UNIT 1 FISCAL DECENTRALISATION- A GLOBAL OVERVIEW

Structure

1.1 INTRODUCTION

Financial responsibility is a core component of decentralisation. If local governments and private organisations are to carry out decentralised functions effectively, they must have an adequate level of revenues –either raised locally or transferred from the Central Government– as well as the authority to make decisions about expenditures. Fiscal decentralisation can take many forms, including:

a) Self-financing or cost recovery through user charges;

b) Co-financing or co-production arrangements through which the users participate in providing services and infrastructure through monetary or labour contributions;

c) Expansion of local revenues through property or sales taxes, or indirect charges;

d) Intergovernmental transfers that shift general revenues from taxes collected by the central government to local governments for general or specific uses; and

e) Authorisation of municipal borrowing and the mobilisation of either national or local government resources through loan guarantees.

In many developing countries, local governments or administrative units possess the legal authority to impose taxes, but the tax base is so weak and the dependence on central government subsidies so ingrained that no attempt is made to exercise that authority.

Developing and transition countries with population over five millions have adopted some form of transfer of fiscal level from Central to Sub-national government (local government). Even highly centralised countries like Kingdoms of Jordan and Morocco have also inherited fiscal decentralisation. As Robert D Ebel opined, the issues that each decentralising country faces are at the same time very different and very similar. The differences arise from the diversity in national economic and demographic structure, institutions, traditions, geography and access to new technologies. As for instance, while designing local property tax systems, Middle Eastern policymakers often take into consideration a complex combination of national, colonial and local tribal law. But the concept of markets as a basis for land valuation is relatively straightforward. In contrast, in (some) countries property rights are well organised, however, the market concept is yet to be sufficiently accepted so that it can serve as a guide for wide spread adoption of *add valorem* taxation. When we look into the world wide fiscal decentralisation, differences and similarities are there. But similarities provide broad policy framework and also it will address the policy options of different countries which will help us to learn from each others experiences. The structural adjustments and the world wide open economy is the basis for policy similarities all over the world. Due to the opening of market economy, the sub national governments (municipalities) cannot restrict the movements of goods and services as well as it cannot control the labour and capital. So, this situation changes the fiscal policy of sub national government.

In this Unit, we will learn about different countries (both developing and developed countries) experience of fiscal decentralisation as case analysis.

After studying this Unit you should be able to:

- Describe the need for fiscal decentralisation;
- Explain the different models of decentralisation with suitable examples; and
- Analyse the cases of fiscal decentralisation in developed, developing and transition countries

1.2 FISCAL DECENTRALISATION: EXIGENCIES AND DIMENSIONS

1.2.1 Exigencies of Fiscal Decentralisation

In the entire world, fiscal decentralisation is associated with issues ranging from the broad issues of achieving a desired degree of both vertical and horizontal balance, to more narrow (but not less important) concerns of expenditure impacts of unfunded mandates imposed by "higher levels of government" and economic and political restrictions, and on the choice of local revenue sources. In this regard, it should be noted that western countries that have relatively long traditions of fiscal decentralisation have much to gain from fiscal decentralisation debate- and research – that is newly emerging in the transition economy (Hegebus and Tosics, Peteric). Apart from this reason the following reasons have also likely to be contributed:

- The reactions from the below to long years of extensive central control.
- The fiscal expediency, where the central governments to ease their own strained finances by reducing transfers and shifting responsibilities down often with little or more regard to the ability of sub national government to pay for their new responsibilities.

With the following assumption the fiscal decentralization has emerged:

- The establishment of performing inter governmental system will execute the economic reforms adopted by the national government.
- To strengthen the economic reforms at the local level, developing and strengthening autonomous local governments is essential and rationalizing the inter-governmental fiscal relationship is also essential.

- The fiscal reform will bring comprehensive changes thus bringing reforms is not difficult politically.

1.2.2 Dimensions of Fiscal Decentralisation

There are three basic dimensions for fiscal decentralization.

i) Devolution

ii) De-concentration

iii) Delegation

i) Devolution

Independently established sub national governments are given the responsibility for delivery of public services. The authority will impose fees and taxes for those services. The sub national governments have flexibility to select the services to provide to their citizens. The sub national governments will get some types of financial support from the national government. The example of this model is given in Box 1.1.

Box 1.1: Water Supply in Hungary

In Hungary, the law on Local Municipalities Act No.33 of 1990 made the drinking water supply as the obligatory duty of the municipalities. The law authorised municipalities to establish municipality institutions or companies to operate public utility services. The managers of these companies were also assigned by the municipalities. Furthermore, the law declares that the public utilities belong to the basic property of the municipalities. The municipalities had to create a new structure of public utility water service in accordance with the changed conditions. The most visible change in the Hungarian public utility water service was the fragmentation of the service provider companies and their numbers increased from 28-350. The mechanism of the specification of water and sewage fees also changed fundamentally. The representative body of the municipalities become the price authority of the municipality owned water works companies.

Reference: MRI, Budapest, 1999 and Inter Governmental Fiscal Relations and Local financial Management, Distance learning module, Central European University, Summer University Programme.

ii) De-concentration

De-concentration is the establishment of Central Government offices at the regional level with some autonomy in decision making, but the centre should approve all deviations from normal practice. You will learn the above definition by applying the following country example from Poland as given in Box 1.2.

Box 1.2: Polish Decentralisation in the 1980s

In the 1980s Poland was divided into 49 Voivodships, and, at the local level 2365 Gminy. The imposition of Martial Law in December 1981 (in effect until July 1983) shifted the balance of power between central and local administrative branches. By the end of 1980s Voivodships had achieved a considerable independence from the central government, with central intervention circumscribed by constraints on information to access political activities. Voivodships were responsible for numerous public services, including health, welfare and transportation, while Gminy were mainly responsible for local services, including garbage collection and public housing maintenance. Although the Gminy had some autonomy, it was not clearly delineated or guaranteed. De-concentration reforms, though accompanied by some devolution of power, essentially transferred authority within an integrated administrative system. Lower administrative levels remained subject to central control.

Bird-Ebel-Wallich: Decentralisation of the Socialist State, World Bank 1995

iii) Delegation

Delegation is an intermediary between devolution and de-concentration. In this, sub national governments are given responsibility to deliver certain services but the Central Government will supervise and provide some forms of finance. All these types may fit in between centralisation and decentralisation. But federalism is different in which public sector decisions can be taken at various levels of government. But in unitary system sub national government act as an administrative unit of national government. You can understand this concept by reading the case study given in Box 1.3.

Box 1.3: Social Services in Estonia

In Estonia the health care regulation law leaves only special medical services to be handled at state level, which means that providing health care should basically be the task of local authorities, and most of the hospitals should be placed under state government administration. Considering the small size of Estonia's local authorities, the individual authorities should form hospital alliances (in most cases one for each county) for the administration of hospitals, through which the communal, construction and remodelling expenses could be financed. Treatment expenses will be covered through the system of health insurance. In practice, the Ministry of Social Welfare has financed the communal and remodelling expenses for all hospitals, up until now.

A similar problem exists with nursing homes, which are financed primarily by the Ministry of Social Welfare, even though, according to law, nursing homes, as a rule, should be in the possession of local governments and financed out of local budgets.

Source: http://www.ceec-logon.net

1.3 MUNICIPAL FINANCE

To strengthen the fiscal domain of municipalities there are different ways. Municipal development funds and intermediaries is one such. The municipal development fund is defined as a pool of money operated at a level above the individual local government primarily for investment in infrastructure. Municipal development intermediaries are the institutions which manages the municipal development fund such as banks or government agencies.

At the global level, municipal finance is broadly categorized into three types:

i) Institutional Borrowing

ii) Municipal Development Fund

iii) Municipal Bunds

In the fiscal decentralisation the municipal governments are augmenting the resources from different sources like borrowing from financial institutions, user charges, transfers, issuing of bonds, loans from financial institutions etc. The banks which finances the municipalities was first started in the United States (US) and later European countries adopted. The case study given in Box 1.4 will explain you further:

1.3.1 Borrowing from Financial Institutions

Box 1.4: The Municipal Bank in Slovakia

The First Communal Bank in Slovakia was established by several municipalities as a specialized bank for the municipal sector in 1993. In 1996 the bank obtained a universal banking license allowing it to operate as a regular commercial bank. Currently, 367 municipalities have 19.62% share in the bank. The majority stakeholder in the bank is Dexia Kommunalkredit holding with a 78.4% stake. This group took over the bank in 2000 as part of its strategy to become the key bank for the municipal sector in Central and Eastern Europe.

During its ten year history the bank focused on the municipal financing sector, as well as the retail and corporate sectors. After the entry of the Dexia group, the bank decreased its activities in the corporate sector and focused primarily on the municipal sector and utilities. According to the bank, the municipal sector is less risky to do business than with corporations. The overall volume of credit funds provided to municipalities is around 3.5 billion Sk. Of this total, about one percent of the loans have repayment problems. Starting in 2000, the bank decreased the volume of credits provided to the private sector and increased its credit involvement in the municipal sector. In the course of the last five years over 75% of all credit funds provided to municipalities has come from the bank. Further areas of service to the municipal sector are deposits and consultancy in municipal and project financing. The bank accounts for 40 to 50% of total municipal deposits in the Slovak banking sector.

The bank also engages in the financing of environmental and investment projects supported by special state funds. The bank is an administrator for the financial funds of the State Environmental Fund and the State Fund for Housing Development. Additional activities of the bank include: mobilisation of sources and funds of municipalities; municipal bond issues; funding activities directed to renewal of municipalities; separate care of the municipal financial funds; depository activity for the first-owners' associations; leasing and consultancy.

Source: Local Government Borrowing, Open Society Institute (OSI), Budapest, Hungary, 2004

1.3.2 Municipal Development Fund

A "Municipal Development Fund" (MDF) is defined as a pool of money operated at a level above the individual local government, primarily for investment in infrastructure. The MDFs are managed by different institutions such as banks or government agencies. These are the "Municipal Development Intermediaries" (MDIs).

With very few exceptions, Western European countries as well as Japan have had for decades a well established MDI channelling investment credit to local governments. In many European countries, these institutions were established also to provide a reliable outlet for private savings. Over the past several decades MDFs have spread rapidly through Asia, Latin America, and Africa. In many of these countries the financing of capital infrastructure has been combined with objectives for longer term institutional development.

The main objective of development funds is to mobilise resources from private lenders, central government, donor agencies, and local governments themselves, and make them available for investment in urban infrastructure. A second objective is to strengthen the operation capacity and efficiency of local governments by assisting them in the design, appraisal, and execution of investment programmes, rationalisation of programmes moving away from *ad hoc* investment practices, and injecting rational criteria in the geographical and sectoral distribution of funds. Development funds are best suited to address the needs of smaller cities which tend to lack skilled administrators and lack access to capital markets. Development funds also provide a way to adopt larger projects.

The most common approach in Western Europe has been to introduce an autonomous institution with a legal and financial identity separate from the Central Government. However, there is great variance in the real degree of autonomy and the precise nature of the institution. The examples are as follows:

Municipal development banks which are primarily concerned with financing municipal investment include Belgium and Danish Municipal Credit Associations, Bank for The Netherlands Municipalities, and the Municipal Bank of Norway. In all these cases municipal government representatives control the management board.

Municipal or local government windows within institutions established to manage state controlled pensions and insurance funds. This is the case in France, Italy, and Spain. In these cases, management is appointed by the central government but municipal governments are represented in the decisions. The British Public Works Loan Board is 100 percent controlled by the Central Government, but half of the board draws membership from local governments.

Direct administration by the central government is the mode adopted by many developing countries. The central agency is the Ministry of Local Development or the Interior, or, in some cases, the Ministry of Finance. Problems with some of these new funds included lack of capacity for sustained assistance, under-capitalisation, poor loan repayment discipline.

In Western Europe and Japan most of the activities of MDFs are funded by direct access to financial markets. However, the initial subscription of shared capital by either central or local governments, though not representing any significant resources for lending, has been important in establishing credibility and control. Additional resources are tapped by competing for private savings deposits. Other financial institutions (banks, insurance companies and pension funds) have been major sources of funds either through the purchase of bond issues or through directly negotiated deposits. In contrast, developing country MDIs have been largely financed with public funds. Even though most of these institutions have the power to issue bonds, most of them do not.

MDFs lend money to local governments for long-term investment at preferential rates which cover interest and administration costs. In some cases, there are elements of grant or subsidised interest. These take different forms, such as matching grants attached to loans that vary with the repayment capacity of the local government or with the type of the project. Most often, eligibility is unrestricted in which the allocation of funds depends on the bids of individual authorities. In some cases, local governments, especially large units, are given a maximum quota.

