National Institute of Public Finance and Policy

MUNICIPAL FINANCE MATTERS

INDIA MUNICIPAL FINANCE REPORT (IMFR)

National Institute of Public Finance and Policy

MUNICIPAL FINANCE MATTERS

INDIA MUNICIPAL FINANCE REPORT (IMFR)
ADB TA 7334 IND

Om Prakash Mathur, Principal Team Leader

Research Team

Debdulal Thakur

A.K. Halen

Samik Chowdhury

Seema Mehrotra

Rita Rakshit

Chandana Sarkar

August 2011

CONTENTS

LIST OF TABLES

LIST OF GRAPHS

LIST OF CHARTS

ABBREVIATIONS

ADB	Asian Development Bank
ARV	Annual Rental Value
CAG	Comptroller and Auditor General
CARE	Credit Analysis and Research Limited
CDP	City Development Plan
CFC	Central Finance Commission
CRISIL	Credit Rating Information Services of India Limited
CSO	Central Statistical Organisation
DLB	Directorate of Local Bodies
DPC	District Planning Committee
EAG	Expert Advisory Group
GDP	Gross Domestic Product
GHMC	Greater Hyderabad Municipal Corporation
GIS	Geographical Information System
GoI	Government of India
GSDP	Gross State Domestic Product
GST	Goods and Services Tax
HMWSSB	Hyderabad Metropolitan Water Supply and Sewerage Board
HPEC	High Powered Expert Committee on Estimating Urban Infrastructure Investment Requirements
HUDCO	Housing and Urban Development Corporation Limited
IDFC	Infrastructure Development Finance Company Limited
IHSDP	Integrated Housing and Slum Development Programme
IMFR	India Municipal Finance Report
JDA	Jaipur Development Authority
JNNURM	Jawaharlal Nehru National Urban Renewal Mission
KWA	Kerala Water Authority
LDA	Lucknow Development Authority
LIG	Low Income Group

MC	Municipal Corporation
MoA	Memorandum of Agreement
MoUD	Ministry of Urban Development
MPC	Metropolitan Planning Committee
MSW	Municipal Solid Waste
NIPFP	National Institute of Public Finance and Policy
NIUA	National Institute of Urban Affairs
NRW	Non-Revenue Water
NSSO	National Sample Survey Organisation
O&M	Operations and Maintenance
OECD	Organisation for Economic Co-operation and Development
PEARL	Peer Experience and Reflective Learning
PHED	Public Health Engineering Department
PPP	Public Private Partnership
PRI	Panchayati Raj Institution
R&D	Research and Development
RGI	Registrar General of India
SFC	State Finance Commission
TFC	Thirteenth Finance Commission
ToR	Terms of Reference
UA	Urban Agglomeration
UIG	Urban Infrastructure and Governance
ULB	Urban Local Body
ULCRA	Urban Land Ceiling and Regulation Act
UN	United Nations
UNDP	United Nations Development Programme
VAT	Value Added Tax

UNITS

10 lakh	= 1 million	
1 crore	= 100 lakh	= 10 million
100 crore	= 1 billion	= 1000 million
1 lakh crore	= 1 trillion	= 1000 billion
Rs. 44.50	= US $ 1	

While the world has changed rapidly, the tax systems that support all levels of government have largely stayed the same. The underlying taxes that support local governments were designed and implemented in a different time and for a different economy. With a few exceptions, these taxes have not changed significantly since their inception. Many scholars believe that without radical changes, many types of taxes cannot continue raising sufficient revenue for the 21st Century.

David Brunori. 2007. Local Tax Policy:
A federalist Perspective.
The Urban Institute Press. Washington D.C.

PREFACE

This study entitled **Municipal Finance Matters: India Municipal Finance Study** comes in at a time when there is increasing concern, both within and outside the government, for the country's municipal sector, for its lackluster growth and performance, and its indifferent response to initiatives such as the 74th Constitution Amendment Act, 1992 and the Jawaharlal Nehru National Urban Renewal Mission (JNNURM). Several reports that have appeared over the past three years, in particular, the Report of the Thirteenth Finance Commission (TFC) (December 2009), the McKinsey Global Institute's study on India's urban awakening: Building inclusive cities, sustaining economic growth (April 2010), the High-Powered Expert Committee on Indian Urban Infrastructure and Services (March 2011), and the World Bank's study on India: Developing a Regulatory Framework for Municipal Borrowing (October 2011), have all drawn attention to the persisting fragility of the municipal system and made important suggestions for its revamping. The Thirteenth Finance Commission, for instance, emphasizes on the need to refurbish property taxation as a key step to strengthening municipal finance and suggests, as a part of its many recommendations, the establishment of state-level Property Tax Boards to impart uniformity in the system of property assessment. The McKinsey Global Institute study underscores the importance of cities and towns to the Indian economy, and links its future growth to unlocking US $ 1.2 trillion for urban infrastructure capital with a key role for municipalities, empowered city administrations, land use planning and spatial choices, and policies in respect of affordable housing, environmental sustainability, and transportation. The High-Powered Expert Committee on estimating urban infrastructure investment requirements has set out standard expenditure norms for municipal infrastructure and services, estimated the financial requirements, and proposed a pattern of financing them with a pivotal role for municipalities. The World Bank's study examines the supply-side constraints to municipal borrowing and emphasizes simplification of local government frameworks and elimination of ambiguities in regulations that govern municipal borrowing. Although these reports and studies address different facets of municipal finance they advance a strikingly similar message: the existing municipal finance is out-of-sync with India's changing socio-economic realities, and there is a need for major restructuring of the municipal finance system if it is to meet the contemporary challenges of growth and urbanization and of those envisioned under the 74th Constitution Amendment Act, 1992.

This study on the finances of municipalities aims to reinforce and advance the suggestion that India's municipal system is in need of major repair and reforms. It builds on the several leads that emerge from these reports and studies and delves into them in depth. The core questions it addresses are: is the existing municipal finance system adequate for India's changing socio-economic realities? Can the existing finance system effectively deliver on the functions envisaged for municipalities under the Constitution? What needs to be done to make the existing system work? What roles will be required of the Central and state governments in reinforcing the municipal finance system? In this context, the study undertakes an assessment of the adequacy and sustainability of the existing municipal finance system for meeting the challenges of a growing economy and urbanization which is expected to rise exponentially as the Indian economy gains further momentum. It analyses the fiscal health and performance of municipalities, and examines as to what might explain the level of fiscal performance - is the performance a function of expenditure assignment and fiscal powers? Is it a matter of efficiency internal to municipalities raising questions of capacities and systems? Is it affected and influenced by macro-economic and regional trends as has been observed in several Latin American countries? The study suggests a way forward for municipalities to be able to effectively respond to the challenges that they face and will face in the coming decades.

The process of municipal sector reform has begun in India. Several reform initiatives acknowledge that the municipal sector has important growth and distributional linkages, and consequently envisage such functions to be directly devolved to municipalities with their fiscal space opened up, restructured, and widened. The study takes note of the fact that the municipal systems are changing across the world for reasons attributable to decentralization, globalization pressures, or simply the need to meet the infrastructure requirements of large urban populations. A number of countries have taken steps to widen the expenditure portfolio of their municipalities and assigned them access to relatively more buoyant revenue instruments including access to at least one economy-wide source of revenue. This study considers these developments and their relevance to the Indian set-up.

This study has been conducted with the financial support of the Asian Development Bank (ADB) under TA-7334. It has received valuable contributions from a cross-section of experts comprising members of the Expert Advisory Group (EAG), Dr. M. Govinda Rao, National Institute of Public Finance and Policy, New Delhi, and Mr. Pradeep Singh, Infrastructure Development Finance Company; members of an International Advisory Group consisting of Dr. Enid Slack, Institute of Municipal Finance and Governance and Munk School of Global Affairs, University of Toronto, Dr. Michael A. Cohen, New School University, New York, and Dr. Junghun Kim, Korea Institute of Public Finance, Seoul; members of the Steering Committee headed by Mr. Venu Rajamony, Joint Secretary, Department of Economic Affairs, Ministry of Finance; Dr. P.K. Mohanty, Ministry of Housing and Urban Poverty Alleviation, New Delhi; Mr. A.K. Mehta and Ms. R. Nivedita, Ministry of Urban Development; Mr. Mitchell Cook, New School University, New York; Ms. M. Teresa Kho, Dr. Tariq H. Niazi, and Irene A. Dionisio, Asian Development Bank, Manila; Dr. Hun Kim, Asian Development Bank, New Delhi; Ms. Anuradha Thakur, Department of Economic Affairs, New Delhi; and Principal Secretaries of the State departments of Urban Development viz., Ms. Pushpa Subramanian and Dr. Vijay Kumar (Andhra Pradesh), Mr. S.M. Vijayanand

(Kerala), Mr. Surya Pratap Singh Parihar (Madhya Pradesh), Mr. Manu Kumar Srivastava (Maharashtra), Dr. G.S. Sandhu (Rajasthan), and Mr. Alok Ranjan (Uttar Pradesh). Also acknowledged is the assistance received from the Korea Institute of Public Finance, Seoul for organising an interactive Roundtable for specialists, experts and policy-makers from India, Republic of Korea, and Canada. Acknowledgment is especially due to the research team – Debdulal Thakur, A.K. Halen, Samik Chowdhury, Seema Mahrotra, Rita Rakshit and Chandana Sarkar, who undertook the ardous task of collecting and collating the municipal finance data – by no means a mean task in a country where each state maintains its own system of municipal budgeting and accounting and analysed the same with a high degree of analytical rigour and precision. Usha Mathur coordinated the production and design of the report and assisted in the administration of the study. As the Principal Team Leader, and the author of this report, I owe to each one of them my gratitude for their substantive support to this study, and simultaneously accept responsibility for the report, its findings and conclusions and the suggestions made therein, and above all, for all the deficiencies in the report.

Dr. KyeongAe Choe, Principal Development Specialist, Asian Development Bank (ADB) was the counterpart Task Manager for his study. As this study report goes into print, Dr. KyeongAe is no more. She died in October 2011. Dr. Choe was central to the study at every stage, be it the strategy for data collection or the selection of statistical tools for analysis or the articulation of the recommendations. On behalf of the team and all those who were associated with this study, I would like to place on record her contributions and dedicate the study to her.

The study report has since been concurred by the Department of Economic Affairs, Ministry of Finance, Government of India, New Delhi (No 7/12/2009-ADB, dated 10 August, 2011).

I do hope that the Department of Economic Affairs (Ministry of Finance), Ministry of Urban Development, the Planning Commission, the state governments, and the Asian Development Bank (ADB) will review the findings and recommendations made in this study report and give them a serious consideration. I also hope that the Sub-Committee of Chief Ministers established by the National Development Council (NDC), on Urbanization Issues will have an opportunity to consider the municipal finance reforms agenda as put out in this study.

The municipal sector has long been neglected in India. In many respects, as this study illustrates, it resembles the initial framework developed in the latter part of the 19th century. The system needs urgent alignment with the country's growth trajectory. It needs a paradigm shift in thinking about municipal finance. I also hope that the urban research community will review the methodology employed in this study for coming to grips with the financial condition of municipalities and improve upon it for undertaking similar exercises in the future. The reality of the finances of municipalities is far more engaging and challenging than what the theory, notwithstanding its intellectual rigour, richness and depth, would like us to believe.

Om Prakash Mathur
Principal Team Leader, ADB study on Municipal Finance
National Institute of Public Finance and Policy
New Delhi
Distinguished Professor of Urban Economics
National Institute of Urban Affairs
New Delhi

August 2011

1 INTRODUCTION

The finances of India's municipalities have been studied with unexceptional regularity over the past two decades. Most studies have pointed out to the grossly unsatisfactory state of their finances, attributing it partly to the internal management of fiscal resources and in part to state policies towards them. Suggestions for improvement in their finances have been crafted accordingly. This study marks a departure from the previous work in three aspects: in coverage which inter-alia includes a survey of 31 municipalities of different population sizes; in the framework of analysis where the municipal fiscal performance is evaluated against the economy-wide movements in incomes and urbanization, inter-state variation in the allocation of financial and fiscal powers, and the level of efficiency in the exercise of fiscal powers; and in the Way Forward which argues for a broad-based municipal fiscal policy that is able to respond to India's emerging urban growth challenges. This chapter dwells on the study's Raison d'être.

The Theme: Why Municipal Finance Matters

Making municipal finance work for economic growth, management of urban policy agenda, and improved service delivery is the theme of this study. This theme, representing a key public policy challenge for India, is important for at least three reasons:

i. *Improving municipal finance is central to the achievement of India's economic growth objectives*. Over the past twenty years, India has registered annual GDP growth rates of over 6.5 percent – a major achievement in macroeconomic policy management. The same period has witnessed a dramatic shift in India's economic structure from rural-based agricultural production to urban-based economic activities and from manufacturing to financial and other services. As a result, urban areas have come to account for 52 percent of the net domestic product (NDP 2004-05), having risen from 45.7 percent in 1993-94[1].

Table 1: GDP Growth Rates

Year	Annual Growth Rate %
1971-1981	3.2
1981-1991	5.4
1991-2001	5.6
2001-2010	7.5

Source: Central Statistical Organisation

Table 2: Urban Share of Net Domestic Product

Year	% Share
1980-1981	41.1
1993-1994	45.7
1999-2000	51.9
2004-2005	52.0

Source: Central Statistical Organisation

While the economic base has shifted inexorably to cities, India's recognition of the role of cities in promoting and accelerating economic development and subsequent prioritization of the municipal sector to manage the process of growth and urbanization has proceeded slowly. As this study will demonstrate, municipal governments have, at best, been a passive participant in the process of economic growth. Their linkages with growth are weak, and they have experienced little success in consolidating reform measures to manage the complex and interdependent dimensions of urbanization in the country. The municipal contribution to India's GDP is minimal (0.54 percent of the GDP), with municipalities unable to capture

[1] Over time this trend will continue; in 109 countries with populations of over one million, both urbanization and per capita income rose between 1960 and 2003. Projections for future economic growth in all countries demonstrate that the trend towards greater concentration of economic activity will occur in urban areas of all sizes. Annex, Michael A. Cohen 2010, a background paper prepared for the India Municipal Finance Report.

the urban-based growth of the recent decades, be it the contribution to incomes or the publicly-raised tax revenues; for this reason, there are questions about the sustainability of the existing system in the context of expected development outcomes such as the maintenance of high economic growth and poverty reduction. There exists a strong perception that higher urban-based growth in India is held back on account of inadequate municipal infrastructure, high regulatory costs, and weak municipal institutions. While there are no India-specific studies on the economy-wide effects of inadequate municipal infrastructure, studies in other countries estimate such costs to be extremely high, reducing both the urban productivity and competitiveness, and resulting in increased financial, economic and institutional pressures on the private sector[2]. These studies also show that municipal policy and poor institutional performance in the provision of infrastructure and services contribute to the growth of urban poverty and not to its alleviation[3]. Reforming the system of municipal finance is, therefore, a priority for both the Central and state governments which, as the trends indicate, will increasingly depend on cities for accelerated growth and poverty reduction.

ii. *A robust municipal finance system is necessary for effective implementation and management of India's urban policy agenda*. Over the past two decades, several initiatives have been taken to open up India's

---

2 Akex Anas, Kye Sik Lee, and Gi-Tak Oh, 1996. "Costs of Infrastructure Deficiencies in Manufacturing in Indonesia, Nigeria, and Thailand". World Bank Policy Research Working Paper No. 1604. According to a recent paper on Infrastructure and City Competitiveness in India, the supply of local infrastructural services such as municipal roads, street lighting, water supply and drainage has a positive and significant effect on city-level attractiveness to investment. These effects, according to the paper, are robust across econometric specifications and estimation procedure. See for details. Somik V. Lall, Hyoung Gun Wang, and Uwe Deichmann "Infrastructure and City Competitiveness in India" in Jo Beall, Basudeb Guha-Khasnobis and Ravi Kanbur (Eds). 2010. Urbanization and Development: Multidisciplinary Perspectives. Oxford University Press. New York.

3 See Annex 2, Michel A. Cohen, *ibid*.

urban sector, strengthen municipal institutions to face the changing socio-economic realities, and put in place fresh governance structures for deepening local-level decision-making. They include the 74th Constitution Amendment Act, 1992, amendment to the Income Tax Act, 1961 to allowing municipalities to issue tax-free bonds[4], and the Jawaharlal Nehru National Urban Renewal Mission (JNNURM). These initiatives which collectively constitute the broad parameters of the urban-municipal reform agenda in India comprise-

- A Constitutional status for municipalities
- Functional reform aimed at an enlarged role for municipalities
- An institutional framework for redesigning the Centre-state-municipal fiscal relations
- Inter-local government linkages and coordination
- Market based financing of municipal services
- Incentives for municipalities to undertake reform of property taxation and user charge system
- Public-private partnership in the provision of municipal services
- Tenural security for slum dwellers
- Reform of the urban land and property market
- Disclosure and transparency in municipal functioning

These initiatives have included prescriptions for a fundamental realignment of the functions, finances, and powers of municipal governments, primarily through the state governments and to an extent, via the Central government. The notable example of the latter has been the long-standing demand for a formal Constitutional recognition of municipal governments as a full-fledged *order* of government which would be tantamount to a quasi-autonomous form of *home rule*, or natural person

[4] Tax exemption is potentially an important source of Central government assistance to local governments.

powers as it is often referred to, giving them greater autonomy in their relations with the Central and state governments[5].

The process of municipal sector and municipal finance reform has thus been set in motion. However, progress on key aspects of the reform process has been tardy and uneven. The passage of the 74th Constitution Amendment Act, 1992, for instance, was intended to formally recognize municipalities and delineate a functional domain for them to play a larger role in the Indian economy and deepen the process of decentralization. In reality, however, there are a motley of institutional arrangements for undertaking several of the functions envisioned for municipalities, resulting in ad-hoc responses to the unprecedented demand for urban infrastructure and services. Consequently, low quality urbanization is observed in most parts of the country[6]. The municipal revenue base consisting of property taxes and user charges continue to suffer from substantial inefficiencies and under-utilization. Incentives for initiating reforms in spheres such as doing away with rent controls that have a direct bearing on property taxes have either not worked or are clearly inadequate. Consequently, the municipal finance system in India remains vulnerable to a broad range of both endogenous and exogenous conditions that influence the performance and efficiency in the provision of local public goods. The entire process of reforms needs to be deepened and made broad-based, bringing in long-run improvement in the financial system of municipalities as also for contributing to India's urban policy agenda.

iii. *Sound municipal finance is a pre-requisite for improved service delivery*. Most studies on municipal finance point to the insufficiency of municipal spending levels for providing and maintaining infrastructural

---

[5] It is an elegant devise for municipalities to conduct a wide range of activities with less encumbrance from legislations and other statutory regulations.

[6] Urbanization is "low quality" if it takes place without being accompanied by infrastructure and services. It is used here in a generic sense.

services at standard normative levels[7]. In 2007/08, municipal government spending (both capital and revenue expenditure) on infrastructure and services such as water supply, sewerage system, solid waste treatment and disposal, storm water drainage, city-wide roads, and street lighting was placed at Rs. 47,026 crore[8] – approximately US $ 10.5 billion – or 1.09 percent of India's gross domestic product (GDP)[9]. It comprised Rs. 18,594 crore of expenditure on creating new infrastructural assets (0.43 percent of GDP) and Rs. 28,431 crore for infrastructure maintenance, establishment charges and salaries (0.66 percent of GDP). A comparison of these spending levels with the norms recently established by the High-Powered Expert Committee on estimating urban infrastructure investment requirements (HPEC)[10] indicates that municipalities in India under-spent to the tune of 1.04 percent of GDP on infrastructure maintenance. In numerical terms, the under-spending amounted to Rs. 22,649 crore or Rs. 731 per capita (about US $ 16.5) – a phenomenal deficit by any measure. Further, the current level of investment for creating infrastructural assets is a fraction of the amount needed both to wipe out the accumulated deficit placed at Rs. 12,37,647 crore, and to meet the infrastructural needs of

---

7 Previous studies that have attempted to estimate the levels of municipal underspending include Om Prakash Mathur et. al. 2002. Options for Closing the Revenue Gap of Municipalities. National Institute of Public Finance and Policy, New Delhi, and P.K. Mohanty et. al. 2007. Municipal Finance in India: An Assessment. Development Research Group. Reserve Bank of India. Mumbai. Both studies used the expenditure norms as set by the Zakaria Committee in 1963 for estimation purposes.

8 It excludes the spending levels of municipalities in Centrally-administered territories.

9 GDP has been taken at factor cost.

10 The norms of expenditure as set by the HPEC are at 2009-10 prices. These have been adjusted to 2007-08 level.

IMFR

incremental urban population for the period 2012-2031 (Rs. 18,60,495 crore)[11]. Other estimates focusing on aggregate demand for basic standards of infrastructure and service provision also point to significant financing gaps that India faces. In a recent report India's urban awakening: Building inclusive cities, sustaining economic growth, the Mckinsey Global Institute estimated that India needed to invest US $ 1.2 trillion in housing, infrastructure and services in its cities and towns over the next twenty years, equivalent to US $ 134 per capita per year. This is almost eight times the level of current spending. They further estimate that more than half of the capital investment is necessary to erase India's infrastructure backlog and the balance to fund cities future needs. Reforming the municipal finance system is thus a first requirement for mobilizing the scale of investment needed for improving the level of infrastructure services.

Currently, the capacity of municipalities to generate resources from their tax and non-tax bases is grossly limited. In 2007-08, municipal own revenues accounted for 0.54 percent of the gross domestic product (GDP). In several states - majority of these being low income and low urbanized states - it was half the national average. The share of municipalities in the country's total tax resources too has continued to stagnate (1.7%), despite a country-wide trend towards improved tax to GDP ratio. Decentralization as embodied in the 74th Constitution Amendment, 1992 has made little difference to the tax raising effort of municipalities; their tax base continues to be narrow and marked by low buoyancy. As this study will demonstrate, the existing municipal system is vastly inefficient, with municipalities unable to optimally utilize their revenue-raising powers. Estimates made in this report indicate that municipalities have the potential of raising revenues significantly (about 110 percent) without any fundamental change in the system of property valuation or the design of tax rate structure.

[11] See Report of the High-Powered Expert Committee (HPEC) on Indian Urban Infrastructure and Services. The estimates include the proposed investment needs for water supply, sewerage, solid waste management, urban roads, storm water drains, urban transport, traffic support infrastructure, and street lighting.

Table 3: Share of Tax Revenues %

Year	Centre	States	Municipalities	Panchayats
2002-03	44.1	53.2	2.5	0.2
2007-08	50.0	48.1	1.7	0.2

Sources: Indian Public Finance Statistics. Government of India and Thirteenth Finance Commission

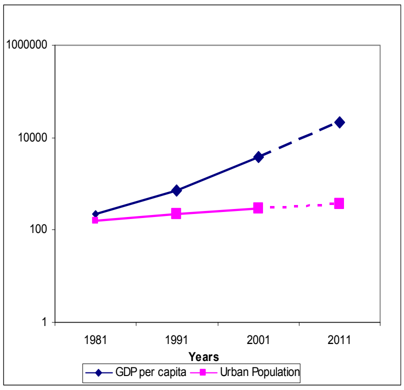
With the increasing recognition of the contribution of urbanization to economic growth, the strengthening of the fiscal position of municipalities through finance reforms has become a key component in the Government of India's development agenda. The Indian economy stands to benefit enormously from increases in the urbanization rate over the next fifty years. While the overall urbanization rate in India has been comparatively low for the economic growth patterns of the past two decades, accelerations in the rate of internal migration and natural urban population growth are predicted to increase urban population from 364 million to approximately 590 million within the next twenty years (United Nations: 2009). The country is projected to have nearly 85 cities with a population of over one million by 2030 and witness conversion of at least 2000 villages into new towns if past trends are any guide for the future.

Table 4: The Scale of India's Future Urbanization

Year	Urban Population (million)
2010	364
2015	410
2020	463
2025	532
2030	590

Source: United Nations: World Urbanization Prospects. 2009.

Graph 1: GDP Per Capita and Urban Population (1981-2001) India



Source: Central Statistical Organisation; and United Nations. World Urbanization Prospects. 2009

The challenges of urbanization, of higher rates of economic growth, shifting composition of growth towards increasingly urban-based economic activities, and increasing global competition are unprecedented in scale and complexity with enormous implications for municipal governments[12]. An effective response to these challenges requires designing a municipal fiscal policy and strategy that can meet the long-term economic growth and welfare needs[13], delineating the respective roles of the three tiers of government in financing urban development and services, and establishing fiscal rules that are consistent with the changing socio-economic realities. The existing patterns of fiscal arrangements are inadequate for this purpose, even if the existing municipal tax powers are utilized to their optimum level. As the country urbanizes, cities will be required to respond to the preferences of citizens, business and industry by addressing growth-welfare equations. How India responds to such demands for infrastructure and services is a question of what model of municipal finance will be pursued in the future[14]. What is unquestionable is the scale and scope of urban transition, and the vast financial resources that will be needed for its management.

---

12 Recent literature on local government finance dwells on the impact of the global crises on sub-national government finance and sub-national dimension of stimulus packages. See Barcelona Economics Institute. 2009. World Report on Fiscal Federalism. Barcelona.

13 This study takes the position that municipal services such as water supply, sewerage, storm water drains, solid waste management, and local mobility comprise some redistributional attributes.

14 Richard Bird's observations in this regard are pertinent. He writes: "If the appropriate expenditure role for subnational governments is simply to provide a few minor local services and perhaps to act as delivery agents for nationally determined public expenditures, the revenue assignment questions turn out to be relatively simple. However, if subnational governments are expected to deliver important (and costly) public services and have some discretion in deciding how and to what extent they do so, determining the appropriate revenue assignment is much more difficult" in Subnational Taxation in Developing Countries: A Review of the Literature. World Bank Policy Research Working Paper 5450. October 2010.

IMFR

The Objectives

This background provides a rationale and establishes a framework for the study that is titled **Municipal Finance Matters.** The study aims to consolidate the evidence on the finances of municipal finance and reassess the trends in municipal expenditures and incomes. It examines several critical questions that shed light on the dynamics of municipal fiscal adjustment including the trade-off between own revenues and transfers and grants-in-aid. Given that the state-level legislations shape the policy space for municipal governments, the study attempts to identify key vulnerabilities and identifies the most fundamental challenges currently facing Indian municipalities. Finally, it aims to present a municipal reform agenda that is able to make direct contributions to the key objectives of improved service delivery, growth, and equity. These objectives drawn from the Constitutional amendment are the benchmarks for future urban-municipal reform. In specific terms, the study undertakes to -

(i) Assess India's municipal finance system and its performance and sustainability in the context of the changing socio-economic realities;

(ii) Broaden the knowledge base on municipal fiscal and financial system;

(iii) Increase awareness and build consensus in the political arena on the need for municipal finance reform; and

(iv) Suggest a municipal finance reform agenda.

The analysis that it undertakes focuses firstly on determining the extent to which municipal incomes and expenditures affect aggregate spending and growth, and secondly on assessing the sustainability of municipal finance where the key issues are how municipal governments in the different states manage the financial stresses to which they are inevitably exposed, how they adjust their revenues and expenditures, and what role do the transfers play in the municipal fiscal dynamics. What form does the adjustment take for bridging the structural imbalances and what gaps remain unmet[15]? Another topic addressed here relates to the incidence of municipal taxation across states where, as the general principles indicate, the fiscal option with municipalities is to select a set of taxes and charges that will equate net benefits across income groups. This study estimates the tax burden and the variations therein across states and attempts to determine its sustainability in maintaining services at some normative levels.

The analysis concentrates on the fiscal performance of 31 municipalities of different population sizes drawn from six states namely Andhra Pradesh (27.7%), Kerala (25.6%), Madhya Pradesh (27.6%), Maharashtra (46.0%), Rajasthan (23.9%), and Uttar Pradesh (21.9%)[16]. This part of the study serves several purposes. First, it maps out the operating functional and fiscal portfolios of the sampled municipalities, with a view to identify the gap between what the statutes provide and what the municipalities actually do. Second, it attempts to measure the level of efficiency with which the municipalities utilize their revenue-raising powers, especially property taxes, land-based levies, and user charges, and examines the inter-governmental transfer system. The key question is whether the existing system of revenue raising and expenditure management at optimum levels of efficiency can take the load of urban challenges identified earlier in this section. Municipal level analysis is extended to ascertaining the size class differences in the fiscal performance of municipalities, addressing the question: does city size-class matter for the fiscal performance of municipalities? Does size bring in scale economies? Currently, municipal corporations (large-sized municipalities) which consist of 41 percent of the country's total urban population account for 72 percent of total municipal spending (Table 5). An

[15] Structural balance is the ability of a municipal government to support ongoing expenditure with ongoing incomes.

