

Financing Urban Services: Principles and Practices

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Financing Urban Services: Principles and Practices

- Introduction.
- What do we learn from fiscal federalism theories?
- Urban Governance Systems: Different Models.
- Expenditure assignment and financial management in urban local bodies.
- Financing Urban services: Own revenues.
- Financing urban services: Intergovernmental transfers.
- Financing Infrastructure spending.
- Concluding Remarks

Introduction

- Three important reasons for focusing on urban finance:
 - Innovation is the key to prosperity and most innovations occur in large cities due to interaction and exchange of ideas. Cities provide a critical mass to support high degree of division of labour, knowledge, business services, infrastructure, institutions and media.
 - Globally competitive cities should provide a wide range of services to attract human capital: transportation, water, sewers garbage collection and disposal, police, fire protection, parks, recreation and culture, affordable housing and social assistance.
 - All these require significant resources: Raising resources to finance these urban services holds the key to making urban centres a leading edge of economic dynamism.
- There are 139 municipal corporations, 1595 municipalities and 2108 Nagar panchayats. 3 of the 10 largest metropolises are in India (Mumbai, Delhi and Kolkata). Over 330 million people are spread over 5100 cities and towns. Contributes over two-thirds of GDP.
- Demand for services is large and growing. Resources inadequate; Actual spending (1999-2004) in 30 large cities was just about 24% of the requirements. Under-spending was over 75% in 17 municipal corporations. Under spending was over 50% in all except three. Investment requirements - 39 lakh crore at 2009-10 prices.

What do we learn from theories of fiscal federalism?

- ❑ ~~Clarity in assignments; assignments according to comparative advantage.~~
- ❑ Systems and institutions to effectively deal with overlapping assignments.
- ❑ Assigning responsibilities to different functionaries – Need to make the elected executive responsible for decision making.
- ❑ Finances should follow functions. “Wicksellian link” - Local governments should have productive tax handles.
- ❑ Accountability requires that local services should be paid for locally and services with spillovers should receive matching transfers.
- ❑ Intergovernmental transfers are inevitable even as they soften the budget constraint. Need to design them properly to avoid perverse incentives.
- ❑ Ensuring a common market is at the heart of creating dynamism in fiscal federalism. Removal of impediments to mobility in factors and products and impediments to internal trade; Efficient factor (land, labour and capital) and product markets including credit and debt markets, institutional factors.
- ❑ Hard budget constraint is critical for efficiency and accountability; This requires clarity in assignments, avoidance of bail outs, avoidance of transfer dependency; development of markets; transparency in decision making.

Principles of Local Finance

- ❑ ~~Linking revenue=expenditure decisions require~~ assignment of independent revenue sources.
- ❑ Local taxes should satisfy the criteria of:
 - Sufficiently productive and buoyant;
 - Put the burden on the beneficiaries.
 - Least distorting: Should mainly tax immobile bases. Should not create impediments for the smooth flow of commodities and people.
 - Visible for accountability.

Municipal Revenues in India

- ❑ Reliable data are not available.
- ❑ Poor revenue collections: 12th FC (2001-02): Total revenue: 0.67% GDP; Own revenue: 0.38% GDP.
- ❑ (Brazil – Revenue 7.4%; Own revenue – 2.6%.)
- ❑ No separate tax schedule.
- ❑ Not surprising that there is large dependence on states and public service delivery is abysmal.
- ❑ Limited autonomy for local governments.

User Charges and Fees

- User charges should be levied on ‘private’ and quasi-public services provided.
- Important for accountability.



- User charges negligible. Less than 10 per cent of the cost of services. Reluctance to charge fees.
- Very little information available.



Local Taxation

- ❑ Tax on land and buildings.
- ❑ Entry tax/octroi.
- ❑ Taxes on entertainment, gambling etc.;
- ❑ Advertisement tax
- ❑ Tax on non-motorised vehicles.
- ❑ Taxes on animals;
- ❑ Tolls;
- ❑ Profession tax/ Payroll tax.