Assessing debt service capacity of local governments is one of the most difficult aspects of managing a MDF. In most cases, the policy is to rely on the statutory limitations established in the law, stating a maximum ratio of debt or debt service for local government revenues. However, in the case of self-liquidating investment, as for public utilities, the limitation depends on the internal financing viability of the enterprise and not the local government *per se*. There are exceptions to this rule. For example, the *French Caisse de Depots* bases it's lending to local governments on financial forecasts, not on debt service ratios.

(Adapted from "Latvia: Local Government Expenditures and Resource Transfers" The World Bank, Report No. 14470-LV, July 20, 1995 and based on "Municipal Development Funds and Intermediaries," by Kenneth Davey, Background Paper for the 1988 World Development Report, The World Bank, July 1988.)

1.3.3 Municipal Bonds

The USAID and the World Bank introduced municipal bonds in transition and European countries based on American experience. Unlike other borrowing there are two reasons which restrict the development of bonds in transition and developing countries.

i) There is no tax exemption for the citizens purchasing bonds in transition and developing countries which restricts the interest of the citizens. But tax exemption is given in US and Central and Eastern European countries.

ii) Reforms in bond market will encourage the citizens to invest.

The example given in Box-1.5 is the best practice in US with regard to bond market.

Box 1.5: Diversification in the US local bond market

In most transition countries, local bond markets are still largely dominated by general obligation bonds, issued against the full faith and credit of the issuer. As markets develop, however, local governments will tend to diversify their borrowing instruments and rely more on structured bond instruments.

The US bond market provides a vivid illustration of the wide diversification of instruments. Beyond the general obligation bonds, the US local bond market offers a wide range of revenue bonds that are issued for project or enterprise financings, in which the security for the bond is the revenue generated from the financed projects. For example water revenue bonds are issued to finance the development of water treatment plans, pumping stations, distribution systems etc., with revenues from connection fees and water charges paid by users. The so called tax allocation bonds are used in the construction sector, secured by additional property taxes collected from new or improved property.

In addition to these various bond structures and instruments, the US market has been characterized by the emergence of a wide array of internal and external credit enhancement structures for municipal bonds, such as refunded bonds, insured bonds, bonds backed by letters of credit, etc.

Source: *Building Sub-national Debt Markets in Developing and Transition Economies. A Framework for Analysis, Policy Reform and Assistance Strategy*, Michel Noel, World Bank Policy Research Working Paper 2339, May 2000

In this session you read about the importance of financial decentralisation and now answer the questions given in Check Your Progress-1

Check Your Progress 1

Note: a) Write your answer in about 50 words

b) Check your answer with possible answers given at the end of the unit

1) Differentiate between Devolution, De-concentration and Delegation.

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2) Define Municipal borrowing and what are the different types of Municipal borrowing?

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1.4 FISCAL DECENTRALISATION IN DEVELOPED COUNTRIES

The fiscal decentralisation of a few developed and transition countries are narrated below.

1.4.1 United States

The United States has a loose and flexible structure of fiscal federalism. The key point of the US local government finance system is the absence of too many specifications. State governments assign local governments taxes and their maximum rates. Rules are clear on whether local governments may seek voter referenda on fiscal decisions such as tax rates, new borrowings and so on. They can formulate their own user charges. On the whole, local government revenues finance about 40 to 70 percent of the expenditure.

Some of the important sources of fiscal earnings of the local governments are:

i) Property tax

Property tax amounts to 70-75 percent of all local tax revenues in USA. The tax is based on capital value of property (often at a rate exceeding 1 percent). It gives a stable source of local funds to local government. It provides a degree of independence to the local bodies from the state and federal governments.

ii) Local option Income tax

State like Alabama, Arkansas, Delaware, Georgia, Kentucky, Indiana, Maryland, Michigan, Missouri, New York and Pennsylvania authorise their municipal authorities to levy local income tax. Some states like Georgia mandate a local choice of either an income tax or a general sales tax. While local jurisdictions usually collect the local option income tax themselves, some states like Indiana and Maryland collect it on behalf of their local governments by piggy-backing onto state income taxes.

iii) General Sales tax

This tax is generally popular among taxpayers, because it is collected in small amounts with many transactions. Local rates of this tax ranged from 0.25% to 6% in the United States in 1993.

iv) Excise Taxes

Excise taxes are sales taxes imposed on specific goods and services and are most commonly assessed on lodging, alcoholic beverages and tobacco products, utilities and motor fuel (local option gasoline tax). Some local jurisdictions levy an excise tax on new construction.

v) User Charges and Fees

User charges and fees pay for the cost of operating and maintaining public facilities and services, as well as repay outstanding debts. Road tolls, park admission fees and water and sewer charges are representative user fees in the United States.

vi) Revenue Bonds

Revenue Bonds are designed to finance revenue-generating facilities, backed by a stream of revenues pledged from user charges for services like water supply, sewerage, drainage, toll roads etc.

1.4.2 Canada

The main sources of municipal finance in Canada include: property tax, business tax, special taxes to raise revenue to pay for a specific service or purpose and local improvement taxes. Some of the services taxes imposed by the local governments are waterworks tax, sewer tax, boulevard tax, dust treatment tax, paving tax, ambulance service tax, fire protection area tax, drainage ditch tax, tax to provide water supply for the residence of a hamlet and recreational service tax.

Local improvement taxes in Canada are generally in the form of betterment levies linked to benefits accruing to specific local areas due to the provision of infrastructure as a result of implementation of local improvement plans.

1.4.3 United Kingdom

The fiscal decentralisation in UK is more systematic and well decentralization. The finance regimes of local authorities in England includes, as follows:

i) A system of non-domestic rates, being a property tax levied on industrial and commercial property- set by the Secretary of State for Environment for England and Wales, collected into the national pool and then distributed among the local jurisdictions based on adult population,

ii) A system of exchequer grants to local authorities, principally the Revenue Support Grant (RSG) designed to compensate local authorities are also able to participate in partnerships with the private sector under the Private finance Initiative, and

iii) A system of local domestic taxation, known as the Council tax.

1.4.4 Hungary

Hungary is the most decentralised country in the central and eastern European. In the year 1990, the local government act of Hungary brought fundamental changes in financing Hungarian local governments. The act regulates the scope of mandatory services that local governments can supplement with other services according to their needs. The act regulates the structure, service financing, assets and revenues of local governments. The act also gives more local autonomy. In this process, actors like businesses, banks, investors are considered to be important partners in the budget process. The act also considers local citizens are important in decision making process and this will strengthen the democracy. This act also delegated broad economic and political authority to local government making region.

The four year programme “Modernising Municipal Financial Management” in Hungary was launched in 1996 with the following objectives:

- Include revenue and expenditure breakdowns of municipal activities that provides a clear picture of how much the municipality spend on various items.
- Documents should be suited in identifying and pursuing the strategic sectoral and programme goals of the municipality.
- Monitoring should be ongoing, focused on issues and outcomes.

- Format and content should be comprehensible and informative to specialist citizens and other participants in municipal financial management.

The notion of programme budgeting was applied during the project period. The programme budgeting approach transform the local budget from a simple accounting, control oriented into a tool for promoting effective and accountable management of city resources. The programme budgeting relates revenues and expenditures to municipal goals, objectives, strategies and anticipated outcomes.

1.5 FISCAL DECENTRALISATION IN DEVELOPING COUNTRIES

The fiscal decentralisation in a few developing countries narrated below are

i) China

ii) Brazil

iii) South Africa

1.5.1 China

China's fiscal system is highly decentralized among the 31 provincial, 331 prefecture, 2,109 county and 44,741 township-level units. Nearly 70 percent of total public expenditure in China takes place at the sub- national (that is provincial, prefecture, county and township) level of which more than 55 percent takes place at sub-provincial levels. Key sub-national expenditure responsibilities in China include sub-national administration, local capital construction, basic local services, maintenance, repair and operation of urban infrastructure, primary and secondary schooling, health and hospitals, support for agricultural production, price subsidies, poverty alleviation, cultural and heritage protection, environmental conservation, local and regional development and physical planning.

The revenue assignment between Central and Sub-national Governments after 1994 reforms stands as follows.

- Central revenues in China comprise import tariffs, consumption taxes, income taxes, import-related consumption taxes and VATs, taxes imposed on banks, non-bank financial institutions and insurance companies (including business taxes, income taxes and the urban maintenance and development tax) and taxes on railroads.

- Sub-national revenues consist of business taxes(excepting taxes imposed on banks ,non-bank financial institutions, insurance companies and railroads), company income tax(excluding local banks, foreign banks and non-bank financial companies), personal income tax, urban land use tax, urban maintenance and development tax (excluding banks, non-bank financial institutions, insurance companies and rail roads), fixed asset capital gains tax, house property taxes, stamp taxes, agriculture and related taxes, tax on contracts and land-value increment taxes.

- Shared revenues include VATs (75 percent central and 25 percent, sub-national governments), stamp taxes on security exchange (50:50 sharing) and resource taxes.

1.5.2 Brazil

In Brazil, municipalities are granted full autonomy. The consumption and production taxes are assigned to all three levels of government. The main municipal taxes in Brazil are those on services (ISS) and urban property (IPTU). ISS rates are set by the municipalities, subject to ceilings introduced by the federal government. IPTU is levied on the capital value of land and buildings.

Based on Constitutionally mandated revenue sharing, the municipalities are entitled to:

a) 25 percent of the revenue from state Value Added tax (ICMS) ,

b) 50 percent of revenue from the state tax on motor vehicles registration (IPVA)

c) 22.5 percent from the federal Value Added Tax (IPI) and income Tax (IR),

d) All revenue from the income tax held at source (IRPF) and paid by the municipalities or by their decentralized agencies,

e) 70 percent of revenue from the federal financial-transactions tax levied on transactions with gold (IOF-Quro)

f) 50 percent of revenue from the federal rural-property tax (ITR). Municipalities also receive compensatory transfers and transfers related to healthcare and investment programmes.

1.5.3 South Africa

The using of application called measuring expenditure needs approach in South Africa transfer fiscal resources equitably to the provinces (South Africa 2006). The equitable share formula applicable for 2006–08 focuses almost entirely on need factors, with only a 1 percent weight given to negative needs (per capita GDP). The formula uses the following shares:

- A basic share (14 percent weight) is derived from each province's share of the national population.
- An education share (51 percent) is based on the size of the school-age population (5–17) and the average number of learners (grades R–12) enrolled in public ordinary schools over the past three years.
- A health share (26 percent) is based on the proportion of the population with and without access to medical aid.
- An institutional component (5 percent) is divided equally among the provinces.
- A poverty component (3 percent) is based on incidence of poverty.
- An economic output component (1 percent) is based on data on GDP by region.

1.5.4 Commonwealth Countries

There are two models that are typical for local government revenues in developing countries of the Commonwealth:

i) Local government rely very much on their own sources of revenues especially taxes user charges/ fees (i.e. Zambia & Swaziland);

ii) Local governments are heavily depended on transfers from central government &/ or donor contribution (i.e. Ghana).

The source of revenue of local self governments of different Common Wealth Countries are given in table below:

Country	Source of local government revenue
Australia	Grants and general or special purpose payments of federal and state governments comprise 23 per cent of local government revenues. Other sources included tax on immovable property, fees and fines, net operating surplus of trading enterprises and interest.
Bangladesh	Taxes, rates, fees and charges levied by local bodies, rents and profits accrued from their properties and money received through its services. Government grants, international project funding and loans raised by local bodies are additional sources of income. Taxes are the most important source of income, while loans and voluntary contribution are rare.
Cameroon	Council taxes, business levy and licenses.
Cyprus	Municipal taxes, duties and fees.
Fiji Islands	Revenues from land tax (town tax) and other local incomes such as grants-in-lieu, rental fees, market and bus station fees, business license fees, building fees and parking fees. Most councils also loans from the local capital market. Grants from central government are rare.
Ghana	Taxes, user fees and charges.
India	Tax revenue- properties, *octroi*, professions and vehicles, non-tax revenue- licenses and service charges, grants-in aid and state/Central Governments loans and borrowings.
Kenya	Fees and charges, water and sewerage fees, local property taxes and business permits.
New Zealand	Property rates, user charges, fees, fuel taxes and returns on investments. Some central governments financial assistance. The rating and charging powers have been provided for in law since 1988 and are important sources of local tax revenue.
Malaysia	Local taxation (assessment rate, rents and fees for services, grants/ subsidies given by state or central government. Some local authorities receive grants-in-lieu of rates. Other sources include miscellaneous forms of charges and fees (licenses, payment for various forms of services, rental penalties and compounds and interest).
Pakistan	Tax and *octroi* (comprising 60 per cent of local governments' revenues) and non-tax sources. Property related taxes (such as local rates or leases on all land assessable to either rent, land revenue or use). Tax on the transfer of property and *octroi* are the largest sources of revenue.
Sri Lanka	Rates, taxes duties, fees, fines, penalties and other charges as well as money from sales, leases or other transactions, revenues derived from properties and grants from other governments' spheres.
Source: Kevin Sproasts, Local Government in Asia an the Pacific: A comparative analysis of fifteen countries; and CLGF (2005)	

In this session you read about the financial decentralisation in various countries and now answer the questions given in Check Your Progress-2

Check Your Progress 2

Note: a) Write your answer in about 50 words

b) Check your answer with possible answers given at the end of the unit

1) Discuss Fiscal Decentralization in Canada.

