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THE URBAN LOCAL FINANCE IN INDIA: A CASE OF NEGLECT AND EXPERIMENTATION

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ABSTRACT

The Indian cities are on the threshold of demographic change, where 31 per cent of population is residing. But, the amount of importance that was needed to be given has been missing for a long time. With the introduction of the 74th Constitution (Amendment) Act, 1992, things are changing. The phase of experimentation is going on and focus is on 3Fs-Functions, Funds, Functionaries. In this paper, the areas of neglect and experimentation have been highlighted to reveal true story.

Keywords: Municipal Bond, Public –Private Partnership, Pooled Finance, Royalty, Fiscal Transfers.

The Urban Local Finance in India: A Case of Neglect and Experimentation

In the context of the Indian Constitution, local government bodies are subject of the State List and thereby governed by State Statutes, or in the case of Union Territories, by the Union Parliament. Federal recognition of local government was substantively expressed in the 74th and 73rd Amendments of the Constitution Acts 1992. The former pertains to urban local government and the latter to rural local government (Mayaraj, 2009). A municipal or local government is the layer of government that is closet to the people. The principles of fiscal equivalence and correspondence provide a strong rationale for decentralization on the grounds of efficiency and accountability. Correspondingly, the principle of subsidiarity makes the case for transfer of revenue generating powers to local governments so as to respond to their clients' needs and provide appropriate services (Sahasranaman, 2014).

The principle of fiscal equivalence states that an overlap of the benefit area and political jurisdiction ensures the optimal provision of public services. The principle of correspondence states that the jurisdiction that determines the levels of provision of a goal should precisely include the individuals who consume that good. The principle of subsidiarity states that taxing and spending should be exercised by lower levels of government unless a convincing case can be made to the contrary (ibid). The literature clearly indicates that local governments are in the best position to be able to communicate with and understand the needs of community that they represent and that they are given the responsibility to provide basic social and infrastructure services to their constituents (ibid). These Acts (73rd and 74th Constitution Amendment) lay down the provisions for the devolution of funds, functions and functionaries to ensure urban local bodies (ULBs) to perform their duties. Since there is a wide scope of functions devolved to local governments (such as urban planning, water supply, public health, fire services, and slum improvement among others), the 74th Constitution Amendment Act(74th CAA) envisioned that assuring regular and predictable funds flow to ULBs would be critical in enabling them to fulfill their mandate. Mirroring the Central Finance Commissions, it proposed the creation of State Finance Commissions every five years to decide on the grants-in-aid for ULBs. In addition, the 74th CAA and enabling State level legislations devolved a set of financing levers-taxes and fees-that could be utilized by the ULBs to generate revenues internally.

The Part IX A of Indian Constitution talks about 'The Municipalities' where Article 243P to Article 243ZG have been assigned to their provisions, duties, powers etc. Article 243Y talks about the Finance Commission which says that "Finance Commission constituted under Article 243-I shall also review the financial position of the Municipalities and make recommendations to the governor as to-

a) The principles which should govern-

i. The distribution between the State and the municipalities of the net proceeds of the taxes, duties, tolls and fees leviable by the State, which may be divided between them under this Part and the allocation between municipalities at all levels of their respective shares of such proceeds;

ii. The determination of the taxes, duties, tolls and fees which may be assigned to or appropriated by the municipalities;The grants-in-aid to the municipalities from the Consolidate Fund of the State;

b) The measures needed to improve the financial position of the municipalities;

c) Any other matter referred to the Finance Commission by the Governor in the interests of the sound finance of the Municipalities

The Governor shall cause every recommendation made by the commission under this Article together with an explanatory memorandum as to the action taken thereon to be laid before the legislature of the State.

Similarly, Article 243Z has the provisions related to the 'Audit of accounts of the Municipalities' which explains that "the Legislature of a State may, by law, make provisions with respect to maintenance of accounts by the Municipalities and the auditing of such accounts. Also Article 243 X talks about the "power to impose taxes by, and funds of Municipalities" and explains-

The Legislature of a State may, by law-

a) Authorize a Municipality to levy, collect and appropriate such taxes, duties, tolls and fees in accordance with such procedure and subject to such limits;

b) Assign to a Municipality such taxes, duties, tolls and fees levied and collected by the State government for such purposes and subject to such conditions and limits;

c) Provide for making such grants-in-aid to the Municipalities from Consolidated Fund of the State; and

d) Provide for constitution of such funds for crediting all money received respectively by or on behalf of the Municipalities and also for withdrawal of such moneys as may be specified in the law.

