" (to both central and local authorities) still remains. but, at a minimum, it is critical that the chief municipal officer should clearly be primarily accountable to the municipality he or she serves rather than to the state, as is now the case.

The Constitution makes urban governance structures a matter to be determined by the states. Although the 74<sup>th</sup> amendment accorded constitutional recognition to municipal bodies, by and large the present urban governance structures have carried over from the past. To strengthen participatory planning, the Constitutional amendment provided for the setting up of Metropolitan Planning Committees to prepare the draft development plan in every metropolitan area and similar District Planning Committees (DPCs) to consolidate and co-ordinate planning for urban areas. In addition, the constitutional amendment mandated the holding of Ward Sabhas (assemblies) to elicit the preferences of the people for public services and to develop planning from the grassroots level. However, none of these requirements were really observed in practice until the national Planning Commission finally mandated the setting up of DPCs (India 2005). Despite this mandate, urban local bodies in most states do not as yet have regular Ward Sabhas and, even when they exist, these assemblies are not used either for urban planning or for eliciting the preferences for public services. Similarly, many states are yet to legislate for, let alone create, the required Metropolitan Planning Committees.

The issue of governance in India's major metropolitan areas is extremely important not only for the millions who live there but also for the economic development of the country as a whole. Big cities need a sound governance structure that works well. To attain this, much more effort is needed to implement the ways of revealing citizen preferences through the citizen access structures (such as Ward Sabhas and the various planning committees) set out in the Constitution. Even more importantly, the roles that different political and bureaucratic actors are supposed to play at the municipal level need to be set out more clearly; and then these officials should be permitted to do their jobs with far less interference from politicians at higher levels of government and with primary accountability to those whom they are supposed to serve—local residents. Until the basic urban governance structure is moved in these directions, Indian cities are, for the most part, going to continue to be unable to respond flexibly or adequately to the changing realities with which they are confronted.

#### 4. What Do Urban Local Governments Do?

Traditional fiscal federalism theory argues that the essential function of local governments is allocative. The potential mobility of economic agents reduces the effectiveness of local governments in carrying out redistribution. Similarly, the openness of local economies means that they can do little in terms of stabilization (Oates 1972). The main task of the local governments is thus to provide local goods and services within the area under their jurisdictions.<sup>3</sup> Except when overridden by distributive considerations, efficiency requires that local governments should levy user charges on those who benefit from the private goods that they provide, such as water supply, sewerage, transportation, and recreation services—. Similarly, local public services benefiting the local population in general should be financed by taxing residents, while services whose benefits spill over jurisdictional boundaries usually need to be financed in part by intergovernmental transfers. Finally, borrowing is, in principle, the best way to finance large capital investments that will continue to provide services long into the future. Of course, it is important to ensure that neither transfers nor borrowing turn into bailouts that soften the budget constraint facing local government decision-makers.

Three key points should be noted about the 18 functions constitutionally devolved to municipal bodies in India. First, the functions listed are identical for all types of municipal bodies—whether huge metropolitan cities or small urban localities. Second, since the extent to which these functions are actually devolved is at the discretion of state governments, the extent of devolution may vary significantly across states. Third, most states are reluctant to devolve functions to municipal governments in part because they argue that they do not have the capacity to undertake them. In addition, because most listed “municipal” items are either in the constitution’s list of state functions or in the concurrent list of state and central functions, there is not only considerable concurrency and overlap between states and municipalities but also between the central government and municipal bodies. Assigning responsibility for the provision of specific services to a specified level of government and ensuring that those who make the decisions are adequately accountable for their actions is thus difficult. This problem is particularly acute in the capital cities of the states where the overlap in functions between the state government and the municipal corporation makes the system particularly opaque.<sup>4</sup>

In principle, there is nothing wrong with concurrent assignment of powers if there is clear demarcation of functional domains. However, no state has yet taken the initiative to undertake so-called “activity mapping” for municipal governments necessary

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<sup>3</sup> This does not mean that local governments do not have any role in redistributive or stabilization functions. Local governments sometimes have local employment programs (Inman and Rubinfeld 1997) and may also play a role in implementing anti-poverty interventions (Rao and Das-Gupta 1995; Rao 2002).

<sup>4</sup> In Delhi, the overlapping problem is even more acute as all the three levels of government—centre, the Union Territory of Delhi and three municipal bodies (the Delhi Municipal Corporation, New Delhi Municipal Committee, and Delhi Cantonment)—divide the powers among them in confusing ways (Mathur 2009).

to know precisely who is responsible for doing exactly what with sufficient clarity to achieve efficiency and accountability in the provision of urban local services.<sup>5</sup> Although about all most state governments have done is to formalise the functions that were being carried on by the various municipal bodies even before the 1991 Constitutional amendment, the fact is that urban municipalities across the country have, to varying degrees, been vested with a long list of functions under the various state municipal laws relating to public health, welfare, safety, regulation, and developmental activities. Functions relating to public health include water supply, sewers, sanitation, and waste disposal/management. Welfare activities include social justice, safeguarding the interests of weaker sections, creation and running of night shelters, street lighting, parks, education, burial grounds and cremation facilities, playgrounds, and recreation. Regulatory functions include prescribing and enforcing city plans, land use, and building by-laws, licensing of shops and establishments, removal of encroachments on public land, registration of births and deaths, and enforcing parking regulations. Public safety includes fire protection and street lighting. Public works include construction and maintenance of inner city roads and buildings. Development functions include town planning and development of markets. In addition to all this, the 74<sup>th</sup> Constitutional amendment assigned additional development functions to municipal governments such as planning for development, urban poverty alleviation, protection of environment, and slum improvement and upgrading.