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2) Discuss the Measuring Expenditure needs approach in South Africa to transfer fiscal resources equitably to the provinces.

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1.6 LET US SUM UP

In this we have discussed the different experiences of fiscal decentralization in different countries. Decentralisation has to be looked from different perspectives like political, social and economic perspective. In this Unit, fiscal decentralisation was explained from economic perspective. The transition countries are vigorously implementing fiscal decentralization. Developed countries like US and Canada have evolved fiscal decentralized structure. In worldwide fiscal decentralisation is considered as a viable option to address socio economic political issues. But due to lack of political will and untrained man power has restricted developing countries to implement fiscal decentralisation unsuccessfully.

1.7 REFERENCES AND SELECTED READINGS

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1.8 CHECK YOUR PROGRESS – POSSIBLE ANSWERS

Check Your Progress 1

1) **Differentiate between devolution, de-concentration and delegation.**

   In devolution, independently established sub national governments are given the responsibility for delivery of public services. The authority will impose fees and taxes for those services. The sub national government have flexibility to select the services to provide to their citizens. Whereas de-concentration is the establishment of central government offices at the regional level with some autonomy in decision making but the centre should approve all deviations from normal practice. Delegation is an intermediary between devolution and de-concentration. In this, sub national governments are given responsibility to deliver certain services but the central government will supervise and provide some forms of finance.

2) **Define Municipal Borrowing and what are the different types of Municipal Borrowing?**

   In the fiscal decentralisation the municipal governments are augmenting the resources from different sources like borrowing from financial institutions, user charges, transfers, issuing of bonds, loans from financial institutions etc. To strengthen the fiscal domain of municipalities there are different kinds of municipal borrowings which are discussed as follows:

a) Municipal Development Fund: A "Municipal Development Fund" (MDF) is defined as a pool of money operated at a level above the individual local government primarily for investment in infrastructure. The MDFs are managed by different institutions such as banks or government agencies. These are the "Municipal Development Intermediaries" (MDIs).

b) Municipal Bonds: The USAID and the World Bank introduced municipal bonds in transition and European countries based on American experience.

Check Your Progress 2

1) Discuss Fiscal Decentralization in Canada.

The main sources of municipal finance in Canada include: property tax, business tax, special taxes to raise revenue to pay for a specific service or purpose and local improvement taxes. Some of the services taxes imposed by the local governments are waterworks tax, sewer tax, boulevard tax, dust treatment tax, paving tax, ambulance service tax, fire protection area tax, drainage ditch tax, tax to provide water supply for the residence of a hamlet and recreational service tax.

Local improvement taxes in Canada are generally in the form of betterment levies linked to benefits accruing to specific local areas due to the provision of infrastructure as a result of implementation of local improvement plans.

2) Discuss the Measuring Expenditure needs approach in South Africa to transfer fiscal resources equitably to the provinces?

The using of application called measuring expenditure needs approach in South Africa transfer fiscal resources equitably to the provinces (South Africa 2006). The equitable share formula applicable for 2006–08 focuses almost entirely on need factors, with only a 1 percent weight given to negative needs (per capita GDP). The formula uses the following shares:

- A basic share (14 percent weight) is derived from each province's share of the national population.
- An education share (51 percent) is based on the size of the school-age population (5–17) and the average number of learners (grades R–12) enrolled in public ordinary schools over the past three years.
- A health share (26 percent) is based on the proportion of the population with and without access to medical aid.
- An institutional component (5 percent) is divided equally among the provinces.
- A poverty component (3 percent) is based on incidence of poverty.
- An economic output component (1 percent) is based on data on GDP by region.

UNIT 2 FISCAL DECENTRALISATION IN INDIA: AN OVERVIEW

Structure:

2.1 INTRODUCTION

Decentralisation has become one of the important dimensions of governance of modern democracy. The devolution of functions, functionaries and funds from the Central Government to the provincial and local government is propagated as a step for the effectiveness of decentralisation. Customarily decentralisation is termed as delegation of decision making power to the lower levels of governments. It is studied that decentralisation improves accessibility, promotes responsibility and accountability and effectiveness of the government. Thus decentralisation intends to disperse decision-making governance closer to people. Dispersal of financial responsibility is an important component of decentralisation. Devolution of funds to the local governments closer to the people believed to promote faster development both in rural as well urban areas. After reading this unit you should be able to:

- Explain the meaning and importance of fiscal decentralisation
- Describe the sources of local government revenue
- Discuss the fiscal decentralisation in India
- Analyse the criteria of fiscal decentralisation and measures for strengthening fiscal decentralisation.

2.2 FISCAL DECENTRALISATION: MEANING AND IMPORTANCE

2.2.1 Meaning of Fiscal Decentralisation

The Central Government is increasingly finding difficulty to meet all of the numerous competing needs of their various constituencies at the regional and local levels. Its therefore attempting to build local capacity by delegating responsibilities downwards to their regional governments and local governments.

At the same time, the local governments are also demanding more functional and financial autonomy. As a result two things have happened:

i) Firstly, Central Government is looking towards local and regional government to assist them on devising economic development strategies;

ii) Secondly, regional and local political leaders are demanding more autonomy and want the taxation powers that comensurates with their expenditure responsibility.

According to Kenneth Davey, fiscal decentralisation comprises the financial aspects of devolution to regional and local government and it covers two interrelated issues:

a) First is the division of spending; and

b) The amount of discretion to be given to regional and local governments to determine their expenditures and revenues.

The concept, fiscal decentralisation caught attention of the various countries only after 1990. However, there are evidences that show that countries like Brazil, Peru and Mexico introduced a system of fiscal decentralisation in their economy in the 1990s. Fiscal decentralisation has become worldwide reform agenda supported by the World Bank, USAID, Asian Development Bank and many other bilateral and international agencies. World Bank perceives fiscal decentralisation and the devolution of power as an important engine for shaping governance and development. James Edwin Kee opines that 'Fiscal decentralisation' is the devolution by the Central Government to local governments such as states, region and municipalities of specific functions with the administrative authority and fiscal revenues to perform those functions. Chio states that, fiscal decentralisation means that the authority of tax collection or expenditure is transferred from superior to subordinate offices. He advocates that fiscal decentralisation has two aspects that is qualitative and quantitative. The qualitative aspect of fiscal decentralisation analyses finance held by a local government, where as the quantitative aspect estimates the presence of autonomy authority in finance. According to N. Feruglio, fiscal decentralisation is a process of shifting decision making power on the composition of expenditure responsibilities and on the composition and level of revenues from the Central Government to elected sub national governments. M. A. Oommen opined that fiscal decentralisation means fiscal empowerment of local governments. More specifically it means devolution of taxing and spending powers to lower levels of government. According to World Bank, fiscal decentralisation accords substantial revenue and expenditure authority to intermediate and local government.

Thus fiscal decentralisation is not only the allocation of resources by the Centre to the regional and local governments but also generation of resources by the regional and local governments. One of the purposes of the fiscal decentralisation in China is to grant the provinces and localities greater flexibility in collecting revenues and making expenditure decisions. The Government of India also made Constitutional provisions for fiscal decentralisation to state and local government.

2.2.2 Importance of Fiscal Decentralisation

The fiscal decentralisation hold merits for several reasons and some of the reasons are as follows::

i) Fiscal decentralisation promotes economic value. The fiscal federalism like the political concept of democracy is considered to be an optimal institutional arrangement. It has the provision of public services with cost minimisation and welfare maximisation. It also combines the advantages of decentralisation with the benefits from economies of scale.

ii) Fiscal decentralisation leads to good governance, by ensuring fiscal responsibility to the lower level of government that is. local self government. Governance values include responsiveness and accountability, diversity and political participation. Decentralisation places allocation decision making close to the people. As a result, this places greater responsiveness to local officials and greater accountability to citizens.

iii) Fiscal decentralisation would enhance political participation at the local level. This has the potential to enhance democratic value and political stability at the local level. It provides a forum for local debate about local priorities and can be a proving ground for future political leaders. It imparts financial education to the local leaders at the grassroots levels.

iv) The fiscal decentralisation is supposed to reduce poverty through the need-based and demand-driven approach of utilisation of resources through participation of locals at the grassroots. The counties like China and India are very much in the favour of fiscal decentralisation for poverty reduction.

v) With fiscal decentralisation, funds are effectively used as

   a) they are demand-driven and there is high degree of local involvement;

   b) their operations are transparent and accountable;

   c) they are carefully targeted to low income group; and

   d) free from official red tapism.

vi) According to Stigler, fiscal decentralisation brings government closer to the people. However a representative government functions in better manner, when it is close to the people. The theoretical perceptive of this argument goes like this "each public service should be provided by the jurisdiction having control over the minimum geographical area that would internalise benefits and costs of such provision."

vii) In a fiscally decentralised system where citizens' participation in decision making is encouraged, locally elected governments have the power to pursue the agenda mandated by voters.

After reading this section, you might have gained idea about the meaning and importance of fiscal decentralisation. Now you would be able to answer the questions given in Check Your Progress-1

Check Your Progress 1

Note: a) Write your answer in about 50 words.

b) Check your answer with possible answers given at the end of the unit

1) What do you mean by fiscal decentralisation?

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2) Discuss a few merits of fiscal decentralisation

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2.3 FISCAL DECENTRALISATION IN INDIA

In India, fiscal decentralisation assumed importance after 73rd and 74th Constitutional Amendments, which envisaged the devolution of functions, functionaries and funds to the local self government institutions. Before 1992, that is prior to the passing of the 73rd and 74th Constitutional Amendment, several committees and commission recommended for the fiscal decentralisation. Let us discuss in detail the recommendations of various committees and constitutional measures undertaken for fiscal decentralisation in India.

2.3.1 Committees

Various committees and commissions were constituted for suggesting measures for establishing financial autonomy of the *Panchayats* and municipalities. In the light of these suggestions, the States have made appropriate provisions in their *Panchayat Raj* Acts. Let us now review the recommendations of various committees appointed from time to time about decentralisation of finances to local self government institutions.

i) Finance enquiry committee

In 1951, the Local Finance Enquiry Committee studied this problem and recommended unconditional assignment of 15% of land revenue to be raised in the *panchayat* area and the proceeds of surcharge levied on the transfer of immovable property to the *Panchayats*. *Panchayats* were also to be empowered to raise their own resources by levying certain taxes in their territories.

ii) Taxation enquiry committee

In 1954, the Taxation Enquiry Committee recommended for reserving certain taxes such as tax on land and building, *octroi*, tax on non-mechanical transport, tax on property, tax on profession, tax on advertisement other than newspapers, theatre tax, and duty on transfer of property, etc. for *Panchayats*.

iii) Santhanan Committee

The Santhanan Committee formed in 1963 strongly recommended that it was essential for stability and growth of local institutions to have substantial and growing resources, which were entirely within their power to exploit and to develop.

iv) Ashok Mehta committee

In 1978, the Ashok Mehta Committee recommended that besides government support, *panchayats* should mobilise enough resources of their own, as no democratic institution can continue to maintain its operational viability by depending upon external resources.

v) Singhvi Committee

In 1966, the Singhvi Committee among others, suggested pattern of compulsory and optional levies. The State Governments shall levy and collect taxes and fees on behalf of PRIs and shall disburse to them based on the recommendation of the Finance Commission in each State. In order to ensure and safeguard the financial autonomy of the PRIs, they should be freed from relying on the "Untied Funds". But encouraged instead to take to innovative resource mobilisation such as generation of income from entrepreneurial activities, projected loans, public contribution, tax-sharing ,tax-assignments and matching grant incentives for tax collection.

2.3.2 Commissions

The 73rd Constitutional Amendment provides for devolution of functions and transfer of functionaries and funds to the three tiers of Panchayati Raj Institutions. The article 243G of the Constitution states, "Subject to the provisions of the Constitution, the legislature of a state, by law, may endow the *panchayats* with such powers and authority as may be necessary to enable them to function as institutions of self-government. Such laws may contain provisions for the devolution of powers and responsibilities upon *panchayats* at the appropriate level, subject to such conditions as may be specified therein, with respect to:

a) The preparation of plans for economic development and social justice; and

b) The implementation of schemes for economic development and social justice as may be entrusted to them including those in relation to matters listed in the Eleventh Schedule.

