Sustainable Financing for Indian Cities

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Municipal finances in India are characterised by the constant tension between the funds and functions of local governments. Cities in India have insufficient revenue tools to meet their expenditure requirements. While the 74th Constitutional Amendment Act (CAA) devolved a great deal of functional autonomy to local governments, a commensurate devolution of financial autonomy was absent. Out of the 18 functions to be performed by municipal bodies under the 74th CAA, less than half have a corresponding financing source. Furthermore, most local governments cannot set tax rates or change the bases of collection without the explicit concurrence of state governments. The high degree of influence that state governments wield in circumscribing the financial autonomy of local governments is evident from the fact that some state governments have, at times, abolished important sources of own revenue for municipalities without providing adequate substitute sources of revenue - as when Rajasthan and Haryana abolished the property tax without consulting urban local governments, or when Punjab, again with no consultation, raised the threshold for the property tax so high that almost two-thirds of the properties were exempt from taxation. However, not all problems of municipal financing in India are attributable to the upper tiers of governments. Local governments have failed to utilize adequately even those tax and fee powers that they have been vested with, in particular by failing to put forth an adequate collection effort. For instance, the Thirteenth Finance Commission (13th FC) estimated that the collection efficiency for property taxes for India stood at 37%, an abysmally low number. The very low levels of own revenue generation in Indian cities have precluded them from providing even the most basic public services to their citizens. For instance, 40% of Hyderabad's population lack access to direct water supply connections, and 50% of households in Bangalore do not have sewerage connections. While the thrust of urban policy in India has been on the metropolitan centres, the current state of public infrastructure and service delivery in India's small and medium cities is, if anything, even more alarming than that in the larger ones. For instance, in the small city of Srirangapatna in Karnataka, we find that close to 39% have no access to garbage collection services, and the road network backlog is close to 51%[1].

The central question that therefore confronts us, in the context of cities both big and small, is this: How can cities sustainably finance the development of public infrastructure to ensure service delivery that conforms to the laid-out benchmarks for all citizens in the next fifteen years?

Sources of Financing for Cities

There are two sources of municipal revenue, namely municipal own revenues and assigned or devolved revenues. Municipal own revenues are revenues generated by municipalities through taxes and fees levied by them, such as property taxes and water charges. Assigned revenues are those revenues assigned to local governments by higher tiers of government, such as the State Finance Commission recommended funding assignments. Local governments can also get funding for the execution of programmes situated at the central or state level such as the National Rural Employment Guarantee Scheme (NREGA) or state level housing schemes.

India's current urban infrastructure investment mandate encompasses two distinct requirements: one, to ensure that the current backlogs in infrastructure provision and service delivery are met sufficiently in the next fifteen years, and two, to meet all additional infrastructure requirements on account of growth in population and economic activity over this time. The Report on Indian Urban Infrastructure and Services (2011) estimates that Indian cities need to invest Rs. 40 lakh crore (at 2009-10 prices) on urban infrastructure over the 20-year period from 2012 to 2031. Bankrolling cities through grants and programs like the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) exerts considerable fiscal burden on upper tiers of governments. Considering the scale of investment that is required and the fiscal situation of both the central and state governments, this overwhelming fiscal dependence that local governments have developed on state and central governments is unsustainable.

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[1] Based on cadastral data collection by authors

In this scenario, Indian cities will necessarily need to generate higher levels of own revenue through local taxes and fees, and supplement this with borrowing from the capital market.

a. Internal Revenue Generation

Any discussion of the financing options available to a municipality will have to begin with an understanding of the finances that it generates internally. This is because, at a fundamental level, the internal revenue generation of a municipality is a reflection of the quality of its governance, and the transparency and accountability of its administration. An assessment of the internal financing capability of a municipality is, therefore, a judgement on its governance standards. A better governed municipality implies better information availability, better assessment capability and better collection efficiencies that are then reflected in the quantum of revenues generated through internal funding levers.

The Twelfth Finance Commission indicates that total revenue of the Indian municipal sector in 2001-02 was merely 0.67% of GDP, of which municipalities' own revenues constituted only 0.38%. Not only are these small numbers by normative standards, they are well below that of other emerging economies like Brazil which, for example, has municipal revenues at 7.4% of GDP and own revenues at 2.6% of GDP. Furthermore, there is a worrying trend of the declining ratio of own revenue to cities' total revenue from 63.5% in 2002-03 to 52.9% in 2007-08.

Property Taxes:

Property taxes are the most important individual revenue source for municipalities. The Thirteenth Finance Commission estimates that property taxes collected constitute between 0.16% and 0.24% of the GDP. The issues they highlight include poor assessment rate of properties at 56%, poor collection efficiency at 37% and more fundamentally, the property valuation methodologies used.