Recognizing that the scope and capacity to undertake various functions is, in fact, likely to vary with the size and character of the municipal body, many states have assigned significant powers with respect to education and healthcare, the regulation of industries, and the provision of intra-city and inter-city transportation services to larger cities. In some cases, independent service providers bypass the elected municipal governments—often precisely because of disenchantment with poor public service delivery by municipal bodies. In some areas water and sewer providers deliver services beyond the boundaries of one municipality to reap economies of scale. Independent service providers are often thought to insulate policy making from political vagaries, thereby providing better public service delivery. Problems with this type of organizational set up may arise from the agency's relative remoteness from the people it serves and its lack of political accountability. In drawing up agreements with such service providers, careful attention must be paid to balancing the desire for professional competence and least-cost provision against the need for local governments to be fully accountable to their residents for the provision of the public services for which they pay.

Ensuring clarity of assignment by specifying the responsibility of each level of government for service delivery is only part of the story. Clarity must be matched both by *accountability* to the local population and by *authority* in terms of the ability to manage expenditures and to determine (within limits) revenues. Financial honesty and political accountability require that municipal budgeting, financial reporting, and auditing should be not only comprehensive, comprehensible, comparable, verifiable, but also transparently public. In Brazil, for example, and increasingly in other countries, more and

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<sup>5</sup> Such mapping was recommended by the Administrative Reforms Commission (India 2007) but as yet little has been done along these lines.

more local budgets and financial accounts are freely accessible on the Internet, and in some instances residents are actively encouraged to participate to some extent in developing the expenditure plans for their areas. However, little has been done along these lines in India.

Whether one goes this far or not, proper public expenditure management at any level of government must (a) adequately control the total level of revenue and expenditure, (b) appropriately allocate public resources among sectors and programs, and (c) ensure that governmental institutions operate as efficiently as possible. To do this, urban local governments need adequate authority to manage both the expenditure and revenue sides of their budgets, sufficient administrative capacity to be able to do so, and an appropriate incentive structure to encourage them to do so. Most Indian cities are handicapped in all these areas. Central and state governments need to provide a more adequate fiscal, financial, and institutional framework if municipal governments are to have even a chance to respond adequately to the problems facing them. Higher levels of government need to ensure that local officials are adequately trained and motivated to do their jobs properly. Central and state governments could usefully establish a model (framework) local budget law and financial reporting system and require adequate external audit. Improving the local budgeting and financial system along these lines will satisfy two essential requirements of good government by establishing the basis for financial control and providing reasonably accurate, uniform, comparable, and timely financial information.

None of these tasks is easy. For example, although improved accountability may be the key to improved public sector performance, improved information is the key to accountability. The systematic collection, analysis, and reporting of information that can be used to verify compliance with goals and to assist future decisions is critical to successful urban development. Such information is essential to informed local participation through the political process and to the monitoring of local activity by the central agencies responsible for supervising and (sometimes) financing such activity. Unless the relevant local “publics” are aware of what is done, how well it is done, how much it cost, and who paid for it, no local constituency for effective government can be created. Similarly, unless higher-level agencies can monitor and evaluate local performance, there can be no assurance that functions of national importance will be adequately performed once they have been decentralized. An important underpinning and accompaniment of any successful program to strengthen urban local bodies must therefore be, perhaps paradoxically, an improvement in national evaluation capacity. Decentralization and improved central evaluation and assessment of local activities are not substitutes—they are complements.

One essential element of the hard budget constraint needed to induce efficient decisions by *local* governments in India is thus adequate *central (and state)* capacity in the shape of credible information-gathering and evaluation. Such “carrots” of central financial support of local efforts as the Jawaharlal Nehru National Urban Renewal Mission program (JNNURM; discussed below) need, at least implicitly, to be accompanied by the possible “stick” of reduced support if performance is inadequate; and to shake a credible stick, one needs some standard of adequacy and some way of knowing how performance measures up. Decentralizing functions to local governments does not

imply that the central and state governments no longer have any responsibility. However, the nature of central (and state) responsibility changes from delivering the services themselves to regulating and monitoring the efficiency and equity of services delivered by local governments. The essential tool needed for this task is an adequate and up-to-date information base—generated, for example, by requiring local governments to file uniform and informative budgets and financial and other reports. Unfortunately, this need for extended and reliable information on local public finances and service delivery has been sadly neglected in India. Unless a major effort to improve matters in this respect is undertaken soon, it is hard to see how the adequacy and quality of urban public services in most Indian cities can be maintained, let alone expanded and improved as the needs of development require.

Better financial oversight of local finances by state and even central officials is clearly necessary, not least because to a considerable extent local governments are spending state and central funds. However, devising and implementing a system of oversight that balances prudence with leaving the main decision-making powers at the local level is not a simple task. Both conceptually and empirically, it has proven difficult even in countries with excellent data to develop ways of measuring local financial performance that will provide adequate indications of possible local mismanagement and, more importantly, impending financial distress. It is important that much more effort and thought be put into developing and implementing a municipal financial reporting system that will be much more adequate in this regard than the present “non-system.”

In addition, if municipal governments are given more scope for making their own decisions on what to do, the fact is that some will undoubtedly make mistakes and in some instances perhaps even bankrupt (in some sense) a locality. While some such errors are undoubtedly an essential part of “growing” a more adequate urban governance and finance structure, it is important that how such mistakes should be dealt with is considered carefully as part of the needed rethinking of how India’s big cities in particular can and should be run more effectively and efficiently. Under what circumstances if at all, for example, should municipal governments be taken over by states? When a municipality cannot pay its debts or meet its current payroll, should it be rescued by a state agency and placed in some form of trusteeship until its financial position is again sustainable? Such questions are not easy to answer in general anywhere, but they must nonetheless be thought about much more carefully than appears to be the case today in any state.

## **5. Financing Urban Services: User Charges and Local Taxation**

An important rule of sound fiscal decentralization is that finances should follow functions (Bahl 2002). Local governments need access to adequate revenue sources to finance the public services they are mandated to provide. In India, it is clear that the lack of adequate resources is one key reason municipal bodies have not been able to provide satisfactory levels of the assigned public services.