Article 243A of the Constitution of India embodies the spirit of the democratic decentralisation.

While 280 (3) (bb) of the Constitution enjoins the Central Finance Commission to suggest measurers needed to augment the consolidated fund of a state to supplement the resources of the *panchayats* and municipalities on the basis of the recommendations made by the Finance Commission of the State.

Article 243-H of the Constitution, empowers the state legislatures to enact laws:

a) To authorise a *panchayat* to levy, collect and appropriate such taxes, duties, tolls and fees;

b) To assign to a *panchayat,* certain taxes, duties, tolls levied and collected by the state government;

c) To provide for making grants-in-aid to the *panchayats* from the consolidated fund of the state; and

d) To provide for the constitution of such funds for *panchayats* and also the withdrawal of such money there from; as may be specified by law.

Article 243-I of the Constitution envisages for the setting up of the State Finance Commission (SFC) once in every five years to review the financial position of the *panchayats* and to make recommendations to the Governor as to:

i) The principles which should govern-

   a) The distribution between the state and the *panchayats* of the net proceeds of the taxes, duties, tolls and fees levied by the state. It may be divided between them under this part and the allocation between the *panchayats* at all levels of their respective shares of such proceeds;

   b) The determination of the taxes, duties, tolls and fees which may be assigned to, or appropriated by the *panchayats*;

   c) The grants-in-aid to the *panchayats* from the consolidated fund of the state

i) The measures needed to improve the financial position of the *panchayats*;

ii) Any other matter referred to the finance commission by the Governor in the interests of sounds finance of the *panchayats*.

The 74th Constitutional Amendment also states that the State Finance Commission to review the financial position of the urban local bodies, their revenue and capital account requirements. It recommended devolution of taxes, charges, fees, tolls, duties, shared revenues, inter-government transfers and grants from the state to the municipalities. It suggested measures for the mobilisation of municipal resources.

2.3.3 The Central Finance Commission

Direct devolution by CFCs to ULBs began with the Xth CFC after insertion of clause 280(c) in the Constitution and entailed an allocation of Rs.1,000 crore for 1995-2000. It was calculated on the basis of:

i) Slum population;

ii) Matching contribution by municipalities;

iii) Funds to be used for the non-establishment segment of O&M.

CFC has also suggested a reform agenda at the state and municipal level to enable full devolution (2.5% of divisible funds) after the first year (2010-11) of the five-year period of 2010-15. This includes a 1% share of divisible pool on taking up the reform agenda of the XIIIth CFC covering:

- Introduction of double entry municipal accounting system based on the Government of India National Municipal Accounting Manual. It will bring transparency in accounts and enhanced efficiency in the mobilization of assets.

- Improved auditing though assignment of technical guidance and supervision (T&GS) to CAG (Comptroller and Auditor General), Government of India, which will induce fiscal discipline.

- Appointment of Independent Local Body Ombudsman to check corruption and malpractices.

- Grants to be transferred electronically to ensure transparency and timely disbursement.

- Laying out qualifications for the members of state finance commission to improve equality and competence of SFC.

- Property tax should be levied on all properties, including central/state government properties.

- States should constitute a Property Tax Board that will lay down norms for the PT system to ensure complete coverage and revenue enhancement.

- States/ULBs should set out service standards (as 31st March) to be accomplished during the next financial year, particularly in relation to core municipal services such as water supply, sewerage, storm water drainage and solid waste management.

All towns with a population above one million should have their own fire fighting service.

2.3.4 The State Finance Commissions

Chapters 243-I and Y of the 73th and 74th Constitutional AmendmentActs, respectively, made it mandatory for state governments to constitute state finance commissions (SFCs) every five years to review the financial position of the *panchayats* and urban local governments, and to make recommendations for the subsequent five-year period on:

a) the principles to govern the distribution and allocation of the taxes, duties, tolls and fees levied by the state, and the allocation between the *panchayats* /local governments of such proceeds;

b) the determination of the taxes, duties, tolls and fees which may be assigned to, or appropriated by, the *panchayats* /local governments;

c) the grants-in-aid to the *panchayats* /local governments from the Consolidated Fund of the state;

d) the measures needed to improve the financial position of the *panchayats* / municipalities; and

e) any other matter referred to the SFC by the governor in the interests of sound finance of the *panchayats* /local governments.

2.4 SOURCES OF LOCAL GOVERNMENT REVENUE

The various sources of local government revenue can broadly be categorized into four heads:

i) Local Taxation

ii) User Charges

iii) Inter Governmental Transfers

iv) Capital Finance

i) Local Taxation:- The local self government in different countries used to impose local taxes as a source of revenue. However, it varies from state to state and region to region depending on decision of the concerned state government. Local taxes are generally divided into three categories such as taxes on property, income and sale of goods and services. Generally it is observed that highly progressive and mobile tax bases are assigned to the centre. While, user charges and fee are found to be vested with the local governments. Therefore, decentralized (local) levels of government rely mainly on taxes like property tax, user charges and fees.

Box: Delegation of financial powers to urban local bodies: 74th Constitional Amendment:

The State may, by law:

- Authorise a municipality to levy, collect and appropriate such taxes, duties, tolls and fees in accordance with such procedures and subject to such limits;
- Assign to a municipality such taxes, duties and tolls and fees levied and collected by the State Government for such purposes and subject to such conditions and limits;
- Provide or make such grants-in-aid to the municipalities from the consolidated fund of the State; and
- Provide for constitution of such fund for crediting all moneys received, respectively, by or on behalf of the Municipalities and also for the withdrawal of such moneys therefrom.

ii) **User charges:** The local governments charges user fee for the services which they provide to the citizen of the municipal areas. Now day local governments are under increasing pressure to increase tariffs to meet the full cost of services which they provide.

iii) **Intergovernmental Transfers:** The intergovernmental transfer are of two types:

i) Share of national taxes distributed either by formula (i.e. per capital) or by origin (i.e. to the local government where they are located).

ii) The second is the grants/ subversions which are either targeted to support specific expenditure (i.e. social benefit, education, etc.) or untargeted and used at discretion of local government (often know as block grants).

Targeted grants are usually intended to stimulate a specific type of expenditure which is favoured or mandated by national government. The untagged or untied grants the other hand can be used by the local governments based on local needs.

iv) **Capital Finance:** Capital expenditure is normally financed from one or more of the following sources:

i) Grant from the state budget or national funds;

ii) Operating surplus representing excess of current revenue over current expenditure

iii) Sale of assets;

iv) Credit (loans and bonds) grants from the state is a common phenomenon.

2.5 SOURCES OF REVENUE OF URBAN LOCAL BODIES IN INDIA

Some of the important sources of revenues of the urban local bodies in India are as follows:

i) **Tax Revenue:** Urban local bodies levy a few taxes in their area such as *octroi,* property tax, profession tax, entertainment tax, advertisement tax, animal tax, market tax, water tax, pilgrim tax, toll on new bridges, etc. Now-a- days most of the states have abolished *octroi* tax, which was a major source of revenue for the urban local bodies. Besides, the urban local bodies also get a percentage of tax revenue from stamp duty, electricity tax and motor vehicle tax imposed by the state government.

ii) **Non-Tax Revenue:** It consists of fees, receipts, fines or income from remunerative activities of urban local bodies. The fees is collected through various forms and processing fees. Besides, fees are collected from park and exhibition ground, halting places, public market, etc.

   a) **Grant-in-Aid:** The State Government gives grants-in-aid to the urban local body. It varies from state to state depending on the recommendations of the concern state finance commission.

   b) **Loans & Bonds:** Under the respective Municipal Acts, the Urban Local bodies are entitled to raise loans from the state governments. The loans are to be paid back within prescribed time limit along with the interest. Besides, the now a days many municipalities and municipal corporations are sailing bonds to enhance their revenue base.

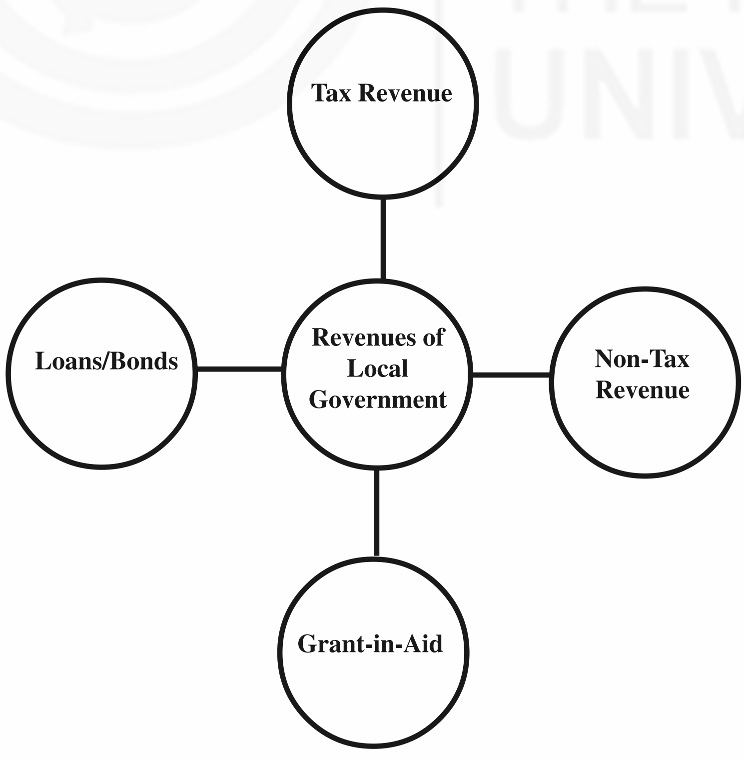

Fig. 2.1: Revenue of ULBs

The progress of implementation of accounting reforms by the ULBs in India is very slow. Only a few states have introduced the measures for raising finance as per the recommendation of the Central Finance Commission.

The Central Finance Commission has suggested several measures to augment the consolidated fund of the state for municipal resource mobilisation. These include land taxes, surcharged cess on state taxes, and property tax. It was also suggested for enhancing of local resources through property tax and fixation of user charges in such a way that the full cost of operation and maintenance is recovered. However, all these suggestions have not been dutifully implemented by various states. Even the state government does not release the funds received on the recommendation of the Central Finance Commission.

The JNNURM (Jawaharlal Nehru National Urban Renewal Mission) has included following mandatory and optional reforms with the objectives to improve pricing and cost recovery of user charges.

i) **Mandatory reforms:**

   a) Levy of reasonable user charges by ULBs with the objective that full cost of O & M is collected within next five years.

   b) Internal earmarking within local body budget for basic services to the urban poor.

   c) Provision of basic services to urban poor including water supply, sanitation, etc.

ii) **Optional reforms:**

   a) Revision of by-laws to make rain water harvesting mandatory in all building to come up in future and for adoption of water conservation measures.

   b) By-laws on re-use of reclaimed water.

   c) Encouraging public-private partnership.

In this section, you read about various sources of local government revenue. Now answer the questions given in Check Your Progress-2

Check Your Progress 2

Note: a) Write your answer in about 50 words.

b) Check your answer with possible answers given at the end of the unit

1) What are the various sources of local revenue?

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2) How local taxation is an important source of revenue?

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2.6 SOURCES OF REVENUES OF PANCHAYATI RAJ INSTITUTIONS IN INDIA

Panchayati Raj Institutions (PRIs) receives revenues from various sources. The important sources of revenue of the PRIs in India are as follows:

i) **Revenue from the Central Government:** Every state gets revenue from the Central Government as per the recommendations of the Central Finance Commission. This is based on the criteria fixed by the Central Finance Commission. The PRIs of states also get grant from the National Planning Commission.

ii) **Revenue from the State Government:** The two main sources of revenue from the state government to the PRIs are:

   a) Allocation as per the recommendation of the State Finance Commission;

   b) Scheme specific grant from the State Planning commission.

iii) **Internal resources of Revenue:** The PRIs in different state applies various mechanisms for internal resources mobilisation. The important sources are

   a) Taxable income and fees

   b) Non-taxable income like income from the common property resources, sales of goods and services, borrowings, income from live stocks, etc.