[16] The figures in parenthesis show the level of urbanization for 2001.

attempt is also made to look at the role of state-level parastatal institutions in the provision and financing of municipal services vis-à-vis that of municipalities.

Table 5: Municipal Spending Levels

Tier of Government	Share of Urban Population	Share of Municipal Expenditure %	
	%	2002-03	2007-08
Municipal Corporations	41.2	66.0	71.9
Municipalities	38.8	27.0	22.5
Nagar Panchayats	11.5	6.3	5.0
Notified Area Committees	0.9	0.7	0.5
Non-municipal Census Town	7.5	-	-
Total	**100.0**	**100.0**	**100.0**

Source: Thirteenth Finance Commission and Census of India

Lastly, the study attempts to measure the fiscal health of municipalities using the expenditure norms developed by the High-Powered Expert Committee on estimating urban infrastructure investment requirements. Fiscal health, the literature suggests, "is the balance between a city's ability to raise revenue and the amount it must spend to obtain services of average quality"[17]. This study assigns high priority to measuring the fiscal health not only for assessing the capacity of municipalities to finances services; but also for other reasons like local government competitiveness, service provision quality and local level creditworthiness.

This study aims to broaden the knowledge base with municipal finance practices. It is an important part of the study report, with international scholarship suggesting that Indian municipalities in comparison with municipalities in other federal countries and countries such as China and

[17] For details on the alternative ways of calculating fiscal health see, Helen F. Ladd and John Yinger. 1989. America's Ailing Cities: Fiscal Health and the Design of Urban Policy. The Johns Hopkins University Press. Baltimore. Ladd and Yinger distinguish between "actual fiscal health" and "standardized fiscal health". Standard fiscal health is fiscal health without taking into account state assistance, while actual fiscal health is the difference between restricted revenue capacity and actual expenditure needed to deliver public services.

Republic of Korea, play a relatively smaller role, entailing just a few interventions, and are endowed with an extremely small revenue base dominated by property taxation. Enid Slack (2010), for instance, points out, "few countries rely on one local tax; some rely on two taxes; and still others have three taxes. Generally, broader spending responsibilities come with a greater diversity of taxes"[18]. In the United States, the use of local sales tax and local income tax has come in partly to promote balanced revenue structures and partly to allow greater local autonomy[19]. The Republic of Korea permits local governments to levy a property tax, automobile tax, motor fuel tax, tobacco consumption tax, and an inhabitant tax[20]. The Indian system is dominated by one local tax, i.e., property tax[21], other taxes being minor in nature. The study selectively introduces recent practices in municipal finance management with the objective of drawing lessons and connecting them with the Way Forward.

The Framework

The study's framework rests on a comprehensive assessment of the fiscal performance of municipalities. This assessment is undertaken at various spatial levels, by using a mix of indicators comprising (i) municipal

---

18 Enid Slack. 2010. Municipal Finance in Federal OECD Countries, a background paper prepared for the India Municipal Finance Report. See Annex.

19 See Advisory Commission on Intergovernmental Relations (ACIR). "Local Government Reorganisational Issues" in the Challenge of Local Government Reorganisation. Washington D.C. US Government Printing office. In this report, the ACIR endorsed the use of income and sales taxes for local governments on the ground that these were more equitable and palatable.

20 See Junghun Kim. 2010. Local Public Finance in Korea. Korea Institute of Public Finance. Seoul. This is a background paper prepared for the India Municipal Finance Report. See Annex.

21 Octroi has been abolished in the country except in the municipal corporations of Maharashtra.

revenues and expenditures as a proportion of gross domestic product (GDP) and gross state domestic product (GSDP), (ii) structural balance between municipal revenues and expenditures, (iii) dependency of municipalities on transfers, (iv) revenue raising capacity to normative expenditure, (v) effective base of property taxation, and (iv) recovery ratios on municipal services. A qualitative assessment of municipal performance is added at places. The study postulates that municipal fiscal performance is crucially dependent on a number of endogenous and exogenous factors. These include the states fiscal policy towards municipalities involving the assignment of functional and fiscal powers, economy-wide trends, the degree of local autonomy, efficiencies in revenue and expenditure management, and governance and accountability[22]. For purposes of this study, we use a framework that postulates municipal fiscal performance to be a function of[23] -

(a) Economy-wide trends – whether the fiscal performance of municipalities is affected by the macroeconomic and regional trends as indicated by gross domestic product (GDP) and gross state domestic product (GSDP), and the level of urbanization;

(b) Assignment of functions and fiscal powers of municipalities;

(c) Efficiency in the use of fiscal powers – whether the fiscal performance is dependent on efficiency, using indicators such as the coverage of the tax base and tax collection ratios;

(d) Municipal capacity, determined by the ratio of supervisory and technical staff to general-purpose staff;

---

22 The study recognizes the importance of governance and accountability in the management of municipal finances. However, these have not been specifically studied.

23 A review of literature points out to other factors which affect the financial condition of municipalities. These include the weather and natural disasters, sector policies of the national governments, the economic development policies of neighbouring jurisdictions, the tax environment in nearby states, labour costs, and the discretionary decisions of local officials. This study focuses on a limited number of such factors.

(e) Autonomy- whether municipal fiscal performance is influenced by the degree of local autonomy; and

(f) City-size – whether fiscal performance is a function of city size.

The methodology for applying the above framework is outlined in the relevant sections.

The study report is laid out in five chapters. Chapter 2 introduces the Constitutional and statutory framework within which municipalities function in India. Chapter 3 is concerned with an assessment of the finances of municipalities. It is divided into several subsections, the first section dealing with an assessment of municipal finances at the national level, comparing their finances across states and identifying inter-state variations and what might possibly explain them. The next sub-section is concerned with an assessment of the finances of 31 sampled municipalities. A size-class analysis is also contained therein. Also included herewith is a brief account of the impact of the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) on the finances and functioning of municipalities and the role of parastatals i.e., the water supply and sewerage boards vis-à-vis that of municipalities.

Chapter 4 looks at the fiscal health of municipalities. Fiscal health is assessed by comparing the revenue-yield potential of municipalities with the normative expenditure levels established by the High-Powered Expert Committee on estimating urban infrastructure investment requirements. Detailed methodology is outlined in the respective section. In addition, we also use the ratings of municipalities to indicate their fiscal health. The final chapter is on the Way Forward. As indicated earlier, several initiatives have been taken in recent years for empowering municipalities and strengthening their finances. Important suggestions have been made by the Thirteenth Finance Commission (TFC) for improving property taxation and strengthening the institution of the State Finance Commission (SFC). The last chapter builds on these suggestions and presents a set of reforms that would enable municipalities to further respond to the requirements of Schedule 12[24] and the future urban growth challenges.

This study makes use of four sets of data bases: (i) the municipal finance data of the 28 states as collected and compiled by the Thirteenth Finance Commission (TFC); (ii) the municipal finance data collected from the 31 municipalities of different population sizes and data obtained from them in a questionnaire; (iii) credit rating results of the JNNURM cities and towns, and (iv) JNNURM progress reports. Other data sources wherever used are mentioned in footnotes.

Several background papers were commissioned for this study. These have been utilized in the preparation of this report and are annexed with the report. Also annexed is a set of basic tables that are used in this study report and a glossary of key terms.

Municipal finance in the context of open economies, decentralization, and globalization is vastly different from that in the traditional system where municipalities function in accordance with Dillon's Rule[25], or within the framework of John Stuart Mill's initial formulation of what local governments

[24] Schedule 12 lists out a set of 18 functions that the Constitution considers appropriate for municipal governments.

[25] J.F. Dillon. 1911. Commentaries on the Law of Municipal Corporations. Little Brown & Co. Boston.

IMFR

should be responsible for[26]. International scholars have begun to emphasize that "if fiscal decentralization is to produce sustainable net benefits in developing countries, subnational governments require much more real taxing power than they now have"[27]. In a country where reforms have barely touched this complex subject questions such as what is a local tax, what constitutes own source revenue, does India follow the widely-held principle of finance follows functions, and what explains the tax assignment choices have surfaced more pointedly than ever before, raising doubts as to how far the principles guiding municipal finance translate themselves into practices. As Roy Bahl writes: "the story (about practice matching the theory) is more complicated and there is much still to be learned about why governments (or constitutions) make the revenue assignment decisions they do."[28] This study raises these questions in order to initiate a larger debate on the municipal sector and municipal finance.

---

[26] John Stuart Mill. 1848. Principles of Political Economy. Parker London. Dealing with the question regarding which area the local authorities should have power, Mill expounded: "It is obvious to begin with, that all business purely local, all which concerns a single locality, should devolve upon the local authorities. The paving, lighting, and cleaning of the streets of a town, and in ordinary circumstances the draining of its houses, are of little consequence to any but to its inhabitants. But among the duties classed as local or performed by local functionaries, there are many which might with equal propriety be termed national, being the share, belonging to the locality, of some branch of the public administration in the efficiency of which the whole nation is alike interested: the goals, for instance – the local police – the local administration of justice". Mill. 1910 "Representative Governments" in Utilitarianism, Liberty and Representative Government, Everyman Edition. Dent. London.

[27] Roy Bahl and Richard Bird. 2008. "Sub-national Taxes in Developing Countries: The Way Forward", Public Budgeting and Finances 28(4).

[28] Roy Bahl and Musharraf R. Cyan. 2010. "Tax Assignment: Does the Practice Match the Theory?" raises an interesting question: why is the degree of tax autonomy given to subnational governments in industrial countries greater than that in developing countries?

IMFR

Box 1

Dillon's Rule

It is a general and undisputed proposition of law that a municipal corporation possesses and can exercise the following powers, and no others: first, those granted in express words, those necessarily or fairly implied in or, incident to the powers expressed granted; second, those essential to the declared objects and purposes of the corporation – not simply convenient, but indispensable. Any fair, reasonable, substantial doubt concerning the existence of the power is resolved by the courts against the corporation, and the power is denied.

J.F. Dillon. 1911.
Commentaries on the Law of Municipal Corporations.
Little Brown and Co.
Boston.

2 MUNICIPAL FISCAL FRAMEWORK

Municipal fiscal frameworks in most countries are a product of either the national Constitutions or the state or provincial statutes or both. At one level of generalization, there is a striking similarity in the frameworks across countries, in the functions that municipalities perform, the taxes they employ, and the powers they are able to exercise. As C.D. Foster (1980) notes: "In country after country one finds many of the same goods and services being provided by local government. This suggests that there may be underlying reasons why some activities are generally held more suitable for local government"[29]. At another level, municipal frameworks exhibit significant variations. India's municipal framework is characterized by 28 different expenditure and tax systems, a part of which is drawn from the Constitution, a part from the state statutes and yet another part stands linked to central government initiatives. Although India has a long history of local government, there is little evidence to explain why the expenditure and tax systems vary across states and why some states choose to diversify their tax systems and others prefer to rely on a single tax. This Chapter presents the core features of India's municipal fiscal framework which, as subsequent sections will demonstrate, have a vital bearing on the levels of municipal revenues and expenditures.

In country after country one finds many of the same goods and services being provided by local government. This suggests that there may be underlying reasons why some activities are generally held more suitable for local government.

Constitution, States, and Municipal Functions

India is a Union of 28 states and seven centrally-administered territories. In this Union, the functions, finances, and powers of the Centre and states are laid out in the seventh schedule of the Constitution of India, in what are known as the Union List, State List, and Concurrent List. While

29 C.D. Foster et.al. 1980. Local Government Finance in a Unitary State. George Allen Unwin. London.

the Constitution of India recognizes municipalities as a tier of government and provides for their constitution, municipalities are a subject of state governments in matters relating to their powers, functions and responsibilities as also the degree of autonomy that they can exercise. Out of its functions and tax powers enumerated for states under the Constitution (State List), the state governments assign certain functions and duties to municipalities. Typically, these comprise public health and sanitation, roads and bridges, water supplies, drainage and embankments subject to certain restrictions, burial and cremation grounds, and markets and fairs. The main functions with which the municipalities are associated with and which they perform include services that have the characteristics of both public goods, e.g., street lighting and municipal roads, solid waste collection and disposal, and merit goods, e.g., water supply, sewerage and drainage, and conservancy and sanitation[30]. In addition, the municipalities are vested with a number of regulatory duties and often with the development of markets, commercial complexes, and the like. Several municipal corporations have a larger functional domain which consists of running hospitals and dispensaries, electricity distribution, and bus transport services. The domain of municipal functions, however, is neither discrete nor absolute; there is a built-in concurrency between the functional domain of state governments and municipalities. In practice, few municipalities have assumed all these responsibilities, and disparities among jurisdictions are large. The functional domain of municipalities has witnessed periodic shifts and changes, on account of the withdrawal of functions in some states (e.g., water supply and sewerage), and equipping them with new responsibilities such as poverty alleviation and planning for economic and social development in others. A municipality has no

A municipality has no inherent powers in the Indian set-up. It draws legitimacy from the state statutes.

30 The benefit of such goods does not extend beyond local jurisdictions, although some non-citizens may benefit from them. This has been the principle that governs the expenditure portfolio of local governments.

inherent powers in the Indian set-up[31].

The Constitutional amendment of 1992 which incorporates a new Schedule (Schedule 12) provides a list of functions that is considered appropriate for municipal governments. It is an illustrative list, but it makes a strong commitment to decentralization (See Box 2). The incorporation of this list has frequently been understood to mean that the municipal functional domain has acquired some sort of a discrete character, apart from an expansion of its portfolio. This is, however, not the case. First, the functions and duties enumerated in Schedule 12 are *not* in addition to what the municipalities were responsible for in the pre-1992 period.

31 Most federal countries give the control over municipalities to provinces or states. Therefore, the powers a municipality possesses depend almost entirely on the powers the province wishes to grant. In Canada, for example, municipalities in some provinces operate under a "laundry list" legislation: their governing legislations spells out every power. In contrast, Alberta gives "natural person powers" to its municipalities. British Columbia has taken a different approach by creating what amounts to a "bill of rights" for municipalities. In other cases, urban areas are recognized in various ways as being different from other municipalities. Vancouver, Montreal and Winnipeg are Charter cities. Toronto is not a charter city, but it has been given additional powers in accordance with the City of Toronto Act of 2006.

Box 2
Comparison between the 1882 Ripon model of Municipal Functions and Finances and the model proposed under the Constitution (seventy-fourth) Amendment Act, 1992

The 1882 Ripon Model	Constitutional Vision
Functions	***Functions***
• the construction, upkeep and lighting of streets and roads, and the provision and maintenance of public municipal buildings; • public health, including medical relief, vaccination, sanitation, drainage and water supply, and measures against epidemics; and • education	• Urban planning including town planning. • Regulation of land-use and construction of buildings. • Planning for economic and social development. • Roads and bridges. • Water supply for domestic, industrial and, commercial purposes. • Public health, sanitation, conservancy and solid waste management. • Fire services. • Urban forestry, protection of the environment and promotion of ecological aspects. • Safeguarding the interests of weaker sections of society, including the handicapped and mentally retarded. • Slum improvement and upgradation. • Urban poverty alleviation. • Provision of urban amenities and facilities such as parks, gardens, play-grounds. • Promotion of cultural, educational and aesthetic aspects. • Burials and burial grounds; cremations, cremation grounds and electric crematoriums. • Cattle ponds; prevention of cruelty to animals. • Vital statistics including registration of births and deaths. • Public amenities including street lighting, parking lots, bus stops and public conveniences. • Regulation of slaughter houses and tanneries.

Finances	*Finances*
• octroi • taxes on houses and lands • tax on professions and trades • road tolls • taxes on carts and vehicles • rates and fees for services rendered in the shape of conservancy, water supply markets and schools	• The Finance Commission constituted under article 243-I shall also review the financial position of the Municipalities and make recommendations to the Governor as to - 1. the principles which should govern- (i) the distribution between the State and the Municipalities of the net proceeds of the taxes, tolls and fees leviable by the State, which may be divided between then under this Part and the allocation between the Municipalities at all levels of their respective shares of such proceeds; (ii) the determination of the taxes, duties, tolls and fees which may be assigned to, or appropriated by, the Municipalities; (iii) the grants-in-aid to the Municipalities from the Consolidated Fund of the State; • the measures needed to improve the financial position of the Municipalities; • any other matter referred to the Finance Commission by the Governor in the interests of sound finance of the Municipalities.

Source: Report of the Local Finance Enquiry Committee, Government of India. 1951 for the 1882 Ripon Model, and the Constitution (seventy-fourth) Amendment Act, 1992 for the 1992 Constitutional vision of municipal functions and finances.

There is substantial overlap between the functions that the municipalities were responsible for in the pre-1992 period and those that are listed in Schedule 12.

Secondly, the significance of Schedule 12 functions for municipalities lies not so much in enlarging the scope of municipal operations as in the fact that many of the functions are drawn from the Concurrent list of the Constitution. At the minimum, it would suggest that there is a group of functions, wherein there is concurrency of interests within all the three tiers of government, i.e., the Central government, state governments and municipal governments. The 1992 Constitutional amendment, however, is vague in that it does not spell out the nature of activities that are required of local governments in respect of such functions as planning for economic and social development, protection of the environment and promotion of ecological aspects, urban poverty alleviation, slum improvement and upgrading, and safeguarding the interests of weaker sections of the society, and the tasks that are to be performed by the Central and state governments[32].

Box 3

Schedule 12 Functions drawn from the Concurrent List of the Constitution

- Planning for economic and social development
- Protection of the environment and promotion of ecological aspects
- Vital statistics

Thirdly, many of the functions listed in Schedule 12 have distributional and developmental attributes which, on the one hand, represent an important departure from the past, and, on the other hand, signal a deviation from the typical Musgrave-Oates model of fiscal federalism under which redistribution is a function best performed at the higher tiers of government. Oates, for instance, argues that the potential migration of residents reduces the effectiveness of local governments in undertaking redistributive functions[33]. For this reason, functions such as poverty alleviation, environmental protection and preservation, and even slum upgrading have continued to be within the ambit of the Central and state governments with a minimal role for municipalities. The Constitutional

[32] An attempt is made in this study to map out the various functions and activities that municipalities in the different states are engaged in (see charts given in the section on the Finances of 31 Municipalities).

[33] Oates, W.E. 1972. Fiscal Federalism. Harcourt, Brace and Jovanovich. New York.

amendment has, however, altered this position, without any formal or informal suggestion on how these might be financed, with what tax bases, and with what intergovernmental transfer arrangements. It has often been labeled as “unfunded mandates” of the municipalities.

The process of the incorporation of 12th Schedule functions into the state statutes is far from complete. Only *a few states have brought the 12th Schedule functions into their statutes; further, a large gap exists between a* ***de-jure*** *incorporation and a* ***de-facto*** *transfer of functions to municipalities*, for reasons that owe to (i) absence of clarity in the roles of the three tiers of government in respect of the functions that are drawn from the Concurrent List, (ii) strong resistance to doing away with the parastatal agencies that are responsible for the provision of water supply and sewerage services in several states, and (ii) reluctance on the part of state governments to transfer such functions as urban planning or urban poverty alleviation to municipalities on grounds that these have inter-jurisdictional implications. Several states have used the low municipal capacity argument for keeping these functions to themselves. The result is that the pre-1992 position in respect of municipal functions persists in much of the country. Consequently, municipal role in the Indian economy stays at the margin in many ways, the present position being no different from that envisioned in Lord Ripon’s model of 1882 (See Box 2).

Municipal role in the Indian economy is at the margin in many ways; the present position is no different from that envisioned in Lord Ripon’s resolution of 1882.

Reference is made above of the parastatal agencies operating in the sphere of water supply and sanitation. Parastatals are the extended arm of the state governments which are mandated to undertake responsibility for services such as water supply, slum improvement, and urban planning. The rationale for constituting Parastatals is that they are better positioned to deliver services that spill over municipal jurisdictions. Vis-à-vis municipalities, they are seen to be in a superior position to address the infrastructure tariff and pricing issues. Most states in India have constituted them; over the years, their functioning in relation to municipalities has come under serious questioning especially, after the passage of the Constitution (Seventy-fourth) Amendment Act, 1992 which lists the functions currently being performed by them in Schedule 12. In Chapter 3, we have discussed the functioning of a water supply parastatal vis-à-vis that of a municipal water supply system.

Chart 1: Dejure Status of Schedule 12 Functions in Selected States, 2005

Functions	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
Andhra Pradesh	x	x	x	√	x	√	x	√	√	x	x	√	x	√	x	√	X	√
Delhi	X	X	√	x	x	√	x	x	x	x	X	√	x	√	√	√	√	√
Gujarat	X	X	X	√	√	√	√	√	√	x	x	√	√	√	√	√	√	√
Haryana	X	X	X	√	√	√	√	x	x	√	x	√	x	√	√	√	√	√
Himachal Pradesh	X	X	X	√	√	√	√	x	x	x	x	√	x	√	√	x	√	X
Karnataka	√	√	X	√	√	√	x	√	√	√	√	√	√	√	√	√	√	√
Kerala	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√
Madhya Pradesh	√	√	√	√	√	√	√	√	√	x	√	√	x	√	√	√	√	√
Maharashtra	X	X	x	√	√	√	√	x	x	x	√	x	√	√	√	√	√	√
Rajasthan	X	X	x	√	√	√	√	x	x	x	x	x	√	√	√	√	√	√
Tamil Nadu	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√
Uttar Pradesh	√	X	x	x	√	√	x	√	√	√	√	√	√	√	√	√	√	√
West Bengal	√	√	x	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√

Note: "x": refers to functions not devolved by the state to urban local bodies;
"√" refers to functions which have been devolved.

Functions codes:

1. Urban planning including town planning
2. Regulation of land use and construction of building
3. Planning for economic and social development
4. Roads and bridges
5. Water supply for domestic, industrial and commercial purposes
6. Public health, sanitation, conservancy and solid waste management
7. Fire services
8. Urban forestry, protection of the environment and promotion of ecological aspects
9. Safeguarding the interests of the weaker section of the society including handicapped and mentally retarded
10. Slum improvement and upgradation
11. Urban poverty alleviation
12. Provision of urban amenities and facilities such as parks, gardens, playgrounds
13. Promotion of cultural, educational and aesthetic aspects
14. Burials & burial ground, cremations, cremation grounds and crematoriums
15. Cattle pounds and prevention of cruelty to animals
16. Vital statistics including registration of births and deaths
17. Public amenities including street lighting, parking lots, bus stops and public conveniences
18. Regulation of slaughter houses and tanneries

Sources: State Municipal Acts

IMFR

Fiscal Assignment for Municipalities

Public finance theory suggests that finance should follow functions; the fiscal powers of local governments should be allocated in a way that the yields therefrom are consistent with the expenditure assignment. Following this broad principle, the state governments in India have endowed municipalities with functions whose benefits are generally confined to local residents - some non-residents will always benefit - and correspondingly, assigned to them tax powers whose burden is borne by local residents. In theory, there is a correspondence between functions and finance. The tax powers include property tax, a tax on advertisement, a tax on non-motorized vehicles, octroi, a tax on professions, trade and callings, and entertainment taxes, conforming to the immobility criterion.

The fiscal space of municipalities in India is limited and dominated by property taxation; other taxes are minor with little revenue significance.

The Constitutional amendment 1992 makes an important departure in laying down the principles for tax assignment. Instead of providing an illustrative list of taxes considered appropriate for municipalities, it mandates the states to constitute, once in five years, a State Finance Commission (SFC) for making recommendations on (i) the taxes, levies, and duties that should be assigned to municipalities, (ii) the taxes, duties, and levies that should be shared between the states and municipalities, (iii) grants-in-aid, and (iv) any other measure that would augment the finances of municipalities. In addition, recognizing that the finance commission of states may still leave unmet revenue gaps, the Constitutional amendment requires the Central Finance Commission (CFC) to make supplementary grants for municipalities[34]. The evidence to date is that the SFCs have not been able to bring about any noticeable change in the fiscal domain of municipalities, with the result that the municipal taxing authority stands limited to implementing and managing property taxation and a few minor

The Constitution provides for the establishment of a state finance commission in each state for laying down the tax powers of municipalities.

---

[34] Article 280(3)(c) requires the Finance Commission to make recommendations on the measures needed to augment the Consolidated Fund of a state to supplement the resources of the municipalities on the basis of the recommendations made by the Finance Commission of the State.

taxes such as advertisement taxes and a tax on non-motorized vehicles[35]. The fiscal space of municipalities is dominated by transfers which on average account for 50 percent of municipal revenues. As subsequent sections will show, a single-tax dominated municipal system and the limited scale of intergovernmental transfers are proving to be grossly inadequate in relation to both the normative expenditure levels and the financing needs for implementing the 12th Schedule of the Constitution[36].

Until the 1992 Constitutional amendment, the intergovernmental transfer system for municipalities was ambiguous. Few state municipal statutes contained any provisions with respect to transfers or the conditions under which state governments would make transfers to municipalities. The 1992 Amendment brings about an extraordinarily important change in the way transfers would be made to municipalities. The provisions are outlined in Articles 243 I and Y of the Constitution under which the state governments are required to constitute, once every five years, a finance commission whose mandates include making recommendations on (i) the taxes, duties, and levies that should be shared between the states and municipalities, and (ii) the grants-in-aid, and in Article 280(3)(a) under which the Central Finance Commission is required to make recommendations on the “measures needed to augment the Consolidated

---

35 Octroi, a tax on the entry of goods into a local area for consumption, use or sale is abolished in all states except the municipal corporations in Maharashtra. While its abolition is a positive step, it has meant depletion of the revenue base of municipalities, with calls being made for its substitution with a revenue source that has the elasticity and buoyancy of Octroi.

36 In countries such as the USA, while property tax is a key source of revenue for municipalities, several states permit local governments to levy local-option sales tax; in 2006, about 9 percent of all local governments in the United States imposed local-option sales taxes. It works out to about 11 percent of total local government tax revenue and about 7 percent of total own source revenue. Many local governments also impose levies on personal income and wages. Although not widely used, these have considerable policy and political implications. See David Brunori. 2007. Local Tax Policy. A Federalist Perspective. The Urban Institute Press. Washington D.C.

Fund of a state to supplement the resources of the municipalities on the basis of the recommendations made by the finance commission of the States". The purpose underlying these Constitutional provisions is to establish a uniform system for assessing the financial requirements of municipalities and making appropriate recommendations on both the grants and shared revenues. It is in this context that the 31 municipalities data, analysed later, should be seen[37].

Box 4

Local governments benefit from a mix of taxes. A mix of taxes gives them greater flexibility to local conditions such as changes in the economy, evolving demographics and shifting expenditure needs. Taxes that grow with the economy provide cities with an incentive to make the kind of investment that stimulate growth. Finally, any tax is certain to create local distortions, but a mix could mean that distortions created by one will be offset by the other. See Enid Slack. Ibid.

Two additional developments that have impacted the finances of municipalities need to be noted. One is the amendment to the Income Tax Act that provides for the issuance of tax-free bonds by municipalities. It is an important source of Central government subsidy to municipalities. Several cities have taken advantage of this facility. Although the expected take-off of this source of revenue is still to occur, it provides to municipalities a channel for financing their infrastructural activities. Second is the reform-linked grant facility under the Jawaharlal Nehru National Urban Renewal Mission (JNNURM). The JNNURM aims at eliminating the structural, systemic, and procedural glitches that have constrained the functioning of the urban sector. The JNNURM, inter-alia, requires the municipalities to undertake property tax and user charge reforms, to shift to an accrual-based accounting system, and bring about transparency in

[37] According to Richard Bird, intergovernmental fiscal transfers constitute part of a complex political, economic, and administrative system. Their design, role, and effects can be understood only in the specific institutional context in which they operate. See Richard Bird and Michael Smart. 2001. Intergovernmental Fiscal Transfers: Some Lessons from International Experiences. University of Toronto. Toronto.

municipal functioning. We analyse this Mission's mandate at some length in the following chapter.