The poor state of urban infrastructure due to significant underfunding was the main motivation for initiating a central program—the Jawaharlal Nehru National Urban

Renewal Mission (JNNURM)—with the aim of improving developmental incentives by linking grants for urban renewal to reforms at both state and local levels aimed at improving fiscal efficiency of the urban local bodies, freeing urban land and housing markets, and preventing the municipal bodies and the states from adopting protectionist policies. The first phase of JNNURM—as discussed further below—covers the period 2005–12. After a slow start, the resources transferred from the centre picked up in the next few years. However, the slowdown of the economy following the global financial crisis—coupled with the political decision to provide particular stimulus to the commercial vehicle sector—led the central government both to dilute the reform requirements set out in the JNNURM program (e.g., to generate significant own resources by reforming property taxes and liberalizing land and housing markets) and to use a considerable portion of JNNURM funds to purchase buses for urban transport rather than for urban renewal as originally envisaged.

Such changes in transfers matter a great deal since, by law, local governments in India cannot run deficits and are therefore required to restrict expenditures to available revenues. Municipal spending in India is extremely low because both own revenues and transfers from central and state governments are low. In 2001–02, for example, aggregate revenues of urban local bodies amounted to only 0.76 per cent of GDP, with about one-third of this amount coming from transfers (Mohanty et al. 2007). Such figures are very low in comparison with countries like Brazil, where total municipal revenues account for 7.4 per cent of GDP, municipal own revenues for 2.6 per cent, and municipal taxes for about 2 per cent (Afonso and Araujo 2006). Not surprisingly, the standards of municipal services in India are generally abysmal.

#### (i) User Charges

One important source of local finance should be from user charges imposed for services provided. To a considerable extent, a local government is like a business providing direct services in the form of what are essentially private goods (like water) to its customers (local residents). Financing such services through user fees or charges not only provides funds with which to supply such services but also provides invaluable information on which services should be provided, in what quantity and quality, and to whom. 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.

This circle needs to be broken, and not only to get revenues to improve services. User charges are especially important as signals to consumers of the scarcity value of the services and to providers about the demands that need to be met through service provision. Establishing this strong link between demand and supply helps to generate resources and ensures efficiency in production and accountability in service delivery. User charges are particularly relevant for services such as water, sewers, electricity, garbage disposal, public transit, and recreation, and are hence generally most important in large metropolitan areas which provide more of such services.

At present, urban fees are not significant in India, with the proceeds from non-tax revenues from all urban local bodies amounting to a mere 0.13 per cent of GDP. Mohanty et al. (2007) show that in 10 large municipal corporations less than 10 per cent of the cost of providing services was recovered through fees; in another six, cost recovery was between 10 and 20 per cent. Only in two of the 25 municipal corporations examined was cost recovery greater than 75 per cent. Interestingly, cost recovery on the whole was relatively greater in those cities in which the estimated normative under-spending was lower. If low cost recovery and poor service quality are thus connected, it may prove possible to collect more user charges, especially if the quality of the services provided can be improved—for example, with the aid of a well-directed transfer system, as discussed in Section 6 below.

Other important sources of non-tax revenues are licence fees for shops and establishments and parking fees. A common feature seen virtually in every urban area in India, particularly the largest cities, is the poor implementation of regulations relating to land use and commercial space occupation. The present system of issuing licences and the common flouting of regulations by shops and establishments provide enormous and highly undesirable rent-seeking opportunities for local officials. Public interest litigation relating to the construction and running of businesses in residential areas against the regulations led to the demolition of several shops and establishments in Delhi in 2005. In some cities, from time to time, the poor implementation of the regulations has been accompanied by periodic amnesties that legalise them after the fact, favouring in particular the politically well connected and powerful.

Finally, parking fees in major metropolitan cities might be able to generate substantial revenues (Barter 2010). The main rationales for levying parking fees are to reduce congestion of vehicles on the roads and to generate resources to construct parking spaces. In most metropolitan cities in India the combination of the poor quality of the public transportation system, inadequate provision of parking spaces, and the present negligible charges for parking, whether legally or illegally, results in large-scale traffic congestion on roads. With sharp increases in household incomes and the emergence of a large middle class, the number of vehicles is going to increase sharply in the coming years. Introducing a more comprehensive policy of charging parking fees in accordance with the scarcity value of open spaces in cities should reduce traffic and at the same time generate revenues to construct multi-storeyed parking places—although neither objective may be achieved without much more rigorous enforcement of street parking regulations. Creating better parking infrastructure in the central business district of major metropolitan cities may perhaps be one appropriate area in which to explore the public-private partnership (PPP) approach to capital finance discussed in Section 7 (and, as noted in Section 6, eligible for JNNURM assistance).

## (ii) Local Taxation

Reliable and effective local taxation is essential to ensure hard budget constraints in financing local public goods (Oates 2005). In particular, it is important that local governments have adequate tax powers to ensure a strong linkage between revenue and expenditure decision at the margin (Bird and Smart 2010). As Bird and Slack (2007)

argue, the most appropriate tax at the local level is that on property, not only because real property is immobile but also because differences in service levels are reflected in property values so that the tax on real property is like a benefit tax. In many developed countries, income taxes generate significant revenues for local governments. However, it is unlikely that such taxes, even applied as supplemental rates to the central income tax, would make much sense in India given the problems in administering even the central tax, the intervening supervisory role of the states, and the extreme heterogeneity of Indian cities. A local payroll tax would perhaps be easier to administer, but it too is unlikely to be advisable in India in part because it creates a tax barrier to employment in the formal sector and may reduce the employment intensity of production. Another tax used at the local level in many countries is some form of sales or consumption tax, including selective taxes on, for example, entertainment services and hotels. Finally, a number of countries have local business taxes (Bird 2003). Most of these local business taxes involve significant exportation of tax burden to non-residents, are costly to administer, and impose substantial compliance burdens. Nonetheless, if Indian cities are to access additional tax revenues, some form of taxation on business and consumption may be worth further exploration.