The revenue sources of *Panchayati Raj* Institutions is given in the form of a diagram below

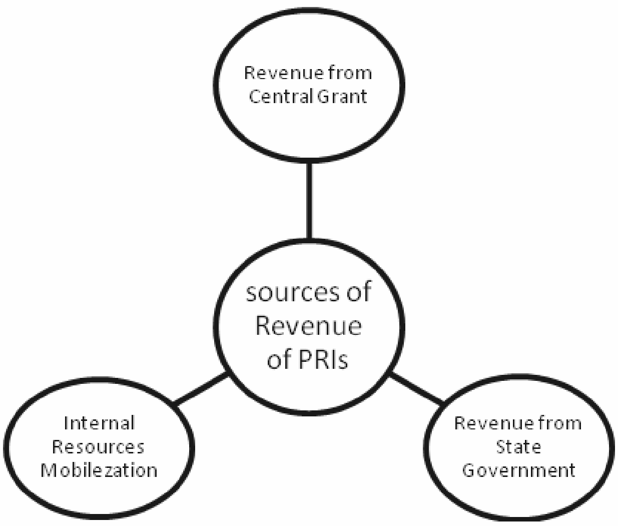

Fig. 2.2: Revenue of PRIs

The PRIs in Kerala, Karnataka and Gujarat enjoy greater financial autonomy. In Kerala, 40 per cent of plan funds go directly to *panchayats*. In Karnataka, each *panchayat* get Rs.3,00,000 annually directly from the state government and in Madhya Pradesh each panchayat gets a grant of rupees Rs.1,00,000 every year from the state government. These are untied funds to be spent according to the need and requirement of each *panchayat.*

For example, the sources of income of village *panchayats* in Karnataka include:

i) Statutory grant (Rs 5 lakhs) from the state government

ii) Property tax, water tax, professional tax, fair and exhibition tax and professional tax. These taxes constitute nearly 17 per cent of the total revenue and

iii) Grants from the Central Finance Commission and Central Plan.

In Kerala, a village *panchayat* levies and collects taxes from the local people. Taxes levied by the village *panchayats* are property tax, profession tax, entertainment tax, advertisement tax, service tax, show tax including surcharge, cess on conversion of land use and surcharges. The government devolves 40 per cent of plan budget directly to village *panchayats* in Kerala.

In Madhya Pradesh, in order to make every village self-reliant (*gram swaraj*) a provision has been made that every village needs to have a gram *kosh* (village fund). The fund comprises funds collected in the form of taxes, Central and State Government grants and funds given by the district *panchayat*. Any other income of the village panchayat shall also be deposited in the gram *kosh*. The gram *kosh* shall have four components such as:

- Food *Kosh*
- Commodity *Kosh*
- Labour *Kosh;* and
- Cash *Kosh*.

The sources of income of the village *panchayat* in Madhya Pradesh are:

- Taxes: house tax, sanitation tax, lighting tax, business tax
- Income from minerals
- Income from fishery
- Grant-in-aids from Central and State government
- Income from common property
- Income from livestock

2.7 CRITERIA FOR FISCAL DEVOLUTION

The following criteria may be suggested for the effective transfer of resources to the local self governments by the central government.

i) **Autonomy:** The essence of decentralisation is self-rule and autonomy. The transfer mechanism in no way should result in a dependency syndrome. Fiscal discipline and own resource mobilisation are the key to autonomy. Therefore, the local self government institutions creativity in mobilisation of resources must be encouraged.

ii) Equity: The well-known dictum of equity, namely,. 'from each according to one's ability and to each according to one's needs' is relevant in considering resource mobilisation and intergovernmental resource transfers as well. It should be noted that *Panchayats* at all levels are very unequal in size, resources and development attainments. Given the extreme regional disparities, decentralisation in such conditions can produce the desirable results.

iii) Predictability: The PRIs should know the amount and timing of the transfers to make provision for planning, budgeting and implementation of their activities. Irregular payments are not conducive to efficiency. Quite often it happens that allocations may not even be paid, resulting in overdue, which eventually may be permanently lost to them.

iv) Efficiency: The resource transfer should be so designed as to facilitate efficient management and discourage inefficient and uneconomic practices. The transfer mechanism should not turn out to be a "gap-filling" approach.

v) Absorptive Capacity: The resource transfer should be in the tune with the utilisation ability of the receiving Panchayat or municipal ward. In other words, principle should be each according to its need. The allocation of fund to the panchayat and municipal ward must be free from bias.

vi) Simplicity: The formula for transfer the inter-governmental resources should be simple and transparent. Besides formula formulated by the Central Finance Commission, the state government must device its own formula based on its socio-economic, geographical and population composition for allocation of resources to panchayat and municipalities and also among the different levels of panchayat and urban local bodies.

vii) Promotion of Incentives: There should be adequate built-in arrangements for encouraging resource mobilisation and penalising wasteful and uneconomic practices. The panchayat which mobilize and generate their own local resources must be given additional matching grant, which will create competitiveness among the local self government institutions.

viii)Poverty Reduction: Removal of poverty should be the main aim the fiscal decentralization. Panchayats and municipalities taking proactive measures in poverty reduction must be given incentives for their initiatives.

ix) Reduction of Disparities: Socio-economic disparities are one of the main concerns of the governments. The local self government can play a vital role in narrowing disparities at the grassroots. This must be a basis for the allocation of revenue among various local self government institutions.

The formula recommended by the 11th Central Finance Commission for the inter se share of the states in tax devolution is given in Table-1.

Table 1: Criteria and Relative weights for determining inter se shares of states

S.No.	Criterion	Relative weight (percent)
1	Population	10.0
2	Income	62.5
3	Area	7.5
4	Index & Infrastructure	7.5
5	Tax effort	5.0
6	Fiscal discipline	7.5

Source: *Report of Eleventh Finance Commission*

The percent share of different sates according to the formula is given in Table-2

Table 2: Inter se share of states

States	Share (percent)
Andhra Pradesh	7.701
Bihar	14.59
Gujarat	2.82
Haryana	0.94
Jammu & Kashmir	1.29
Karnataka	4.93
Kerala	3.05
Madhya Pradesh	8.83
Maharashtra	4.63
Orissa	5.05
Punjab	1.14
Rajasthan	5.4
Tamil Nadu	5.38
Uttar Pradesh	19.79
West Bengal	8.11

Source: *Report of Eleventh Finance Commission*

2.8 MEASURES FOR STRENGTHENING FISCAL DECENTRALISATION

Fiscal decentralisation can be strengthened by various ways:

i) Deciding institutional system to strengthen inter-governmental economic relations. The economic relation among the centre, state and local governments must be cordial and healthy. Besides, the basis of financial devolution among the different tiers of local self government must be clearly defined, this will lead to fiscal collaboration rather confrontation.

ii) Planning fiscal transfers to assure regional fiscal equality and to build an effective environment for advanced and competitive service delivery.

iii) Restructure tax responsibility to allow local revenue autonomy, efficiency and accountability. Delegation of responsibility to the local government to collect and spend their taxes according to the local needs will strengthen the fiscal decentralisation.

iv) Determining the functionary funds of different levels of government on the criteria of equality and efficiency.

v) Providing sub-national government an access to responsible credit market. However, with the globalization, the local self government institutions must have access to capital market.

vi) According to Bahl, a measure of fiscal decentralisation should reflect the key characterises of a fiscally decentralised system, such as existence of elected local council, approved budget, local government to collect taxes.

vii) Institutional reforms that minimize adverse incentives and promote transparency, accountability and predictably should be executed to have an effective fiscal decentralization.

In these sections, you read about fiscal decentralisation in India, criteria of fiscal decentralisation and measures to strengthen fiscal decentralisation. Now answer the questions given in Check Your Progress-3

Check Your Progress 3

Note: a) Write your answer in about 50 words.

b) Check your answer with possible answers given at the end of the unit

1) What are the various sources of revenue of PRIs in India?

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2) Explain three criterions for fiscal decentralisation.

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2.9 LET US SUM UP

In this unit you read about the fiscal decentralisation. Fiscal decentralisation is an important component of democratic decentralization. The fiscal decentralization process started since 1990 and in India it was geared up after 1992 with the implementation of 73rd and 74th constitution amendment. In common parlance fiscal decentralization aims at shifting of financial responsibilities from the central to the lower level of governments. As the financial responsibilities become closer to the people, it is believed that it will lead to good governance, transparency and accountability. Besides, meaning and importance of fiscal decentralization, this unit also covers sources of local government revenue in general and of local self government institutions in India in particular. Lastly, this unit also covers criteria for fiscal decentralization and measures to strengthen fiscal decentralization.

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2.11 CHECK YOUR PROGRESS-POSSIBLE ANSWERS

Check Your Progress 1

1) **What do you mean by fiscal decentralisation?**

   Fiscal decentralisation means decentralisation of financial power to the lower levels of governments. According to N. Feruglio fiscal decentralisation is a process of shifting decision making power on the composition of expenditure responsibilities and on the composition and level of revenues from the central government to elected sub national governments. M. A. Oommen opined that fiscal decentralisation means fiscal empowerment of local governments. More specifically it means devolution of taxing and spending powers to lower levels of government.

2) **Discuss a few merits of fiscal decentralisation.**

   Two important merits of fiscal decentralisation are:

   i) Fiscal decentralisation promotes economic value. The fiscal federalism like the political concept of democracy is considered to be an optimal institutional arrangement for the provision of public services with cost minimisation and welfare maximisation;

ii) Secondly, fiscal decentralisation leads to good governance, by ensuring fiscal responsibility to the lower level of government i.e. local self government. Governance values include responsiveness and accountability, diversity and political participation.

Check Your Progress 2

1) What are the various sources of local goverment revenue?

The various sources of local government revenue can broadly be categorized into four heads:

i) Local Taxation

ii) User Charges

iii) Inter governmental Transfers

iv) Capital Finance

2) How local taxation is an important source of revenue?

The local taxes are important sources revenue for the local self government. Higher the local taxes imposed by the local self government institutions, lower will be their dependence on the central and state governments for grant. However, it is seen that the local self government are reluctant to impose taxes on the people because their very closer to the people.

Check Your Progress 3

1) What are the various sources of revenues of PRIs in India?

The important sources of revenue of the panchayati raj institutions in India are as follows:

i) Revenue from the Central Government: Every state gets revenue from the central government as per the recommendations of the Central Finance commission;

ii) Revenue from the state government: The two main sources of revenue from the state government to the PRIs are:

a) Allocation as per the recommendation of the State Finance Commission; and

b) Scheme specific grant from the State Planning commission and

iii) Internal resources of Revenue: The PRIs in different state applies various mechanism for internal resources mobilization. Two important sources are:

i) Taxable income and fees

ii) Non-taxable income like income from the common property resources, sales of goods and services, borrowings, income from live stocks, etc.

2) Explain three criterians for fiscal decentralisation.

The three important criteria for fiscal decentralization are

i) Autonomy**:** The essence of decentralisation is self-rule and autonomy;

ii) Equity**:** The well-known dictum of equity, viz. ‘from each according to one’s ability and to each according to one’s needs’ is relevant;

iii) Predictability: The PRIs should know the amount and timing of the transfers to make provision for planning, budgeting and implementation of their activities.

UNIT 3 MUNICIPAL FINANCE IN INDIA

Structure

3.1 INTRODUCTION

It should be explicitly recognised that urbanisation is a natural consequence of economic development and cities contribute far more to national economic growth than their share in total population. They contribute significantly to the country's national income and exchequer. Therefore, urban policy needs to enable cities to contribute to national development through the effective provision of infrastructure and services. This, however, cannot be viewed in isolation from broader economic and social policies. These policies lead to unintended spatial consequences, which may sometimes be far more profound than those intended or envisaged originally. In view of the above, the approach to urban development and management needs to take account of the likely impacts of multiple sectoral and spatial policies at Central, State and Local Government levels. Municipal finance reforms will have to be undertaken within the ambit of these policies and the structure of fiscal federalism in India. This unit deals in details the status of municipal finance in India. After reading this unit you would be able to:

- Explain the importance of Municipal Finance in Urban Development.
- Give an overview of the Municipal Finance in India.
- Describe the mechanisms to improve Municipal Revenue.

3.2 IMPORTANCE OF MUNICIPAL FINANCE IN URBAN DEVELOPMENT

Urban Local Bodies directly influence the welfare of the people by providing services and facilities in urban areas. Given their strategic position in delivering services in the hierarchy of Government set up, following the 74th Constitutional Amendment Act, more functions, powers and resources have been provided to them. However, this increase has happened without commensurate enhancement of their resource base.

Any analysis of finances of State and Central Governments in isolation (excluding that of the local bodies) will not provide a holistic picture of the public finances of the country. Recognising the fact that India is increasingly urbanising, and given the estimate that of more than 50 per cent of India's population will live in urban areas in another 3 to 4 decades, one cannot afford to ignore the fiscal situation of ULBs. Civic infrastructure and services in most cities and towns are in woefully dismal condition. They are grossly inadequate even for the existing population; leave alone the need for planned urbanisation and peripheral development to accommodate migrants and population growth. The floods in Mumbai, Chennai, Hyderabad and Bangalore in the recent past have exposed the vulnerability of cities, their fragile ecology, weak infrastructure systems, faulty planning, long records of under-investment and fiscal imbalances. With rising expectations from the public, the financing of civic infrastructure and services has assumed critical importance socially, economically and politically.