Municipal finance system in India has limited autonomy in fixing tax rates, determining the tax exemption policy, accessing capital markets, or restructuring personnel policies[38]. Their taxing and spending powers have existed under the provisions of state laws which often deny municipalities the power either to impose a particular tax or to impose a tax on a particular class of tax payers. The state laws do not provide for the protection of municipal fiscal domain nor do these lay down a policy governing transfers. There exist no performance standards or measures for municipalities, with the result the finance system at this level is extremely "soft".

Municipal finance system in India has limited autonomy.

States require municipalities to maintain a balanced budget or post a surplus making the budget process revenue-driven. Available resources determine the level of spending. While some restrictions on the autonomy of municipalities are observed globally, and possibly justified on grounds of macro-economic implications, the Indian states place severe limitations on the extent and choice of taxes that municipalities can impose on their residents.

While finance follows functions is one of the widely accepted principles, in practice, available financial resources determine the level of spending.

The municipal fiscal framework that supports municipal services in India has remained largely unchanged, notwithstanding the fact that the macro-economic environment which it caters to, has undergone major changes.

Box 5

Local autonomy is widely accepted to be an important feature of local government systems and a pre-requisite for desirable consequences flowing from a well-functioning system of fiscal federalism.

in The Property Tax and Local Autonomy
Bell, Brunori and Youngman

---

38 Most countries place restrictions on local governments. See the Advisory Commission on Intergovernmental Relations. 1962. State Constitutional and Statutory Restrictions upon the Structural, Functional, and Personnel Powers of Local Government. A Commission Report.

The municipal fiscal framework that supports municipal services in India has remained largely unchanged, notwithstanding the fact that the macro-economic environment which it caters to, has undergone major changes. Many of the local taxes and the supporting charge system were evolved and designed for a different time and in a different context[39]. Municipal governments in India now operate in an environment which is being shaped by a different set of events and demographics, and can hardly be considered sufficient for meeting the needs of the new environment. Also, the relationship between municipalities and other governmental tiers is in a phase of important transformation whose implications are still to be fully grasped. In the next Chapter, we present a comprehensive evidence and analysis on the fiscal performance of municipalities and place it in the evolving macroeconomic context.

Box 6

Local Government in the USA and Canada

In Canada and the United States, local governments are under the full jurisdiction of provincial or state governments. U.S. municipal governments tend to have more autonomy than local governments in Canada, with the scope of their authority specified in a charter provided by the state (referred to as “home rule”). In some U.S. states, the powers of municipalities are actually protected in the state constitution. In Canada, by contrast, the range of local government’s authority is defined by provincial government legislation – although some provinces (British Columbia, Manitoba, Quebec and New Brunswick) have introduced charters that confer additional or city-specific powers on their cities.

Local governments in the United States provide much the same set of services as their Canadian counterparts – including police, fire protection, garbage collection, building and maintenance infrastructure, regulating land use, public water and sewer systems. However, they do so in the context of a very different financing structure. U.S. local governments generate about two-thirds of their own revenue, with the remainder of their funding coming from federal and state grants. The comparative figure for own-source revenues in Canada is about 71 percent. Local governments in Canada make greater use of property taxes, while U.S. municipalities rely more heavily on user fees and sales taxes. In some U.S. states, local governments can levy income taxes. On the spending side, variations exist because of jurisdictional differences across levels of government.

Source: Federation of Canadian Municipalities

---

[39] See United cities and Local Governments. 2011. Local Government Finance: the Challenges of the 21st Century. Edward Elgar. Cheltenham. U.K.

3 MUNICIPAL FINANCE: AN ASSESSMENT

Municipal finance assessments are usually expressed in terms of the levels of municipal revenues and expenditures, growth rates, and often in terms of revenue–expenditure shares in such national and regional aggregates as the gross domestic product (GDP), regional incomes, public expenditures, and tax revenues. Such assessments are important to determining the fiscal role, fiscal performance, and fiscal health of municipalities. This chapter gives the results of such an assessment. Given that the state legislations in India powerfully shape the fiscal space for municipal governments, the level and patterns of revenues and expenditures that emerge vary sharply. A key question that this assessment attempts to address is: what differentiates the level and patterns of revenues and expenditures of municipalities in one state from another – is it an issue of assignment or is it determined exogenously or is it an issue of efficiency?

Assessing Municipal Finances

The finances of India's municipalities have been assessed and analysed with a high degree of regularity over the past two-three decades[40]. Most assessments have pointed out to the unsatisfactory state of municipal finances, highlighting (i) the inadequacy of internally generated revenues for meeting revenue expenditures, (ii) the discretionary and ad-hoc nature of the transfers and grants-in-aid, and (iii) high level of expenditure on establishment (wages and salaries) vis-à-vis expenditure on operations and maintenance of services. A few assessments have also brought out inadequacies in the system of budgetary classification and lack

[40] See Annex for a list of studies on municipal finances conducted over the past decade.

of adequate finance data[41]. Suggestions that have emanated from the studies relate to the strengthening of property tax and user charge regimes and making the intergovernmental transfer system predictable and criteria or formulae-based.

Box 7

India's Municipal Finance Studies

Municipal finance studies fall into four broad groups: (i) those which analyse the finances of municipalities – these studies are in the nature of updation of municipal finance data in order to determine whether the finances have improved or deteriorated; (ii) those which examine the specific aspects of municipal finances, e.g., nature of the intergovernmental transfer system, property taxation, local finance data systems, and municipal borrowings; (iii) those which are aimed at estimating the level of under-spending on municipal infrastructure and services and the financial requirements for the same; and (iv) studies that have focused on analysing the reports of the Central Finance Commissions, and the State Finance Commissions especially the revenue-sharing methodology formulated by them.

In this study, the financial position of India's municipalities has been assessed at various levels and in a number of ways. One is an overview of the municipal finances, referring to the level and composition of revenues and expenditure and the changes observed therein over a period of five years (2002-03 to 2007-08), both from a macro perspective and that of the states. At the macro level, the overview presents the trends in incomes and expenditures, while the state-level overview focuses on analysing the (i) inter-state variations in internal resource generation, the balance between revenue incomes and expenditure and the nature of adjustment that municipalities make to address the problem of imbalances; and (ii) the pattern of financing municipal expenditures – which level of government finances what part of the municipal expenditure. Municipal finance data, as compiled and put out by the Thirteenth Finance Commission

41 Om Prakash Mathur. 2001. Local Finance Data Systems. National Institute of Public Finance and Policy. New Delhi.

(TFC) form the basis of the overview[42].

Complementing the assessment at the macro and state levels is an in-depth analysis of the finances of 31 municipalities, the primary focus of which is on assessing the finances of municipalities. This assessment is extended to estimating the level of efficiency with which the municipalities have used their revenue-raising powers, in particular, property taxes and user charges which are said to be the principal sources of revenues. The efficiency factor is utilized in estimating the revenue-raising capacity of municipalities for measuring their fiscal health (Chapter 4). Also analysed is the system of intergovernmental transfers and the extent to which it has been structured for greater stability and predictability in the finances of municipalities. Municipal level analysis is used to assess the size-class differences in the finance of municipalities, addressing the question: is size-class an important factor in municipal fiscal policy? This Overview also attempts to explore as to what explanations might be available for inter-state differences in municipal revenues and expenditures. First, we evaluate the levels of municipal incomes and expenditures in relation to such macro, external factors as the gross domestic product (GDP) and levels of urbanization, acknowledging that such causalities are difficult to establish, and even more difficult to interpret. Later in the section, we look at the assignment of functions and fiscal powers in selected states, in order to ascertain the extent to which these may have contributed to inter-state differences in municipal revenues and expenditures.

42 Municipal finance data as compiled and put out by the Thirteenth Finance Commission (TFC) relate to 28 states. It provides data on revenue incomes and expenditures of municipalities of all grades, aggregated at the level of states. It is by far the most comprehensive data base on the finances of municipalities in the country. In providing a macro perspective, data of all the 28 states are analyzed. However, in view of the fact that municipal finance in Northeastern states of Arunachal Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, and Tripura is still in an incipient stage, these have been excluded from the state wide overview.

We also attempt to bring in a brief account of the role of parastatals such as the water and sewerage boards vis-a-vis that of municipalities in the provision of services.

A Macro Overview

An overview of the finances of India's 3667 municipalities aggregated for all 28 states is given in the following Table[43]. According to table 6, in 2007-08, the total municipal revenue income amounted to Rs. 44,429 crore and total municipal expenditure to Rs. 47,026 crore. In per capita terms, the revenue income was placed at Rs. 1430 (US $ 32.1) and expenditure at Rs. 1513 (US $ 34.0). Own revenues formed 53 percent of the total revenue, and the balance was accounted for by assignment, devolution and grants-in-aid from states (33.4 percent), central government grants (5.3 percent), and grants from the finance commissions (2.0 percent). Revenue expenditure formed 60.5 percent of the total expenditure. The table further shows that own revenues formed 0.54 percent of the gross domestic product (GDP), while this proportion was 1.09 percent for municipal expenditure. There was a revenue account surplus of approximately 37 percent over expenditure and a deficit of about 6 percent if capital expenditure was accounted for[44].

[43] The total number of municipalities consists of 109 municipal corporations, 1498 municipalities, and 2060 Nagar Panchayats. See the Report of the Thirteenth Finance Commission (TFC). 2009. The municipal finance data given by the TFC excludes municipalities that fall within the Union Territories.

[44] Surplus of municipal revenue over expenditure should be read with caution: Firstly, revenue income, according to the classification in which the finance data are compiled includes central government transfers which are meant for asset creation; and secondly, most state governments require municipalities to maintain either a balance budget or post a budget surplus.

Table 6: The Finances of Municipalities, All States

Finances	2002-03		2007-08		CAGR %
	Amount Rs. crore	Per Capita Rs	Amount Rs. crore	Per Capita Rs	
Revenue Income					
Own tax revenue	8,838.13	311	15,277.72	492	11.57
Own non-tax revenue	4,441.84	156	8,243.66	265	13.16
Total own revenue	13,279.97	466	23,521.38	757	12.11
Assignment and devolution	3,657.06	128	9,171.11	295	20.19
Grants-in-aid	2,259.76	79	5,676.25	183	20.23
Others	1,137.52	40	2,818.32	91	19.90
Transfers from the Central Government	308.86	11	2,372.97	76	50.35
Finance Commission Transfers	276.53	10	869.02	28	25.74
Total revenue income	20,919.69	733	44,429.05	1430	16.26
Expenditure					
Revenue expenditure	15,691.46	550	28,431.45	915	12.62
Capital expenditure	5,938.28	208	18,594.08	598	25.64
Total expenditure	21,629.74	758	47,025.53	1,513	16.80
Gross domestic product (GDP) (India)[45]	22,61,415	21,415	43,20,892	37,969	13.83
Own tax as % of GDP	0.39		0.35		
Own revenue as a % of GDP	0.59		0.54		
Municipal expenditure as % of GDP	0.96		1.09		

Note: Gross Domestic Product at factor cost (current prices).
Source: TFC data.

Important changes have taken place in the structure of revenues and patterns of expenditure over the reference period of the study (See Graph 2). Firstly, the share of own tax revenues in total revenues has steadily

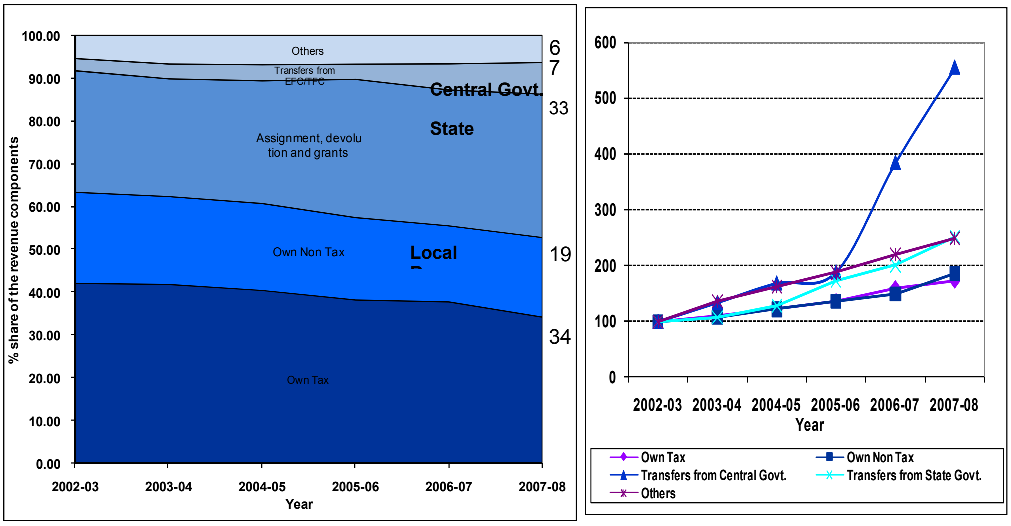
[45] Local government expenditures as a percent of GDP in several federal OECD countries (2007) are as under:

Country	% of GDP
Australia	2.3
Austria	7.4
Belgium	6.9
Canada	7.2
Germany	7.2
Spain	6.4
Switzerland	9.7

Source: International Monetary Fund. Government Finance Statistics. 2008.

declined from 42 percent to 34 percent between 2002-03 and 2007-08. Own tax revenues have risen at rates that are lower compared to the other components of revenue income. Although a part of the decline is attributable to octroi abolition and a part to the dilution of property tax regime in such states as Haryana, Punjab and Rajasthan, it is a significant development. Second, the share of non-tax revenues too has

Graph 2: Changes in the Structure of Municipal Revenue (indexed to 100 in the base year)



declined from 21.2 percent in 2002-03 to 18.5 percent in 2007-08, putting the municipal revenue-raising effort at just about 53 percent of municipalities total revenues. The balance of the municipal income has accrued from the Central and state governments.

Third, as a share of total municipal revenue income, fiscal transfers have risen from 36.5 percent in 2002-03 to 47.1 percent in 2007-08. This hike in the share of fiscal transfers is driven in part by an increase in the share of assignment, devolution, and grants from the state governments, and in part by the central government transfers. Municipalities, it should be noted, are recipients of intergovernmental transfers from the Central and state governments, the latter targeting both the vertical and horizontal imbalances. At the state level, grants-in-aid made to municipalities are used to correct imbalances in fiscal capacity. Municipalities also have access to assignment and devolution grants which consist of funds from state tax revenues shared with municipalities and revenue from local taxes levied by the states. Transfers from the central government come in the form of grants linked to reforms, designated specifically for asset creation and capital works. Intervention by the central government in the municipal sector has, within a short span of time, altered the intergovernmental fiscal framework. The Central Finance Commission makes grants-in-aid at five-year intervals that are allocated through the states to municipalities. Finance commission grants are used to fill the revenue account gaps at local levels and are allocated according to a mix of weighted criteria that takes into account factors such as urban population, geographic area, level of development, local revenue effort, an index of decentralization, an index of deprivation, and the level of conformity with the 74th Constitutional Amendment[46]. The Thirteenth Finance Commission has, however, adopted a different approach to the finances of local governments which will be outlined later.

Fourth, this period has witnessed an extraordinarily large increase in transfers from the central government; as the table shows, Central government transfers amounted to Rs. 2372 crore in 2007-08 compared to a meager Rs. 308 crore in 2002-03. Over this period, these transfers increased at an annual compound rate of over 50 percent, from a per capita of Rs. 11 in 2002-03 to Rs. 76 in 2007-08 in the form of grants from the Central government mainly under the Jawaharlal Nehru National Urban

---

[46] Criteria for allocation of grants-in-aid for municipalities are established by the successive Central Finance Commissions. These, therefore, change with every Finance Commission. The Thirteenth Finance Commission (TFC) which has **made** recommendations for the period 2010-15, has adopted an altogether different approach for municipal finances. Reference is made of the TFC's approach in a subsequent section.

Renewal Mission (JNNURM). Although these grants are meant for asset creation, they are shown as a component of the revenue income[47].

Table 7: Central Government Grants to Municipalities

Year	Amount (Rs. Crore)
2002-03	308.9
2003-04	406.8
2004-05	545.3
2005-06	336.9
2006-07	1221.9
2007-08	2372.9
CAGR %	50.35

Source: TFC data

Fifth, total municipal expenditure grew at a compound annual rate of 16.8 percent over the 2002-03 to 2007-08, increasing in the aggregate from Rs. 21,629 crore, to Rs. 47,026 crore. Data in Table 6 indicate that the municipal sector is now on course to increasing the levels of capital expenditure. Capital expenditure consisting of the transfers from the Central and state governments, and budgetary surpluses have risen at twice the rate of revenue expenditure over the six year period. What is important is that despite a decline in own source revenue as a percent of GDP, total expenditure registered an increase from 0.96 percent of GDP in 2002-03 to 1.09 percent of GDP in 2007-08. Here, the role of the JNNURM in financing municipal services needs to be acknowledged. Since its launch in 2005, it has directly involved the state governments and municipalities in matching the Central government grants; moreover the procedure so established is likely to have a long term impact in leveraging market funds for municipal infrastructure.

47 Reference to the JNNURM grants here includes Central government support under the sub-missions of Urban Infrastructure and Governance (UIG), Basic Services to the Urban Poor (BSUP) and Urban Infrastructure Development Scheme for Small and Medium Towns (UIDSSMT) and Integrated Housing and Slum Development Programme (IHSDP).

This overview of the finances of municipalities underscores the fact that over the 2002-03 and 2007-08 period, the own revenue component of municipal revenues witnessed no sign of buoyancy or vitality; in fact, as a proportion of the gross domestic product (GDP); own tax yields dipped from 0.39 percent in 2002-03 to 0.35 percent in 2007-08 and own revenue component from 0.59 percent in 2002-03 to 0.54 percent during the same period. Although the decline is attributable in part, to the abolition of octroi which was an important source of revenue for municipalities (and still is in the municipal corporations in the state of Maharashtra), and in part to state policies towards property taxation in states such as Haryana, Punjab, and Rajasthan, the fact that this component of municipal revenues has not registered any change cannot be obscured. It also suggests that unlike the reform of the central and state taxes undertaken in India in mid-1990s (and still continuing), municipal taxes have been outside of any comprehensive reform effort. Even the first principle that local governments should have access to tax instruments that have little or no inter-jurisdictional implications has not been adhered to, as several of such taxes have been transferred to or appropriated by the higher tiers of government. It also speaks of the low level of buoyancy of municipal tax instruments. As municipalities face higher responsibilities, the issue of their access to taxes such as the Goods and Services Tax (GST) needs deeper examination[48]. As a subsequent section will show, while the state municipal statutes enumerate close to 50 different kinds of revenue instruments, most of them are either not in use or have extremely low level of productivity. Several of them are obsolete, with no relevance to the socio-economic realities and the changing economy of cities.

Over the 2002-03 and 2007-08 period, the own revenue component of municipal revenues witnessed no sign of buoyancy or vitality.

Secondly, the Overview shows an increase in fiscal transfers to municipalities from 0.37 percent in 2002-03 to 0.55 percent in 2007-08.

48 In Belgium, Germany, and Switzerland, more than 80 percent of local tax revenues are derived from personal and corporate income taxes. More than 80 percent of local government tax revenues in Australia, Canada, and the US are derived from property taxation. Sales taxes are levied mainly by cities in the US and there is a mix of local taxes in Austria (30% revenue from sales tax) and Spain (40% revenues from sales tax). See Enid Slack. Ibid.

While the state government transfers are designed to meet the gap between what the municipalities raise and the level of their revenue account expenditures, the composition of transfers demonstrates that the Central government has begun to appreciate the key role of cities in the Indian economy, recognizing that investment in urban infrastructure is as much a central government responsibility as a municipal one. It further recognizes that the macro economic trends have important implications for municipal governments, as many of these trends are beyond their control warranting interventions by the Central government. That urban development is beginning to be seen as a multi-level developmental activity needs to be explicitly acknowledged and fostered.

The Central government has begun to appreciate the key role of cities in the Indian economy, recognizing that investment in urban infrastructure is as much a central government responsibility as a municipal one.

Municipal Finance
A State-Level Assessment

State government policies shape and determine the fiscal space of municipalities. This section looks at the fiscal space of municipalities in 21 states, recognizing that there is an enormous heterogeneity in revenue structures and arrangements, institutional systems, and economic conditions that affect the municipal financial performance across states. Table 8 gives the state-level structure of municipal revenues and expenditure.

State government policies shape and determine the fiscal space of municipalities.

Table 8: State-level Structure of Municipal Revenues and Expenditures, 2007-08

States	Per capita own revenue (Rs.)	CAGR of own revenue 2002-07	% share in total revenue	Per capita revenue expenditure (Rs.)	CAGR of revenue expenditure 2002-07
Andhra Pradesh	748	13.0	58.5	1060	18.5
Assam	143	4.8	38.2	205	10.8
Bihar	105	4.8	14.6	711	48.8
Chattisgarh	376	11.6	14.1	1449	34.1
Goa	282	3.9	57.8	400	8.2
Gujarat	1079	7.7	61.5	1135	10.2
Haryana	281	3.6	33.5	328	2.9
Himachal Pradesh*	595	14.9	47.8	--	--
Jammu & Kashmir	90	21.2	9.9	452	20.1
Jharkhand	86	12.6	20.2	134	15.5
Karnataka	545	6.4	34.2	750	10.5
Kerala	329	3.6	39.5	517	14.4
Madhya Pradesh	121	6.8	11.6	998	16.9
Maharashtra	2600	11.7	76.1	2237	13.8
Orissa	38	14.7	4.5	405	17.6
Punjab	1049	7.2	89.1	925	10.6
Rajasthan	387	16.6	39.5	447	11.0
Tamil Nadu	396	7.4	38.4	665	8.1
Uttar Pradesh	94	2.1	14.8	245	2.1
Uttarakhand	116	0.6	21.8	330	8.6
West Bengal	394	10.4	51.7	574	6.3

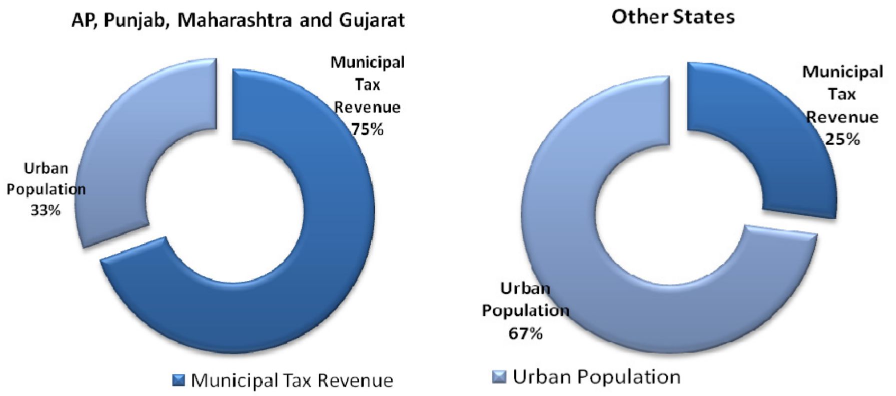
Note: This Table and the subsequent tables in this section provide finance data for 21 states.

* Data relates to 2006-07.

Several observations emanate from the above Table. First, there is an extremely large variation in the level of municipal own revenues and revenue expenditure across states (Graph 4 and 5). In Maharashtra, municipalities are able to generate a per capita annual revenue income of Rs. 2600 (US $ 58.4) and post a per capita revenue expenditure of Rs. 2,237 (US $ 50.3); in comparison, per capita revenues of municipalities in Orissa, Jharkhand, Uttar Pradesh, Bihar and Madhya Pradesh are Rs. 38, Rs. 86, Rs. 94, Rs. 105 and Rs. 121 respectively, a fraction of the municipal revenues in Maharashtra. These states are not the only ones at the bottom of the ladder, nor is Maharashtra the only one at the top. There are other states too which are not able to generate enough resources from their revenue-raising mandates. Indeed, the inter-state differentials in municipal revenues are extremely large. The municipalities in the four states of Maharashtra, Gujarat, Punjab and Andhra Pradesh accounting for 33 percent of the country's urban population generate over 75 percent of the revenues (Rs. 17,809 crore out of Rs. 23,490 crore). In contrast, the five states of Orissa, Jharkhand, Uttar Pradesh, Bihar and Madhya Pradesh generate only 3.4 percent of the total municipal revenues while accounting for 26 percent of urban population. The coefficient of variation is 154, and has risen between 2002-03 and 2007-08. The variation in municipal revenue expenditure is also significant, with municipalities in Maharashtra recording an annual per capita revenue expenditure of Rs. 2,237 as against Rs. 205 for municipalities in Assam, Rs. 245 in Uttar Pradesh, and Rs. 134 in Jharkhand. The coefficient of variation is, however, lower (77) as transfers have played an important role in narrowing down the differences. Nevertheless, the variations are large enough to provoke the question: is it the spatial pattern of the economy-wide growth that has led to accentuation in inter-state differences, or is it the outcome of the state policies towards municipal finance? We address this question later in the section.

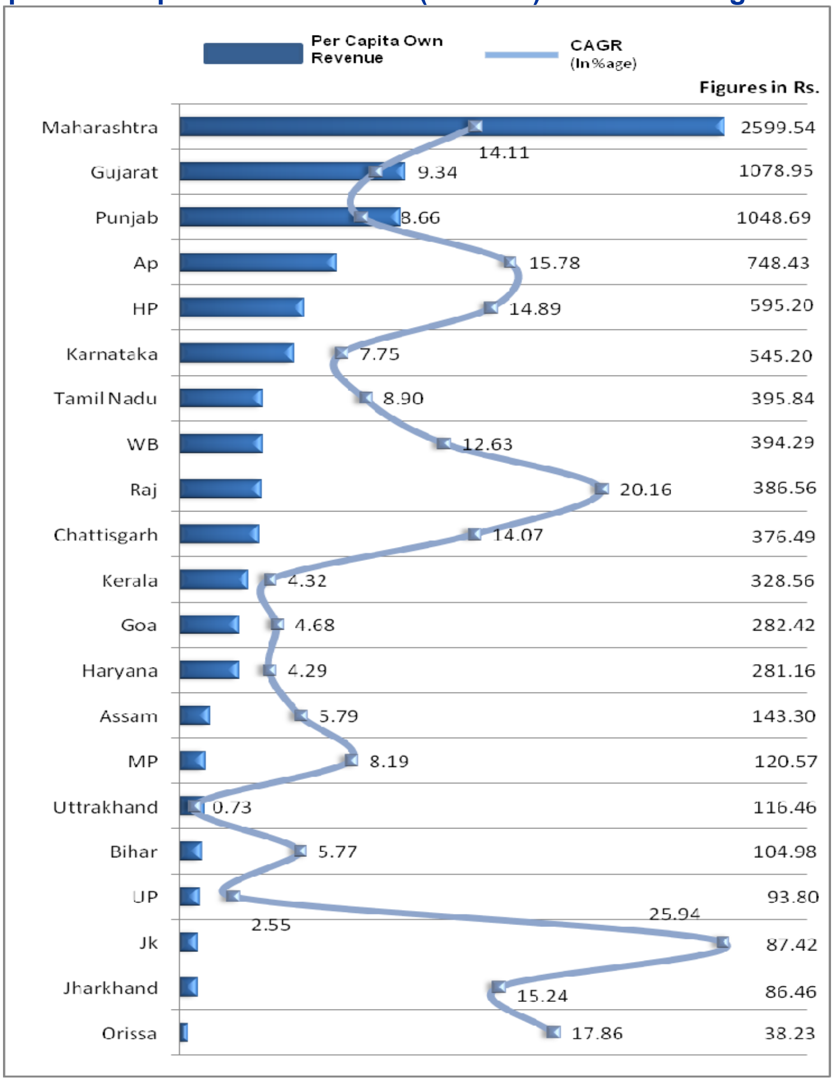
The municipalities in the four states of Maharashtra, Gujarat, Punjab and Andhra Pradesh accounting for 33 percent of the country's urban population generate over 75 percent of the revenues (Rs. 17,809 crore out of Rs. 23,490 crore). In contrast, the five states of Orissa, Jharkhand, Uttar Pradesh, Bihar and Madhya Pradesh generate only 3.4 percent of the total municipal revenues while accounting for 26 percent of urban population.