Indian municipal bodies can levy and collect only those taxes that are specified by the state governments from the list of taxes assigned to the states in the Constitution. Unsurprisingly, the taxing powers assigned are non-uniform across states. However, the most important local tax bases fall broadly within those indicated above as potentially useful: (a) taxes on lands and buildings, (b) a tax on the entry of goods into a local area for consumption, use, or sale, which is known as octroi, (c) taxes on luxuries including those on entertainment, amusement, betting and gambling, (d) taxes on advertisements other than those published in newspapers or broadcast on radio or television, (e) taxes on non-motorized vehicles, (f) taxes on animals and boats, (g) tolls, and (h) taxes on professions, trades, callings, and employment.

In reality, however, most of these taxes are simply not levied in most urban areas. The most important tax actually levied at the local level is undoubtedly that on land and buildings (real properties). Octroi was an important source of municipal revenue in some states until recently. However, the tax was considered obnoxious, distorting, iniquitous, and a major source of corruption, and it is not surprising that all states except Maharashtra have now abolished the tax. Even in Maharashtra, the tax is levied only in municipal corporations and not by smaller cities. Some states replaced local octroi with an “entry tax” at the state level—a tax which is not much better in economic terms and is also an impediment to internal trade. In most cases, even when states replaced octroi by entry tax, they did not compensate municipal governments for the loss of revenue. Generally, when states abolished octroi, they provided no alternative source of revenue and simply increased the size of the unfunded mandates confronting municipal governments. In a few states, however, municipal governments do have some limited access to consumption taxes. In Kerala, for instance, the power to levy an entertainment tax is given to the urban local governments. In Andhra Pradesh, local governments receive a fixed share of the revenue from entertainment tax. In a few states, urban local bodies also collect some revenue from advertisement tax.

The property tax is by far the most important source of own revenues of municipal bodies although collections are generally poor and the revenue buoyancy of the tax is low. Recently, however, initiatives in some municipal corporations have shown that revenues from this tax can be substantially increased with strong local leadership and proper reform of the tax system. Bruhat Bangalore Mahanagara Palike (BBMP; Greater Bangalore Municipal Corporation), for example, reformed its property tax by revising the area-based values, introducing a self-assessment system and improving the technology of the payments system with the result that revenue increased from Rs. 4400 million in 2007–08 to Rs. 7800 million in 2008–09 and increased still further the following year.

The starting point for property tax reform in India was the introduction of area-based assessment by the Patna Municipal Corporation in 1992–93. Previously, the tax was collected on the basis of the annual rental value, defined as gross annual value rent at which the property may be reasonably be expected to be rented. This system gave enormous discretion to tax collectors and yielded little in tax revenue. The prescription of unit values (per square foot) based on the area of location and type of construction of the property instead of the annual rental value removed most discretion from the tax collectors and resulted in such a large increase in base that the tax rate was reduced from 44 per cent to 9 per cent.<sup>6</sup> Subsequently, municipal corporations in a number of states adopted the Patna model. In Bangalore, for example, properties are classified into different zones based on the guidance values set by the Department of Stamps and Registration. For each zone, rental value per square foot was determined on the basis of type and quality of construction and age of the buildings. A handbook was brought out detailing these values so that each individual property owner can now compute his tax liability simply by plugging in the location, type of construction, and area of his property, and then pay the tax online. Similar reforms in other urban local bodies might reasonably be able to double their (low) revenues from property tax.

A major weakness of this system is the need to revise the unit values periodically in keeping with changes in prices. In the absence of periodic revision revenues will not respond to changes in the values of properties, and the buoyancy of the tax will depend only upon the addition of new properties. As a rule, it is politically difficult to change values periodically. One way to overcome this problem and keep tax revenues expanding with needs might be to link the guided values automatically to the index of property values in various cities determined by the National Housing Bank. This system could be expanded if states would initiate the estimation of price changes on real property in every urban local body based on the methodology adopted by the National Housing Bank and then link the guided values automatically to the price index to estimate the tax liability.

Several important lessons from the Bangalore experiment in the reform of property tax are worth noting. First, the system should be simple and transparent enough to be easily understood by the general public. Second, there should be clarity in the reform process and thorough public discussion and debate when the reform is adopted. It is important for the tax department to provide prompt and clear answers to queries by the general public through newspapers, radio, and television as well as through so-called

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<sup>6</sup> In view of the very considerable degree of under-spending in Patna—the worse of the 30 cities examined by Mohanty et al. (2007)—its pioneering role in property tax reform has apparently not been carried through over time in a way that sustains municipal revenues.

“social media” when appropriate. It is also important to facilitate online payment of the tax so that the taxpayer does not have to be in contact with the tax collector. Computation of the property tax liability based on the guided values and online payment of the tax obviates the need for taxpayers to go to the tax department and face harassment simply in order to pay the tax. This kind of direct, simple action to simplify and improve local fiscal procedures is needed to enable Indian cities to cope more adequately with their changing reality.

Another major reform needed in the property tax system is the expansion of the tax base. The Administrative Reforms Commission (India 2007) noted that only about 60–70 per cent of properties in urban areas are actually assessed. A large number of property owners simply do not pay the tax. The Commission recommended matching the properties paying the tax with those in the Geographical Information System (GIS) to identify those that are not paying the tax. BBMP has undertaken this exercise for all properties within its 800 sq. kilometre area. By matching the actual properties paying the tax, excluding government buildings and slums, it is possible to identify the properties evading the tax. The Bangalore experiment is worth replicating in other municipal corporations and municipalities.

Widespread evasion exists in part because much of the new construction as well as additions to existing buildings have been done without getting proper approval. Some have expressed the fear that allowing such properties to pay the tax could mean giving them legal recognition. It is important to keep these two issues separate. It is also important to examine the nature of violations. In general, if violations are not major, property owners should be allowed to pay the penalty and regularise them.<sup>7</sup> On the other hand, in cases where the violations are major, the structures should be demolished.

Apart from the property tax, which is potentially a good source of local revenues but definitely needs reform, larger cities in particular are likely to need some additional broad-based tax source, such as a supplemental rate “piggybacked” on a national or state tax and administered with that tax, but with the proceeds going to the local government. Any such local rates should be set within predetermined limits. A ceiling is needed to prevent localities from exporting tax burdens (in excess of benefits received) to non-residents and a floor to prevent richer areas from “stealing” tax base from poorer areas.