Reforming Municipal Revenue Systems

- Residential Property Tax:
 - ~~Appropriate because (i) real property is immovable and (ii) there is a link between services provided and value of property.~~
 - Base - Capital value or rental value? Presumptive tax; Problem of administration – periodic valuation of properties; Patna model.
 - Most property tax system are antiquated. Reforms on the lines of BBMP could triple the revenues. 13th FC has taken this as one of the performance indicators for the grant.
- Income tax piggybacking - Particularly useful in large metropolitan areas; Long term reform agenda.
- Payroll taxes: Important in Mexico and South Africa – Piggybacking income tax is preferable.
- Vehicle and fuel taxes; preferable at regional level.
- GST: Piggybacking is ideal but in India, states should levy an additional one/two per cent.
- Business taxes – distortionary; can be applied in a limited manner.

Intergovernmental Transfers

- Own revenues are insufficient to finance local public services.
- Unconditional grants: Given to enable adequate level of services at reasonable tax rates – based on capacities and needs. Most countries do not have such equalization grants.
- Specific purpose grants are given to finance the portion of local public service spilling over the boundaries.
- In India, the system varies from place to place. They are neither rational not adequate.
- Functioning of State Finance Commissions leaves much to be desired. Central finance commissions have largely confined themselves to giving lip service.
- Central finance Commission grants: 12th FC gave Rs. 4500 Crore during 2005-10 (of which Rs. 475.46 was not drawn). (Grants to augment water supply required covering 50% of maintenance through user charges).
- 13th FC: Giving a share in central taxes of the previous year varying from 1.5% to 2.5% .
 - Basic Grant: 1.5% every year- Exclude special areas (Rs. 20 per capita) - all states eligible. (population – 50%; area – 10%; Distance – 20%; Index of devolution – 15%; Sc/St pop – 5%)
 - Performance grant effective 2011-12 - 0.5% to 1% if they fulfil 9 conditions
- Specific Purpose Transfers: JNNURM and UIDSSMT.

Financing Infrastructure

- JNNURM: Important source of financing infrastructure.
- Services with nation-wide externalities should be financed from the Centre. Prevention of pollution to river water systems from the untreated sewerage discharge from municipal bodies on the banks of rivers.
- Borrowing
 - Is a good way to finance infrastructure. However, municipal bond markets have hardly developed in most developing countries. Even where it is developed, State government guarantees may be needed.
 - Latin American countries have faced difficulties with imprudent borrowing. In the long run, it is necessary to loosen the restrictions on the, institute checks and balances and subject the municipalities to market discipline.
 - Larger municipalities should be allowed to access markets with sufficient safeguards.
- Development Charges
 - Development charges collected by the developers. “Growth should pay for itself”; can act as marginal cost pricing.
 - What about renewal?
- Proceeds from the sale of land and housing

Financing Infrastructure

- Public Private partnerships.
 - Advantages: No upfront spending by municipal bodies; greater efficient and implementation capacity (lower unit costs);
- Models:
 - Private sector invests and collects charges on it over a specified time span.
 - Both make investments and acquire rights for future income streams.
- Examples in India:
 - Municipal solid waste management in Chennai – ONYX.
 - Water supply in Hubli – Dharwar, Gulbarga and Belgaum by “Veolia Water”.

Information System

- Major constraint in both design and reform of local revenue systems.

- Finance Commission: 11th, 12th and 13th: Data furnished by the states as well as the SFC reports failed to provide a sound basis of estimation of required augmentation of the consolidated funds. 12th FC urged the states to build data bases:
- 13th FC: budget supplement on transfers;
- Need to have up to date information on:
 - Land, buildings, geography and ecology and land use pattern - GIS; Demographic profile of population; Socio-economic information.
 - Fiscal information.

Concluding Remarks

- ❑ The issue of urban finance is of paramount importance; They determine how the cities can accelerate the growth process as growth engines.
- ❑ The issues will differ depending on different sizes of ULBs, different regions of the country. What is important is that broad principles should be kept in view in the reform efforts.
- ❑ Need for clarity in tax assignment to local bodies
- ❑ Improving the finances of urban local bodies requires building urban infrastructure as well as augmenting services. This calls for creating a systematic information flow.
- ❑ Need to insulate the urban agglomerations from state populism.
- ❑ Need to insulate the local governments from interference by State/central MLAs and MPs.
- ❑ Put the information system in place. Designing and reforming the tax system requires a strong information system.