Graph 3: Share of Municipal Tax Revenue



Graph 4

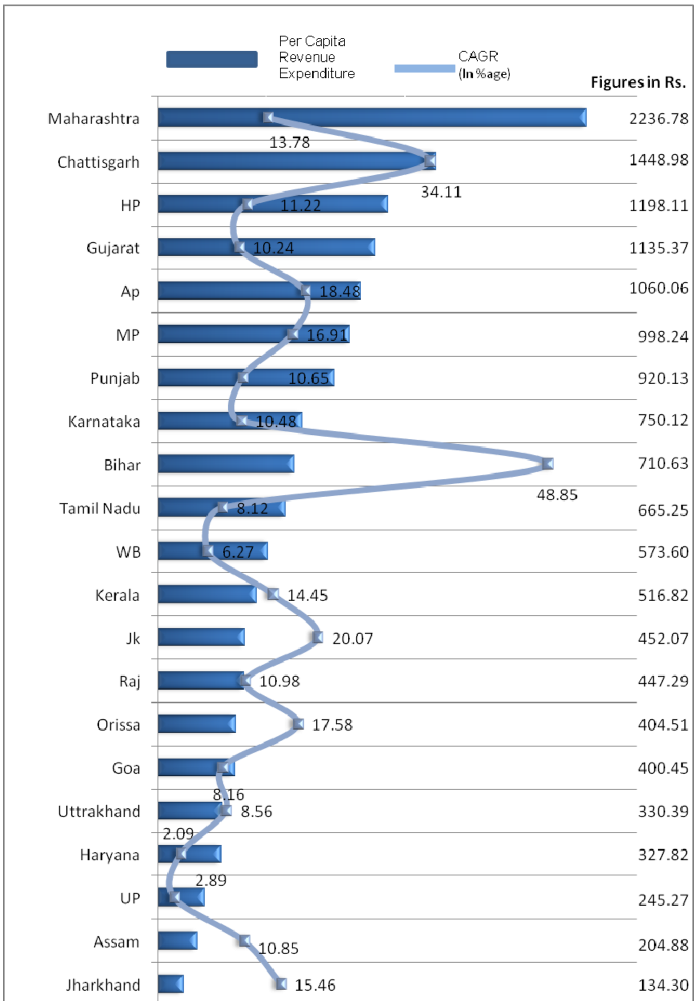
Per Capita Municipal Own Revenues (2007-08) and Percentage CAGR



Note: Index Ap: Andhra Pradesh; HP: Himachal Pradesh; WB: West Bengal; Raj: Rajasthan; MP: Madhya Pradesh; UP: Uttar Pradesh; JK: Jammu and Kashmir. Also note that the CAGR in this table refers to the CAGR of per capita municipal own revenues and may not, therefore, tally with Table 8 where the CAGR has been worked out from the aggregate numbers.

Note: Compound average growth rate, CAGR relates to the period 2002-03 to 2007-08.

Graph 5
Per Capita Municipal Expenditure (2007-08) and Percentage CAGR



Note: Index HP: Himachal Pradesh; Ap: Andhra Pradesh; MP: Madhya Pradesh; WB: West Bengal; JK: Jammu and Kashmir; Raj: Rajasthan; UP: Uttar Pradesh. Also note that the CAGR in this table refers to the CAGR of per capita municipal expenditure and may not, therefore, tally with Table 8 where the CAGR has been worked out from the aggregate numbers.

Note: CAGR relates to the period 2002-03 to 2007-08.

A second point that must be highlighted relates to the role of own source revenues in the financial structure of municipalities. Literature has consistently placed high importance to own revenue adequacy and autonomy in promoting accountability of municipal governments to their residents. Perusal of the table indicates that, as a share of total revenue, municipal own source revenues have declined 10.54 percentage points over the 2002-03 to 2007-08, and this trend is observed across states with varying levels of incomes and urbanization. The decline in own revenues ranges from 1.98 percentage points in Orissa to massive declines in Bihar, Haryana and Karnataka. Only three states have registered an increase in the share of own revenues. The question here is: what has contributed to the decrease in the own source component of revenue – is it the decline in the tax component or in the non-tax component? We present below a table on the ratio of tax to non-tax revenues together with their compound average growth rates. It shows the amount of non-tax revenue for every Rs. 1 of tax revenue.

Table 9: Ratio of Tax to Non-Tax Revenue

(A)

States where ratio has risen			% CAGR of	
States	2002-03	2007-08	Tax revenue	Non-tax revenue
Bihar	0.15	0.61	-1.0	25.4
Chattisgarh	0.56	0.79	9.0	15.7
Goa	1.18	1.35	2.5	5.0
Gujarat	0.20	0.31	6.2	14.1
Haryana	1.55	1.80	2.0	4.5
Jammu & Kashmir	2.75	7.37	6.0	24.9
Karnataka	0.60	0.85	3.9	10.0
Kerala	0.44	0.67	1.1	8.4
Punjab	0.28	0.29	7.1	7.5
Rajasthan	8.33	24.63	-1.5	18.0
Tamil Nadu	0.50	0.53	7.0	8.0
West Bengal	0.78	1.20	6.5	146

Source: TFC data

(B)

States where ratio has fallen			% CAGR of	
States	2002-03	2007-08	Tax revenue	Non-tax revenue
Andhra Pradesh	0.87	0.64	15.5	9.8
Assam	2.02	0.86	13.6	-1.5
Madhya Pradesh	1.09	0.79	9.6	3.9
Maharashtra	0.47	0.46	11.9	11.1
Orissa	0.42	0.39	15.1	13.6
Uttar Pradesh	0.66	0.62	2.5	1.5
Uttarakhand	1.85	1.44	3.3	-1.0

Source: TFC data

The table shows a dip in the tax to non-tax revenue ratio in seven states, and a increase in the tax to non-tax ratio in the other 12 states. Municipalities in category (B) have been able to marginally improve on their tax efforts vis-a-vis the charges and fees, while municipalities in the former category (A) have been able to tweak the non-tax component more decisively compared to the taxes. The last two columns provide the supporting data: higher CAGR for tax revenues in the category B states and higher CAGR for the non-tax component in the latter category A states. What the table shows is that the states and municipalities exercise policy choices – some prefer to adjust the tax component, while others opt to use the non-tax component. This is, in part, a reflection of the political economy of local taxes.

There is a severe problem of structural imbalances in much of the country in that municipal own revenue are insufficient to meet the revenue expenditure.

Municipal own revenues are insufficient to meet the revenue expenditures in all but two states, namely, Maharashtra and Punjab. There is a severe problem of structural imbalance. The problem is severe in such states as Bihar, Madhya Pradesh, and Orissa where own revenues are able to cover less than one-fifth of the ongoing expenditures. It also needs to be noted that the level of insufficiency as shown in the table is with reference to the ongoing expenditures rather than those that are necessary to provide an acceptable level of infrastructure services. If own revenues are taken as a measure of decentralization as the international literature shows, then, India has moved backwards in implementing the objectives embodied in the 74th Constitution Amendment Act, 1992 (See Table 10). Apart from the extremely low proportions of own revenues to the gross domestic product of states i.e., less than 1 percent of the overall state product (excepting the case of Maharashtra where it is 1.49 percent), the fact to note is the decline in these proportions over the five period of the study. Municipal own revenues have risen slower than the gross domestic product; municipalities have not been able to capture the growth registered during the period. Even the annual growth in the real estate sector[49] which in the aggregate was 15 percent between 2002-2007 did not trickle down to municipal finance via property taxation.

Municipal own revenues have risen slower than the gross domestic product; municipalities have not been able to capture the growth registered during the period

Aggregate municipal expenditures as a proportion of the Gross Domestic Product (GDP) are, however, substantially higher compared to

[49] The growth rate figures relate to real estate, finance, insurance, and business services.

municipal revenues. These have risen noticeably in such states as Andhra Pradesh, Chattisgarh, Karnataka, Madhya Pradesh, and Maharashtra. Several states report a fall in the aggregate municipal expenditure which reflect both a decline in own tax revenues as well as inadequate Central and state government transfers and assistance.

If own revenues are taken as a measure of decentralization, then India has moved backwards in implementing the objectives embodied in the 74th Constitution Amendment.

Table 10: Measuring Decentralization

	Own Tax Revenues as a % of GSDP		Municipal Expenditure as a % of GSDP	
States	**2002-03**	**2007-08**	**2002-03**	**2007-08**
Andhra Pradesh	0.26	0.32	0.88	1.18
Assam	0.03	0.05	0.14	0.26
Bihar	0.10	0.06	0.20	0.61
Chattisgarh	0.20	0.14	1.21	1.76
Goa	0.13	0.07	0.39	0.30
Gujarat	0.91	0.60	1.45	1.40
Haryana	0.10	0.05	0.33	0.40
Himachal Pradesh	0.12	0.14	0.28	0.29
Jammu & Kashmir	0.01	0.01	0.33	0.61
Jharkhand	0.08	0.09	0.36	0.43
Karnataka	0.40	0.26	1.04	1.49
Kerala	0.18	0.10	0.46	0.46
Madhya Pradesh	0.08	0.09	1.21	1.72
Maharashtra	1.48	1.49	2.52	2.94
Orissa	0.02	0.01	0.34	0.46
Punjab	0.65	0.56	0.83	0.76
Rajasthan	0.03	0.01	0.80	0.71
Tamil Nadu	0.37	0.29	1.42	1.29
Uttar Pradesh	0.10	0.07	0.82	0.54
Uttarakhand	0.06	0.04	0.35	0.29
West Bengal	0.18	0.14	0.67	0.76

A third point that springs from the state-level overview relates to the relative importance of the different components of municipal revenues and expenditures across states. In six states, own revenues account for over 50 percent of the total revenues – these being Andhra Pradesh (58.5%), Goa (57.8%), Gujarat (61.5%), Maharashtra (76%), Punjab (89.1%), and West Bengal (53.1%). In these states, tax revenues mainly property taxes and octroi in Maharashtra and Punjab dominate the revenue structures. Other states are transfer–dependent, where transfers account for anywhere between 60 percent and 95 percent of their revenue incomes. In 2007-08, transfers comprising assignment and devolution, grants-in-aid, Central government grants, and finance commission dispensations accounted for 95 percent of the total revenue income in Orissa, 88 percent in Madhya Pradesh, and 85 percent in Uttar Pradesh. There is a trade-off between own revenues and transfers, with the latter serving as a substitute for declining own revenues.

A fourth point that emerges is the increasing emphasis in recent years on creating new municipal infrastructural assets. Consistently low levels of capital expenditure have historically been a symptom of poor performance in the municipal sector. Data for the reference period, however, suggest reversal of this trend. Out of the 21 states, all but three registered a compound annual growth of over 15 percent in aggregate capital expenditure over the period. Consequently, the composition of expenditures has changed over 2002-03 to 2007-08 and shows a strong alignment towards a higher share of outlays of capital expenditures in total expenditures. The evolution of this composition of total expenditures somewhat tracks that of intergovernmental transfers. Central government has emerged as an important source of urban infrastructure finance in the country, its share being 5.3 percent in 2007-08. In 2002-03, it was placed at 1.5 percent.

In sum, the state-level overview brings out –

i. *High and rising inter-state disparities in the management of municipal finance.* Although the coefficient of variation differs with the different constituents of municipal revenues and expenditures (Table 11), it is large and has risen uniformly for all constituents, except the state government grants-in-aid to municipalities. Some states have evidently paid far greater attention to the municipal tier compared to others, suggesting that state policies hold the key to the reform of the municipal finance system.

Table 11: Coefficient of Variation in Municipal Revenues and Expenditure

Constituent	Coefficient of Variation (CV)	
	2002-03	2007-08
Own tax revenue	125	154
Own non-tax revenue	89	97
Assignment and devolution	86	99
State grants-in-aid	104	83
Transfers from the Central government	109	123
Finance Commission dispensation	57	61
Revenue expenditure	69	77
Capital expenditure		
Total expenditure	64	76

ii. *Declining importance of "own revenues" in the financial structure of municipalities;* it is not only that the share of own revenues has dipped, their growth rates vis-à-vis other revenue constituents have also declined. As a result, municipalities in several states are at a high risk in maintaining their fiscal identity as the third tier of government. This study takes the position that stable own revenues are a pre-requisite for the credit worthiness of municipalities in India.

iii. *Rising state government transfers to compensate municipalities for the loss on account of the abolition of octroi levies and dilution of property tax regimes.* While the abolition of octroi which is an inherently bad tax and whose adverse effects on the economy have been documented and its abolition is a positive step, the dilution of property tax regimes has caused erosion of the tax base of municipalities in several states (Rajasthan being one of them) and has resulted in increasing dependence of municipalities on state government transfers and grants-in-aid. It is a matter of vital concern, touching upon the very nature of the relationship between municipalities and the state governments. The HPEC, taking note of such occurrences, has proposed the creation of an exclusive list of taxes for municipalities, evidently to provide protection to their fiscal domain. The Thirteenth Finance Commission (TFC) has proposed that each state should set up a Property Tax Board which, in part, will ensure that the state governments maintain the centrality of this tax for municipal governments and put in place appropriate methods of property valuation and assessment. This study too underscores the need to protect the fiscal domain of municipalities. Indeed the suggestions made herein emphasize that all taxes that fulfil the basic test of a "local tax" be placed in the municipal domain and conditions created for their optimal utilisation.

iv. *An extraordinarily significant shift in the inter-governmental fiscal framework as it relates to municipalities*; the Central government and the state governments have played a significantly larger role in municipal service provision, over the reference period of the study, signalling a new trend in India's municipal fiscal framework (Table 12). The table also reinforces the trend noted earlier: the shares of the Central and state government transfers in municipal revenues are significantly higher in the relatively low-income states and the share of municipal own revenues is higher in the higher-income states.

Table 12: Relative Shares of the Different Government Tiers in Municipal Revenues, 2007-08

States	% of revenue incomes		
	Municipalities	State government	Central government
Andhra Pradesh	58.4	37.9	3.7
Assam	38.2	27.2	34.6
Bihar	14.6	79.4	6.0
Chattisgarh	14.1	60.9	25.0
Goa	57.8	42.2	--
Gujarat	61.5	36.4	2.1
Haryana	33.5	41.9	24.6
Himachal Pradesh	47.8	49.0	3.2
Jammu & Kashmir	16.9	90.1	--
Jharkhand	20.2	50.8	29.0
Karnataka	34.2	57.3	8.5
Kerala	39.5	51.1	9.4
Madhya Pradesh	11.6	82.8	5.6
Maharashtra	76.1	19.1	4.8
Orissa	4.5	57.4	38.2
Punjab	89.1	8.6	2.3
Rajasthan	39.5	45.2	15.3
Tamil Nadu	38.4	49.5	12.1
Uttar Pradesh	14.8	81.2	4.0
Uttarakhand	21.8	76.6	1.6
West Bengal	51.7	44.1	4.2

Inter-state differentials: What might explain them?

How might these inter-state differentials in municipal revenue and expenditures be explained? The framework of analysis as presented in Chapter 1 has pointed out that such differentials may arise on account of factors such as assignment of fiscal powers, efficiency in the use of such powers, autonomy of municipalities in using their fiscal powers, capacity levels, and economy-wide trends. In the preceding pages, we noted that municipal revenues are higher in states that have octroi, and lower in others including those that have diluted property taxes. We also noted the effect of the direct absorption by states of salaries and wages of municipal staff on the finances of municipalities. Here, we explore the extent to which these are linked with the key macroeconomic indicators. Literature points to a positive association between the levels of urbanization and incomes. The issue here is: do such an association hold good for the finances of municipalities in India? Are the finances of municipalities positively correlated with urbanization and incomes? We undertake two complementary exercises to understand the link between municipal incomes and macro-economic indicators, presenting firstly a table giving (i) the percentage of tax and non-tax revenues to gross state domestic product (GSDP), arranged by the income level of states (income effect on municipal revenues), and (ii) percentage of tax and non-tax revenues to the level of urbanization in different states (urbanization effect on revenues). A second exercise involves plotting selected municipal revenue and expenditure variables of states on their respective gross domestic product, and fitting a trend line to explore the association between them.

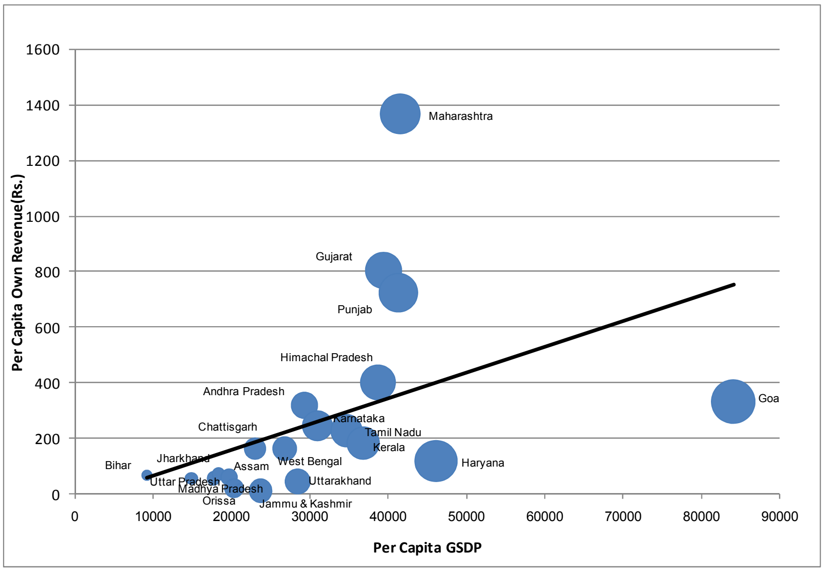
Table 13: Income and Urbanization Effect on Municipal Revenues, 2007-08

States classified by	Tax to GSDP	Non-tax to GSDP
Per capita income		
High income > Rs. 40,000 (9 states)	0.73	0.31
Middle incomes Rs. 25,000-40,000 (7 states)	1.13	0.15
Low income < Rs. 25,000 (5 states)	0.07	0.04
Level of urbanization		
High urbanized > 35% (6 states)	0.80	0.36
Moderately urbanized 25-35% (7 states)	0.09	0.09
Low urbanized < 25% (8 states)	0.14	0.10

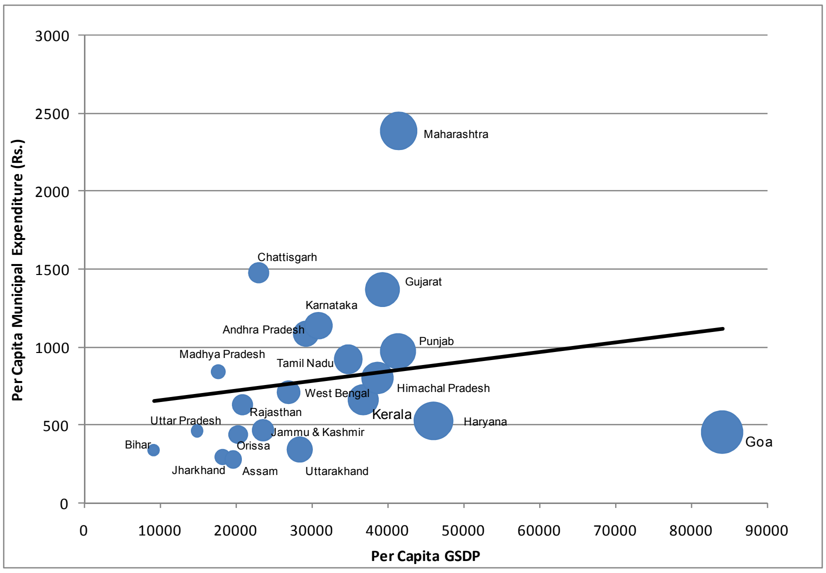
The Table above shows the link between municipal revenues and the GSDP and municipal revenues and the level of urbanization. High income states with higher urbanization levels as a group generate higher per capita municipal incomes compared with low level income states with low levels of urbanization. This suggests that income levels and urbanization are important for the generation of a stronger municipal finance system. The following graphs plot municipal own revenue and municipal expenditures of states against the gross domestic product of states. The relevant figures are the averages for the years 2002-03 to 2007-08, the period of the study.

High income states with higher urbanization levels as a group generate higher per capita municipal incomes compared with low income states with low levels of urbanization. This suggests that income levels and urbanization are important for the generation of a stronger municipal finance system.

Graph 6: Association between Municipalities Own Revenue and GSDP



Graph 7: Association between Municipal Expenditure and GSDP



The gross state per-capita revenues and expenditures are represented by the size of circles while the municipal finance variable is on the Y axis. As is evident from the gradient of the trend line, there exists a distinct positive association between the aggregate GSDP and own revenues as well as the total expenditure of municipalities. Further, the GSDP is found to have a slightly larger impact on municipal own revenues compared to municipal expenditure. This exploratory analysis indicates the potential role of macroeconomic variables on municipal finances, the general economic performance of the states being one of the factors contributing to the large inter-state variation in the fiscal space of municipalities.

The Finances of 31 Municipalities

(i) Boundaries of the survey

Complementing the macro and state-level analysis of municipal finance are the results of a survey of 31 municipalities of different population sizes, drawn from six states, namely, Andhra Pradesh, Kerala, Madhya Pradesh, Maharashtra, Rajasthan, and Uttar Pradesh[50]. The survey was designed to gain insights into (i) the operating functional and fiscal profile of municipalities as distinct from what the municipal statutes provide, (ii) the level of efficiency with which such profiles were made use of by the sampled municipalities, and (iii) the issues of financial management. The survey was meant to also assess the impact of the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) reforms on the finances and functioning of municipalities in addition to ascertaining the nature of

50 Pursuant to a decision taken in the meeting of the Expert Advisory Group (EAG) held on 20 November 2009, the National Institute of Public Finance and Policy (NIPFP) wrote to all major states (21) asking for their interest in participating in this study. The six states covered by the survey were the first ones to respond to NIPFP's letter and were thus included in the study. The NIPFP drew a sample of 30 municipalities based on the location and size class and finalised it in consultation with the state governments. One municipality was added to the sample at the suggestion of the Government of Maharashtra.

relationships between parastatal agencies such as water supply and sewerage boards and municipalities.

Accordingly, the survey results are organised to present –

i. a map of the functions and activities actually being performed by municipalities and the fiscal powers exercised by them; it represents the most robust evidence of the role and place of municipalities as practiced in the different states as distinct from what the municipal statutes provide;

ii. an analysis of the finances of the 31 municipalities. It is divided in two parts with the first part devoted to an examination of the structure of municipal revenues and expenditures and variation therein across cities of different population sizes, and the second part focused on an assessment of the level of efficiency with which the sampled municipalities have used their fiscal portfolio[51].

iii. the directions of change that the JNNURM is expected to bring to the finances and functions of municipalities, and

iv. the financial performance of a parastatal, a water supply and sewerage board vis-à-vis a municipality in the provision of water supply[52]

---

51 The efficiency factor so derived is utilized for assessing the revenue potential of municipalities (See Chapter 4).

52 The survey was also supposed to look at issues of financial management, specifically the accounting systems in the sampled municipalities. The survey results indicate that municipalities have started to change over from single entry, cash based accounting system to double entry, double entry and accrual based accounting system. Given that the process of instituting the double entry and accrual based accounting system has been put in motion and taking into account the field level observation that it has a longer gestation period, this aspect has not been pursued.

The sample of 31 municipalities is drawn from six states which belong to high and low income categories and similarly represents a cross-section of high and low-urbanized groups. The sample states are in different stages of decentralization. The aggregate state-level per capita municipal revenues and expenditures also vary. Each state is represented by five municipalities of different population sizes[53]. They have faced population growth pressures of different orders and have literacy rates varying between 63.9 percent and 92.7 percent. The following table gives their basic characteristics.

[53] Six municipalities from Maharashtra.

IMFR

Table 14: Characteristics of the Sampled Municipalities

Municipalities	Area (Sq.Km)	Population 2001(Lakh)	Annual population growth 1991-2001 (%)	Estimated population 2007/08 (lakh)	Literacy rate (%)
Size-Class: Greater than 1 Million					
Mumbai	603.00	119.78	1.88	136.45	86.80
Greater Hyderabad	172.70	54.05	2.69	66.85	78.70
Jaipur	484.64	23.20	4.65	31.88	78.10
Lucknow	310.10	21.86	3.00	26.89	77.10
Bhopal	298.48	14.58	3.16	18.13	79.70
Size-Class:5 Lakh to 1 Million					
Jabalpur	134.94	9.56	2.23	11.16	84.40
Vijaywada	59.70	9.00	2.40	10.62	78.60
Thiruvanthapuram	177.77	8.90	2.40	10.51	92.70
Kota	221.36	6.94	2.56	8.29	80.50
Aligarh	40.43	6.69	3.32	8.41	63.90
Kozikhode	62.36	6.20	3.05	7.65	91.70
Amravati	121.65	5.50	2.65	6.60	89.70
Size-Class:2.5 Lakh to 5 Lakh					
Ujjain	92.93	4.31	1.74	4.86	82.10
Malegaon	12.95	4.09	1.79	4.63	79.30
Kollam	167.62	3.80	9.99	7.40	94.40
Muzzafarnagar	12.05	3.32	2.92	4.06	75.30
Nizamabad	30.50	2.89	1.82	3.28	71.80
Bhilwara	118.49	2.80	4.20	3.73	76.70
Jalna	81.64	2.36	2.99	2.90	78.30
Karimnagar	23.80	2.06	3.24	2.58	83.30
Size-Class:1 Lakh to 2.5 Lakh					
Palakkad	45.02	1.97	0.90	2.10	90.20
Baharaich	13.30	1.68	2.19	1.95	69.30
Kadapa	33.80	1.48	0.48	1.53	77.60
Chindwara	22.01	1.22	2.61	1.46	86.00
Panvel	12.17	1.04	5.67	1.53	89.10
Jhunjhunu	37.02	1.00	3.29	1.25	71.60
Size-Class: Less than 1 Lakh					
Azamgarh	3.13	0.94	1.74	1.06	82.20
Dhar	17.48	0.75	2.40	0.89	80.50
Payyannur	54.63	0.69	0.75	0.73	92.10
Jaisalmer	126.27	0.57	3.79	0.74	74.90
Baramati	4.35	0.51	1.48	0.57	84.20

Source: Census of India, 1991 and 2001 and projected population, using linear trends.

(ii) The operating functional and fiscal portfolio

That there are as many municipal systems as the number of states has been pointed out in an earlier section of the study report. One such evidence of the range and diversity of systems is the functional and fiscal profile of municipalities. Using the municipal budgets, the functions and activities of 31 municipalities together with the operating tax sources of revenues have been mapped. Chart 2 (next page) presents the functions and activities of the sampled municipalities[54]. Two observations of importance are made from this chart. One is the large spectrum of activities in which the municipalities are engaged. An examination of the chart shows that most municipal activities are in the spheres of public works – maintenance of roads and pavements, bridges and flyovers, parks and playgrounds, ponds and lakes, street lighting, and other public spaces such as dharamshalas (rest houses), and public health involving provision of water supply, sewerage systems, waste dumping sites, solid waste collection, public toilets, hospitals, and control of aids and leprosy, epidemic control, family planning, public toilets and the like. A few municipalities engage in redistributional activities involving slum improvement, poverty alleviation, scholarship for the poor, etc. A few municipalities also maintain museums, statues, heritage, arts, and culture on the one hand, and markets on the other. In addition, municipalities are engaged in the regulation and licensing of a number of activities and issuance of certificates of marriages, births and deaths and enforcement of the provisions of Acts such as food adulteration, location of obnoxious activities in residential neighbourhoods and the like.

Notwithstanding a long list of activities, effective functional space of municipalities in the provision of services is narrow for much of the country and is loaded with regulatory activities.