In India, if the central income tax were a broader, simpler, and more effectively administered tax than at present, perhaps state and even some larger local governments might be allowed to piggyback their rates subject to a ceiling rate. Such a system would reduce the scope for evasion and avoidance of income tax, provide a stable source of revenues to both state and local governments and, in particular, ensure that large business and manufacturing centres like Mumbai have the funds to maintain and upgrade their infrastructure to sustain their key role in India’s national economic dynamism. However,

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<sup>7</sup>Recently the government of Karnataka state attempted to pass an ordinance regularising 700,000 illegal constructions within the Bangalore Municipal Corporation area on the eve of an election to the municipal body. The scheme (called the “Akrama-Sakrama” scheme) was approved by the state cabinet but in the end did not receive the approval of the Governor on the grounds that the government should pass the legislation and not simply pass an ordinance.

before such measures can be considered many changes would have take place not only at the constitutional level but also, equally importantly, in terms of political willingness to tax adequately and properly at all levels of government.

Another possibility might be a surcharge on the consumption tax as an additional source of revenue for municipal governments. As with the income tax, however, for such measures to be considered there would first have to be a more or less uniform sales tax base at both the central and state levels, something which has not yet been achieved, although considerable progress has been made in this direction. Interestingly, even in the present (incomplete) transition to a “dual” central and state goods and services tax (GST), Gujarat recently decided to impose an additional one percentage point levy on the sales tax, earmarking the levy as compensation to the municipal corporations for the loss of revenue from abolishing octroi. As the present consumption tax system is replaced by the GST regime, the possibility of providing additional revenue to local governments more generally by (as in Japan, for example) levying an additional percentage point for this purpose at the central level or perhaps as each state decides and then distributing the revenues to localities by formula might perhaps be considered.<sup>8</sup> Firm estimates of GST base are not available but a conservative estimate made at the National Institute of Public Finance and Policy (NIPFP) for 2007–08 put the GST base at Rs. 16,000 billion after adjusting for the prevailing exemptions (Rao and Chakraborty, 2010). A 1 per cent levy on this base would yield Rs. 160 billion for municipal governments, which is about 0.34 per cent of GDP. Since even the most optimistic estimate of revenue from property tax is just about 0.2 per cent of GDP (Mathur, Thakur and Rajyadhyaksha, 2009), a 1 per cent levy on the GST could yield virtually double the amount collected from property tax. This possible important source of revenue deserves serious consideration.

As a final note on local taxes, it is particularly important that states cease the pernicious practice of abolishing local taxes without providing adequate substitute sources of revenue to municipalities. For example, the Gujarat government abolished octroi to fulfil its election promise without any mechanism to compensate the municipal corporations, although later they decided to levy a one percentage point additional rate on the sales tax. Rajasthan and Haryana simply abolished the property tax without even consulting the urban local governments. Punjab put the threshold for the property tax so high that almost two-thirds of the properties are exempted. Since the property tax is the only important tax for municipal governments, when a state government abolishes or severely restricts this tax, it is deliberately disempowering its municipalities.

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<sup>8</sup> Conceivably, some states may perhaps even want to consider allowing at least the large metropolitan areas to impose (piggyback) an additional rate of their own on the state tax base but this is unlikely to be a good idea given the complexities involved in making such a system work. Even Canada, which makes considerable use of such provincial supplementary rates on its central GST as described in detail in Bird and Gendron (2010), has not considered, and is unlikely to consider, extending this facility below the level of the province.

## **6. Financing Urban Services: Intergovernmental Transfers**

In principle, municipal governments should raise revenues from their residents to finance local public services. In most countries, however, municipalities are seldom able to generate the required revenues from their own source. Transfers from higher levels of government either by way of tax devolution or grants are therefore found in every country, as are specific purpose transfers intended to ensure minimum standards of services for those with significant benefit spillovers.

### **(i) General Grants**

In India, state governments are constitutionally required to appoint a State Finance Commission (SFC) every five years to determine the measures needed to improve the financial position of the municipalities, including the distribution between the state government and the municipalities of state revenues and the allocation of such proceeds between municipalities at all levels, the revenues that may be assigned to or utilized by municipalities, and the grants-in-aid to municipalities from state funds. Since the 1991 Constitutional amendment, the Central Finance Commission (CFC), which reports every five years), has also been obligated to make recommendations on measures needed to augment state funds in order for states to be able to supplement municipal resources as recommended by the respective SFC. As yet, however, the CFC has not done so, essentially because most SFC reports have not been made available on a timely basis or have been unusable, either because they were not accepted for implementation by the states or because the methodology employed was not only not uniform but also left much to be desired. As the Twelfth Finance Commission (India 2004) noted, even when the recommendations of the SFCs were accepted by the governments, they were not fully implemented in letter or spirit and the annual budgetary allocations were often well short of the recommendations. Moreover, the SFCs often did not have the expertise or time to undertake the technical exercises required to estimate the requirements of the municipalities, even if the necessary information and data existed, which was almost never the case. In short, the presumed goal of providing an objective and scientific basis for state transfers to municipalities through the device of the SFC has not been achieved. Most state transfers to municipalities are ad hoc—often based simply on past trends—inadequate, opaque, and often discretionary. After transfers, as before, urban local bodies are left with large unfunded mandates and woefully inadequate public services.

Moreover, since the CFCs have been unable to take account of the recommendations of the SFCs, they have usually simply set an essentially arbitrary and token amount for municipal grants in their recommendations. For instance, the Eleventh Finance Commission recommended a grant of Rs. 20 billion for the five-year period 2000–05 and the Twelfth Finance Commission recommended Rs. 50 billion grants to urban local bodies for 2005–10. In short, both central and state block transfers to urban local governments are wholly inadequate and bear no relationship to expenditure needs. Major revisions are needed if central-state-municipal fiscal transfers are to play a meaningful role in empowering India's cities to achieve their development potential.