Further, Article 243 W (Twelfth Schedule) talks about the powers, authority, and responsibilities of Municipalities, etc. subject to the provisions of this Constitution, the Legislature of a State may, by law endow-

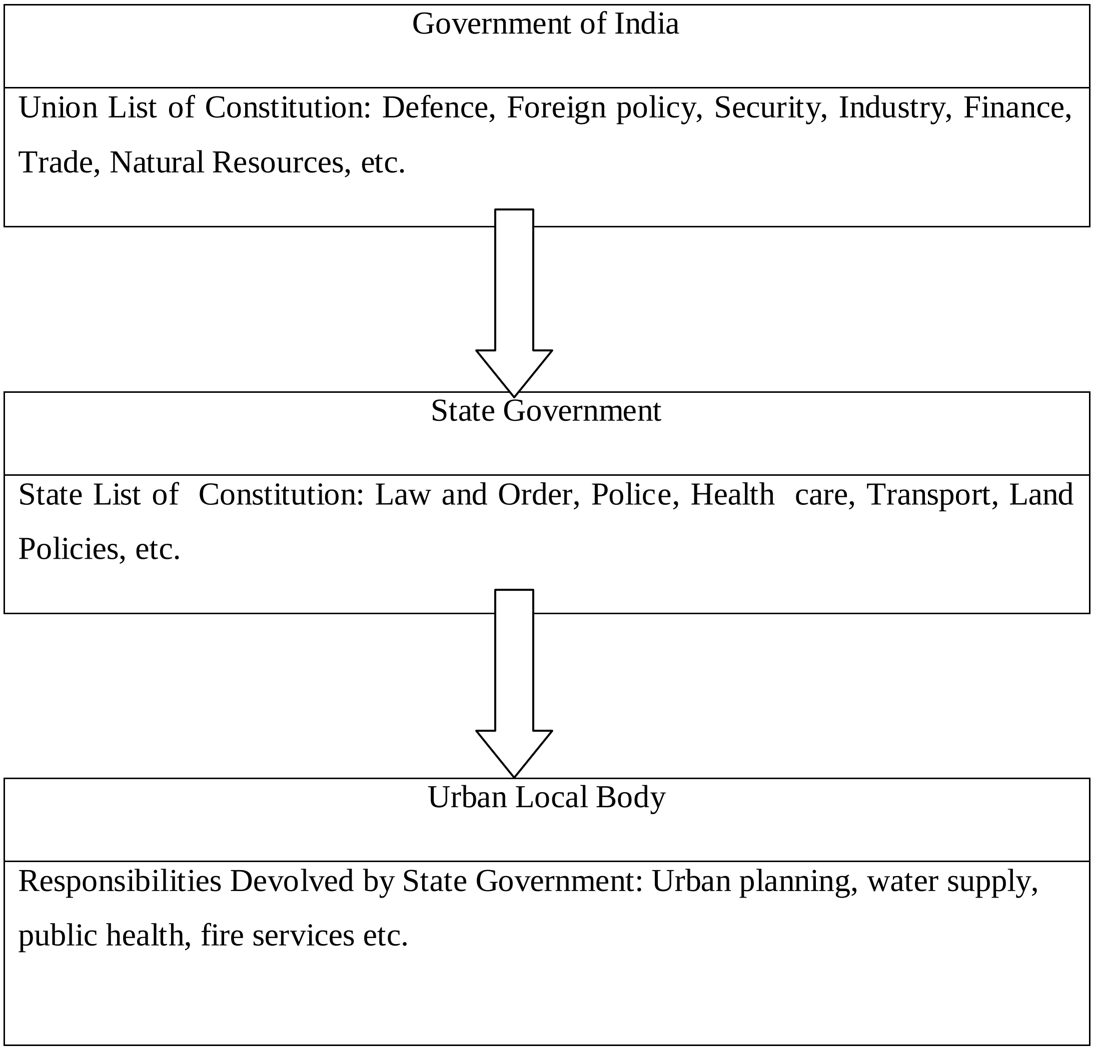
a) The Municipalities with such powers and authority as may be necessary to enable them to function as institutions of self government and such law may contain provisions for the devolution of powers and responsibilities upon Municipalities, subject to such conditions as may be specified therein, with respect to-

i. The preparation of plans for economic development and social justice;

ii. The performance of functions and the implementation of schemes as may be entrusted to them including those in relation to the matter listed in the Twelfth Schedule;

b) The committees with such powers and authority as may be necessary to enable them to carry out the responsibilities conferred upon them including those in relation to the matters listed in the Twelfth Schedule.