Second, this large spectrum is not observed uniformly across municipalities; there are significant inter-municipal differences. At one extreme is the state of Maharashtra where several of its municipalities are engaged in the provision of higher order services such as hospitals,

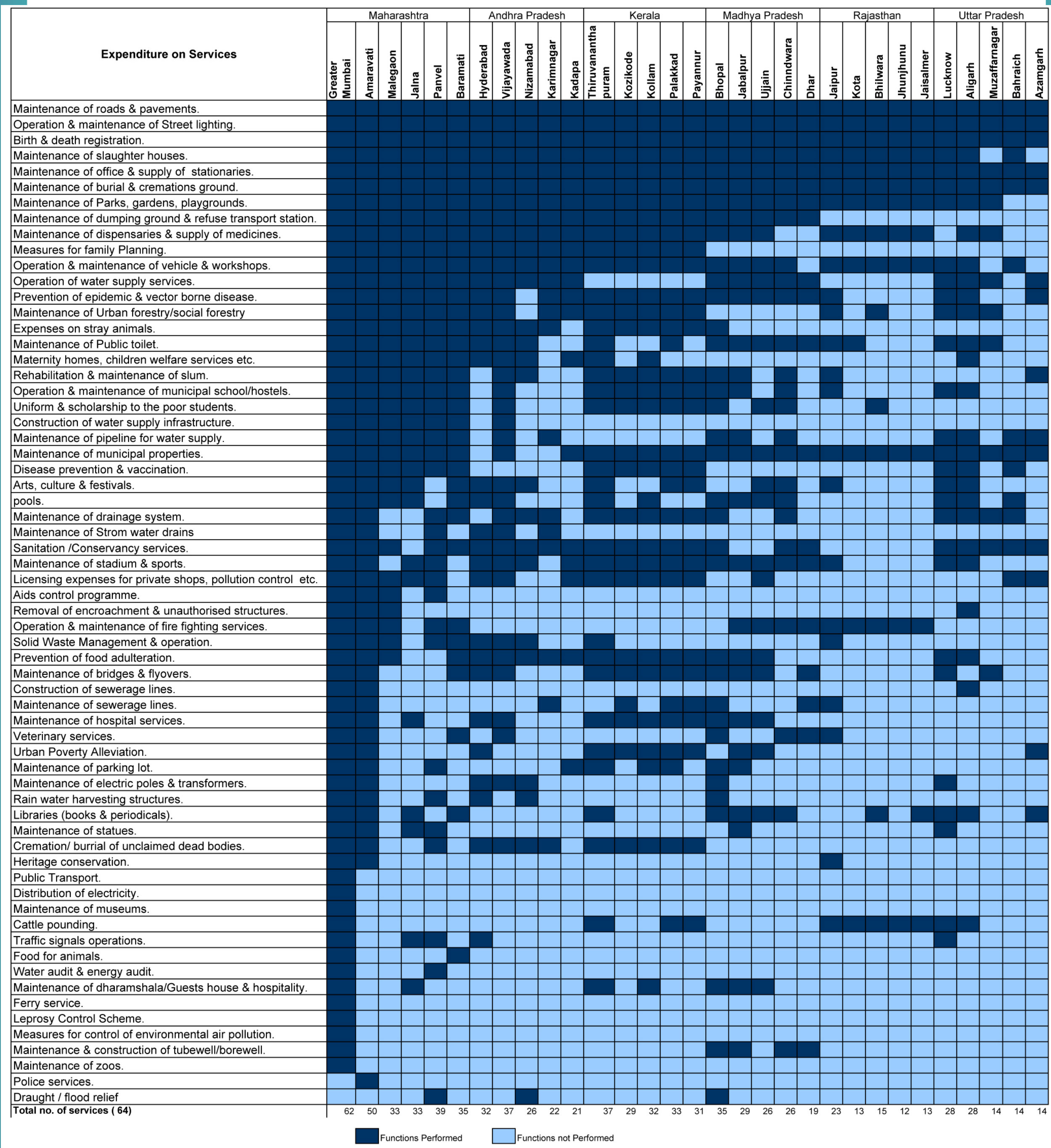
54 This chart provides the first step towards preparing a detailed activity map of municipalities.

electricity distribution, and education, compared with municipalities in Rajasthan which are primarily occupied with lower order, basic services like solid waste collection, street lighting, maintenance of municipal roads, pavements, parks and playgrounds, and cremation and burial grounds. The chart brings out that there are functions which are (i) commonly undertaken by municipalities of all sizes across states – many of these happen to be the regulatory functions; (ii) specific to municipalities in a few states, and (iii) specific to municipalities of larger sizes. A comparison of this chart with the 12th Schedule functions shows a big hiatus between the Constitutional vision for municipalities and their operating functional portfolio. The hiatus relates, in particular, to functions such as planning for economic and social development, urban planning, urban poverty, slum improvement and upgrading, fire services, and water supply. Thus, it is a long road for municipalities to begin to take on functions as laid down in the Schedule 12[55].

[55] This study hypothesizes that if there is a revenue model in place for financing the 12th Schedule functions, it will serve as an incentive for states to devolve the 12th Schedule functions to municipalities. The ambiguity in respect of the role of the Central and state governments in financing functions such as urban poverty, slum improvement, and protection of the environment acts as an impediment to the devolution and assignment of 12th Schedule functions to municipalities.

IMFR

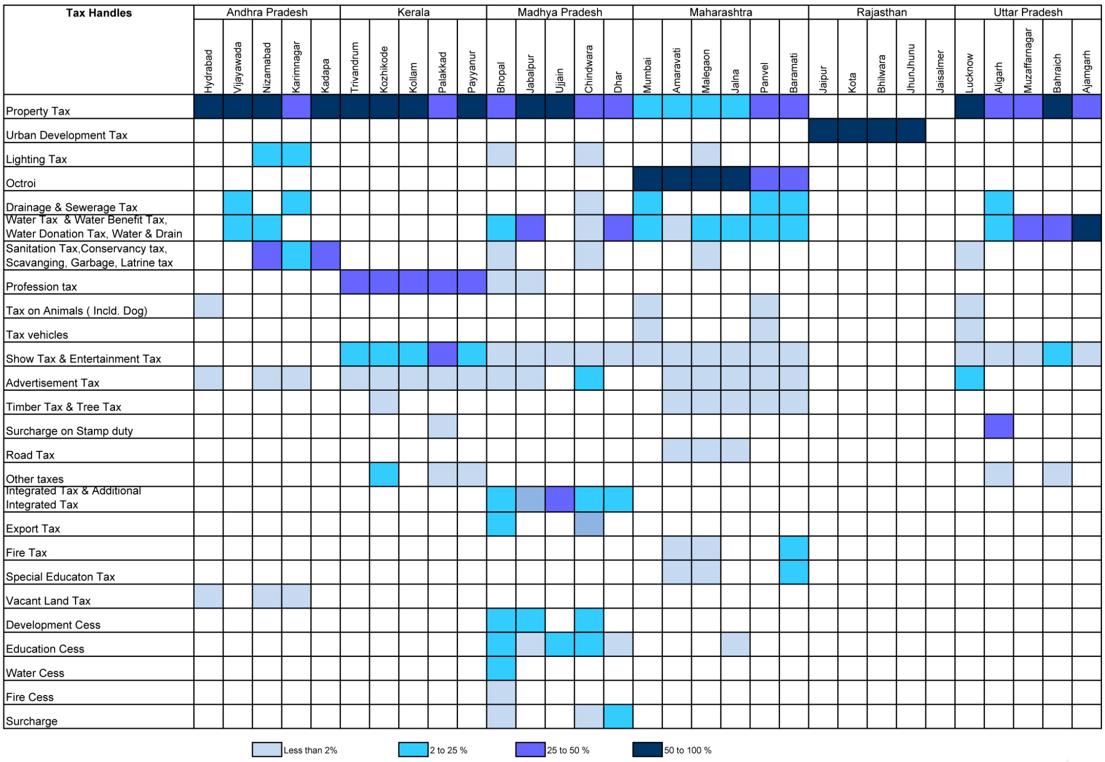
Chart 2: Operating Functions and Activities of 31 Municipalities



Source:Municipal Budgets

A similar inventory has been prepared for tax instruments that the sample municipalities use for generating resources. Like in the case of functions, the list of tax instruments is also large (though a number of them are adjuncts to property taxation). Perusal of the inventory indicates that the municipal tax jurisdiction comprises (i) a tax on land and property and appurtenances such as a tax on drainage, water, sanitation, lighting, latrines etc., (ii) a tax on vacant lands, (iii) a duty on transfer of immovable property, (iv) octroi levies (v) an entry fee, (vi) a tax on professions, (vii) a tax on shows and entertainment, (viii) a tax on animals, non-motorized vehicles, and (ix) a tax on advertisement.

Chart 3: An Inventory of Tax Instruments in-use in Sampled Municipalities



Source: Municipal Budgets

(1) Integrated Tax -it is a compulsory tax and levied to all properties whether they are covered under property tax or not, or exempted from property tax. It is a combination of three taxes namely general sanitation tax, general fire tax and general lighting tax. (2) Cess is the tax levied along with any other tax or in lieu of tax and is considered income of ULB. (Chapter 8: Cess, Page No. 8.1, National Municipal Accounts Manual, Government of India, Ministry of Urban Development). (3) Surcharge is miscellaneous Surcharge on different tax. (4) Export Tax- It is a terminal tax on goods (produced with in ULB limit) or animals exported from the limits of the ULB.

Chart 3 gives an inventory of taxes which municipalities use for generating resources together with the share of each of them in the total tax revenues. Apart from the inter-municipal differences in their usage with municipalities in Rajasthan relying on a single tax, i.e., urban development tax, and others using a diversified tax structure, the chart lists out taxes that are specific to states, for example, the levy of an integrated tax (a combination of a general sanitation tax, general fire tax, and a general lighting tax) in the municipalities of Madhya Pradesh; a tax on export of goods produced within the municipal limits, also in Madhya Pradesh, octroi in Maharashtra, a profession tax in Kerala, and a tax on vacant land in Andhra Pradesh. Property tax is universally levied except in Rajasthan. It will be shown later that many of these taxes have low or near-zero revenue productivity, and are characterised by a high degree of obsolescence.

Municipalities in several states have access to state-specific taxes for generating resources.

With the exception of property taxes, profession taxes in Kerala and land-based taxes and levies in Andhra Pradesh, the balance of the fiscal space is either unused or produces little revenue.

Box 8

The traditional theory of fiscal federalism prescribes a limited tax base for local governments. The main criteria for such taxes are those that are easy to administer locally, and those which do not cause problems of competition between local governments or between local and state governments. The Indian system has broadly followed this principle in determining the tax base for municipalities.

Despite these broader principles, Roy Bahl and Richard Bird note that there are strong arguments for assigning some significant taxes to sub-national governments. Local governments are likely to hold officials more accountable if local public services are financed to a significant extent from locally imposed taxes and charges as opposed to Central government transfers.
See, Roy Bahl and Richard Bird. 2008. "Sub-national taxes in Developing Countries: The Way Forward". Public Budgeting and Finance.

(iii) Revenue-expenditure balance

The table below presents the revenue-expenditure balance of the 31 sampled municipalities. Revenue streams in this table represent the money value of the taxes, charges, levies and fees that the 31 municipalities employ (Charts 3)[56], and expenditure streams representing the money value of the expenditure incurred on the functions and activities as shown in Chart 2.

Table 15: Own Revenue- Revenue Expenditure Balance, 2007-08

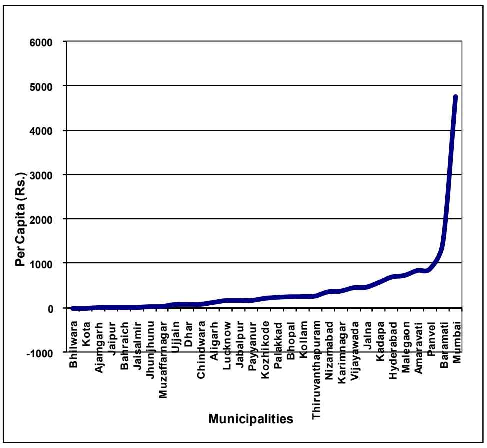
State	Municipalities	Per-capita own revenue Rs.	Per-Capita revenue expenditure Rs.	% of own revenue to revenue expenditure	CAGR between 2002-03 and 2007-08	
					Own revenue %	Revenue expenditure %
Andhra Pradesh	Hyderabad	1162.0	922.3	126.0	14.0	21.1
	Vijayawada	1064.3	786.9	135.3	10.2	-1.6
	Nizamabad	497.7	357.5	139.2	2.1	-2.8
	Karimnagar	479.6	578.20	82.9	2.7	12.1
	Kadapa	818.0	1175.70	69.6	15.8	23.8
Kerala	Thiruvanthapuram	319.4	600.90	53.1	-1.6	22.4
	Kozhikode	253.3	557.20	45.5	1.4	7.7
	Kollam	294.9	206.90	142.6	20.9	6.3
	Palakkad	402.3	348.50	115.4	3.5	6.9
	Payyanur	242.0	220.00	110.0	2.2	12.7
Madhya Pradesh	Bhopal	328.0	815.60	40.2	4.0	9.4
	Jabalpur	237.9	772.60	30.8	-0.2	5.9
	Ujjain	339.5	540.50	62.8	10.0	29.4
	Chindwara	289.1	871.60	33.2	8.2	14.2
	Dhar	341.8	669.10	51.1	19.5	21.8
Maharashtra	Mumbai	6208.8	4887.30	127.0	11.9	11.3
	Amaravati	951.0	1020.40	93.2	9.2	7.3
	Malegaon	1002.6	824.60	121.6	16.2	10.4
	Jalna	554.9	643.60	86.2	5.0	5.2
	Panvel	1129.6	1448.40	78.0	7.5	14.4
	Baramati	2004.1	1283.50	156.1	12.2	7.3
Rajasthan	Jaipur	224.3	492.80	45.5	36.3	13.0
	Kota	95.3	623.10	15.3	20.0	3.5
	Bhilwara	135.7	459.70	29.5	5.0	9.5
	Jhunjhunu	151.1	282.60	53.5	7.1	10.1
	Jaisalmir	210.7	384.30	54.8	15.8	7.7
Uttar Pradesh	Lucknow	384.4	485.20	79.2	18.2	17.9
	Aligarh	239.6	598.70	40.0	17.3	9.6
	Muzaffarnagar	79.2	288.90	27.4	4.3	8.5
	Bahraich	33.6	282.80	11.9	2.8	4.5
	Azamgarh	117.2	727.30	16.1	10.4	26.8

Source: Municipal Budgets.

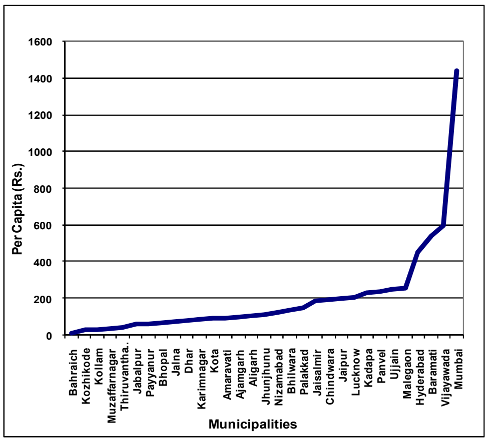
[56] Also see, chart in Annex which displays a list of charges, fees, fines, rents, and incomes.

The table brings out three features: first, a large variation in the revenue yields from both the tax and non-tax components. The municipalities from Maharashtra have high revenues; similarly, municipalities from Andhra Pradesh have relatively higher own revenues. The other extreme is represented by municipalities in Rajasthan and Uttar Pradesh. The level of revenue yields reflects the effect of the assignment of revenue instruments to municipalities as also the productivity of various taxes. It is elaborate later.

Graph 8 Per Capita Municipal Tax Revenue 2007-08



Graph 9: Per Capita Municipal-Non Tax Revenue, 2007-08



Secondly, there are a number of municipalities which are able to generate enough revenues from their own sources to be able to cover the revenue expenditures, and even post a surplus on revenue account. These municipalities are those that levy octroi or are being compensated for the loss of octroi and those whose establishment costs are being absorbed directly in the state budget like Andhra Pradesh. In addition, own revenues in three municipalities of Kerala are in excess of municipal expenditure. Municipalities in most states are required to maintain a balanced budget and in some cases, a surplus equal to 1-3 months of staff salaries. This fact is important to be kept in view while reviewing the excess of revenues over expenditure. Thirdly, there are as many as 22 out of 31 municipalities whose revenue expenditures are in excess of own revenues. Transfers bridge the vertical gap.

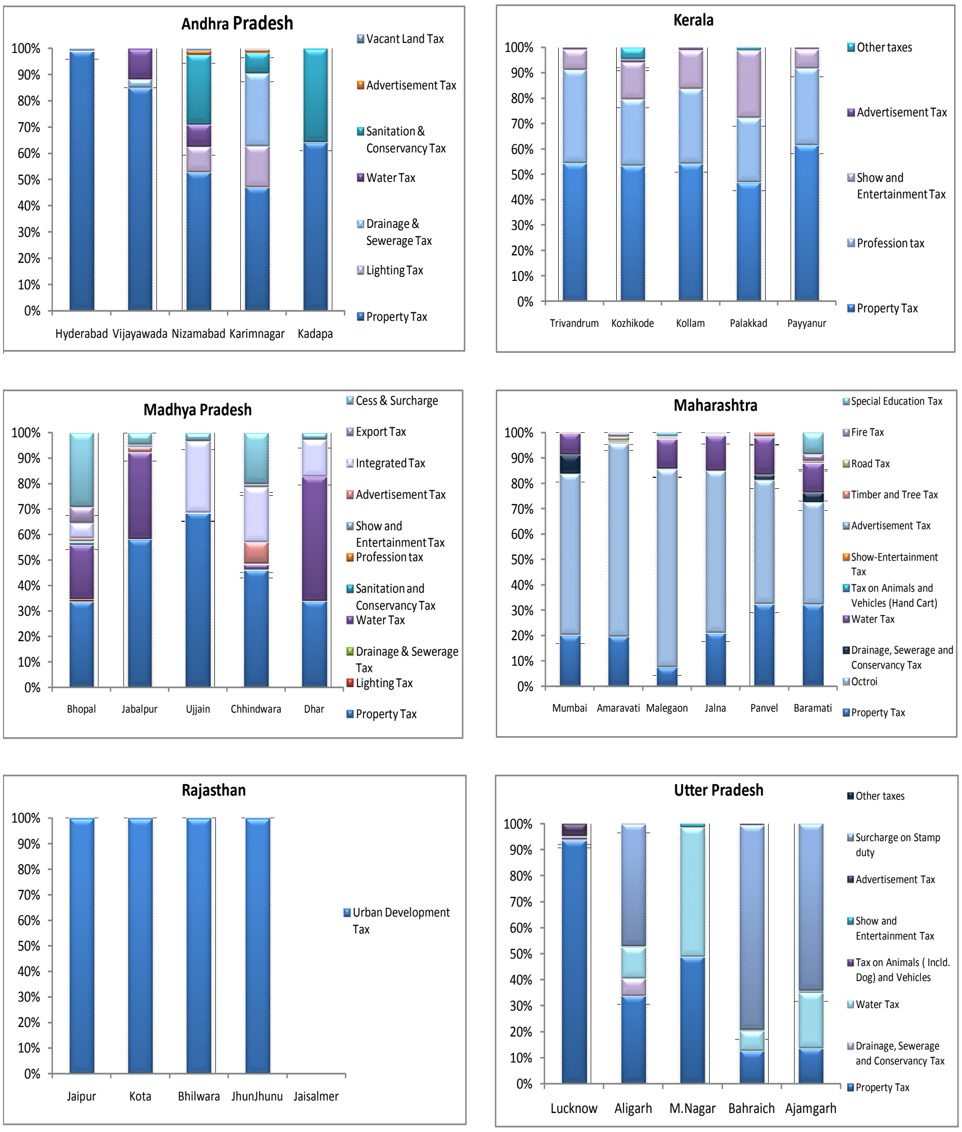
Thirdly, as many as 10 out of 31 municipalities posted a compound annual growth of less than 5 percent and another 6 municipalities registered a growth rate ranging between 5 and 10 percent. In other words, their own revenues declined in real terms; revenue expenditures too either declined or posted marginal increases. This fact constitutes a disconcerting trend in the finances of municipalities, underscoring the need for feasibility of establishing performance standards in respect of revenue-sharing and similarly, benchmarks for expenditure on key services.

This brief introduction to the municipal finances of 31 municipalities is supplemented by two other tables showing firstly, the structure of municipal revenues, i.e., the share of the different components of revenue income, and secondly, the structure of municipal expenditure. According to these tables, municipalities in Maharashtra, Andhra Pradesh and Kerala rely to a larger degree on tax revenues. Municipalities in Andhra Pradesh also make extensive use of the development charges and betterment levies. On the other hand, municipalities in Madhya Pradesh, Rajasthan, and Uttar Pradesh are transfer dependent; these are municipalities where transfers account for over 80 percent of the total revenues – Azamgarh (87.5%), Bahraich (92.9%), Bhilwara (83.7%), Bhopal (81.1%), Kota (89.2%), and Muzzafarnagar (86.7%). Several municipalities maintain a tax base which is, at best, notional in revenue terms - these being Azamgarh (Rs. 19.8), Bahraich (Rs. 21.8), Bhilwara (Rs. 0.40), Jaipur (Rs. 20.7), Jaisalmer (Rs. 22.0), Kota (Rs. 0.8), Muzzafarnagar (Rs. 44.8), and Ujjain (Rs. 88.1). The non-tax component of these municipalities is also small, if not insignificant.

Table 16: Revenue Structure in Sampled Municipalities, 2007/08

State	Municipality	% share in per capita revenues			Per capita revenues (Rs.)
		Tax	Non tax	Transfers	
Andhra Pradesh	Hyderabad	60.06	38.63	1.30	1177.30
	Vijayawada	33.82	43.40	22.77	1378.20
	Nizamabad	64.74	21.64	13.63	576.20
	Karimnagar	70.52	16.08	13.40	553.80
	Kadapa	40.07	15.82	44.11	1463.70
Kerala	Thiruvanthapuram	28.33	4.13	67.54	983.80
	Kozhikode	49.55	6.25	44.20	453.90
	Kollam	34.80	3.84	61.36	763.30
	Palakkad	39.67	24.22	36.11	629.70
	Payyanur	23.31	8.01	68.68	772.90
Madhya Pradesh	Bhopal	15.12	3.77	81.11	1736.60
	Jabalpur	19.99	6.60	73.41	894.60
	Ujjain	10.22	29.13	60.66	862.80
	Chindwara	9.13	19.10	71.77	1024.20
	Dhar	9.89	8.52	63.82	944.80
Maharashtra	Mumbai	75.81	22.90	1.28	6289.40
	Amaravati	80.98	9.16	9.87	1055.10
	Malegaon	43.03	15.04	41.93	1726.70
	Jalna	43.16	6.93	49.92	118.00
	Panvel	62.45	16.57	20.98	1429.50
	Baramati	58.68	21.71	19.61	2492.90
Rajasthan	Jaipur	2.84	27.97	69.19	728.00
	Kota	0.09	10.68	89.23	884.90
	Bhilwara	0.05	16.24	83.72	833.60
	Jhunjhunu	5.76	16.07	78.17	692.20
	Jaisalmir	3.20	27.40	69.39	688.60
Uttar Pradesh	Lucknow	16.52	19.26	64.21	1074.30
	Aligarh	16.77	13.03	70.20	803.80
	Muzaffarnagar	7.59	5.83	86.58	589.90
	Bahraich	4.56	2.45	92.98	478.30
	Azamgarh	2.11	10.36	87.54	940.00

Chart 4: Structure of Municipal Revenues



The financial dependence of municipal governments on the higher tiers is an important feature of the inter-governmental fiscal system in much of the developing world[57]. Indeed, they are a dominant source of revenue for municipal governments. According to Roy Bahl, transfers are "the cornerstone of sub-national financing in most developing and transition economies. Transfers are a compromise in that they allow the Central government to hold control over the public financing system while they offer a way to channel money into the budgets of provincial and local government". According to Richard Bird, intergovernmental fiscal transfers constitute part of a complex political, economic and administrative system. Their design, role, and effects can be understood only in the specific institutional context in which they operate[58].

The term "transfers", it may be noted, refers to different kinds of public financing instruments: grants, shared taxes, subsidies, and subventions are but a few. They are designed in different ways; some are centralizing in nature while others are decentralizing. They are intended to address a wide variety of different issues".

---

57 Roy Bahl. 2000. "Intergovernmental Transfers in Developing and Transition Economics: Principles and Practice". The World Bank.

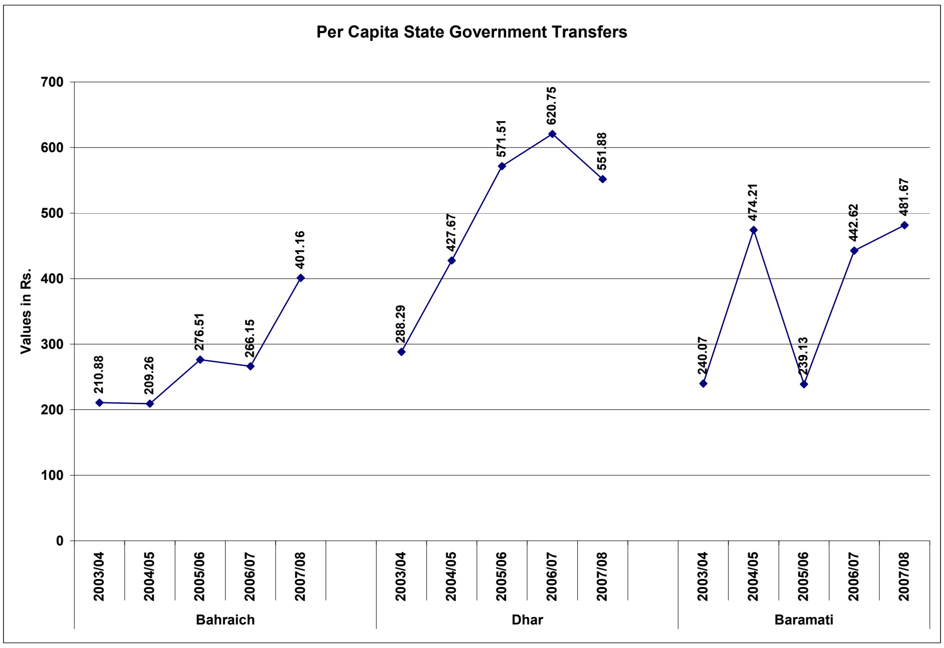
58 Literature on this subject emphasizes that while intergovernmental transfers are commonly observed and are an integral part of local government finance system, the institutional setting within which local governments in developing countries function fall into one of the three categories: (i) the over-controlled local finance sector, (ii) under-controlled local finance sector, and (iii) the perversely regulated local finance sector. The over-controlled local finance sector is common in most Asian countries including India; here, the state governments control most details of local government – the personnel policy, salary scales, tax rate etc. Such micro control produces weak and incapable local governments. In some countries, the amount of transfers received depends upon the size of the local budget deficit –an obviously perverse incentive. In some Indian states, transfers are estimated on the basis of actual revenue account deficit which proves to be a disincentive for municipalities to optimize their revenue-raising potential.
See for details. Richard Bird and Michael Smart. 2001. Intergovernmental Fiscal Transfers: Some Lessons from International Experience, University of Toronto.

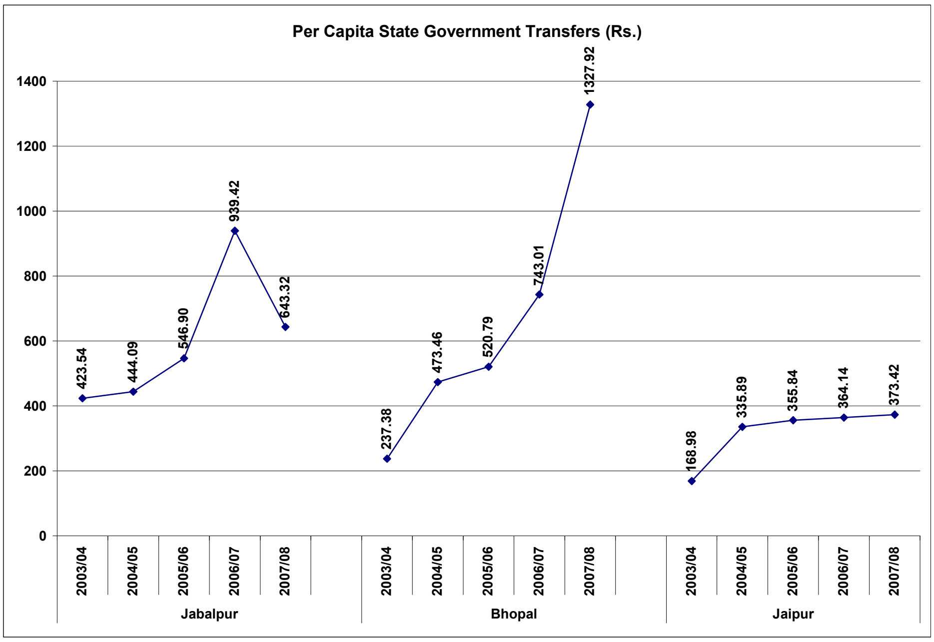
Transfers have consistently played a vital role in the finances of municipalities in bridging the vertical and horizontal gaps and in a few instances, compensating municipalities for the loss of revenues, e.g., octroi abolition. Transfers are also meant to bring in stability to the revenue base, a necessary attribute for municipalities to maintain the delivery of services. An earlier table assessing the finances of municipalities at the state level showed that transfers formed 27 percent of the total municipal revenues and financed 31 percent of the revenue account expenditure. The data of the sample municipalities reinforce the important role of transfers in financing municipal services, excepting in a few municipalities of Andhra Pradesh and Maharashtra which have access to Octroi revenues (Maharashtra) and revenues from land-based sources (Andhra Pradesh). Further municipalities in Andhra Pradesh are also less dependent on state transfers for the reason that the state government directly meets the wages and salaries of municipal staff – a case of implicit transfers[59]. Over-time analysis, however, highlights that the role of transfers has been erratic in several municipalities, (see chart 4). Another important fact emerging from the table is that transfers play an important part in several municipalities of Kerala even when their own revenues are in a position to meet the excess of revenue expenditure. Transfers have accrued to them as a part of decentralization strategies being pursued by the Government of Kerala without ensuring their effective utilisation for improving services and infrastructure. The municipalities in Kerala have registered low levels of expenditure but high transfers. (The shaded portions in table 16 on the revenue structure show the extent of transfer dependency of municipalities.)