While the Twelfth Schedule of the 74^{th} Constutional Amendment Act, 1992 demarcates the functional domain of municipal authorities, the Amendment Act has not provided for a corresponding 'municipal finance list' in the Constitution of India. The assignment of finances has been completely left to the discretion of the State Governments, excepting in that such assignment shall be 'by law'. This has resulted in patterns of municipal finances varying widely across States and in a gross mismatch between the functions assigned to the ULBs and the resources made available to them to discharge the mandated functions. The ULBs depend on the respective State Governments for assignment of revenue sources, provision of inter-governmental transfers and allocation for borrowing with or without State guarantees. Constitutionally, built-in imbalances in the functions and finances eventually reflect in the high dependency of urban local bodies on State governments and of the State Governments on the Central Government.

3.3 OVERVIEW OF MUNICIPAL FINANCE IN INDIA

Municipal finance can affect the nature and location of development. An overview of municipal finance includes the structure, composition, functions and finances of Urban Local Bodies (ULBs), examine the status of core municipal services and the financial needs for upgrading core infrastructure and services in India.

12th Finance Commission Report states that India has 3,723 ULBs, of which 109 are MCs, 1432 are municipalities and 2182 are Nagar *Panchayats*. The total revenue of the municipalities grew from Rs.11, 515crore in 1998-99 to Rs.15, 149 crore in 2001-02 The total expenditure increased from Rs 12,035 crore to Rs 15,914 crore during the same period. But total revenue of the municipal sector accounts for about 0.75 per cent of GDP of the country. Municipal revenue forms a little more than 2 per cent of combined revenue of State and Central Governments. In terms of total expenditure, the municipal sector accounts for about 0.79 per cent of the GDP of the country and a little over 2 per cent of the combined expenditure of State and Central Governments.

3.3.1 Municipal Revenues

Fiscal assessment of any entity is generally based on revenue and fiscal balance. Similarly, to assess qualitative aspects, the ratio of revenue expenditure to total expenditure is considered. Any entity generating surplus in revenue account (and if possible, in capital account) and maintaining low proportion of revenue expenditure to total expenditure, is considered to have sound financial health. However, this "standard approach" for making assessment may not hold for the ULBs. Municipal authorities are constrained by statutory mandates of balanced budgets and they are also not granted liberal permission by State Governments to incur debt. However, revenue expenditure is not undesirable, if a good proportion of this goes for operation and maintenance of civic amenities provided by the ULBs.

i) Structure of Municipal Revenue

The revenue base of MCs can be broadly categorized into:

a) Tax revenues ,

b) Non-tax revenues,

c) Assigned (shared) revenue,

d) Grants-in-aid,

e) Loans and

f) Other receipts.

While, property tax is the major revenue source, in most of the MCs, *octroi* is the major source in the MCs of Maharashtra and Gujarat. *Octroi* has been abolished in all other States excepting Maharashtra and Gujarat. An account of the various sources of revenue of the MCs is given in Table-1.

Table 1: Revenue Sources of Municipal Corporations in India 1998-2002

Revenue Head/ Category	Sources of revenue
Tax revenue	Property Tax, *Octroi*, Advertisement Tax, Tax on Animals, Vacant Land Tax, Taxes on Carriages and Carts
Non-Tax revenue	User Charges, Municipal Fees, Sale & Hire Charges, Lease amounts
Other receipts	Sundry receipts, Law charges costs recovered, Lapsed deposits, Fees, Fines & Forfeitures, Rent on Tools & Plants, Miscellaneous Sales *etc.*
Assigned (Shared) revenue	Entertainment Tax, Surcharge on Stamp duty, Profession Tax, Motor Vehicles Tax
Grants-in-aid	i) Plan Grants made available through planned transfers from upper tier of Government under various projects, programmes and schemes. ii) Non-Plan Grants made available to compensate against the loss of income and some specific transfers.
Loans	Loans borrowed by the local authorities for capital works *etc.* – HUDCO, LIC, State and Central Governments, Banks and Municipal Bonds.

Source: *Budgets of Municipal Corporations.*

Apart from their own revenue sources, i.e., tax and non-tax revenue sources, the 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. In addition to own revenues, shared revenues, user charges and fees and grants-in-aid, loans also constitute an important source of municipal revenues in some ULBs.

ii) Significance of Municipal Revenue

The revenue of the municipal government has significance to development of urban areas. Ironically, the percentage of municipal revenue is astoundingly low only 2.3 percent of total revenue of the centre and state combined during the year 2001-02. Research suggests that the urban local bodies need to have a good number of local taxes so as to become financially sound and match the number of functions assigned to municipalities successfully. The status of MCs revenue and its percentage to the GDP is given in Table-2.

Table 2: Significance of Municipal Revenue

Year	Municipal Revenue (Rs. Crore)	Percentage of GDP at Factor Cost	Relative share of Municipal Revenue (as percent of Total Revenue of)		
			State Govt.	Central Govt.	Combined State & Central Govt.
1998-99	11,515	0.72	4.4	4.1	2.5
1999-00	13,173	0.75	4.2	4.4	2.5
2000-01	14,581	0.77	4.2	4.5	2.4
2001-02	15,149	0.73	4.1	4.2	2.3

iii) Composition of Municipal Revenue and Trends

Between 1999-2000 to 2003-04, while the share of non-tax, assigned revenue, non-plan and plan grants improved, the share of tax revenue in total revenue receipts of MCs declined. Among the various revenue sources, tax revenue assumes greater importance in terms of both size and share. The composition of municipal revenue from various sources is given in Table-3.

Table 3: Composition of Municipal Revenue and Trends

(Rs. in Lakh)

Sl. No	Revenue component	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	Average %
1	Tax revenue	458509	554597	461895	573952	599387	8.23
2	Non-Tax revenue	238670	297890	296487	421422	434905	17.42
4	Assigned revenue	84557	115909	110146	132588	131076	11.66
5	Non-Plan grants	26667	34145	33341	54876	50161	20.42
6	Other revenue receipts	98600	86769	48024	64177	63271	-6.11
7	Revenue Receipts	910003	1089310	949893	1247015	1278800	10.18
8	Plan grants	16753	15665	31712	30027	49898	39.20
9	Loans	19917	47245	31805	28520	32835	27.33
10	Other capital receipts	11228	18101	18622	25785	33948	33.55
11	Capital Receipts	47898	81011	82139	84332	116681	27.89
12	Total Receipts	957901	1170321	1032032	1331347	1395481	11.04

Source: Based on the Budgets of Municipal Corporations

Table 4: Composition of Municipal Revenue and Trends

(Per Cent to Total)

Sl. No	Revenue component	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	Average %
1	Tax revenue	47.87	47.39	44.76	43.11	42.95	45.21
2	Non-Tax revenue	24.92	25.45	28.73	31.65	31.17	28.38
3	Assigned revenue	2.78	2.92	3.23	4.12	3.59	3.33
4	Non-Plan grants	9.14	9.90	10.67	9.96	9.39	9.87
5	Other revenue receipts	10.29	7.41	4.65	4.82	4.53	6.34
6	Revenue Receipts	95.00	93.08	92.04	93.67	91.64	93.08
7	Plan grants	1.75	1.35	3.07	2.26	3.58	2.40
8	Loans	2.08	4.04	3.08	2.14	2.35	2.74
9	Other capital receipts	1.17	1.55	1.80	1.94	2.43	1.78
10	Capital Receipts	5.00	6.92	7.96	6.33	8.36	8.36
11	Total Receipts	100.00	100.00	100.00	100.00	100.00	100.00

Source: Based on the Budgets of Municipal Corporations

3.3.2 Municipal Expenditure

Municipal governments in India are vested with a range of functions through the state legislature and other administrative orders. They are however, constrained in discharging their obligatory functions due to a limited resource base. The low per capita receipts of municipal governments do not enable them to meet the minimum standards of services. On the whole, the status of municipal finance in India suggests that the present revenues are insufficient to meet the growing expenditure needs of urban areas.

i) Expenditure Pattern

Municipal governments are legally required to have a balanced budget. The municipal expenditures are thus conditioned by the level of resources available. In the states, where the municipal receipts are very low, the municipal expenditures are also low. These low expenditures have a crucial impact on the quality and nature of services provided by the municipality. Often, the repairs and maintenance of services is poor and the expenditure on capital works is postponed

The expenditure incurred by the MCs can be broadly categorised into:

a) Revenue expenditure

b) Capital expenditure

Revenue expenditure broadly comprises:

i) establishment expenditure;

ii) administrative expenditure;

iii) operations and maintenance expenditure; and

iv) interest payments on loans.

Capital expenditure comprises:

i) expenditure on capital formation; and

ii) principal repayment.

Table 5: Categorization of Municipal Expenditures

Expenditure Category	Expenditure Items
Establishment expenditure	Staff salaries, Allowances, Wages, Pensions & Retirement benefits *etc.*
Administrative expenditure	Rents, Rates & Taxes, Office maintenance, Communications, Books & periodicals, Printing & Stationary, Travel Expenditure, Law Charges *etc.*
Operations & Maintenance	Power & Fuel, Bulk Purchases, Stores, Hire Charges, Repairs & Expenditure
	Maintenance and Interest payments made on loans
Capital expenditure	Buildings, Water Supply & Sewerage, Energy/ Lighting, Solid Waste Management, Roads, Bridges, Culverts, Causeways, Health & Sanitation, Parks and Recreation Spaces, Furniture & Fittings, Tools & Plant, Equipment *etc.*, Principal repayments of loans
Other expenditure	Miscellaneous expenses not accounted for in the above

ii) Significance of Municipal Expenditure

Municipal expenditure holds key to municipal development. However, due to abysmally low generation of resources, the municipal expenditure fall short of the required level in order to promote development of urban areas. The municipal expenditure, constitute less than one percent of GDP and less than three percent of total expenditure.

Table 6: Categorisation of Municipal Expenditures

Year	Municipal Expenditure (Rs. Crore)	Percentage of GDP at Factor Cost	Relative share of Municipal Expenditure (as percent of Total Revenue of)		
			State Govt.	Central Govt.	Combined State & Central Govt.
1998-99	12035	0.75	4.52	4.31	2.21
1999-00	14452	0.82	4.60	4.85	2.36
2000-01	15743	0.83	4.53	4.84	2.34
2001-02	15914	0.76	4.22	4.39	2.15

Source: (i) Report of Eleventh and Twelfth Finance Commission (ii) Handbook of Statistics on Indian Economy, RBI, 2005-06.

iii) Composition of Municipal Expenditure and Trends

The expenditure on operations and maintenances of municipal services accounts for only one fifth of the total expenditure. The level of spending on O & M of core services is important for maintaining a minimum standard of services in the urban settlements. Among all the components of municipal expenditure, the expenditures on capital works, establishment & administration, and operations & maintenance assume importance. The establishment & administrative expenditure constituted 36.25 per cent of the aggregate total expenditure, during 2000-2004. Capital expenditure, which is an important component, constituted less than 13 per cent of the total expenditure, during the same period.

Table 7: Composition and Trends of Municipal Expenditure

(Rs. in Lakh)

Sl. No	Expenditure component	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	Average %
1	Establishment and administration expenditure	279216	330414	329592	411432	402550	10.19
2	Operation and maintenance expenditure	107383	128165	142174	164406	154400	9.96
3	Other revenue expenditure	51830	56120	55954	58190	56265	2.17
4	Revenue Expenditure	438429	514699	527750	634028	613215	9.20
5	Capital Expenditure	96933	105942	119463	124817	150424	11.76
6	Other Expenditure (not classified)	209744	266611	210685	399205	470925	28.40
11	Total Expenditure	745106	887252	857868	1158050	1234564	14.34

Source: Budgets of Municipal Corporations

Table 8: Composition and Trends of Municipal Expenditure

(Rs. in Lakh)

Sl. No	Expenditure component	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	Average %
1	Establishment and administration expenditure	37.47	37.24	38.42	35.53	32.61	36.25
2	Operation & maintenance expenditure	14.41	14.45	16.57	14.20	12.51	14.43
3	Other revenue expenditure	6.96	6.33	6.52	5.02	4.56	5.88
4	Revenue Expenditure	58.85	58.01	61.52	54.75	49.67	56.56
5	Capital Expenditure	13.01	11.94	13.93	10.78	12.18	12.37
6	Other Expenditure (not classified)	28.15	30.05	24.56	34.47	38.15	31.07
7	**Total Expenditure**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**

Source: Budgets of Municipal Corporations

In these sessions you read about the significance and various sources of municipal revenue and now answer the question given in *Check Your Progress-1.*

Check Your Progress 1

Note: a) Write your answer in about 50 words.

b) Check your progress with possible answers given at the end of the unit.