The Union List, State List of Constitution related to the functioning of executive powers assigned and further the responsibilities devolved by state government can be represented as below:



Source: Sahasranaman, A., IFMR Finance Foundation, www.financing cities.ifmr.co.in

The very changes and Constitutional provisions are creating a lot of debate about devolution of three Fs: Funds, Functions, and Functionaries to local urban bodies and constant thoughts and suggestions, deliberations, and recommendations, dissent and differences are erupting in the political, social, economical as well as scholarly fields related to it. The problems related to municipal budgeting, municipal auditing, municipal accounting, municipal funding/funds etc. common to more or less all municipal bodies; whereas the issue of fiscal consolidation, municipal resources, municipal accountability and fiscal decentralization are major issues to resolve and involve in for betterment of policies and performance of these bodies.

Here in this article we shall explore the resources, their status. Challenges, recommendations related to the very Municipal Self Government or ULBs in their financial arena.

Significance of Finance in Urban Local Bodies

The Significance of finance is too obvious to need any elaboration as no organization can exist, much less achieve its objectives without at least a minimum of finances. That is why Kautilya, the great Indian philosopher, remarked, "all undertakings depend upon finance, and hence foremost attention should be paid to the treasury". Every administrative act has its financial implications, either creating a charge or making a contribution to the treasury. The importance of finance is so great in administration that Lloyd George is said to have once remarked that 'government id finance'. In fact finance constitutes the backbone, the life and blood of government; it provides fuel to the administrative machinery. Sound fiscal policy is therefore of crucial importance to the government whether Central, State or Local. Imprudent financial management not only brings discredit to the government, but also alienates the people, and may endanger its very existence (Sachdeva, 2011).

The Welfare State concept, decentralized pattern of service deliveries, cutting down the layers of bureaucracies and rapid rise of urbanization and corresponding duties, responsibilities and expectations from municipal bodies that they serve is increasing. Continuous rise of functions and mounting pressure on the civic facilities and amenities and importance of these objectives must be satisfied with continuous, adequate and supplementary funds, grants, and generation and management of resources. It is regrettable that the importance of these obligations with adequate resources has never been efficiently recognized. Since Independence, this aspect has been enquired into by numerous Central and State commissions and committees but their recommendations have not been matched with adequate follow up action towards implementation. The decentralization movement of post-independence period ahs not radically adhered to financial conditions of local government and they continue to suffer from paucity of resources, and the gap between their finances and desired level of services is continuously widening (Sachdeva, 2011).

Further the Reserve Bank of India in its bulletin has rightly stressed the importance of the Local Government finances as follows: "with the increasing industrialization and urbanization under the impetus of development and planning, the local authorities form a growing part of the expanding public sector, with powers to rise and considerable amounts of public funds for development purposes. Local authorities form an important segment of public sector in India. The contribution of the local bodies to income generation and capital formation is of considerable significance in of there large number and the area and population they cover" (Goel, 2008). Municipal Financial Administration can be defined as the art and science of policy making, planning, decision making, coordination, control of the processes of securing adequate resources, ensuring their safe custody, genuine allocations among different areas of development activities, effective utilization and avoiding the pilferages and leakages of resources and duplication of efforts to ensure best services to the people living in the area of the local government. In short we can say that municipal financial administration is the technique of maximizing financial output, the optimization of financial resources and their judicious utilization.

Finance thus constitutes the lubricant for the wheels of the local government. Without it, the governmental machinery at local level will come to a standstill and the local democracy will become meaningless (Goel, 2008). That is why there is an urgent need for continuous, uninterrupted finance mechanism for ULBs to deal with crises, opportunities and availabilities exploration related to indigenous, State, Centre, International and others help, grant, devolution, such transfers, allocations, distribution and disbursements etc. of finance and funds.