[59] Data do not permit an assessment of the volume of such implicit transfers.

IMFR

Graph 10: Per Capita State Government Transfers in Selected Sampled Municipalities





Source: Budgets

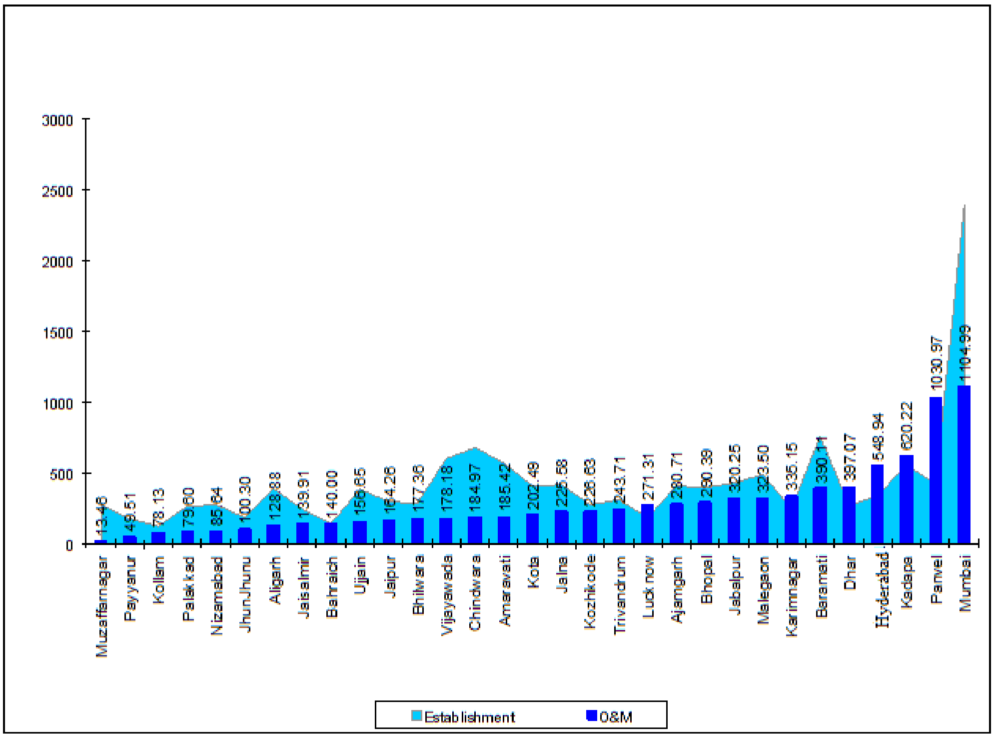
The expenditure portfolio comprises expenditure on establishment wages, salaries, managerial, and supervision costs, operation and maintenance of services, and other miscellaneous costs. The following table gives the aggregated position in respect of 31 municipalities.

Table 17: % Composition of Revenue Expenditure

Composition	Percent	
	2003-04	2007-08
Establishment	57.8	44.9
Operations and Maintenance	19.6	27.2
Others	22.6	20.9
Total	100.0	100.0

Establishment expenditure accounts for 45-60 percent of revenue expenditure.

Graph 11: Per Capita Establishment and O & M Expenditure of Sample Municipalities, 2007-08



Establishment costs account for a substantial part of the total expenditure. In 2007-08, these accounted for 44.9 percent of the total expenditure costs. It needs to be pointed out that several of the municipal responsibilities and functions e.g., solid waste collection and transportation are labour-intensive in nature, involving payment of wages and compensation. One redeeming feature of the pattern of expenditure, however, is that municipalities have begun to assign greater priority to operations and maintenance expenditure although as the Graph shows, the expenditure on establishment is still higher across most sampled municipalities.

The survey brings out several features that are consistent with those arrived at in the earlier parts of the Chapter, in particular, the large inter-state and inter-municipal variation in the levels of revenues and expenditures; a declining role of tax revenues vis-à-vis that of transfers; and weak finances of municipalities in low income and low-urbanized states. As a part of the survey, we also probed the effect of the population size of municipality on their finances, under the hypothesis that small-sized municipalities may be disadvantageously placed in terms of raising revenues and the cost of providing services. Many of the services are characterized by indivisibilities. The table below provides the requisite data:

Table 18: Mean Values of Key Finance Indicators for large and small municipalities

Indicators	Mean values (Rs.) for municipalities with over one million	Mean values (Rs.) for municipalities with less than 100,000 population
Property tax	324.58	134.31
Other taxes	256.83	94.77
Octroi	605.8	160.14
Non - tax	474.29	193.94
Own revenues	1661.5	583.16
Total transfers	539.64	584.67
Total revenues	2201.13	1167.84
Establishment expenditure	718.34	368.33
O& M expenditure	475.98	251.46
Total revenue expenditure	1520.65	656.84

Source: Budgets

Small-sized municipalities are disadvantageously placed in terms of revenue generation.

For every indicator, the mean values of revenue and expenditure components are higher for municipalities in the > 1 million category compared to municipalities in <100,000 category. Mean average property tax revenue of municipalities with less than 100,000 population are 41 percent of those in municipalities with over 1 million population; likewise, the mean expenditure levels of smaller municipalities are 43 percent of the larger sized municipalities; evidently, no special aid or assistance has accrued to smaller municipalities from the states or the Central government. The budget data are not adequate to explain if population size itself is a limiting factor in resource raising or if it is the economy of small cities that affects the level of revenue of such cities. Some of the lag is picked up by transfers which as the table shows, are significantly higher for smaller-sized municipalities. The apparent disadvantage of smaller municipalities-whatever may be the explanatory factors -- lends support to what has often been suggested that small-sized municipalities demand a separate municipal tax policy and fiscal strategy.

The mean values of revenue and expenditure components are higher for municipalities in the > 1 million category compared to municipalities in <100,000 category.

The apparent disadvantage of smaller municipalities-whatever may be the explanatory factors – lends support to what has often been suggested that small-sized municipalities demand a separate municipal tax policy and fiscal strategy.

IMFR

(iv) Internal Management of Municipal Revenues: Assessing efficiencies

(a) Property Taxation

Property tax is an important, possibly the most important, revenue source for local governments in much of the developing and developed world. Using it properly and efficiently is of vital importance to local governments. However, it is a grossly underused and controversial tax instrument among the family of taxes. This is the case in India. Despite the fact that property tax is the principal own-source revenue for municipal governments, its performance has been poor, in fact, poorer in comparison with its performance in most large developing and transitional economies. According to a study undertaken for the Thirteenth Finance Commission (TFC),[60] revenues from property taxes in 2006-07 were estimated between Rs. 6,275 crore and Rs, 9,425 crore, or 0.15 percent – 0.23 percent of the country's gross domestic product (GDP), compared with 0.6 percent for developing countries, 0.68 percent for transitional economies, and 1.04 percent for all countries[61]. In India, the property tax base is narrow and constricted. Assessed value of properties for purposes of taxation uniformly lags behind the market values; in some places, assessed values are reported to be about 8-10 percent of market values. The income-elasticity of property tax is reported to be low. The system is also characterised by other forms of inefficiencies that are connected to the structure of tax rates and collection strategies. As Roy Bahl puts it: "Property taxation in developing countries is a fiscal paradox. On the one hand, it seems to be everyone's candidate for the primary source of local

Property taxation in developing countries is a fiscal paradox. On the one hand, it seems to be everyone's candidate for the primary source of local government revenue. On the other hand, the property tax is little used in developing countries. (Roy Bahl)

---

60 Om Prakash Mathur et.al. 2009. Urban Property Tax Potential In India. National Institute of Public Finance and Policy.

61 Roy Bahl et. al. 2008, Making the Property Tax Work: Experiences in Developing and Transitional Countries. Lincoln Institute of Land Policy. Cambridge. Mass.

government revenue. On the other hand, the property tax is little used in developing countries"[62].

Property tax in India is commonly understood as a tax on property that permits a municipal government to cover a part of the cost of services that it provides. It is thus in the nature of a benefit tax. One of the appealing features of property taxation is that it is a local tax. It is not levied by any other level of government[63]. Its role is limited to revenue generation, and not extended to serving other purposes such as optimizing the use of land. Nor is it considered as a mechanism to address economic, political, and social problems. Property tax remissions or rebates are not used for influencing economic growth and development, e.g., attracting business and industry to specific areas within cities and towns as in the United States and to a lesser extent, in Canada.

Box 9

Local property taxes effectively function as a price that indicates to households the marginal cost of providing local public goods. Households thus pay for the benefits they receive, and for this reason the Hamilton-Tiebout perspective on local finance has become known in the literature as the `benefit view'.

Michael E. Bell, David Brunori, and Joan Youngman. 2010.
The Property Tax and Local Autonomy.

Past studies on India's property tax system indicate that the property tax revenues fall short of their potential, on account of low coverage, low valuation, large exemptions, low collection, and an obsolete tax structure[64]. Significantly, none of the past studies have attempted to measure the money value of inefficiencies on these accounts. This study attempts to undertake this exercise by looking at three measures: (i) coverage of

62 Roy Bahl et.al. ibid..

63 In a few countries, property taxes are levied by national governments and provincial governments.

64 Om Prakash Mathur. Ibid.

properties, i.e., the extent to which the municipalities are able to keep a count and listing of properties, (ii) exemptions – while exemptions are commonly observed, the practice of according exemptions is often misused with adverse impact on the finances of municipalities, and (iii) collection inefficiencies. Measuring inefficiencies in valuation and from the tax structure are not attempted here for reasons that these are location specific. The factor of inefficiency is later used for estimating the potential of this tax.

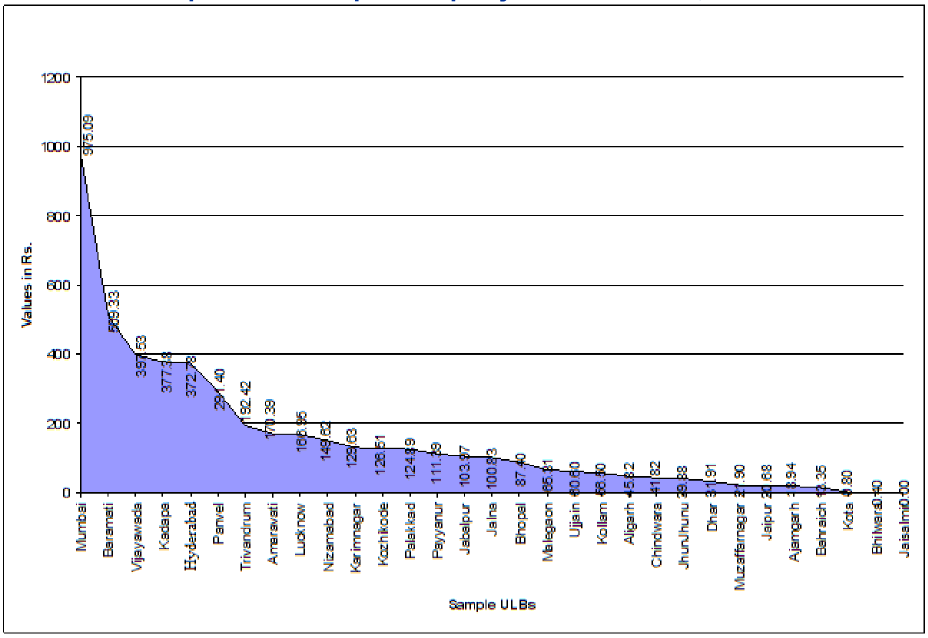
The level of efficiencies in property taxation is assumed to depend on two sets of factors: the first set of factors, endogenous in nature, are those that are linked to the base of property taxation, valuation system, including revaluation, determination of the rate structure, and the design of collection strategies, while the second set consists of those that are assumed to impact property values via the larger economy-wide factors. The latter are exogenous and assume that a relatively fast growing regional and city economy would have a positive effect on property values and consequently on property tax revenues. The former has a direct impact on property tax revenues, while the impact of the latter accrues via property values. We focus on the former in this study.

Inefficiencies reduce property tax yields by about 71 percent. This estimate excludes inefficiencies on account of the inability to assess properties at market prices.

The survey results in respect of property taxation are captured in the following graph and table which show firstly, large inter-municipal variations in property tax yields – a per capita high of Rs. 975 and Rs. 397 in Mumbai and Vijayawada respectively, and a low of Rs. 13 in Bahraich, Rs. 21.9 in Muzzafarnagar, Rs. 31.9 in Dhar and several others; secondly, property tax yields account for about 25 percent of revenues in the municipalities of Maharashtra, between 30-40 percent in those of Andhra Pradesh and Kerala, less than 20 percent in Madhya Pradesh, and 20-40 percent in Uttar Pradesh. Property tax was abolished in Rajasthan; it has been replaced with an Urban Development Tax which applies to a small number of large properties. Thirdly, property tax yields have grown but in no way do these reflect the real estate boom that many of these cities including

Mumbai, Hyderabad, Jaipur, Lucknow, and Bhopal have experienced in recent years.

Graph 12: Per Capita Property Tax Collection, 2007-08



As a part of the urban sector reforms, the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) has established benchmarks relating to coverage of properties and collection of property taxes, suggesting that if those benchmarks are met the property tax system will be considered to be efficient. We follow these benchmarks for assessing the level of efficiency in the implementation of the property tax system in the 31 municipalities. In other words, a property tax system is taken to be efficient if 85 percent of **total** properties are subject to taxation (at rates which have correspondence with the benefit) and if 85 percent of the tax so assessed and demanded is collected[65].

65 The benchmark of 85% coverage of properties and 85% collection of the property tax demanded is set under the JNNURM. These are assumed to be "reasonable".

The survey of 31 municipalities indicates that in the aggregate; (i) 28.6% percent of properties were not on the house tax register of the municipalities; (ii) 8.8 percent of properties were exempted from payment of properties, and (iii) 53.9 percent of tax demanded was not collected. The aggregate inefficiency in money terms works out to be 71 percent, meaning that the yields from property taxation will be higher by 71 percent if 85 percent of properties were brought within the tax net and if 85 percent of tax demanded was collected[66] without making any other change.

Box 10

Glossary for estimating inefficiencies in property tax collection

Number of total property = Assessed property + unassessed properties

Unassessed properties = Exempted properties + free riders – free riders are those that are not on the property tax register.

Coverage ratio = (Assessed property/total properties) x 100

Collection efficiency= (Property tax actually collected/property tax actually demanded) x 100

Loss incurred due to inefficiencies = (per capita property tax demand x number of properties under the head).

Effective tax demand = Actual demand +demand lost due to the inefficiencies

Percent of demand lost due to inefficiencies = (Loss in demand due to the inefficiency/effective tax demand) x 100

[66] Assessing the level of efficiency is an arduous task involving estimation of the (i) tax yields from the different sizes of municipalities, (ii) number of unenumerated properties, and (iii) collection to demand ratios. The figures in respect of losses incurred on these three counts are as under: Statutory loss (Rs. 455.51 crore); loss on account of low collection (Rs. 2095.01 crore), and loss due to free riders (Rs. 1107.32 crore).

Table 19: Property Tax Collection, 2007-08

States	Municipalities	Per Capita Property Taxes (Rs)	CAGR in % (2003-04 to 2007-08)	% Property taxes to Municipal Own Revenue
Andhra Pradesh	Hyderabad	372.78	8.66	32.08
	Vijayawada	397.53	17.70	37.35
	Nizamabad	149.62	5.21	30.06
	Karimnagar	129.63	13.87	27.03
	Kadapa	377.38	13.24	46.13
Kerala	Thiruvanthapuram	192.42	13.05	60.25
	Kozhikode	126.51	5.72	49.95
	Kollam	56.5	13.49	19.16
	Palakkad	124.89	8.53	31.04
	Payyanur	111.39	6.54	46.02
Madhya Pradesh	Bhopal	87.4	5.89	16.03
	Jabalpur	103.97	12.43	16.63
	Ujjain	60.6	11.77	9.17
	Chindwara	41.82	6.11	7.55
	Dhar	31.91	40.55	9.33
Maharashtra	Mumbai	975.09	14.80	15.71
	Amaravati	170.39	14.46	17.92
	Malegaon	65.31	56.32	6.51
	Jalna	100.83	13.78	18.17
	Panvel	291.4	11.32	25.80
	Baramati	509.33	26.07	25.41
Rajasthan	Jaipur	20.68	-8.22	3.51
	Kota	0.8		0.10
	Bhilwara	0.4	-38.52	0.06
	Jhunjhunu	39.88	65.07	9.78
	Jaisalmer			0.00
Uttar Pradesh	Lucknow	166.95	21.21	43.43
	Aligarh	45.82	12.41	19.13
	Muzaffarnagar	21.9	3.37	27.67
	Bahraich	13.35	3.48	39.77
	Azamgarh	18.94	15.89	16.17

Source: Municipal Budgets

(b) User fee

User fees are by far the largest of the non-tax revenues. These are best used to support the provision of goods and services that, in good part, are private in their character but which are provided by a municipality (or an arm of the government). User fees have often encountered challenges of fixing appropriate "pricing" for municipal services, among them being the challenge to exclude "free riders", for unless users who do not pay can be excluded, it is not possible to fix an appropriate charge or fee. There is an ongoing concern about setting the fees or rates that recover the costs of providing a service. What proportion should be provided by the actual users of a service and what proportion by the general public via taxation is a matter of both economic analysis and political economy.

In this study, municipal budgets have been used to determine what part of the expenditure incurred on a service is covered by a fee or a change. Collections via a fee or charge have been aggregated and the uncovered part of the expenditure is assumed to be the level of inefficiency. It is later used in combination with the inefficiency in managing property tax, for arriving at the revenue-raising potential.

Table 20: Non-tax Revenue Receipts and Expenditure: Selected Municipalities

States	Municipal	Services	Outgoing expenditure			Revenue receipts			Revenue as a % of expenditure		
			2005-06	2006-07	2007-08	2005-06	2006-07	2007-08	2005-06	2006-07	2007-08
			Rs. In Lakh						%age		
Maharashtra	Amravati	Water Supply	186.00	134.43	177.04	16.29	14.37	17.45	8.76	10.69	9.86
		Sanitation & Solid waste	883.34	958.83	1044.92	1.35	1.51	1.57	0.15	0.16	0.15
	Malegaon	Water & Drainage	350.68	324.31	405.73	228.11	383.27	455.60	65.05	118.18	112.29
		Sanitation & Solid waste	676.63	732.92	706.18	6.45	11.46	18.31	0.95	1.56	2.59
	Baramati	Water Supply	46.86	85.83	146.53	59.44	58.87	106.32	126.85	68.59	72.56
		Drainage & Sewerage	66.19	77.07	69.54	21.15	18.12	33.26	31.95	23.51	47.83
		Sanitation & Solid waste	82.58	78.95	102.46	0.22	0.02	0.13	0.27	0.03	0.13
Madhya Pradesh	Bhopal	Water Supply	3104.06	3617.41	3383.36	1260.40	1226.11	1171.49	40.60	33.89	34.63
		Sanitation & Solid Waste	152.77	135.00	237.06	61.94	51.17	53.92	40.54	37.90	22.75
	Jabalpur	Water Supply	541.57	1258.27	1835.00	848.46	793.60	710.82	156.67	63.07	38.74
		Sanitation & solid waste	233.82	253.87	359.20	2.17	19.47	84.00	0.93	7.67	23.39
	Ujjain	Water Supply	5.32	5.52	3.88	3.65	4.23	3.89	68.61	76.64	100.28
Andhra Pradesh	Palakkad	Public sanitation	170.82	169.29	148.48	6.74	0.72	0.89	3.95	0.43	0.60
	Hyderabad	Water Supply	1.91	13.19	2034.83	1.96	2.38	888.56	102.62	18.04	43.67
		Sanitation, solid waste and conservancy	4475.51	4732.71	9723.15	7403.35	7708.15	9491.12	165.42	162.87	97.61
	Nizamabad	Water supply	115.85	111.00	81.65	74.58	107.84	77.74	64.38	97.15	95.21
	Karimnagar	Water Supply & Drainage	155.14	145.25	143.67	228.94	257.90	343.48	147.57	177.56	239.08
Uttar Pradesh	Lucknow	Public Health, Sanitation, Drainage	3968.59	4449.54	5435.12	42.47	39.03	35.95	1.07	0.88	0.66
	Aligarh	Water Supply	262.61	286.63	290.41	361.33	481.91	323.58	137.59	168.13	111.42
		Drainage and Sewerage	1497.06	1733.29	2538.60	75.35	89.53	90.62	5.03	5.17	3.57

Source: Municipal Budgets

The budget data show that (i) a number of municipal services are subject to a fee or a charge which include water, sanitation and solid waste, health, education, markets and slaughter houses, and public sanitation (public toilets). Indeed, the entire non-tax component is an interesting and noteworthy collection of "charges", "fee", "rent", "lease income", and even "sale" of products such as manure and compost. (See Chart in Annex). More often than not, revenues from these sources are combined, making it difficult to distinguish a charge for a service like water supply from other revenue sources like a fee for providing a service like a birth or death certificate. This fact makes it difficult to estimate the "user charge" component where charging would appear to be relevant. Data as contained in Table 20 may be read with this caveat. Water charges as a proportion of expenditure vary between 9.8 percent in Amravati (Maharashtra) to 112.3 percent in Malegoan, 34.6 percent in Bhopal and 38.7 percent in Jabalpur. Recovery ratios for sanitation and solid waste collection are uniformly low, excepting in the case of Hyderabad. In several municipalities, it is charged via taxation and often incorporated into a property tax. In the aggregate, the level of inefficiency in service provision (if all services and markets are taken together) is 39 percent, meaning that the recoveries have the potential of increasing by 39 percent to reach a 85 percent coverage established under the JNNURM. We use this ratio for estimating the revenue-potential of municipalities.

(c) Urban land as a source of municipal revenue

Urban land as a source of municipal revenue and as an instrument for financing urban infrastructure is a much discussed subject in many developing countries. The China example where `land' has played a key role in financing urban development is often citied in discourses on the subject. As a revenue source, taxation of urban land as also levy of various kinds of charges commonly include a tax on vacant land, betterment levies and development charges, valorization charges, impact fee, exactions, fee for change in land use, purchasable development rights, and town planning fee and charges. It, however, excludes stamp duties and capital gains tax, these being in the domain of state and central governments.

With the exception of vacant land tax which is a municipal levy in most parts of the country, other land-based charges are leviable by both the municipalities and development authorities. The development authorities appropriate much of the gains from such levies.

Municipalities in India use only a few of these taxes and charges, which typically comprise a vacant land tax, betterment levies and development charges, town planning fee and charges, purchasable development rights and sale and lease of lands. It should be noted that most of these charges, e.g., development charges and betterment levies, are project-linked and, therefore, revenue streams from them are a one-time revenue; they are also irregular and lumpy. It is important to note that while municipalities in Andhra Pradesh make use of vacant land tax and betterment levies and development charges, municipalities in Rajasthan have used the sale and lease of lands for generating revenues. Municipalities in Maharashtra make use of purchasable development rights, while Madhya Pradesh municipalities use a combination of land-based sources.

Land-based taxes and charges amounting to Rs 254 crore for the 31 sampled municipalities account for 8 percent of the total municipal tax revenues. In several municipalities, however, land-based taxes and charges account for a substantial proportion of own revenue, (over 30 percent in Hyderabad, Vijayawada, and Chindwara). Municipalities in Rajasthan draw income from the sale and lease of lands.

Municipal role in making use of land-based instruments is limited, with the development authorities playing a significant role in applying them.

Reference to land-based taxes in this chapter is, at best, partial as the municipal role in levying these taxes and charges is limited and it is the development authorities who, in a number of states are statutorily empowered to levy development charges and betterment levies and make use of revenues from the development and sale of lands. A fair assessment is that the municipal role in making use of land-based instruments is limited, with the development authorities playing a significant role in applying them for purposes of revenue-raising and using them for development of land and infrastructure. Notwithstanding the 74th Constitutional amendment which envisages urban planning functions to be transferred to municipalities states have held on to the pre-amendment institutional structures, depriving municipalities from playing a direct role in urban planning and development and more importantly, from using this potentially important source of revenue for financing urban development.

(d) Municipal finance vis-à-vis the finances of a parastatals

State-level and city-level parastatal institutions occupy an important role in the provision of services such as water supply and sewerage and in the planning and development of settlements and their peripheries, especially in the preparation of long range Master Plans, determination of land use, and development, lease, and sale of lands. Several states have set up housing boards and slum improvement boards as parastatals. While there are no firm estimates of the `investments' that such parastatals make in the development and maintenance of what would ordinarily be municipal infrastructure, it is said to be substantial, close to 1 per of the country's gross product. According to the 74th Constitutional amendment, provision of water supply, urban planning, regulation of land use, and slum improvement and upgradation are legitimate municipal functions, but as shown in Chart 1, there has been little progress in this respect.

Do the parastatal bodies have an advantage over municipalities in providing services as water supply? Do such bodies undermine the finances of municipalities? This study undertakes a limited enquiry into this question by comparing the key budget ratios in respect of (i) a municipality where provision of water supply is a municipal function, i.e., Vijayawada; (ii) a state-level parastatal where it is wholly responsible for water provision, i.e., Hyderabad Water Supply and Sewerage Board; and (iii) two state-level parastatals responsible for capital works and operations and maintenance respectively i.e., Uttar Pradesh Jal Nigam and Jal Sansthan. A comparison of their finances shows three important features: establishment costs between the three institutional arrangements vary between 17 percent of the expenditure on water provision in Vijayawada, 35.6 percent in Hyderabad, and 44 percent in Lucknow; electricity is a major cost line in the provision of water; and revenue expenditure exceeds revenue income irrespective of the institutional arrangement. That the parastatals also being unable to recover the costs incurred in providing services weakers their case for continuing to hold responsibility for services such as water. However, the sample of three municipalities is not adequate to provide a robust conclusion in regard to their financial viability. More substantive work in necessary to test the merits of parastatals in the provision of urban services.

Table 21: Revenue Receipts as a Percent of Revenue Expenditure

Year	Lucknow	Hyderabad	Vijayawada
2003-04	58.8	105.1	89.5
2007-08	73.9	95.6	96.2

What does this analysis add up to?

India's urban sector is tiny - revenues are equivalent of 0.53 percent of GDP and expenditures are equal to 1.09 percent of GDP. This size of the sector can not be expected to deliver services at some standardized levels. Factors that have kept the size tiny include -

- A single-tax dominated municipal tax system
- Low or near zero productivity of many municipal taxes
- State policies towards property taxation
- Inefficiencies in internal management of resources
- Large scale subsidies in service provision
- Irregular state transfers

India's municipal sector is characterized by large scale inter-state differences. A part of the differences is attributable to state policies – what fiscal powers they assign to or devolve on municipalities and the efficiencies with which municipalities exercise those powers. But inter-state differences have arisen as the analysis shows, on account of factors over which municipalities have little control; it is these exogeneous economy-wide factors that have put municipalities in several states at high risk.