A good property tax system is predicated on five pillars- identification, inventory management, assessment, collection, and enforcement mechanisms. The implementation of Geographical Information Systems (GIS) to map all the properties in a city can have a huge impact on the assessment rate of properties as it provides the municipal administration a visual, spatial tool pinpointing the location of properties that are not in the tax net. GIS implementation by cities in India has been slow to take off, but cities such as Ahmedabad, Bangalore and Hyderabad have GIS maps now that are beginning to be used for property tax assessment. In fact, the Thirteenth Finance Commission also estimates that if all-India property assessment rates and collection efficiencies were both at 85%, the revenues generated by property taxes would be 0.68% of GDP, three to four times their current levels.

As far as assessment methodology is concerned, there has been some progress in reforming the system in recent years with the advent of JNNURM, requiring reform of rent control laws. Therefore, some states have amended their rent control acts and redesigned their property tax regimes to a quasi-market based Area Based system, which bases the value of the property on the location and usage characteristics of the property, away from the older Rental Value based mechanisms. It is essential that all cities in India are incentivised to move towards such Area-based systems, and ultimately towards a Capital Value based system, so that increments in land value can be better captured. This can make the property tax a buoyant source of revenue. The Thirteenth Finance Commission indicates that property taxes in OECD countries are at around 2% of GDP, while those in developing and transitional economies are at 0.65%. India, with property taxes at 0.20% of GDP, has to move towards these benchmarks. Even at 0.50% GDP, the property tax collection in India would be at a very substantial Rs 20,000 crore as compared to the Rs. 8,000 crores currently. At OECD levels, this amount could approach Rs 1 lakh crore.

Another important aspect of the property tax regime in India is that property rates are, to a large extent, set by the state government and not the city. This is not in keeping with the principle of decentralization and effectively takes out the prime funding lever available to a municipality. Without property taxes, a ULB is essentially left with a heavy load of responsibilities to fulfil without any significant funding lever. In this context, it is instructive to look at the property tax regimes in similar developing countries such as South Africa that have mandated that the Capital Value System be used to value properties in all municipalities, and have also specified that all properties be valued every 5 years. This clear centrally mandated legislation has helped ensure that property tax rates and collections are controlled by cities, but within reasonable limits in order to prevent distortionary rates.

User Charges:
A second major funding handle available to municipalities is that of user charges for public services such as water supply, sewerage and garbage disposal. These are goods that have a private characteristic, in that the benefits of these services can be said to be 'private' at the level of the household. Since there are no public 'spill-over' effects to contend with, levying user charges on these services is eminently feasible. However, revenues generated from user charges are abysmally low in India, as evidenced by the statistic that non-tax revenues from all ULBs amounted to 0.13% of the GDP. In the absence of a user charge regime, cities are severely handicapped in their ability to provide even the basic minimum services.

For sustainable delivery of a basic minimum quality of a service, it is essential to charge user levies that cover for the on-going Operating & Maintenance (O&M) costs. Despite the fact that this has received considerable focus under the JNNURM, less than 10 cities have achieved full cost recovery for water supply and sewerage services, while less than five cities have achieved full cost recovery in solid waste services. It is pertinent to add here that, in most cases, cities have to get the approval of state governments for levying user charges and this hampers their ability to set user fee rates that they consider appropriate. Like in the case of property taxes, the power to levy charges must be in the hands of the city to incentivise improved service provision.

Periodic revisions in user charges are also required in order to recover the expenses incurred in service provision. But increase in user charges must also be accompanied by perceptible improvements in service delivery, in order to ensure that the fee increase is palatable to the paying public. Experiences in India and around the world have demonstrated that households are willing to pay for the availability of reliable and continuous services. Cities should be able to charge appropriate user levies and ensure that any cross-subsidisation be planned in such a manner that the overall O&M cost is recovered, even if equity considerations require that different segments of the population are charged differently.

Unless cities are able to generate much higher levels of revenue through property taxes and user charges, it is difficult to see how the mandate for higher quality public service delivery in India can be achieved. For instance, if Indian cities managed to attain the internal revenue generation benchmarks established in comparator countries like Brazil, internal revenues generated would be seven times the amount today. Such an increase in the own revenues base would also mean that the relationship between own revenues and assigned/devolved revenues can be fundamentally altered by an order of magnitude: from a ratio of 1.3 currently to potentially 9 or 10. This, in many ways, represents the immense potential for growth of own source revenue in Indian cities.

b. Leveraging Markets for Financing
Once the own revenue levers of a city are in working order, it opens up the possibility of raising funding from debt capital markets. Internal revenue sources like the property tax and user charges are the most critical funding levers available to a municipality because without effective, predictable generation of internal revenues, it will be a tremendous challenge to attract new, external sources of funding. External sources, whether in the form of bank loans, bonds or other capital market instruments, will be available to municipalities only on the basis of the internal revenues they generate now and are expected to generate in the future. This is because, any debt is just an upfront source of funds which is predicated on predictable, regular repayments from revenue that the municipality is reasonably expected to generate in the future and therefore, cannot be thought of as an additional source of funding. Debt therefore provides for maturity transformation, enabling longer term planning by cities. A municipality will need to demonstrate that it is capable of generating this stable stock of funds on an on-going basis before it can expect to attract external debt.