Taxing Powers and Resources

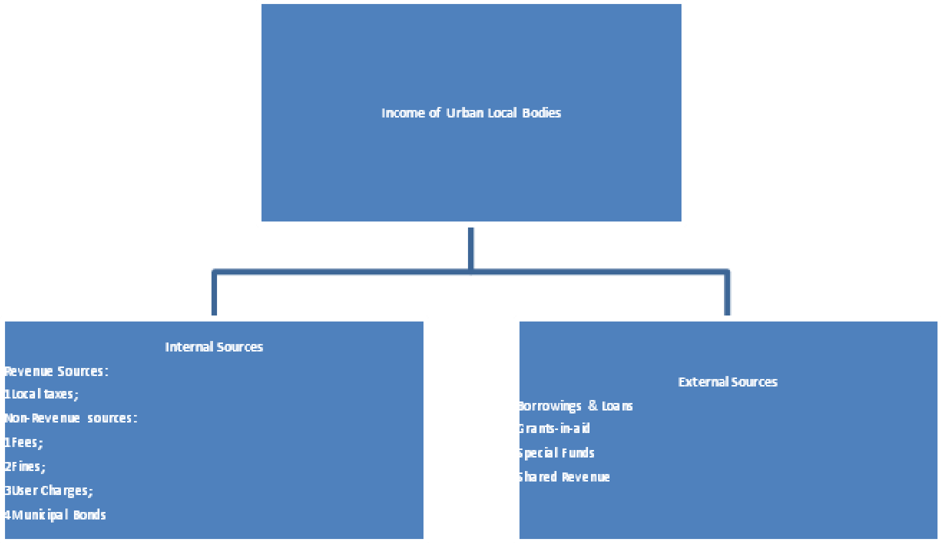
"One who maintains wide sources of taxation, collects his revenue and guards his finance by careful budgeting of expenditure that is a real ruler"-Thirukkural an explanatory translation 'sloka' 385 (Goel, 2008).

Powers of Taxation of Local Government

Local governments in India do not have the inherent power of taxation –the Constitution does not specify any taxes for their exclusive use (Sachdeva, 2011). 'The Scheduled Tax Rules' framed under the Government of India Act, 1919, contained an exclusive list of taxes to be utilized by or for the local authorities. These rules were repeated with the abolition of the distinction between provincial and local taxation in the new federal scheme embodied in the Government of India, 1935 putting every local tax into the basket of the tax resources of the provincial governments. The present Constitution of India has inherited and sanctified the same arrangement. As such, local governments are empowered to levy only such taxes as have been approved by the State Government. Consequently, they are at the mercy of the State Government in respect of their finance. A demand has been often made that they should be given separate list of taxes on the lines of Union and the State Lists, and the Constitution amended accordingly (Sachdeva, 2011).

Sources of Income of Municipal Bodies

The sources of income of Municipal bodies can be categorized into two: internal and external. Amongst the internal sources are the taxes, fees, penalties, user charges, and municipal bonds. On the other the external sources are the loans and borrowings from market, higher level of Governments (Central or State), division or sharing of resources between States and ULBs, and grants-in-aid. The local taxes constitute the most important source of income of ULBs. Amongst this property tax, octroi, toll tax, taxes on advertisement comprises the major portion. Of late municipal bonds have started to play an important role, especially in bigger Municipal Corporations. A municipal bond is an evidence of the obligation of a ULB to repay a fixed principal amount on a certain maturity date along with the interest, at a stated or formula-based rate (Dirie, 2005). Municipal bonds have advantages in terms of the size of borrowing and the maturity period which may extend up to 20 years. Apart from their own revenue sources, *i.e.*, tax and non-tax revenue sources, the Municipal Corporations (MCs) depend upon grants from State Governments. These grants are primarily intended to compensate for the mismatch of functions and finance. Most of the MCs receive financial support in the form of revenue grants from State Governments to meet current expenses. Similarly, capital grants are also provided for meeting project related expenditure (Mohanty et.al. 2007). Being a Federal country, there is a mechanism through which division of resources takes place between the Central, State and Local Governments. The Finance Commission of India and respective State Finance Commissions based on a formula focusing on population, area, backwardness, income, and poverty recommend the sharing of financial resources. The figure below depicts the current scenario of urban financing in India.