Smaller municipalities in much of the country, have cost disabilities and are characterized by poor resource base, raising a vital issue of developing a revenue model that will be able to address their fiscal problems.

Decentralization as embodied in the 74th Constitution Amendment when measured in terms of either resource generation or municipal expenditure has made little progress over the past two decades. This study argues for a fiscal architecture which is consistent with the requirements of the 12th Schedule.

Inefficiencies in internal management of resources run across municipalities of different population sizes. There exists no performance standards to enforce – a major lacuna in the management structure of municipalities.

That the financing of municipal infrastructure and services is a multi-tier responsibility is one of the key findings of this analysis.

4 FISCAL HEALTH OF MUNICIPALITIES

The fiscal health of a municipality is its capacity to raise revenues in order to be able to provide services at standardized or normative levels. The revenue-raising capacity of a municipality is the revenue it can raise from taxes having a standard tax burden on its residents, while the standard expenditure need is the amount it must spend, given a standard set of service responsibilities, to provide services of a standard quality. Assessing the fiscal health of municipalities is considered important not only because it has to do with the ability of municipalities to finance the necessary services, but also because it affects business location decisions, local government competitiveness, long run creditworthiness, and tax cost of local government on citizens. While there is no generally accepted measure of fiscal health, three sets of criteria are frequently used: (i) fiscal capacity and expenditure need, (ii) bond ratings, and (iii) revenue surplus and deficits. Acknowledging that such a measure is relevant for India's municipalities, we use a modified version of the two criteria, viz., fiscal capacity and expenditure need and bond ratings for assessing the fiscal health of municipalities.

The Terminology of Fiscal Health

Considerable amount of work has been done globally on measuring the fiscal health of local governments[67]. It is viewed as an important tool for determining the capacity of local governments to be able to meet their financial and service obligations. Groves and Valente describe the long

[67] See, Beth Walter Honadle et al. 2004. Fiscal Health for Local Governments. Elsevier Academic Press. San Diego. Cal; and Halen F. Ladd and John Yinger. 1989. America's Ailing Cities: Fiscal Health and the Design of Urban Policy. The Johns Hopkins. University Press. Baltimore.

run fiscal health as revenue-level solvency, or the ability of a municipal government to provide adequate services, given the existing resource base. Others define it in terms of the extent to which a local government is able to balance its fiscal structure with the risks, demands and pressures of the environment[68]. Yet others have concluded that a revenue balance for its own sake does not necessarily achieve the goal of a healthy revenue structure[69].

Assessing fiscal health is necessary for other reasons, apart from the need to finance the required services. According to Honadle, "there are compelling reasons for local government officials to strive for better fiscal health, not the least of which is to get elected by the voters. Other reasons why maintaining fiscal health is important include the fiscal health influences on homeowner location decisions, business location decisions and economic development, local government competitiveness, service provision quality and variation in services provided, long term credit worthiness and tax cost of local government on citizens"[70].

Academics and practitioners have developed indicators for measuring the fiscal health, and indicators for the purpose of assessing, monitoring and exercising fiscal health checks on municipal finances and taking corrective actions. Rebecca Hendrick, for instance, has developed a framework for assessing the financial condition and fiscal health of

---

68 S.M. Groves and M.G. Valente. 1994. Evaluating Financial Condition: A Handbook for Local Government. International City County Managers Association. Washington D.C.; and George Peterson (Ed.) 1994. Big-City Politics, Governance, and Fiscal Constraints. The Urban Institute Press. Washington D.C.

69 See Shannon Hill et. al. 2009. "Measuring the Financial Position of Municipalities: Numbers do not speak for themselves" in Public Budgeting and Finance. Hill and others make a distinction between the city's financial condition and financial position, the former being an assessment of a city's financial condition relative to some objective standards, and the latter being an assessment of a city's position relative to the financial position of other cities.

70 Honadle. Ibid. pp 4.

municipalities, evolved indices for some dimensions of the framework, and applied them to 264 suburban municipalities in the Chicago Metropolitan Region[71]. The framework is based on a systems view of the financial condition of local governments showing that fiscal health is a complex and multidimensional concept with varying time frames. In a comprehensive survey, Changhoon Jung examines the practices of assessing financial condition and fiscal health of local governments in the United States, stating that "not much is known about how local governments assess their financial condition and health", and that "unless state governments require their local governments to regularly assess financial condition, not many local governments are likely to assess their own financial conditions" [72]. As an aid to local governments, he surveys the fiscal heath monitoring systems as developed from time to time and provides a brief account of their strengths and weaknesses. We suggest a similar practice to be in place in India.

No attempt has so far been made in India to measure the fiscal health of municipalities. Some studies have attempted to measure the level of underspending in relation to expenditure norms developed by the Zakaria Committee[73]. Given, however, the emerging role of municipalities in the context of the Constitutional amendment which envisages them to assume developmental and redistributional responsibilities and given that the municipal governments are increasingly vulnerable to external factors such as the performance of the regional and national economy, inflation, rates of economic growth, and changing demographics, it is necessary to build exercises for assessing their fiscal health and gradually establish a system

---

71 Rebecca Hendrick. 2004. "Assessing and Measuring the Fiscal Health of Local Governments". Urban Affairs Review. Vol. 40. No. 1 September 2004.

72 See Changhoon Jung. 2008. "Practices of Assessing Financial Conditions and Fiscal Health in Local Governments in the United States". Auburn University.

73 See P.K. Mohanty et.al. 2007. Municipal Finance in India: An Assessment. Reserve Bank of India. Mumbai, and Om Prakash Mathur and Sandeep Thakur. 2004. India's Municipal Sector: A Study for the Twelfth Finance Commission. National Institute of Public Finance and Policy, New Delhi.

of monitoring the financial position of municipalities. This Chapter responds to this need apart from addressing two questions – (i) whether the existing municipal fiscal capacity can deliver services at standardized levels; and (ii) whether municipalities in India have capacities to enter the bond market?

Assessing Fiscal Health

Two sets of criteria are used in this study for assessing the fiscal health of municipalities, namely, (i) fiscal capacity and expenditure, and (ii) bond ratings. Fiscal capacity, as stated earlier, is how much revenue a municipality can raise with a standard tax burden on residents from taxes and charges; expenditure need is the amount a municipality must spend in order to provide services of average quality. Assessing the fiscal health with this method requires data on: (i) fiscal or revenue yielding capacity of municipalities, and (ii) expenditure norms for services. The finance data set for municipalities in India comprises revenue yields from taxes and charges that they employ. No assessments of the fiscal capacity of municipalities are made locally or at the level of the states. To this extent, the analysis of fiscal health remains handicapped. In this study, we use firstly the actual revenue yields and compare them with the normative levels of expenditure, and then adjust own revenue yields upwards by a factor of 1.1 in order to arrive at the fiscal capacity or revenue-yielding potential of municipalities. The methodology for estimating inefficiencies has been outlined in the preceding chapter.

The standardized expenditure norms are derived from the Report of the High-Powered Expert Committee on Indian Infrastructure and Services[74]. Necessary adjustments have been made in respect of the base year[75]. Further, the expenditure norms vary by city-size. These have been taken into account in arriving at the expenditure norms for each of the 21 states, and are given in the following table alongwith firstly, the actual own revenues, and secondly, the fiscal capacity or revenue-yielding potential of municipalities, aggregated at the level of states.

---

74 India has historically had the benefit of having expenditure norms developed by a Committee headed by Dr. Rafiq Zakaria in 1963. Since then, those norms have been widely used for estimating the financial requirements of municipalities. Considering that these norms have lost relevance in the present scenario, the HPEC was inter-alia given the task of developing expenditure norms for 8 services, six of which are commonly undertaken by municipalities. The HPEC has taken the service benchmarks as developed by the Ministry of Urban Development, and applied the per capita cost of services drawn from the JNNURM project proposals to the service bench marks for evolving expenditure norms. This study uses the HPEC's expenditure norms with appropriate adjustments.

75 The HPEC operations and maintenance expenditure norms for (2009-2010) and adjusted norms for the year 2007-08 for the different size classes of cities and towns are given here. These norms relate to six services, viz, water supply, sewerage, storm water drainage, solid waste management, urban roads, and street lighting. The adjusted norms reflect a 50% mark-up to account for expenditure on establishment and wages and salaries.

City Size	Per capita HPEC Norms 2009-10	Per capita Adjusted Norms, 2007-08
> 1 million	3942	3497
500,000 – 1 million	3332	2956
100,000 – 500,000	3062	2717
50,000-100,000	2416	2143
20,000-50,000	2212	1962
<20,000	1842	1362
Average		2665

Source: High-Powered Expert committee. Ibid. Adjusted by using a deflator of 0.8872.

IMFR

Table 22: Fiscal Health of Municipalities, 2007-08

State	Per Capita Rs.			Percent of	
	Actual municipal revenue	Fiscal or Revenue yielding capacity	Normative municipal expenditure	Actual revenue to normative expenditure	Fiscal or revenue capacity to normative expenditure
	1	2	3	1/3	2/3
Andhra Pradesh	748	1571	2724	27.4	57.7
Assam	143	300	2348	6.1	12.8
Bihar	105	220	2940	3.6	7.5
Chattisgarh	376	790	2468	15.2	32.0
Goa	282	592	2006	14.1	29.5
Gujarat	1079	2266	2868	37.6	79.0
Haryana	281	590	2628	10.7	22.4
Himachal Pradesh	-	-	-	-	-
Jammu & Kashmir	90	189	2572	3.5	7.3
Jharkhand	86	181	2366	3.6	7.6
Karnataka	545	1144	2676	20.4	42.7
Kerala	329	691	2394	13.7	28.9
Madhya Pradesh	121	254	2548	4.7	9.9
Maharashtra	2600	5460	2985	87.0	182.9
Orissa	38	80	2384	1.6	3.3
Punjab	1049	2203	2673	39.2	82.4
Rajasthan	387	813	2585	15.0	31.4
Tamil Nadu	396	832	2452	16.2	33.9
Uttar Pradesh	94	197	2660	3.5	7.4
Uttarakhand	116	244	2250	5.2	10.8
West Bengal	394	827	2728	14.4	30.3
All States (21 states)	747	1569	2665	28.0	58.9

A number of points are observed. *In the aggregate, the fiscal health of municipalities in India is unsatisfactory.* Actual municipal revenues are less than a third of what are needed to maintain services at standardized levels[76]. Actual revenues account for less than 10 percent of the normative levels of expenditures in Assam, Bihar, Jharkhand, Madhya Pradesh, Orissa, Uttar Pradesh, and Uttarakhand. Moreover, a key point from this table is that even at optimal utilisation of property taxation, i.e., bringing 85

Fiscal health of municipalities – measured as a gap between fiscal capacity and normative levels of expenditure is unsatisfactory.

[76] State-level expenditure norm = (size class expenditure norm x population in each size class) / state's urban expenditure norm, see footnote 71.

percent of properties under assessment and closing the gap between tax demanded and tax collected and user charges fixed so as to be able to cover 85 percent of the cost incurred, municipalities in these states will not be able to produce revenues equal to the normative levels of expenditure. There will still be a large gap between the fiscal capacity of municipalities and the normative levels of expenditures with the exception of municipalities in Maharashtra whose revenue profile includes octroi revenues. Even in states such as Gujarat and Andhra Pradesh, the fiscal capacities of municipalities are not such that the recurrent expenditures at norms established by the HPEC can be met. Moreover, municipalities with the given fiscal domain will not be able to post surpluses for undertaking asset creation activities.

Municipalities in several states are at a high risk in that their revenue yielding potential to be able to provide services at normative levels is low.

The table also shows that municipalities in several states are at a high risk in that their current revenue levels and revenue-yielding potential to provide services at normative levels are extremely low – less than 25 percent of the normative expenditure levels. These states have relatively low incomes and have low urbanization levels. A separate strategy will be necessary for municipalities in such states.

Bond Rating as a Fiscal Health Measure

Bond rating is another method of assessing the fiscal health of a municipality. "Rating is an independent opinion on the future ability, legal obligation and commitment of a borrower – in this case, the municipality – to meet its financial obligations of interest and principal in full and in a timely manner". It is an evidence of the issuer's obligation to repay a specified principal amount on a date, together with interest at a stated rate, or according to a formula for determining that rate. Rating is important for municipalities for two reasons: (i) investors are reluctant to buy bonds if they are not rated; in several countries including India, municipalities are not permitted to sell unrated bonds[77]; and (ii) the rating often serves, particularly in countries where interest regimes are allowed to operate freely, to determine the interest rate at which sub-sovereigns can issue debt in the capital market. The riskier the ability of the borrower to service debt payments, the higher the interest rate sub-sovereigns have to pay.

Municipal government borrowing in India is regulated by the Local Authorities Loans Act, 1914. This Act specifies (i) the purposes for which local bodies may contract a loan, (ii) limits on the amount of the loan, (iii) the duration of a loan, (iv) security or collateral, and (v) repayment procedures. Subject to the limits imposed by this Act, the state governments have the flexibility to determine the framework within which local governments – a term used to comprise all forms of local bodies including the parastatals, can borrow from the market.

In India, credit rating is mandatory for debt instruments with a maturity exceeding 18 months. The four major credit agencies viz., CRISIL, ICRA, CARE, and FITCH together with their partners Standard and Poor's and Moody serve the Indian market in terms of rating bonds and debentures and other papers.

Box 11

Credit ratings are

- Assessment of the ability and willingness of a borrower to make full and timely payments
- Opinions as to the credit quality of the issuer throughout the life of the bond
- Credit ratings are not
- Recommendations to buy, sell or hold a security

The World Bank. 1999. Credit Rating and Bond Issues at the Sub-national level

77 Most countries that permit local borrowing have established debt limits intended to keep local authorities from borrowing irresponsibly. Many prohibit local authorities from borrowing in foreign currencies. Some require central government approval of all sub-national debt. A few countries forbid local borrowing all together.

The rating agencies use different frameworks for rating municipalities. The CRISIL (Credit Rating Information Services of India Limited) for instance, takes into account the legal and administrative framework for accessing the capital market, the economic base of the area that the municipality is responsible for, the existing operations of a municipality, managerial assessment (initiatives taken by the management of a municipality to enhance the resource base), project-specific issues, and municipal finances. An indepth analysis of the finances of municipalities forms an integral part of a credit rating exercise. The CARE (Credit Analysis and Research Limited) considers parameters such as the fiscal profile of the bond issuing municipal body, profile of the project being financed and its related risk factors, revenue streams assigned for repayment of bonds, the level of local government autonomy, and the administrative capability of local government among key factors for the purposes of rating. The analytical methodology used by Standard and Poor focuses on the range of the economic system and administrative factors, budgetary performance and flexibility, and the financial position of the rating agency. Since the first bond issued by the Bangalore Municipal Corporation in 1997 (guaranteed by the State government) followed by the bond issue by the Ahmedabad Municipal Corporation (repayment by escrowing the octroi collection), 14 such bonds have been issued.

Whichever way the rating agencies may establish the criteria, they refer to –

- Economic base, diversity and growth
- Financial operations, revenue and expenditure
- Analysis of outstanding debt
- Sovereign ceiling
- Local government's administrative structures, legal factors, and political dynamics.

As stated earlier, the primary objective of assessing the fiscal health of municipalities is to ascertain the extent of weight the rating assigns to different parameters, the issue here being whether the own resource component has a critical bearing on the rating of municipalities? The policy question in turn is whether `own source' is a critical component in achieving a higher rating for municipalities to access capital market funds?

We present here the rating results of 41 JNNURM municipalities together with the structure of municipal revenues. Revenue structures are in two parts own revenues and transfers[78]. In this exercise, municipalities have been rated according to their capacity to enter the capital market. The rating results do not pertain to any specific instrument.

78 As an aid to reinforce the JNNURM, credit rating agencies were asked to "rate" all JNNURM municipalities on a stand-alone basis. The results of this exercise are used in this Chapter.

Table 23: Rating Results

Municipality	Rating	% Share of own revenue	% Share of transfers
Agra	BB-	27	73
Ahmedabad	A+	90	10
Ajmer	BBB-	9	91
Allahabad	B+	24	76
Amritsar	BB-	57	43
Asansol	BB	51	49
Bangalore	BBB+	52	48
Bhopal	BBB-	31	69
Chandigarh	A+	27	73
Chennai	BBB+	57	43
Coimbatore	BBB+	58	42
Greater Hyderabad	AA-	63	37
Greater Mumbai	AA-	90	10
Greater Visakapatnam	A	71	29
Howrah	BB-	42	58
Indore	BBB	31	69
Jabalpur	BB+	35	65
Jaipur	BBB+	34	66
Kalyan Dombivili	A	96	4
Kochi	BBB-	67	33
Kolkata	A+	60	40
Lucknow	BB	33	67
Ludhiana	BBB-	55	45
Madurai	BBB+	49	51
Mathura	B	17	83
Meerut	BB	23	77
Mira Bhayandar	A-	96	4
Mysore	BBB+	55	45
Nagpur	A	93	7
Nanded-Waghala	BBB-	99	1
Nashik	AA-	98	2
Navi Mumbai	AA	99.5	0.5
Pune	AA-	94	6
Raipur	BBB-	31	69
Rajkot	A-	88	12
Surat	AA-	90	10
Thiuvanthapuram	BBB-	60	40
Ujjain	BB	41	59
Vadodra	A-	91	9
Varanasi	B+	22	78
Vijaywada	BBB+	67	33

Source: Reports of the Credit-Rating Agencies. Ministry of Urban Development.

Two points are to be noted. One, with the exception of Chandigarh, all municipalities which have ratings ranging between AA- and A+, have a high component of `own revenues' and their dependence on transfers is low. Several of them, as the above table shows, have over 90 percent of revenues accruing from own sources which would tend to suggest that high own source is crucial to achieving investment grade rating. Two, the high own revenue component in the case of municipalities with ratings of AAA- and above, is explained by octroi revenues excepting in three cases, i.e., Chandigarh, Hyderabad, and Kolkata, advancing the case for a revenue source which is as buoyant as octroi to enable municipalities access capital market funds.

High component of own source revenue is a critical component in securing an investment grade bond rating.

In the aggregate, three important conclusions emerge[79]:

(i) The fiscal health of municipalities in India is unsatisfactory. The existing revenue base even at optimal capacity is insufficient to cover the normative levels of expenditure;

(ii) The rating results underline the need for a buoyant source of revenue for municipalities to enable them access the capital market funds, implying that the current structure is too narrow to give municipalities an investment grading.

(iii) While transfers are important to bridging the gap between the fiscal capacity and normative levels of expenditure, they are of secondary importance in rating municipalities.

[79] It needs to be recognized that municipal borrowing is also constrained by supply side restrictions imposed by the Reserve Bank of India and other regulatory bodies. See the World Bank. Ibid.

5 THE WAY FORWARD TOWARDS A MUNICIPAL FISCAL POLICY

"While the world has changed rapidly, the tax systems that support all levels of government have largely stayed the same. The underlying taxes that support local governments were designed and implemented in a different time and for a different economy. With a few exceptions, these taxes have not changed significantly since their inception. Many scholars believe that without radical changes, many types of taxes cannot continue raising sufficient revenue for the 21st century" (Brunori. 2009)[80]. This quote serves as the foundation for the Chapter: The Way Forward: Towards a Municipal Fiscal Policy. This Chapter carries the postulate that the future of India's municipalities will be in jeopardy if the way they are currently financed is not significantly altered.

Municipal Finance Reform: A Global Occurrence

Municipal finance reforms are currently underway in a number of developing and developed countries[81]. Several countries have undertaken to reform the municipal system in order to pursue and deepen decentralization goals and objectives or put in place the principle of subsidiarity; in others, reform are being brought in to institute a new system

80 David Brunori. 2009. Local Tax Policy: A Federalist Perspective. The Urban Institute Press. Washington D.C.

81 George M. Guess (Ed). Fast Track Municipal Fiscal Reform in Central and Eastern Europe and the former Soviet Union Open Society Institute, Budapest; Celina Souza. 2003. Brazil's System of Local Government, Local Finance, and Inter-governmental Relations, School of Public Policy. University of Birmingham. UK.

IMFR

of local government. Yet, in others, reforms have resulted in offloading of functions from the higher tiers onto municipalities. In Central and Eastern Europe, reforms have focused on local taxation, municipal property management, budget formulation, and budget implementation. Reforms in Canada, as Gracea and Le Sage report, have been designed to advance several overarching goals, entailing creation of governance capacity, improved inter-governmental relations between municipal governments and their respective provincial governments, and improved relations between municipal governments and members of the communities. Notably, as the authors indicate, the goals have not always been shared equally by all provinces. "In some instances, they have articulated quite different purposes"[82]. The Brazilian Constitution 1988 is often cited for upgrading the political and financial role of municipalities in the country. As Celina Souza notes: "no Constitution prior to 1988 has provided local governments with the amount of resources they now enjoy. – there is a consensus that Brazil is one of the most decentralized countries in the developing world and that financial decentralization has favoured the municipalities to a greater extent than the states.[83]" Brazil has put in place a Fiscal Responsibility Law which prohibits the bailing out by the federal government of new debts contracted by local governments.

Beginning with the 74th Constitutional amendment India has entered into an important phase of municipal reform. The rationale of the constitutional amendment as embodied in the Statement of Objects and Reasons is described as under: "in many states, local bodies have become weak and ineffective on account of a variety of reasons, including the failure to hold regular elections, prolonged supersession and inadequate devolution of powers and functions. As a result, urban local bodies are not able to perform effectively as democratic units of self-government. Having

82 Joseph Carcea and Edward C. Le Sage Jr. 2005. Municipal Reform in Canada. Oxford University Press. London.

83 Celina Souza. 2003. Brazil's System of Local Government, Local Finance, and Intergovernmental Relations. School of Public Policy. University of Birmingham. U .K.

regard to these inadequacies it is considered necessary that provisions relating to urban local bodies are incorporated in the Constitution particularly for (i) putting on a firmer footing the relationship between the state government and urban local bodies with respect to (a) the functions and taxation powers, (b) arrangements for revenue sharing, (c) ensuring regular conduct of elections and, (d) providing adequate representation to the weaker sections". Underlying in the Statement is the argument that only with such wide-ranging initiatives in the form of Constitutional support and enhanced financial jurisdiction and increased access to financial resources would the municipal governments be able to perform their governance and service delivery functions efficiently and effectively. With this, the Constitution has laid the foundation for reforming the municipal financial structures. Since the amendment, municipal reforms have been further advanced. As pointed out earlier, the Income Tax Act has been amended to provide for issuance of tax free bonds by municipalities. In 2002, the Government of India established a fund called the Urban Reform Incentive Fund (URIF). The Jawaharlal Nehru National Urban Renewal Mission (JNNURM) now constitutes one of the largest initiatives to reform, among others, the finances and functioning of municipalities.

This Chapter on the Way Forward: Towards a Municipal Fiscal Policy begins with a recapitulation of the core questions that this study set out to address, these being: is the existing India's municipal system adequate for India's changing socio-economic realities? Can the existing finance system effectively deliver on the functions envisaged for municipalities under the Constitution? What needs to be done to make the existing system work? What roles will be required of the Central and state governments in reinforcing the existing system? This study has addressed these questions. Although the main findings and conclusions have been brought out in different places of the study report, a few of them needs reiteration here.

i. the present system even at optimal capacity is unable to generate resources that would deliver services at some standardized norms;

currently, what the municipalities generate is 28 percent of what would be needed to maintain services at standard levels;

ii. the existing system is out of sync with the present day realities; it is burdened with taxes that have no productive value and are obsolete. Property taxes, although vital for the fiscal viability of municipalities, have accumulated a lot of inefficiencies. Other taxes that meet the test of immobility, e.g., land-based taxes, stand appropriated by state-level development authorities;

iii. the system of transfers to municipalities lacks policy in that there are no stated guidelines under which transfers may take place; it seriously affects the functioning of municipalities;

iv. there are no performance standards for municipalities with the result that they have accumulated huge inefficiencies in the internal mobilisation and management of resources and are hardly ever confronted with a hard budget constraint;

v. the municipal finance system is additionally faced with the problem of inter-state differences in the levels of municipal revenues and expenditures, in part, because of state policies towards municipal taxation, and in part, on account of the factors that are beyond the control of municipalities;

vi. the existing system lacks a formal recognition of the role of the Central government in the financing of municipal infrastructure and services; and

vii. municipalities are made up of staff which has little technical and managerial capacities. This survey showed that supervisory and managerial staff constituted less than 10 percent of the total staff, the balance being clerical and service staff.

Municipal Finance Reform on the Ground

As stated earlier, beginning with the 74th Constitutional amendment a string of municipal finance reforms have been initiated in the country. In the main, these comprise –

IMFR

i Reform of property taxation involving coverage of properties for purposes of taxation through the Geographic Information System, improved collection, and more recently, the proposal of the Thirteenth Finance Commission (TFC) to set up in each state a Property Tax Board for establishing a proper system of property assessment and valuation;

ii transition from the annual rateable value (ARV) method of assessing values to unit area and capital valuation;

iii 85 percent collection of user charges on municipal services;

iv shift from a single entry, cash-based accounting system to one which is a double-entry, accrual-based accounting system[84];

v refurbishing of the State Finance Commissions (SFC) with a clear template for addressing their Constitutional mandate; and

vi putting in place a system where the finance commission grants are linked to municipal performance. The Thirteenth Finance Commission, giving recommendations for the period 2010-15, has laid down that a part of the grants-in-aid for municipalities will accrue to them upon the fulfilment by states of nine conditions. The conditions are given in Box below.

[84] There are several other reforms under the JNNURM aim at the strengthening of the municipal finance system. These include reform of rent control levies, reduction in stamp duties, procedures for conversion of rural lands into urban, and property titling.

Box 13

i. Putting in place a supplement to the budget documents for local bodies.

ii. Putting in place an audit system for all local bodies. The C&AG must be given TG&S over the audit of all the local bodies in a State at every tier/category and his Annual Technical Inspection Report as well as the Annual Report of the Director of Local Fund Audit must be placed before the State legislature.

iii. Putting in place a system of independent local body ombudsmen who will look into complaints of corruption and maladministration against the functionaries of local bodies, both elected members and officials, and recommend suitable action.

iv. Putting in place a system to electronically transfer local body grants provided by this Commission to the respective local bodies within five days of their receipt from the Central government.

v. Prescribing through an Act the qualifications of persons eligible for appointment as members of the SFC consistent with Article 2431 (2) of the Constitution.

vi. Enable local bodies to levy a property tax (including tax on all types of residential and commercial properties).

vii. Putting in place a state level Property Tax Board, which will assist all municipalities and municipal corporations in the state for establishing an independent and transparent procedure for assessing property tax.

viii. Putting in place (gradually) standards for delivery of all essential services (water supply, sewerage, storm water drainage, and solid waste management) provided by local bodies.

ix. Putting in place a fire hazard response and mitigation plan in all municipal corporations with a population of over 1 million (2001 Census) for their respective jurisdictions.

This study reinforces the above reform agenda and its underlying rationale. Note should also be made of the fact that there exists a vast amount of literature on local government finance which lays down important principles and criteria for local government functioning and taxation. In 1879, Henry George expounded that the expenditure of government could be funded from the site rents, eliminating the need to tax productive activity[85]. It later came to be known as Henry George Theorem. Literature has made extensive references to the normative rules for tax assignment (See Box below). Principles such as finance follows functions have guided the developing countries in significant ways.

Box 14

1. The tax base should be immobile to allow local authorities some leeway in varying rates without the tax base disappearing
2. The tax yield should be adequate to meet local needs and remain sufficiently buoyant (i.e., expand at least as fast as expenditures).
3. The tax yield should be stable and predictable over time
4. The tax should be perceived as reasonably fair by taxpayers
5. The tax should be easy to administer efficiently and effectively
6. It should not be possible to export much, if any, of the tax burden nonresidents
7. The tax base should be visible to ensure accountability

Richard Bird

Imperatives for Making Municipal System Work

It is in this context that the Way Forward has been developed and visualized. It is composed of six imperatives:-

1. Restructuring and broad-basing of the existing municipal finance system

2. Providing municipalities with access to the proposed Goods and Services Tax (GST)

3. A new role for the State Finance Commission and Central Finance Commission in addressing issues of municipal finance

4. Restructuring of the JNNURM-grant facility in ways that it contributes to growth and equity-linked municipal infrastructure (transport, climate change, slum improvement, and poverty reduction).