## (ii) Specific Purpose Grants

Most specific purpose grants come from central government ministries. As noted above, the major specific purpose central transfer for urban local bodies is the Jawaharlal Nehru Urban Renewal Mission (JNNURM) under which grants are given to upgrade the urban infrastructure on the condition that the states and the municipalities will undertake reforms. This ambitious program, intended to augment urban infrastructure and services, is linked to a reform agenda that includes doing away with urban land ceiling act and rent control act as well as reforms in property tax. Rs. 500 billion is to be allocated from central funds during 2006–12, with matching contributions from city and state governments. Track I of JNNURM assistance is to flow to 63 identified cities to enable planned development, ensure integrated development of urban infrastructure, and ensure provision of urban services to the poor. Under Track II, assistance will be extended to other cities under two programs—Urban Infrastructure Development Schemes for Small and Medium Towns (UIDSSMT) and Integrated Housing and Slum Development Programmes (IHSDP).

Admissible components for assistance under JNNURM include urban renewal, sewerage and water supply, solid waste management, storm water drainage, urban transport, parking spaces on PPP basis, development of heritage areas, prevention and rehabilitation of soil erosion, and preservation of water bodies. Among the municipal level reforms associated with JNNURM financing are introduction of an accrual based accounting system, reform of the property tax by using GIS information, levying user charges to recover 100 per cent of operation and maintenance charges, provision of basic services to urban poor, and internal earmarking of budgets for this purpose. State-level reforms under JNNURM include enactment of public disclosure law, full implementation of the provisions of 74<sup>th</sup> Constitutional amendment including the setting up of District Planning Committees and Metropolitan Planning Committees, enactment of community participation laws, associating elected representatives with the function of city planning, repeal of the urban land ceiling act and reform of the rent control act, and rationalization of the stamp duty to bring it down to no more than 5 per cent within the next five years. In addition, optional reforms relate to revision of by-laws, simplification of legal and procedural frameworks for conversion of agricultural land for non-agricultural purposes, earmarking 20–25 per cent of developed land for economically weaker sections of the population, introduction of computerized process of registration of real properties, making water harvesting mandatory in all buildings and by-laws to introduce recycling of water, encouraging public-private partnerships, and sundry structural and administrative reforms. The grant and loan portions and the matching ratios for the centre, state, and local bodies (including parastatals and financial institutions) are shown in the following table.

<b>Financing Pattern for JNNURM</b> (Per Cent of Total Project Cost)			
Urban Infrastructure and Governance Funding Pattern	Grant		ULB/Parastatals/Loan from Financial Institutions
	Centre	State	
Cities with more than 4 million population	35	15	50
Cities with more than one million but less than 4 million population	50	20	30
Cities in North Eastern States and Jammu and Kashmir	90	10	-
Other Cities	80	10	10
Setting up desalination plants	80	10	10

JNNURM is clearly a comprehensive specific purpose scheme for urban renewal and infrastructure support intended to foster many of the reforms in urban governance and finance discussed earlier. Indeed, it is in all likelihood too comprehensive and might perhaps have been more effectively focused on a shorter and more easily attainable list of objectives. In reality, however, little has happened so far since states have proved reluctant to undertake the reforms required to access the assistance. In the first year (2005–06) of operation, only 15.6 per cent of the grants estimated in the budget were allocated. In the second year, although the estimated outlay increased to 78 per cent of budget, the total amount disbursed was still less than Rs. 36 billion. However, with the onset of the financial crisis in 2008–09, disbursements increased sharply. Unfortunately, this increase was achieved in part by diluting the reform content of the package, for example, by using the funds to purchase buses as part of the fiscal stimulus to the commercial vehicles sector. Putting more buses on already overcrowded urban streets may well increase rather than reduce congestion and other on-going urban management problems. Just as the states have been reluctant to undertake the pro-market reforms called for by JNNURM, the centre has, regrettably, proved too ready to use the funds committed for purposes other than those originally intended.

## 7. Financing Urban Infrastructure

For India's cities to play the role they should in the country's future development, considerable investment will be needed in urban infrastructure. Even if tax and user charge reforms increase the resources required for basic urban public services and maintenance expenditures as discussed in Section 5, substantial improvements in urban infrastructure will require resources well beyond the capacity of even the best run urban local bodies to generate. Major capital works in urban areas in other countries are often financed at least in part from central funds, and correctly so to the extent that some of the benefits from such works may be felt nationally as well as locally. The major effects of urban infrastructure projects, however, are clearly local and the main benefits are reaped by local residents (including local businesses as well as households) usually through

capitalization in local property values. It thus seems only right that much of the cost should be substantially borne by local residents.

Four ways to finance major capital expenditures are discussed briefly here: local borrowing; levying developmental charges in the residents; selling land and other assets; and public-private partnerships.

(i) Borrowing

When the benefits from infrastructure projects are enjoyed over a period of time, it may be both fair and efficient to finance such projects in part or whole by borrowing. Moreover, borrowing may be the only practical way to finance large capital projects without large and undesirable fluctuations in local tax rates from year to year. However, municipalities in India can contract loans only if they are permitted to do so by the state government.<sup>9</sup> In most cases, state governments have to guarantee local borrowings, in which case the loan becomes the liability of the state and is included in the overall ceiling under the respective fiscal responsibility legislations. States are reluctant to guarantee municipal bonds because their fiscal responsibility legislation requires them to limit their committed liabilities to 0.5 per cent of Gross State Domestic Product (GSDP) and their fiscal deficit at 3 per cent of GSDP.<sup>10</sup> Municipal corporations must thus issue bonds on the strength of their own credit rating rather than based on state government guarantees.

State governments permit urban local governments to borrow under their respective municipal laws, which lay down the framework for borrowing: the projects for which the borrowing is allowed, the volume of borrowing and the security to be pledged, the procedure for applying to the state for the permission to borrow, and the manner in which accounts must be kept. If local bodies borrow without state government guarantees, generally they must place some revenue stream in escrow in order to guarantee the service of the debt. In most cases, state governments only allow municipal corporations to borrow from the market based on the value of their real property tax base. Most states have issued guidelines for local borrowing, such as borrowing should be for less than 30 years, the interest rate should not exceed interest rate on government securities, and there should be sufficient provisioning for debt servicing.