The Central Government has been providing five types of assistances to the States for the better implementation of socio-economic planning. This percolates down to local bodies, both urban as well as rural. Normal Central Assistance (NCA) is being given in the form of untied grants to overcome the problems of maintenance and other related works. Additional Central Assistance (ACA) is given to meet specific targets in agriculture, infrastructure, and social sectors. Special Central Assistance (SCA) is provided to address the needs of special sections of the population, like people living below poverty line or people living in remote areas or economically weaker sections. Central Sector Schemes are grants provided to States to execute central projects, and are entirely funded by such grants. These are intended to influence expenditure in areas that are the constitutional responsibility of the States. Centrally Sponsored Schemes are shared cost programmes that have uniform matching ratio across the States, depending upon the project (Alam, 2014).

An important emerging area of financing urban local bodies has been pooled finance. Since majority of cities and towns in India belong to the small and medium category, viability of municipal bonds is challengeable. Therefore, a group of local bodies can be created to act as a pool that would be feasible while borrowing. This creates interest in the capital market which wants to invest in long term projects. It is nothing but the idea of pooled financing that was given an impetus with the collaboration of United States Agency for International Development (USAID) and National Institute of Urban Affairs (NIUA). In order to promote such a pool, the Government of India launched The National Pooled Finance Development Scheme (NPFDS) in

2006 to provide credit enhancement to Urban Local Bodies (ULBs) to access market borrowings based on their credit worthiness through State-Level-Pooled Finance Mechanism.

In case, the ULBs cannot have means to finance works, their last resort is to borrow from the State Governments. This power has been restrained under the Local Authorities Act, 1914. There is an involvement of Reserve Bank of India (RBI) in clearance of the amount to be borrowed by the local authority. Generally, local bodies can borrow for either development works or clearing their previous debts. In times of emergencies like drought, flood, and other natural calamities defined under exceptional circumstances, the ULBs can also opt for loans. Here also the Municipal Corporations have been given the longest period for which they can raise loans. The power of raising loans is also dependent on their credit ratings where agencies like Credit Rating Information Services of India Limited (CRISIL) play an important role. But ultimately, it is the State Government that will decide the amount of loans to be raised by a local authority.

Present Status of Finance of Urban Local Bodies in India

According to the report of the Thirteenth Finance Commission of India, property tax revenues in the 36 largest cities in India are estimated at Rs. 4522 crore, yielding a per capita revenue of Rs. 486. In these cities, on an average, property tax revenues constitute 23 per cent of the total municipal revenues and 28.5 per cent of own source revenues. There are large inter-city variations in property tax revenues, with the Mumbai Municipal Corporation registering per capita annual revenue of Rs. 1334 as against Rs. 25 for the Patna Municipal Corporation. Further, The all-India collection of property tax yield blown up from the 36-city sample is estimated to be between a low of Rs. 6274 crore and a high of Rs. 9424 crore, or between 0.16 and 0.24 per cent of the country's GDP. There has been a trend of over dependence on the higher levels of government for the daily functioning of local bodies. The following reasons are the root cause of this:

Poor management of financial records

One of the cardinal requirements of the financial administration is the sound record keeping. This has been one of the weakest points of the local governments, which was highlighted by various Finance Commissions of India and their state counterparts. To quote, Fourteenth Finance Commission, "Finance Commissions since the FC-XI have sought data from States on finances of local bodies but were hampered by the lack of reliable data. Despite our concerted effort, we found that the quality of the data that was supplied to us varied across States and was not in a useable form. We were, therefore, handicapped, like the previous Finance Commissions, in using the supplied data to determine the resource gap at the level of rural and urban local bodies".(p.107,2014) Such a scenario retards the determination of principles on the basis of which devolution of financial resources might take place.

Haphazardness in the working of Finance Commission of India and State Finance Commissions

After the enactment and enforcement of 74th Constitution (Amendment) Act, 1992 the states have to constitute State Finance Commissions. Their main role is similar to that of Central Finance Commission. They have to assist the respective state governments in determination of principles for devolution of taxes and grants to the local bodies. But, one clause is creating hurdle between the Central and State Finance Commissions. As per Article 280, the Finance Commission of India has to make suggest the amount of central grants to be given to the local bodies on the basis of recommendations of respective state finance commissions. This has not been possible because of difference in their dates of constitution and timing of submission of reports. As a result of which the central grants have not been able to act as a succor for the local bodies. Their availability to a large extent is dependent on the coordinated functioning between the central and state finance commissions.

The issue of Public –Private Partnership (PPP)

Before 1990s, the common practice with regards to availability of local finance was giving grants by both, the Central and State governments. But with an increase in number of welfare schemes and responsibilities, it was not possible for the Governments of the day to provide this source of income. Even, technology and efficiency criteria that were applied for service delivery and infrastructure was inadequate and far from satisfactory. Therefore, collaborative venture between public and private was thought to be an easy and better alternative. This led to the emergence of Public-Private Partnership (PPP).