1) What is the main revenue base of municipality?

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2) Describe main expenditure pattern of municipality.

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3.4 ESTIMATED INVESTMENT REQUIREMENTS, NORMS AND STANDARDS

Accurate estimates of financial resource requirements for urban infrastructure are difficult to arrive at. The costs of desired service levels are dependent on a number of factors including as the technology used, topography and geology of the urban area, past investments in a particular service, the size of population, economic profile of the urban area and the geographical area to be covered. Despite these difficulties, various efforts have been made in India to evolve norms and standards of urban infrastructure and services and compute average per capita costs. For computing the financial needs of urban infrastructure, the physical norms have to be converted into financial norms. The Zakaria Committee on Augmentation of Financial Resources of urban local bodies had attempted to evolve per capita investment norms for various urban services in early sixties; The Task Force on Housing and Urban Development, Planning Commission worked out these norms in 1983.

Table 9: Physical Standards of Services for Human Settlements

Service	Sector	Minimum levels of services required to be obtained		Remarks
		Population/ Area target	Service level target	
I. Water Supply	Urban	100% population to be covered	Piped water supply with sewerage: 150* lpcd Piped water supply without sewerage: 70* lpcd 40 lpcd with spot sources/ standposts (* Including wastage of water – roughly 20%)	Public stand posts in the low income settlements One source for 20 families within a walking distance of 100 metres.
II. anitation / Sewerage	Urban	100% city area to be covered by sewerage system with treatment facilities in large urban centres Low cost sanitation methods for other urban areas.	Large city: Full coverage by sewerage with treatment. Medium town: Public sewers with partial coverage by septic tanks. Small town: Low cost sanitation methods.	In low income areas of large cities, community latrines may be provided
III.Solid waste collection and disposal	Urban	All the solid waste generated should be collected and disposed.	100% collection of generated waste, with its proper disposal. Hazardous wastes such as hospital wastes must be incinerated in all cases. Whereas mechanized composting and incineration is recommended for large urban centres, sanitary land fill method of disposal may be used in small and medium towns.	Keeping in view the refuse generation level and its composition, each local body should determine the requirements of collection bins/ collection centres, kind of transport vehicle to be used , staff deployment for various activities, type of treatment to be given to the collected wastes, etc.
IV. Primary Education	Urban & Rural Both	Fulfilment of national goal of universalisation of elementary education for children up to 14 years of age.	Provision of primary school in all areas of the country as per the following guidelines: At least three reasonably large all weather rooms with teaching material At least one teacher per class room/section One primary school for every 3000-4000 population, Area: 3 acres; seats/school: 300-400	In order to improve enrolments at the upper primary stage specially for girls, the walking distance of school should normally be 2 kms In case of primary schools, this standard is 1 km.
V. Primary health care	Urban & Rural Both	Fulfilment of national goal of health for all by 2000AD.	One PHC for 20,000 – 30,000 population. One-sub centre for 3000-5000 population. One community health centre for one lakh population.	Primary health care has been accepted as the main instrument for achieving the goal of 'Health for All'.

Source: NIUA (1995), Working Group report on Norms and Expenditure for Infrastructure, prepared for the Fourth National Seminar of State Finance Commissions, New Delhi, November, 1995.

Table 10: Suggested Financial Norms for Provision of Core Civic Services at 1988-99 prices

(Rs. /capita)

Core Services	Planning Commission		Zakaria Committee (Wt.Avg.)
	Low	High	
Water Supply	980.00	1470.00	706.69
Sewerage	980.00	1102.50	961.26
Solid Waste Disposal	122.50	196.00	n.a.
Storm Water Drains	367.50	490.00	483.72
Roads	980.00	1470.00	828.02
Street Lighting	294.00	294.00	410.66
All services	3724.00	5022.50	3390.36

n.a. Comparative norms (per capita) are not available/not provided.

Note: Planning Commission have suggested two levels of norms – one at low level and another at high level of service standards.

Source:

i) *Zakaria Committee, Augmentation of Financial Resources of Urban Local Bodies, Report of Committee of Ministers, Constituted by the Central Council of Local Self Government, 1963 (weight age averages worked out as per class wise norms).*

ii) *Planning Commission; Task Force on Housing and Urban Development, - Financing Urban Development, 1983.*

Table 11 gives the estimated additional investment needs for provision of core services in the urban areas of the country for the years 2000 to 2020. The range of required investments by 2005 works out to be approximately Rs. 55 thousand cores to 74 thousand crores.

Table 11: Estimated Additional Investment Needs for Provision of Core Urban Services as per Planning Commission Norms and Standards, at 1998-99 prices.

Year	**2010**		**2015**		**2020**	
Projected Population	391,567,855		458,052,907		535,826,583	
Services	Low	High	Low	High	Low	High
Water Supply	19937	29906	26453	39680	34075	51112
Sewerage	19937	22430	26453	29760	34075	38334
Solid Waste Disposal	2492	3987	3307	5291	4259	6815
Storm Water Drains	7477	9969	9920	13227	12778	17037
Roads	19937	29906	26453	39680	34075	51112
Street Lighting	5981	5981	7936	7936	10222	10222
All services	75762	102180	100521	135572	129484	174634

Method to Compute the Requirement:

Requirement 2020 = (norm × (pop2020 – pop1998) + ((pop1998.30)*norm))/10000000*

Where: Population 98 = 268,748,694

Table 12: Estimates of Urban Infrastructure Investment Requirements

Agency	Services covered	Period of Recommen-dation	Resource Requirements (Rs. In crore)
NIUA (Planning Commission Norms updated to 1998-99 prices)	Water Supply, Sewerage, Solid Waste Disposal, Storm Water Drains, Roads, Street Lights	2000-2020	129484-174634
Zakaria Committee Norms (updated to 1998-99 prices)	Water Supply, Sewerage, Drainage, Roads and Street Lights	2000-2020	113754
India Infrastructure Report (Rakesh Mohan Committee)	Water Supply, Sanitation and Roads	1996-2001	41636-43573
Ninth Plan Document	Water Supply and Sanitation	1997-2002	50000

The Indian Infrastructure Report (Rakesh Mohan Committee) estimated a fresh funds required to augment the core services of water supply, sanitation and roads to clear the backlog provision, new investments and operation and maintenance of the services provided. The committee had estimated that a total of Rs. 42 thousand crores to 44 thousand crores for the period 1996-2001 are needed for augmentation of these services. This includes backlog provisions as also the new investment needed for the purpose.

It is significant to note that the Zakaria Committee's financial norms adjusted for inflation are still widely used as benchmarks for assessing infrastructure needs in urban areas, even though they are outdated and cannot match with the changing life style of the people, technological advances and growth in the economy. Considering this, the Ministry of Urban Development, Government of India has prescribed service level benchmarks for a number of urban services, and has published a hand book on service level benchmarking in 2008. The 13th Central Finance Commission has endorsed these benchmarks and has made compliance with them a necessary condition for urban local bodies to obtain performance-linked grants.

3.5 MECHANISMS TO IMPROVE MUNICIPAL REVENUE

Faced with growing demand for urban services, urban local bodies (ULBs) in India are challenged to generate more revenue. The devolved sources of revenue do not match a wide range of functions required to be performed by them. This has led to increasing dependence of ULBs on higher levels of government. Broadly, they can increase revenues from their own internal sources, seek external funding from outside agencies, and reduce expenses. An increasing demand on local services, abolition of *Octroi*, loss of buoyancy and elasticity of annual rental value (ARV) based Property Tax(PT) and the consequent fiscal stress of ULBs in India have become compelling reasons to innovate new sources of revenue. Some of the mechanisms, the ULBs can develop for enhancing their credit worthiness are follows. To mobilize resources on their own, ULBs can impose new taxes, increase tax or fee rates, or introduce management innovations within the existing revenue structures. Imposing new sources or increasing tax or user fee rates require approval of the elected municipal council and/or state government, a cumbersome and time-consuming process.

i) Refurbishing Major Taxes

Octroi and PT (Property Tax) have traditionally constituted the mainstay of municipal finance in India. In India, it is abolished in all states except in the states of Punjab, Orissa and the municipal corporations in Maharashtra and Gujarat. Analysis of data on revenue from PT reveals that share of PT in the total tax revenue is declining. In the state of Rajasthan, the share of PT in total revenue is only about 2 percent.

Decline in fiscal role of PT in India is due to a host of administrative and legal reasons. Revenue generation from PT depends on an updating of the base according to the prevailing rental values. This is hardly done despite a legal provision for this in municipal laws. Other administrative reasons pertain to lack of transparency in determination of the base and rationalisation of rate structure.

ii) Property Tax Innovations

Property taxes are the major source of revenue of ULBs in India. However, in most cities, not all properties are assessed, records are not updated regularly, and tax collection is far from satisfactory. ULBs can increase revenue by improving property inventories, record management, public awareness and participation, and tax collection. Collections from property tax can be enhanced substantially by maintaining the tax base through indexing and regular valuation, supported by legal safeguards. Some critical observations in the context of property tax administration in the country in the past include the following:

The area-based property tax systems introduced by Andhra Pradesh and Patna in the recent past is simple and innovative. When introduced in Patna, despite a reduction in the rate from 69 per cent to 9 per cent, the revenue increased substantially. These positive attributes of the system have led to its snowballing effect in other states. The system first introduced in Andhra Pradesh, has now travelled to Gujarat, Rajasthan, Uttar Pradesh, Madhya Pradesh, Tamil Nadu and Delhi. Besides, adopting a Unit Value system of Property Tax, the State Government of Uttar Pradesh has also amended Municipal Laws for de-linking the standard rent concept of the Rent Control Law from valuation of Property Tax base.

The agenda for property tax reforms may cover: simplification of tax assessment and collection, introduction of area-based methods that link property tax to location, type of building and type of use parameters based on some rational criteria, bringing government properties and unauthorised constructions into tax net, elimination of discretion on the part of assessors, self-assessment of tax and payment through banks, rationalisation of exemptions, computerisation of accounts and speedy procedures for dispute resolution.

Transparency, objectivity and simplicity of the unit value system not withstanding the system is unlikely to enjoy buoyancy and elasticity as the unit values are frozen. In order to address this problem the unit values would need to be reviewed periodically and indexed with inflation. In any scheme of refurbishment of PT, what is important is that it has to be conceived within the existing legal framework in each country so that it could be sustainable in law. Also intervention is required on all the four important organs of PT, are as follows:

a) Nature of base,

b) Valuation and assessment practices,

c) Rate structure, and

d) Collection efficiency.

Isolated intervention on any one of these organs is unlikely to enhance revenue productivity of this tax.

All these organs would need to be addressed at the same time.

iii) Effective Tax Administration

Maladies in tax administration relate to:

i) Lack of effective and objective valuation of tax base; and

ii) Deficiencies in assessment of demand, billing and collection.

Widening of tax-net, addressing the question of under assessment, review of exemptions of lands and buildings from Property Tax are required to be objectively addressed. Some of the cities have now gone for tax mapping for widening the tax-net.

Physical surveys of lands and buildings by using GIS base maps tried in the cities of Ludhiana, Indore, Mirzapur, Ghaziabad, Agra, Lucknow, Kanpur and other cities have dramatically widened the local tax-net and enhanced revenue. It has also helped in imparting objectivity and transparency in valuation and assessment of Property Tax.

Tax collection and generation of additional revenue could be ensured through (i) a scheme of incentives and penalties for municipal staff and the taxpayers and (ii) by profitably adopting the ABC Analysis, which is usually applied in management of inventory in an organisation or a project. Some of the tax administration measures taken by various state governments are narrated behalf.

a) **Self-Assessment System (SAS):** Several ULBs introduced SAS to make property tax assessments simpler and more transparent. This method helps taxpayers to understand the assessment process and removes the discretion of the assessors to assess the properties in an arbitrary manner. It increases taxpayers' involvement by allowing them to calculate their own assessment within pre-established guidelines.