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<sup>9</sup> Under Article 293 of the Constitution, even state governments have to seek the permission of the central government to borrow if they are indebted to the latter. The pattern of plan financing until 2004–05, when much plan assistance was given to the states in the form of central loans, ensured that states were indeed usually so indebted. Consequently, when states borrow from the market in effect the Union Finance Ministry, Planning Commission, and the Reserve Bank of India really determine the allocation of market borrowing to each state.

<sup>10</sup> The 3 per cent GSDP target recommended by the Twelfth Finance Commission was supposed to be reached by 2009–10. However, the Government of India raised the fiscal deficit limit to 3.5 per cent and later to 4 per cent of GSDP in 2008–09 as a part of its fiscal stimulus package, and many states revised their targets accordingly. The Twelfth Finance Commission also recommended that states should enact fiscal responsibility legislation; 28 states (with the most important exception being West Bengal) have done so.

Only recently have municipal corporations accessed funds from the capital market. By and large, most such borrowing has been from public institutions such as Housing and Urban Development Corporation (HUDCO) or Life Insurance Corporation (LIC) for housing and water supply schemes. After Credit Rating Information Services Ltd. (CRISIL) began rating municipal corporations in 1996, however, the groundwork necessary for the municipal bond market was established. Ahmedabad Municipal Corporation was the first municipal entity to issue Rs. 1 billion bond with the credit rating of “A+”. Subsequently, other credit rating agencies began to rate municipal corporations and a number of municipal corporations have issued bonds, particularly after the Ministry of Urban Development issued guidelines for tax-free municipal bonds. The critical requirement for issuance of such bonds is that the municipal corporation issuing the bonds is required to maintain a debt-service coverage ratio of at least 1.25 throughout the period.<sup>11</sup>

Despite these developments, not much has happened in the municipal bond market in India. The volume of bonds issued has been small and trading very thin. In total, only nine municipal corporations have so far issued bonds amounting to Rs. 6.2 billion, in part because few can fulfil the collateralization condition mentioned above. Although so far the amount of resources raised from the bond market by the municipal corporations is small, all bonds were issued on their own strength and not based on state government guarantee, with the exception of those issued by Bangalore Municipal Corporation and Indore Municipal Corporation. So long as there is no state bailout, as time goes on the demonstration effect may lead to still more municipal recourse to borrowing for capital finance. The regulations of the JNNURM program provide another impetus for widening and deepening the bond market: the centre and states together will provide 50 per cent of the resources required for investment in urban infrastructure as grants if the municipal corporation can generate or borrow the other 50 per cent. Further development of the municipal bond market could increase the flexibility of urban finance in the future.

#### (ii) Development Charges

One way to finance basic urban infrastructure, particularly in new areas being developed, is to levy development charges based on the land area being developed. A development charge is a one-time levy imposed on property developers (including Development Authorities) to finance growth-related capital costs for the area where the development takes place. The objective is to finance the infrastructure associated with the new development project by taxing those who are presumed to benefit directly in the form of increased property values owing to the new infrastructure.. Generally, developers recover the amount by charging the property owners based on the land area owned by them in the new development project. Who ultimately bears the cost of course depends on the demand and supply conditions for land and housing in the area. On the whole, however, in view of the relative scarcity of land and the strong demand for land and houses in urban areas in India, most development charges are probably ultimately borne by the buyers. When well designed and implemented, development charges in effect amount to a

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<sup>11</sup> Debt-service coverage ratio is defined as the ratio of net income (after meeting all obligations) to long term debt service obligations.

form of marginal cost pricing of urban infrastructure and may thus encourage more orderly and efficient development of urban agglomerations.

Such charges are feasible in newly developed areas within urban agglomerations. However, in practice in places where parallel Development Authorities exist with the mandate of creating housing infrastructure, the charges are collected by them and not by the municipal bodies. From the perspective of sensible urban finance and planning it is unfortunate that these Authorities are directly responsible to the respective state governments and not to the municipal body concerned.<sup>12</sup> Dividing up capital and operational functions and finances in this way evidently makes it more difficult to develop coherent urban policies.

### (iii) Proceeds from Sale of Land and Buildings

On the face of it, land for housing and for commercial purposes is scarce in all urban areas, given the high growth of urban population. In many urban agglomerations, as just mentioned, Development Authorities have been set up to acquire land and to develop it either for sale or to directly build affordable houses for the poor and middle-income groups.<sup>13</sup> They acquire land from the private owners, mostly agricultural land in the surrounding areas, put the basic infrastructure in place, and then sell the 'improved' land for housing or commercial building purposes. Generally, they generate considerable surpluses which could be used to improve infrastructure and services in municipal areas.

Despite the frequent complaints that land for housing and commercial purposes in most cities are scarce, there is in fact often considerable land potentially available in urban areas, much of it owned by public sector agencies such as railways and defence as well as by municipal bodies themselves. An essential first step is to make a complete inventory of land potentially available for development and sale in municipal areas. Once this is done, it may be possible to develop such lands, sell them, and use the proceeds to finance urban infrastructure. In the case of the defence sector, for example, the cantonments that were created were initially outside cities. However, as cities expanded over the years, they have come within the urban agglomeration. Cantonments run their own systems of service delivery, including schools and hospitals, and could certainly be located outside the city limits, reducing the risk to the safety of civilians at the same time. The central government, with co-operation from the state governments, should take action to relocate such establishments, with the state government or the municipal corporation paying for the cost of land acquisition and redevelopment. The relocation of defence establishments could release large chunks of land and thus help reduce skyrocketing real estate prices. The proceeds from the sale of these properties can be used for redevelopment of defence establishments outside the city, and any surplus revenue earmarked for augmenting urban infrastructure and services.

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<sup>12</sup> The Delhi Development Authority until recently was not even accountable to the Delhi State administration but was under the Union Home Ministry.

<sup>13</sup> In some instances, however, the Development Authority has ended up acting as a monopoly agency, thus restricting the supply of housing in cities and defeating its original purpose.