The essence of PPP could be understood in terms of 3Ds-Design, Development, and Delivery. But, "…historical experience of PPPs in developed and developing countries have been decidedly mixed. This has been attributed to a number of reasons: lack of clarity in scope and framework for PPPs, absence of rigourous contracts, weak policy and regulatory support, inadequate capacity of stakeholders, lack of strong leadership to drive projects, and unavailability of baseline data" (Sahasranaman, Kapur, 2014). A large number of urban services and infrastructure projects have been funded and managed by PPPs in India, but poor policy framework, higher risks, absence of accountability mechanism, cost escalation have prevented its success.

Inefficient Tax Administration

The survival of a government is dependent on efficient tax administration that is based on the sound principles of levying, assessment, collection, and utilization. There is great discrepancy in local tax administration. The power to levy and assess the taxes lies with the state governments and the responsibility to collect is with the local bodies. Further, even its utilization is dependent to a great extent on the higher level of government. This has been followed due to the dichotomous approach whereby, the local interests which give way to parochialism have to eliminated the power to levy, assess and utilize taxes should be with state governments.

A large number of taxes like entertainment, advertisement, boat, and the like though of local nature have not been devolved upon in majority of states in India. The collection of taxes is also filled with issues of pilferage, discretion, and exemption. It is the state government that decided who can be exempted or given discounts in case of certain local taxes. The officials are not able to use the latest technology like Geographic Information System (GIS) in assessment of property tax that affects the incomes of municipalities. The State Finance Commissions reports have been suggesting for imposition of new taxes and devolution of taxes after pooling, but states have not given heed to such advice.

Non-Tax Revenue and capacity of Urban Local Bodies

Apart from the taxable sources of income, there are user charges and royalty for mining rights that act as a valuable source of income for the ULBs. In case of water charges there is again a dichotomous approach that has been followed in most of the states. In Uttar Pradesh there is a para-statal agency-Jal Nigam that decides the policy decision regards water charges and water metering. Another body, Jal Sansthan, which is under the authority of Municipal Corporation deals with supply aspect and collection of dues. A large number of local areas do not have piped water facility and collection process by officials is full of faults.

In some cities mining of natural resources takes place, the royalty of which is taken away either by the Central or State governments. The Fourteenth Finance Commission was of the view that since the local environment gets affected, further local manpower and infrastructure is used, the local bodies can be given a portion of royalty. This can be an important source of income and given as such to both rural as well as urban local bodies.

Discretionary nature of Fiscal transfers

The governments in a federation have to perform functions mentioned in a written Constitution. There can be a situation where the financial position of the higher level governments is better in comparison to local. This might result in vertical imbalance and affect the finance of local bodies. Similarly, the financial strength of local bodies themselves might vary due to the internal and external conditions. Thus, horizontal imbalances can affect the nature of services rendered. In order to avoid this and to lessen the burden of the Central Finance Commission, the 74th Constitution (Amendment) Act, 1992 set up the State Finance Commissions. Though a large portion of devolution is to take place through this mechanism, but a large number of Central and State Governments schemes have emerged as a parallel source that skips the purview of the commissions.

Such a discretionary transfer of resources affects the sanctity of the State Finance Commissions. The promotion of tied or special grants results in the curtailment of financial powers of the local bodies. The State Finance Commissions have been criticized for following the practice of gap-filling approach instead of calling for devolution of financial resources.

The situation which was worse in the beginning of 1990s has been addressed to large extent but drastic reformation is yet to be accomplished. The distinction between planned and non-planned expenditure has to be done away with so that the State Finance Commission based transfers are given priority. In case the transfers of finance have to be done through concerned Ministry, the former should be taken into confidence. There is a need to focus on public-private collaboration in both debt as well equity areas with well laid out policy framework that promotes a feeling of trust between the two service providers. The State must also be ready to give the Constitutional recognition to ULBs by giving in detail the activity mapping of 3Fs-Functions, Funds, and Functionaries. The local bodies should also assert themselves by coming together to protect, conserve, and preserve their cause through an all India association. Initiatives like municipal bonds, pooled finance should be rewarded and promoted by State governments to maintain the financial autonomy of ULBs.

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