The Municipal Corporation of Hyderabad (MCH) introduced SAS for property taxes in 1999-2000. MCH computerized all property records and gave each unit a unique identification number. The corporation involved the public in determining the revised tax rates by consulting resident welfare associations. Tax education and publicity campaigns, including newspaper advertisements, helped the corporation introduce the reforms. Consequently, the city increased its property tax revenue from Rs. 569 million in 1998-99 to Rs. 1008 million in 2000-01.

b) **Improved Information Base:** In 1997-98, the Chennai Corporation introduced a computerized information system that enables better linkages between property taxes and facilitates close monitoring of collections. This helped the corporation to increase its property tax revenue by 50 percent. The Indore Municipal Corporation (IMC) computerised existing property tax records and conducted a physical survey of all wards to identify properties not on record. It increased number of properties identified from 1.55 to 2.67 lakh. Some city governments have put in place friendly payment gateways like collection through banks and web-based tax collection. Indore Municipal Corporation has introduced a system of group health insurance of senior citizens. This enables the senior citizens to avail of free hospitalisation up to Rs. 20,000 provided they have paid Property Tax. A few cities have put in place a tax collection system by involving banks and on-line payment of PT.

c) **Collection Drives:** Ahmedabad conducted a special campaign to increase property tax revenue by forming special collection teams. The corporation gave the teams power to disconnect water supply or drainage lines, attach the property of defaulters, and issue arrest warrants for non-payment of property taxes. The result: in two years, 1993-94 to 1995-96, Ahmedabad nearly doubled its property tax collection, which rose from Rs. 47 crore to Rs. 92 crore.

d) **Outsourcing Bill Distribution:** Tax administration systems are labour intensive and sometimes the cost of collection exceeds the revenue collected. Some ULBs have begun to outsource sub-processes. The Municipal Corporation of Ludhiana (MCL), introduced a courier system for bill distribution. MCL had 28 bill distributors to serve property tax and water charge bills and issue overdue notices at an annual salary expense of Rs. 3.5 million. It reassigned these employees to other positions as they became vacant and gave their work to three private couriers. The couriers completed the task for Rs. 1.1 million, saving nearly Rs. 2.5 million per year.

e) **Tax Collection Centres:** ULBs in Tamil Nadu organised special tax collection camps in a group of wards. The councillors took a keen interest in organising these camps and carried out door-to-door campaigns to inform people about them, urging them to utilise the facilities and pay their taxes. The Tirunelveli Municipal Corporation opened 17 unit offices in the city to improve its property tax collection. They publicized this through all available media and fitted corporation vehicles with audio announcements and banners. Due to this publicity, 65 percent of taxpayers paid their dues before the due date and the collection were Rs. 185 lakh within six months compared to Rs. 200 lakh collected in 12 months during the previous year. In Andhra Pradesh, the Guntur Municipal Corporation also increased the number of collection centres and opened these centres on every second Saturday or Sunday. The Vishakhapatnam Municipal Corporation opened city civic centres so citizens can easily visit them to make payments.

f) **Tax "*Adalats*"(Tax courts):** Often property tax is vexatious and disputes end up in courts. Delays in solving such cases result in loss of revenues for ULBs. To avoid delays in settling property tax matters some ULBs have established special tax "*adalats*" to resolve tax disputes quickly.

3.6 NEW AREAS FOR IMPROVING MUNICIPAL RESOURCES

Some of the new suggested areas needed for the improvement of municipal revenue are described below.

1) Municipal Asset Management

Municipal Corporations usually have limited sources of revenue generation, moreover, most of the sources remain unexplored or under explored. Just for instance, not all the properties are assessed for property tax. There is undervaluation of properties and there are many trades which are not assessed for trade tax, license fees and municipal properties encroached etc. At the same time they lack proper mechanisms for expenditure management and linking of budgets and accounting systems. These two together lower creditworthiness of the Corporation as they first limit the Corporation's capacity for efficient service delivery and second limits its capability to raise funds from capital market, pooled funds, and special schemes like JNNURM etc. ULBs generally hold a significant amount of fixed assets in real estate. But very few local bodies have exploited the commercial potential of these properties to generate non-tax revenues. Most ULBs do not have a proper inventory of assets nor do they update them regularly. Often villages on the periphery are brought into municipal limits as the city expands. *Panchayat* land then comes under municipal ownership.

The Guntur Municipal Corporation regularised all the subleased municipal shops by collecting 30 percent of land and shop construction value. The Vishakhpatnam Municipal Corporation leased out the aquarium and marriage halls by fixing daily rents for them. Through this measure, corporation collected Rs. 80 lakh and was free from the related liability and expense of maintaining these properties.

2) User Fees and Charges

This is an area which needs to be focused for greater resource mobilisation and linkage between tax payment and service delivery. User charges promote efficiency by providing information on demand to the public service providers and ensure that what the public sector supplies are valued (at the margin) by citizens. They have the advantage of tying the mobilised revenues to the costs of services being provided. Institutional financing of projects becomes feasible if loans raised by ULBs are paid back through project revenues. User charges may be designed based on the users pay/beneficiaries pay principle. Services provided by a public organisation are grouped as

i) Public-goods and

ii) Merit goods or non-public goods, or private goods.

The latter is fit for application of principle of exclusion. The consumers are identifiable and the quantum of services consumed is possible to be measured. In case the consumers do not pay for the services consumed, the service can be disconnected.

User fees can also increase municipal revenues. User charges levied by ULBs include fees for water, sewerage, solid waste management, parks, parking, birth and death certificates, business licenses, streetlights, ad space, and cable TV.

a) **Sewerage Charges:** Most cities in India do not levy fees for sewerage and also are unable to provide the service. Several small ULBs in Tamil Nadu structured an innovative mechanism to finance construction of underground drainage systems. Beneficiaries contribute connection fees that share in the capital costs, reducing the debt required. The Alandur Municipality built 120 kilometres of underground drainage and a 24 million-litre per day sewage treatment plan using these deposits. The municipality charged a one-time deposit of Rs. 5000 or Rs. 10000 per connection for domestic and non-domestic users respectively. The municipality also fixed monthly sewerage maintenance charges of Rs. 150 per household connection, Rs. 450 per commercial connection and Rs. 750 per industrial connection. The ULBs conducted awareness campaigns to obtain people's support. These programmes were supported by the ULB's elected and administrative officials, as well as by state officials. The Amravati Municipal Corporation in Maharashtra built a sewerage scheme by levying sewerage charges of Rs. 2019 per year per household. They also used the revenue for debt servicing and operation and maintenance of the scheme.

b) **State Guidelines for Setting Water Charges:** Municipal water charges are generally very low and not revised for very long periods. The Government of Karnataka issued a government order for ULBs to set water charges in line with actual costs. It requires them to levy minimum water charges that would cover expenditures for operation and maintenance and debt servicing.

c) **Parking Fees:** The BMP implemented a *pay and park* scheme in the central business district. Parking fees are based on the duration of parking.

d) **Eco Fee:** The BMP council resolved to levy an "eco fee" on the persons using the municipal garden. The city collects this fee at the entrance of the garden but regulars can obtain a monthly pass. Children and senior citizens are exempted.

e) **Charges for Collecting Solid Waste:** Various ULBs levy solid waste charges for the use of public places based on the amount of waste generated. The ULBs decided that organizers of private functions in the city's marriage halls should pay a fee for waste collection. Similarly, some ULBs levy lifting charges to remove debris from construction sites.

f) **Fees for "Tatkal" (Hindi for "Quick") Delivery of Services:** Issuing birth and death certificates and building permits are ULB responsibilities. To simplify the process some ULBs in Tamil Nadu decided to mail birth certificates to applicants. These ULBs levy a service charge of Rs. 5 per certificate for postal expenses. Some municipalities in Tamil Nadu and West Bengal charge extra for the delivery of this certificate on a priority basis.

The Guntur Municipal Corporation streamlined issuance of building plans by providing that any applicant paying a 25 percent additional fee with an affidavit from a licensed surveyor gets approval across the counter. Many appreciate these convenient procedures and choose the quick delivery of service.

g) **Advertisement Tax:** BMP's revenue from the advertisement tax rose from Rs. 2.43 crore in 1999-2000 to Rs. 4.01 crore in 2000-01 due to increased space available from construction of bus shelters and public toilets and other administrative measures. The MCH's advertisement income increased with its aggressive auctioning of space on billboards, bus shelters, road arches, and footpath railings.

h) **Cable Charges:** The Government of Tamil Nadu allowed ULBs to charge cable TV operators for the use of public property. Gobichettipalayam, the first to implement this order, charges cable operators Rs.5.5 per year per kilometre of cable. In addition, the council collects from the cable operators a monthly fee of Rs. 15 per connection. The total revenue generated from these measures was about Rs.4.19 lakh in 2000-01.

i) **Street Tax:** The Pune Municipal Corporation in Maharashtra levies a street tax to help finance a plan to improve traffic and public transportation. The fee is collected with the property tax and is five percent of annual rateable value.

3) Using Land as Resource

The installation of infrastructure (e.g., roads, water, sewer, and electricity) increases the value of the land in the vicinity of the infrastructure investment. Unused land owned by local governments or state government has a market value that can be put to use to accomplish development objectives highlighted in a city development plan (CDP). Converting land values into resources needed to pay for infrastructure is an important alternative to using debt financing and is being used in rapidly growing cities like Bangalore, Mumbai, and Pune.

4) Internal and External Development Charges:

These charges include costs of off-site and on-site infrastructure such as water source development, laying of water, sewer and power lines, development of freeways/roads, parks, etc. The development charges could be collected at the time of giving approvals to layouts and buildings. These charges, which cover costs towards the following range of infrastructure amenities, provide an excellent example of cost recovery:

1) Water supply;
2) Sewerage;
3) Storm water drainage;
4) Roads;
5) Electrification including 26.5 per cent operation and maintenance and supervision charges;
6) Street lighting;

7) Community buildings;
8) Diversion of high tension (HT) lines;
9) Horticulture including first five years maintenance;
10) Conservancy;
11) Nominal maintenance of roads
12) Resurfacing of roads;
13) Maintenance of Public Health Services for first five years
14) Maintenance of street lights for first five years;
15) Maintenance of street lights beyond five years and up to 10 years;
16) Horticulture after 5 to 10 years;
17) Beautification of entry points, junction improvements and levelling;
18) Development of recreational and communication zones; and
19) Protection works, etc.

In these sessions you read about various mechanisms to improve the sources of revenue for the municipal government. Now answer the question given in Check Your Progress-2.

Check Your Progress 2

Note: a) Write your answer in about 50 words.

b) Check your progress with possible answers given at the end of the unit.

1) Describe one of the mechanisms to enhance the municipal revenue.

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2) What are the internal and external charges for raising municipal revenue?

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3.7 LET US SUM UP

Municipal Finance is critical to municipal development. It can affect the nature and location of development. Government of India from time to time has introduced various reforms in order to enhance the revenue base of municipal government.

As a part of municipal tax reforms, it is necessary to broaden the existing tax base of the Municipalities and to improve collection from other important municipal taxes such as Profession Tax, Entertainment Tax, Advertisement Tax, Motor Vehicles Tax and Business Licensing Fees. Many developed countries authorise the levy of local option income, sales and excise taxes by the local authorities. The possibility of levying a local surcharge on sales and excise taxes (on petrol, diesel, etc.) may need to be explored.

Increasing municipal revenue is a major challenge for ULBs. Some have implemented management innovations resulting in significantly increased revenues. Improved information systems simplified billing and collection, better enforcement, and public communication are key elements of success. The most important lesson learned is that the reform process requires the strong commitment and unwavering support of elected leaders as well as of administrators.

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3.9 CHECK YOUR PROGRESS: POSSIBLE ANSWERS

Check Your Progress 1

1) **What is the main revenue base of municipality?**

   The important revenue base of the MCs can be broadly categorized into:

   d) tax revenues ,

   e) non-tax revenues,

   f) assigned (shared) revenue,

   d) grants-in-aid,

   e) loans and

   e) other receipts.

2) **Describe main expenditure pattern of municipality?**

   Revenue expenditure pattern of the MCs can broadly comprise:

   i) establishment expenditure,

   ii) administrative expenditure,

   iii) operations and maintenance expenditure, and

   iv) interest payments on loans;

   Capital expenditure comprises

   i) expenditure on capital formation and

   ii) principal repayment.

Check Your Progress 2

1) **Describe one of the mechanisms to enhance the municipal revenue.**

   User charges promote efficiency by providing information on demand to the public service providers and ensure that what the public sector supplies are valued (at the margin) by citizens. They have the advantage of tying the mobilised revenues to the costs of services being provided. Institutional financing of projects becomes feasible if loans raised by ULBs are paid back through project revenues. User charges may be designed based on the users pay/beneficiaries pay principle. Services provided by a public organisation are grouped as

   i) Public-goods and

   ii) Merit goods or non-public goods, or private goods.

2) **What are the internal and external charges for raising municipal revenue?**

   The internal and external charges include costs of off-site and on-site infrastructure such as water source development, laying of water, sewer and power lines, development of freeways/roads, parks, etc. The development charges could be collected at the time of giving approvals to layouts and buildings. These charges, which cover costs towards the following range of infrastructure amenities, provide an excellent example of cost recovery:

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- Resurfacing of roads;
- Maintenance of Public Health Services for first five years
- Maintenance of street lights for first five years;
- Maintenance of street lights beyond five years and up to 10 years;
- Horticulture after 5 to 10 years;
- Beautification of entry points, junction improvements and levelling;
- Development of recreational and communication zones
- Protection works, etc.