Much the same holds for vacant land belonging to other agencies which could also, after proper development, be disposed of and the proceeds shared between the municipal body and other owners. When the development of infrastructure by the municipality increases the capital value of such land, any gains realized through sale should be shared with the municipality. Of course, all these issues are contentious, and consensus on them will not be easy to achieve. Nonetheless, if centre and state governments can cooperate, it should certainly be possible to work out an acceptable formula for sharing the proceeds from the sale of land that would provide some needed infrastructure finance to growing cities.

#### (iv) Public-Private Partnerships

In India's complex public sector it may often be so difficult to get different components of the public sector to cooperate that a better approach may be to deal with the private sector. Indeed, public-private partnerships (PPPs) may have significant potential for financing and delivery of urban services. For example, the private sector may be asked to contribute funds for specified services in return for certain rights or future incomes. There are many services such as water supply sewerage, solid waste management, recreational facilities, rain water harvesting, and urban transportation where public-private partnerships are eminently feasible in principle.

Indeed, PPPs have a number of potential advantages in delivering urban public services. First, the urban local government does not have to spend the money up front. Second, contracting out services may result in greater efficiency as better service delivery. Empirical studies show that contracting out generally results in lowering of unit costs of services (Kitchen 2002). Chennai was the first city in India to initiate contracting out municipal solid waste management services to a foreign private agency, ONYX, a Singapore-based company. The scope of privatization includes activities such as sweeping, collection, storing, transporting of municipal solid waste, and creating public awareness in three municipal zones. ONYX collects about 1100 metric tons of waste from three zones per day and transports it to open dumps. This experiment holds a lot of promise for other municipal corporations and municipalities as well. A number of other municipalities have contracted out waste disposal and solid waste management to the private sector, including to NGOs.

Another successful example is in the provision of water supply in Hubli-Dharwar, Belgaum, and Gulbarga cities of Karnataka State. Residents of these cities used to get water supply for only one or two hours a day. However, the PPP arrangement, undertaken on a pilot basis to cover about 200,000 residents in the three cities, enabled them to enjoy the benefits of a continuous water supply with a state of the art water distribution system and at little additional cost. The private partner in this case is a French water company, Veolia Water, which was entrusted with the task of providing 100 per cent metered customer connections. The responsibility for providing adequate supply of bulk water was entrusted to the Karnataka Urban Water Supply and Drainage Board (KUWSDB). Considering the enormous success of this pilot, Karnataka government has approved

upscaling of the project to the entire population in the three cities (Ahluwalia and Nair 2010).

Mixed public-private financing of urban infrastructure definitely deserves to be further explored in the Indian context. At the same time, care must be taken to ensure that certain conditions are satisfied if this approach is to produce beneficial results (Engel et al. 2010). This approach is most likely to prove successful when projects are carefully designed and implemented, and when the responsible public agencies are technically and financially able to hold up their end of the deal. Weak governments cannot rely on private agents to overcome their weaknesses and expect to make the best possible bargains for the public they represent. Governments must also be careful that they do not end up assuming the downside risk of projects, while allowing their private partners to reap any upside gains. Similarly, care must be exerted to ensure that what occurs is not simply the replacement of public sector borrowing by (often more expensive) private sector borrowing. Privatizing the design, construction, and operation of urban infrastructure may have many merits if done properly, but it is neither a panacea nor free.

## **8. Conclusion**

Cities are the central drivers of growth the world over: they are the leading edge of economic dynamism. However, the extent to which cities fulfil this role by promoting competition, galvanising innovation, and accelerating growth depends critically on the nature, adequacy and flexibility of urban governance and finance. Adequate finance is necessary to ensure satisfactory standards of infrastructure and services, and finance needs to be flexible enough to accommodate sometimes rapid changes in circumstances. Governance systems determine not only the allocative and technical efficiency of spending but also the responsiveness and accountability with which services are actually delivered. Good policies, efficient and responsive local governance systems, and sound arrangements to finance public services are thus all critical elements in sustainable urban development. They shape the nature and quality of public services provided as well as the structure of incentives and accountability.

This paper identifies a number of reforms needed in India's urban governance and finance to ensure competitive standards of urban public services and effective governance systems that are responsive, efficient, and effective. Clearly, no one system of urban governance is likely to work equally well for all urban local bodies. The governance system adopted should vary with the size of the urban local body and the nature of the institutions in the area where that body is located. It can be particularly important from a national perspective, for instance, for the largest cities to be somewhat insulated from localized and parochial biases by being made more independent of states. Moreover, emphasis should be put on developing governance system in cities that promote cosmopolitanism and accommodative policies to promote healthy social and economic interactions.

All Indian cities now suffer from many problems: ambiguous expenditure assignment (including independent and higher-level agencies operating under different mandates), inadequate attention to critical issues of public finance management, poorly

developed institutions and mechanisms for participatory planning, and inadequate and poorly implemented resources with respect to own source revenues, intergovernmental transfers, and methods of financing needed for urban infrastructure development. Solutions to most of these problems are not hard to find in the literature, by looking at experience elsewhere, and by considering local innovative actions already seen in a few cities in India.. Such solutions range from essential reforms in the property tax system and adequate exploitation of user charges and fees for various services delivered through reformed central and state transfers to more imaginative exploitation of various possible ways to finance urban infrastructure. To achieve much success with such reforms, however, what is needed is stronger urban leadership and, especially, fundamental changes to governance structures, such as the effective use of State Finance Commissions and the implementation of many of the reforms set out in the JNNURMM program.

Such reforms in urban governance and finance are critical for improving the quality of life of the people living in urban areas and ensuring that India's cities, and especially its large metropolitan areas, realize their potential as key drivers of economic growth rather than being, too often, places whose crowded and potholed streets and lack of clean water and other amenities make development unattractive. If India's rate of economic growth is to be sustained and even increased in the face of continuing economic, political, and environmental uncertainty, much closer attention to reforming urban policies, encouraging urban initiative, and improving urban outcomes is necessary.

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