Therefore, the internal sources of funding of a municipality need to be in healthier order prior to contemplating leverage by external, commercial debt.

It is important to realise that there is nothing inherently desirable about accessing capital markets for funds; if the central or state governments were able to guarantee low cost funding for all of a city's needs then naturally that would be the most attractive option for the city. However, given the reality of fiscal constraints on the centre and the states, and the magnitude of financing required for cities, raising funding from the capital market becomes imperative.

Municipal Bonds:

The idea of municipal bonds is not new to India. The 1998 bond issue by the Ahmedabad Municipal Corporation to finance water supply infrastructure marked the beginning of municipal bond market development in India. Subsequently, municipal bonds have been issued by Hyderabad, Chennai, Nagpur, Indore, Madurai, Ludhiana and Vishakapatnam, among others. The introduction of tax-free municipal bonds in 2000 led to a slew of tax-free bond issues; more than Rs. 900 crore of tax-free municipal bonds were issued. The municipal bond market seemed poised for a substantial increase in issuance volumes, but this has not materialised and part of the reason for this could be attributed to the JNNURM. Out of the overall sanctioned investment of Rs. 1.15 lakh crore under JNNURM, about 53% came in the form of assistance from the Central Government, which while undoubtedly demonstrating increased investment in urban infrastructure, also illustrated the disincentive for cities to attract funding from the market. This rightly sparked concerns regarding the 'crowding out' of commercial funds by government money, as evidenced by lower levels of municipal bond issuances after the advent of the JNNURM. Programs such as JNNURM or the newly proposed 100 smart cities project need to explicitly require that grant funds be leveraged with debt from the capital markets, thus ensuring that scarce government resources are spread across many more critical public projects than would be possible if each project were to be financed completely or substantially using these grants.

The municipal bond market has also seen some very valuable innovation in the form of the pooled bond mechanism to enable small and medium sized cities that lack the requisite creditworthiness and expertise to access the capital market on their own. Pooled Financing enables a number of cities to come together and borrow under one umbrella and avail the benefits of economies of scale and credit enhancement, thereby allowing them access to the capital markets at a lower cost than if they had each attempted to access the markets on their own. Pooled financing, as a concept, has been proved with successful bond issues in Tamil Nadu and Karnataka. This concept has tremendous benefits in terms of helping smaller cities build capacities, improve the quality of their processes and systems, and become stronger, more creditworthy entities. State Pooled Financing Entities (SPFEs) have been set up in a number of states to promote Pooled Finance issues, but most SPFEs are yet to be operationalized. There needs to be a greater thrust in ensuring that this market is active, and smaller municipalities have the opportunity to access the debt capital markets.

There is also once piece of critical market infrastructure that is currently missing in the Indian context: a market making institution that provides guarantees and credit enhancements for municipal debt issuances. This institution could catalyse activity in the municipal bond market by adopting strategies such as: (i) providing guarantees on municipal debt to entice commercial banks to lend to municipalities, (ii) investing in lower rated tranches of municipal bond issuances, thereby incentivising private investors to invest in the higher rated portions of the capital structure, (iii) underwriting specific pooled bond issues and (iv) providing subordinate debt to a pool of projects raising bond finance. In South Africa, for instance, the Development Bank of South Africa (DBSA) plays this market making role using instruments such as credit guarantees. In the Indian context, an institution like HUDCO could become a market maker by reorienting its focus away from being a subsidised lender to large power and gas projects and closer to its original mandate of financing urban infrastructure. HUDCO can thus, one the one hand, expose municipalities' true creditworthiness to the market, providing for transparency and incentivising municipalities to address their governance and service delivery issues and on the other hand, help attract commercial funds into investing in credit enhanced municipal debt as well as allowing lower rated municipalities to access the debt market.

In conclusion, the failure to sustainably finance the provision of basic levels of infrastructure and service delivery in our cities will significantly hamper the nation's ability to reap the benefits of urbanisation and economic growth. Indian cities will, therefore, need to increasingly generate higher levels of own source revenue and efficiently use market based financing mechanisms to ensure minimum levels of service delivery.