85 Henry George. 1879 and 1975. Progress and Poverty. Robert Schalkenbach Foundation.

5. Capacity building aimed at effective implementation of the municipal finance reform agenda

6. Introduce fiscal responsibility at the level of municipalities.

Restructuring and broad-basing of the existing municipal finance system

Restructuring and broad basing the municipal fiscal framework is evidently a key imperative for sound public finance. It aims at (i) making property tax reform comprehensive, (ii) restoring to municipalities those taxes that fulfill the criterion of immobility, and (iii) reiterating the need to reduce subsidies on the provision of municipal services. We elaborate these below.

The property tax reform which currently focuses on an improved coverage of properties with the use of the Geographic Information System (GIS), improved collection of property taxes, and the proposal of the Thirteenth Finance Commission (TFC) to set up in each state a Property Tax Board, should be expanded to include the following elements:

Box 15

Property Tax Board

State governments must put in place a state-level Property Tax Board, which will assist all municipalities and municipal corporations in the state to put in place an independent and transparent procedure for assessing property tax. The Board (a) shall or cause to , enumerate all properties within the jurisdiction, (b) shall review the present property tax system and make suggestions for a suitable basis for assessment and valuation of properties, and (c) shall make recommendations on modalities for periodic assessment.

Report of The Thirteenth Finance Commission

- Use of the approved Floor Space Index (FSI) or Floor Area Ratio (FAR) as the effective floor space for purposes of valuation and assessment as opposed to the current practice of using the carpet area or the constructed space. Using the FSI/FAR as the effective floor space has two distinct advantages over the existing system: (a) it will prevent hoarding and speculation which is commonly observed in a number of large and growing cities; and (b) spur housing activities. It will also do away with the need to levy taxes an vacant lands. Taxes on vacant lands are sparingly levied for reasons that in the main include the problem of defining what is vacancy.

- Registration of all properties. One of the findings of this study is incomplete registration of properties on the municipal house tax registers. The Geographic Information System (GIS) is one method of bringing properties under a municipal house tax register. Registration of properties needs to be made mandatory.

- Reduction in the number of properties exempted from property taxation. Exempted properties reduce property tax yields by about 8 percent. The proposed Property Tax Boards should undertake the task of laying down the criteria for exempting properties from the purview of property taxation.

The local tax powers are broadly determined on the criterion of the immobility of the tax base, the principle being that the burden of the tax should be localized and inter-jurisdictional spillover be minimized. There are at least two revenue sources that meet the criterion of immobility but are in the fold of the state government.

i. Non-commercial motor vehicles registered within the jurisdictional limits of municipalities; and

ii. Stamp duty on sale and purchase of properties located within municipal limits.

The study suggests that these two taxes be made a part of the fiscal powers of municipalities in addition to sharing of the proceeds of the development charges and betterment levies on works undertaken within the municipal boundaries.

The HPEC has proposed that there should be an exclusive list of local taxes, apparently prompted by the fact that the state governments often exercise their powers to withdraw tax authority from municipalities or dilute their tax powers, thereby weakening their revenue base. Several states, e.g., Rajasthan, Haryana, Punjab, and Himachal Pradesh have, in recent years, reduced the powers of municipalities in respect of property taxes. The Chart showing the de-facto tax powers shows wide inter-state differences in municipal tax authority. This study proposes that the fiscal powers of municipalities be made uniform across states and safeguarded from encroachment by the state governments.

Application of proper `user charges' has been a recurring theme in most discussions on municipal finance reforms, with the common view being that there should be a fuller correspondence between the cost and price of services. This study has identified a large gap between the cost of providing services and the price fixed for cost recovery. A sound municipal finance system is unsustainable with such large subsidies. The study suggests reducing the subsidies to be no more than 15 percent of the cost of delivering the services.

Imperative 2: Goods and Services Tax for Local Government

It has been shown and argued in this study that the fiscal domain of municipalities is narrow and has in recent years been constricted by the abolition of octroi. Although octroi abolition is a positive step, it has in a sense, broken the link of municipalities with the local economy. It is also stated elsewhere in the study report that a key impediment to the devolution of 12th Schedule functions is the lack of an appropriate revenue model. Several of the states currently share a pool of state taxes with municipalities, albeit not consistently. The Thirteenth Finance Commission (TFC) has proposed that the proposed Goods and Services Tax (GST) be shared with local bodies. The TFC has further proposed that the following taxes be subsumed in the GST.

i. Value Added Tax
ii. Central Sales Tax
iii. Entry Tax, whether in lieu of octroi or otherwise
iv. Luxury Tax
v. Taxes on lottery, betting and gambling
vi. Entertainment Tax
vii. Purchase Tax
viii. State Excise Duties
ix. Stamp Duty
x. Taxes on Vehicles
xi. Tax on goods and passenger
xii. Taxes and duties on electricity
xiii. All state cesses and surcharges

This study reinforces the suggestion, and proposes that the method of GST sharing as also the share of GST that should be assigned to the municipalities be worked out by an Expert Group.

Imperative 3: New Role for the States Finance Commission as established under Article 243 (I) and (Y) and for the Finance Commission as established under Article 280

A third imperative refers to the role of the Finance Commissions as provided for under Article 243 (I) and (Y) and Article 280. As the fiscal domain of municipalities undergoes a change and is provided protection, the role of the State Finance Commission (SFC) and of the finance commission set up under Article 280 requires to be redefined. This study makes the following proposal:

Role of the State Finance Commission (SFCs): The key roles and responsibilities of the SFC should comprise the following:

- Estimate the vertical gap between what the municipalities ought to raise from their mandated tax powers and non-tax revenue sources and what they need to spend on services at levels as may be laid down, and recommend a strategy for revenue sharing between the State and municipalities.
- Estimate the horizontal gap and formulate a strategy for bridging the same
- Develop a strategy of support for smaller municipalities whose needs can not be met within a formulae-driven system
- Appraise progress on the implementation of the municipal reform agenda and suggest appropriate actions for their timely implementation
- Prepare once in five years, a State of the Municipal Finance Report as a complement its report

Central Finance Commission: The Constitution requires the Finance Commission, set up under Article 280 of the Constitution, to make recommendations, among others, on "the measures needed to augment the Consolidated Fund of the State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State". Successive Finance Commission have recommended grants-in-aid for municipalities (See Table 24);

Table 24: Finance Commissions recommended Grants-in aid for Municipalities

Commission	Basic Grant (Rs. crore)	Earmarked or performance linked (Rs. crore)
11^{th} FC (2000-05)	2,000	2.93
12^{th} FC (2005-2010)	5,000	-
13^{th} (2010-15)	15,110	8,000 (Performance linked)

Sources: Reports of the Finance Commissions

Prima facie, the grants-in-aid as recommended by the Finance Commission, with annual grants ranging from Rs. 400 crore (11th Finance Commission), Rs. 1,000 crore (12th Finance Commission), Rs. 4662 crore (13th Finance Commission) do not bear any relationship with the fiscal needs of municipalities. The inability on the part of the Finance Commissions to link their grants with the fiscal needs of municipalities persists to be a major weakness in implementing the Constitutional Amendment of 1992. This study envisages that the way forward for the SFCs and other suggestions made in this section will contribute to a better assessment of the fiscal needs of municipalities. This study further envisages that the Finance Commission should undertake the following responsibilities.

i. Rework the fiscal gap of municipalities, taking into account the normative standards for revenue raising by municipalities and service provision, and provide for it in the form of a percentage or share of the divisible pool;

ii. Examine and address issues of inter-state variation in municipal revenues and expenditure, the extent to which these are caused by exogenous, economy-wide factors; and

iii. Introduce and finance measures that aim at long run fiscal sustainability of municipalities on the lines recommended under the JNNURM and by the Thirteenth Finance Commission.

Imperative 4: Redefine the Role of the Central Governments

The Central government has a vital interest in making municipalities work: the level of efficiency at which municipalities work impacts macroeconoic goals and objectives. Earlier in the report, it is mentioned that as India urbanizes, provision of urban infrastructure and services, becomes a multi-level responsibility. This framework should permit the

Central government to play the following roles that impinge on the finances of municipalities.

i. Bring in place a system of safeguarding the financial and fiscal jurisdiction of municipalities;

ii. Provide financial assistance for such urban infrastructure projects that have a significant contribution towards macro goals and objectives, especially urban transport, climate change, slum improvement and upgrading, and urban poverty reduction.

iii. Incentivise the states to undertake such structural and procedural reforms which would assist municipalities in improving their finances and functioning.

Imperative 5: Municipal Fiscal Responsibility: Suggested Ingredients

Brazil and Nigeria provide successful examples of local body fiscal responsibility Acts. New Zealand and South Africa have well-functioning municipal fiscal management Acts. It is critical because unsustainable and populist fiscal policies jeopardise public service delivery and safety of the municipal financial system. It is stated earlier in this study report that there exist no performance standards for municipalities, either for revenue raising or expenditure management or delivery of services. They operate under a soft budget platform which is inconsistent with the role envisaged for them under the 74th Constitutional amendment. This study suggests that an appropriate legislation on Fiscal Responsibility for Municipalities, be brought in to gradually bring them into a system that requires them to adhere to a minimum performance standards. Such an Act should provide for the following:

- Preparation of a Medium Term Fiscal Plan, which would set forth a five-year rolling target for the municipal-level fiscal indicators, along with a clear target of the physical and financial targets, and adherence to performance codes/standards.

- Creation of an expenditure stream only against a matching revenue stream, and managing expenditure consistent with the level of revenue generated.

- Fixation of ceiling on expenditure on administration.

- Ensure proper procedure for preparation, submission and audit of accounts, and proper scrutiny and adherence to the audit reports.

- No credit operations without the authorization of Municipal Councils.

- Publication of an annual report on the impact of tax exemptions and price subsidies in the municipal budget.

- Laying down measures to enforce compliance to the provisions of the Act.

Imperative 6: Capacity Building

Absence of adequate capacities at the level of municipalities has long been citied as the principal reason for their poor performance. Capacity building assumes added importance in the context of India's urbanization and increasing complexity of cities and their governance and management. Currently, the municipal-level functionaries do not have the necessary skills, knowledge and training for taking on functions that are linked to reforms aiming at efficiency, equity, transparency and participation. This need has been underlined in all Central government's urban sector interventions. This study reinforces the need to mount a major capacity building programme for municipal functionaries.

IMFR

Conclusions

Municipal finance has grown in complexity in recent years. It has several other important facets that this study has not been able to address. At the same time, scholars have begun to accord high priority to local governments than ever before, not only in connection with their role in service delivery and growth, but also poverty alleviation and environmental management. According to Michael Cohen: While it is commonly understood in India that India's poor lived primarily in rural areas, there is now growing understanding of the urban poor and the cumulative disadvantages which they face: low wages, high costs for essential services including water and food, insecurity, and low human capital investments. It is also widely understood that the phenomenon of slums *per se* is not an indicator of the low disposable incomes of slum residents but rather also a result of inefficient urban land use regulations such as the Urban Land Ceiling Act and building standards for FSI which distort markets for urban land and housing by reducing supply and thus increasing the cost of urban housing. While many of these regulations are not formally legislated at the municipal level but rather come from the states, they contribute to poor municipal performance.

Municipal policy and institutional performance in the poor provision of needed infrastructure and municipal services thus contributes to the growth of urban poverty and most regrettably, not to its alleviation.

Cohen also observes: An increasingly visible aspect of urban India is the rising vulnerability for urban populations due to increased urban population concentration and inadequate municipal capacity and services to assure their safety and security. Indian urban areas are increasingly susceptible to various forms of negative externalities including both so-called natural disasters and man-made disasters. These threats include natural disasters, such as floods such as the Mumbai monsoon floods of 2005 and 2006, whose heavy loss of life and huge financial losses resulted in large part from poor municipal maintenance of urban drainage. They also include the likelihood of sea-level rise which will affect cities such as Mumbai, Kolkata, Chennai, and many others.

Vulnerability also comes from man-made hazards such as fires, acute pollution of air and water, industrial accidents, and mass transportation and traffic accidents. The incidence and impacts of these problems depends significantly on the effective capacity of municipal institutions. These issues are likely to occur in rapidly-growing secondary and tertiary urban areas having less urban management capacity to address them. Knowing that these increased vulnerabilities are present as “unaddressed urban liabilities” suggests that a high priority reason for strengthening municipal capacity is to prevent future problems which can bring very high costs.

Connolly, Brunori, and Bell assert that “the acceptance of strong autonomous local self government is a normative good that provides the foundation for our federal system of government”[86]. Although it is written in the context of the USA, it should serve as a norm for strengthening the municipal finance system in India. The municipal finance system is a crucial component in addressing issues of growth, poverty reduction, and urbanization. It deserves far greater than attention than what it has been given to it thus far.

---

[86] Connolly, Katrina et. al. 2009. “Are state and local finances becoming more or les decentralized and why should we care”, in Property Tax Roundtable. Washington D.C.

REFERENCES: BOOKS

Bahl, Roy W., and Johannes F Linn. 1992. *Urban Public Finance in Developing Countries*. Published for the World Bank. Oxford University Press. New York.

Bahl, Roy., Jorge Martinez-Vazquez, and Joan Youngman. 2008. *Making the Property Tax Work: Experiences in Developing and Transitional Countries*. Lincoln Institute of Land Policy. Cambridge. Mass.

Baker, Benjamin. 1957. *Urban Government*. D. Van Nostrand Company, Inc. Canada.

Bell, Michael E., David Brunori, and Joan M. Youngman. 2010. *The Property Tax and Local Autonomy.* Lincoln Institute of Land Policy, Cambridge. Mass.

Bird, Richard and Michael Smart. 2001. Intergovernmental Transfers: Some Lessons from International Experiences. University of Toronto. Toronto.

Brunori, David. 2007. *Local Tax Policy: A Federalist Perspective*. The Urban Institute Press. Washington D.C.

Foster, C.D., R.A. Jackman, and M. Perlman. 1980. *Local Government Finance in a Unitary State*. George Allen and Unwin. London.

Garcea, Joseph and Edward C LeSage. 2005. *Municipal Reform in Canada: Reconfiguration, Re-Empowerment, and Rebalancing*. Oxford University Press. Canada.

Government of India. 2009. Report of Thirteenth Finance Commission, New Delhi.

Hobson, A.R. Paul and France St. Hilaire. 1997. *Urban Governance and Finance A Question of Who does What*. The Institute for Research on Public Policy (IRPP). Montreal, Canada.

Honadle. Beth Walter., James M. Costa, and Beverly A. Cigler. 2004. *Fiscal Health for Local Governments: An Introduction to Concepts, Practical Analysis, and Strategies*. Elsevier Academic Press. UK.

IEB's World Report on Fiscal Federalism 2009. Institut d"Economia de Barcelona.

Jawaharlal Nehru Urban Renewal Mission. http://jnnuram.nic.in

Kaplan, Marshal., and Franklin J. James. 1990. *The Future of National Urban Policy*. Duke University Press.

Ladd, Helen F. and John Yinger. 1991. *America's Ailing Cities Fiscal Health and the Design of Urban Policy*. The John Hopkins University Press. Baltimore.

Local Government Finance: The Challenges of the 21st Century. Second Global Report on Decentralization and Local Democracy. United Cities and Local Governments. Barcelona. 2010

Mathur, Om Prakash, Pratishtha Sengupta and Anik Bhaduri. 2000. *Options for Closing the Revenue Gap of Municipalities: 2000/01 to 2004/05*. National Institute of Public Finance and Policy. New Delhi, India.

Mathur, Om Prakash, and Sandeep Thakur. 2004. *India's Municipal Sector*. National Institute of Public Finance and Policy. New Delhi, India.

Mathur, Om Prakash and George Peterson. 2006. State Finance Commissions and Urban Fiscal Decentralization in India: India Urban Initiatives. The Urban Institute. Washington. D.C.

Mathur, Om Prakash, Debdulal Thakur, Nilesh Rajadhyaksha and Roy Bahl. 2009. *Urban Property Tax Potential in India*. National Institute of Public Finance and Policy. New Delhi, India.

Michael Spence, P Annez and Robert Buckley. 2009. Commission on Growth and Development. Urbanization and Growth. The World Bank Washington DC.

McKinsey Global Institute 2010. India's Urban Awakening: Building Inclusive Cities, sustaining economic growth.

Mohanty P.K., B.M. Msra, Ranjan Goyal, P.D. Jeromi, 2007. *Municipal Finance In India : An Assessment*. Reserve Bank Of India, Mumbai.

National Institute of Urban Affairs : Best Practices on Property Tax Reforms In India", Ministry of Urban Development. Government of India, New Delhi, March 2010. Research Study 111.

United cities and Local Governments. 2011. Local Government Finance: the Challenges of the 21st Century. Edward Elgar. Cheltenham. U.K.

Oates, Walles E. 2001. *Property Taxation and Local Government Finance*. Lincoln Institute of Land Policy. Cambridge. Mass

Peterson, George E. 1994. *Big City Politics, Governance, and Fiscal Constraints*. The Urban Institute Press. Washington D.C.

Pola, Giancailo et. al (Eds). 1996. *Development in Local Government Finance Theory and Policy*. Edward Edgar. Cheltenham, UK.

Register General of India, 2006. Census of India 2001. Population Projections for India and States 2001-2026. New Delhi. India.

Report on Indian Urban Infrastructure and Services. High Powered Expert Committee 2011, Ministry of Urban Development, New Delhi.

Shah, Anwar (Ed). 2006. *Local Governance in Developing Countries*. The World Bank. Washington D.C.

Slack, Enid and Rupak Chattopadhyay (Eds). 2009. *Finance and Governance of Capital Cities in Federal Systems*. McGill-Queen's University Press. Canada.

The World Bank 2010, Developing A Regulatory Framework for Municipal Borrowing in India. Draft Report.

United Nations 2008, World Urbanization Prospects: 2007 Revision, New York,

Wallace, Sally. 2010. *State and Local Fiscal Policy : Thinking Outside the Box?* Edward Elgar Publishing Limited. UK.

REFERENCES: ARTICLES

Annez, Patricia Clarke. 2010. "Financing Indian Cities: Opportunities and Constraints in an N^{th} Best World. World Bank Policy Research Working Paper No. 5474, World Bank, Washington DC.

Bahl, Roy and Richard Bird. 2008. "Subnational Taxes in Developing Countries: The Way Forward". Public Budgeting and Finance. 28(4), 1-25.

Bahl, Roy., and Musharraf R. Cyan. "Tax Assignment: Does the Practice Match the Theory? International Studies Working Paper No. 1004, Andrew Young school of Policy Studies, Georgia State University, Georgia, USA.

Buettner, Thiess, and David E. Wildasin. 2006. "The Dynamics of Municipal Fiscal Adjustment". Journal of Public Economics. 90(6-7), 1115-32.

Carroll, Deborah A. 2009. "Diversifying Municipal Government Revenue Structures: Fiscal Illusion or Instability? Public Budgeting and Finance. 29(1), 27-48.

Chernick, Howard, Adam Langley, and Andrew Reschovsky. 2010. "Revenue Diversification and the Financing of Large American Central Cities". Lincoln Institute of Land Policy. Cambridge, USA.

Clark, Gordon L. 1984. "A Theory of Local Autonomy". Annals of the Association of American Geographers. 74(2), 195-208.

Cohen, Michael. 2009. "Growth and Recovery in a Time of Default: Lessons from the Role of the Urban Sector in Argentina". Working Paper No. 2011/10, UNU-WIDER, Helsinki.

Ebel, Robert D., and Serdar Yilmaz. 2002. “On the Measurement and Impact of Fiscal Decentralization”. The World Bank Institute. Public Finance in Developing and Transitional Countries, edited by Jorge Martinez Yazquez and James alm, EE Publishing Limited, Cheltenham, UK.

Eom, Tae Ho., and Ross Rubenstein. 2006. “Do State-Funded Property Tax Exemptions Increase Local Government Inefficiency? An Analysis of New York State’s Star Program”. Public Budgeting and Finance. 26(1), 66-87.

Estache, Antonio, Sergio Perelman, and Lourdes Trujillo 2005. “Infrastructure Performance and Reform in Developing and Transition Economies: Evidence from a Survey of Productivity Measures”. World Bank Policy Research Working Paper No. 3514, World Bank, Washington DC.

Fjeldstad, Odd-Helge. 2001. “Intergovernmental Fiscal Relations in Developing Countries: A Review of Issues”. CMI Working Paper 2001:11 Chr. Michelsen Institute, Bergen, Norway.

Hendrick, Rebecca. 2004. “Assessing and Measuring The Fiscal Health of Local Governments: Focus on Chcago Suburban Municipalities”. Urban Affairs Review. 40(1), 78-114

Jung, Changhoon. 2008. “Practices of Assessing Financial Conditions and Fiscal Health in Local Governments in the United States.”

Nowlan, David M. “Local Taxation as an Instrument of Policy”. In The Changing Canadian Metropolis : A Public Policy Perspective, Vol 2, Frances Frisken, ed Berkeley, CA : Institute of Governmental Studies Press, University of California, Berkeley.

Slack, Enid. 2010. “Financing Large Cities and Metropolitan Areas”. Presentation to the sixth Symposium on fiscal federalism on financing local government. Barcelona. 14-15, June 2101.

Slack, Enid. 2010. “The Property Tax in Theory and Practice”. Institute of Municipal Finance and Growth Working, Toronto, Canada. Paper 02.

Sohl, Shannon., Michael T. Peddle, Kurt Thurmaier, Curtis H. Wood, and Gregory Kuhn. 2009. “Measuring the Financial Position of Municipalities: Number Do Not Speak for Themselves”. Public Budgeting and Finance. 29(3), 74-96.

Su, Ming., and Quanhou Zhao. “The Fiscal Framework and Urban Infrastructure Finance in China”. World Bank Policy Research Working Paper 4051, World Bank Washington DC.

Warner, Mildred., and Amir Hefetz. 2002. “Applying Market Solutions to Public Services An Assessment of Efficiency, Equity, and Voice. Urban Affairs Review. 38(10), 70-89.

GLOSSARY

Accounting System – The total structure of records and procedures that identify record, classify, and report information on the financial position and operations of a governmental unit or any of its funds, account groups, and organizational components.

Accrual Basis of Accounting – A method of accounting that recognizes the financial effect of transactions, events, and inter-fund activities when they occur, regardless of the timing of related cash flows.

Assessment – The official act of determining the amount of tax base. In case of property tax, the official act of discovering, listing, appraising and placing a value on property in the course of such act.

Balance Sheet – A statement that discloses the assets, liabilities, reserves, and equities of a fund or governmental unit at a specified date.

Betterments Levy – Whenever part of a community benefits from a public improvement, or betterment (e.g., water, sewer, sidewalks, etc.), special property taxes may be assessed to the property owners of that area to reimburse the governmental entity for all, or part, of the costs it incurred in completing the project.

Bond – A means to raise money through the issuance of debt. A bond issuer/borrower undertakes in writing to repay a specified sum of money, alternately referred to as the face value, par value or bond principal, to the buyer of the bond on a specified future date (maturity date), together with periodic interest at a specified rate.

Bond Rating (Municipal) – A credit rating assigned to a municipality to help investors assess the future ability, legal obligation, and willingness of the municipality (bond issuer) to make timely debt service payments.

Budget – A plan for allocating resources to support particular services, purposes and functions over a specified period of time.

Capital Expenditure – Cash investments to acquire or improve an asset that will have a life of more than one year; as distinguished from cash outflows for expense items normally considered as part of the current operations.

Cash Basis – An accounting convention in which transactions are recorded in the period in which payment is made or received as opposed to the period in which the transaction took place (accruals basis)

Central Finance Commission – Constituted by the President under article 280 of the Constitution, mainly to give its recommendations on distribution of tax revenues between the Union and the States and amongst the States themselves. Two distinctive features of the Commission's work involve redressing the vertical imbalances between the taxation powers and expenditure responsibilities of the centre and the States respectively and equalization of all public services across the States. It is the duty of the Commission to make recommendations to the President on (1) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them and the allocation between the States of the respective shares of such proceeds, (2) the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India, (3) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats (rural local bodies) in the State on the basis of the recommendations made by the Finance Commission of the State, (4) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Municipalities (urban local bodies) in the State on the basis of the recommendations made by the Finance

Commission of the State, and (5) any other matter referred to the Commission by the President in the interests of sound finance. The Commission determines its procedure and have such powers in the performance of their functions as Parliament may by law confer on them.

Collection Efficiency – Ratio of property tax collection to property tax demand.

Coverage Ratio – Ratio of assessed properties to total properties within municipal limits.

Credit Rating – Estimation of the credit worthiness of an individual, corporation, or even a country. It is an evaluation of a potential borrower by rating agencies on the basis of his overall credit history, current assets and liabilities and indicates to the lender the probability of the subject being able to pay back a loan.

Deficit – The excess of expenditures over revenues during an accounting period. Also refers to the excess of liabilities of a fund over its assets.

Exempted Property – A property that enjoys a property tax waiver in accordance with statutory directives. For example, Central Government owned properties are often exempted from property tax on the ground that a sovereign cannot tax itself.

Grants – All non-repayable transfers received from other levels of government or from private individuals, or institutions including reparations and gifts given for particular projects or programs, or for general budget support.

Gross Domestic Product (GDP) – The total value of all goods and services produced within the geographical boundaries of a country during a specified period.

Gross State Domestic Product (GSDP) – The total value of all goods and services produced within the geographical limits of a state during a specified period.

Horizontal equity – In a tax system horizontal equity means that people of similar means are taxed similarly.

Incidence – A reference to the person or persons who ultimately bear the burden of the tax, are required by statute to pay it and who may pass some or the entire burden to someone else.

Intergovernmental grants/transfers -- Sometimes called grant-in-aid, are transfers of funds from one government to another, most often from a higher-level government in the federal system to a set of lower level governments.

Jawaharlal Nehru National Urban Renewal Mission (JNNURM) – A Central Government programme launched during December 2005 that aims to encourage reforms and fast track planned development of identified cities.

Non-tax revenue – Revenue collected from sources other than compulsory tax levies. Includes those collected in exchange for direct services rendered by government agencies to the public, or those arising from the government's regulatory and investment activities.

Own Revenue – Revenue a government raises by means of its own legislation or other action, as opposed to grants-in-aid or transfers from another government.

Per Capita Revenue/Expenditure – Revenue or expenditure accruing to each individual within municipal limits. Calculated as total revenue or expenditure divided by the population residing within the municipal area.

Public Private Partnership (PPP) – Public–private partnership (PPP) describes a government service or private business venture which is funded and operated through a partnership of government and one or more private sector companies. PPP involves a contract between a public-sector authority and a private party, in which the private party provides a public service or project and assumes substantial financial, technical and operational risk in the project.

Revenue Expenditure – The operating costs incurred by the authority during the financial year in providing its day to day services. It generally comprises of establishment, operation and maintenance and other expenses.

State Finance Commission – A constitutionally mandated body under Articles 243I and 243Y to review the financial position of Panchayati Raj Institutions (PRI's) and Urban Local Bodies (ULB's) and to make recommendations to the governor as to (a) the principles which should govern (1) the distribution between the state and the local governments (PRI's and ULBs) of the net proceeds of taxes, duties, tolls and fees leviable by the state and the inter se allocation between different PRIs and ULBs; (2) the determination of taxes, duties, tolls and fees which may be assigned to or appropriated by the local governments; (3) the grants-in-aid from the consolidated fund of the state to local governments (LGs); (b) the measures needed to improve the financial position of PRIs and ULBs; (c) any other matter referred to the commission by the governor in the interests of sound finance of PRIs and ULBs.

Total Property – Sum of all properties, assessed and un-assessed within municipal limits.

Total Revenue – The sum total of own revenue and intergovernmental transfers and grants.

Un-assessed Property – Sum of exempted properties and unrecorded properties within municipal limits.

User Charges/Fees – A municipal funding source where payment is collected from the user of a service to help defray the cost of providing the service.

Vertical equity – Tax evaluation criterion that requires that taxes should distribute burdens fairly across people with different abilities to pay.

Annex

Non-Tax Revenue Instruments in use in Sampled Municipalities

Tax Revenue Instruments for 2007/08	Maharashtra						Andhra Pradesh					Kerala					Madhya Pradesh					Uttar Pradesh					Rajasthan				
	Mumbai	Amaravati	Panvel	Jalna	Malegaon	Baramati	Hyderabad	Vijaiwada	Kodapa	Karimnagar	Nizamabad	Thiruvananthapuram	Palakkad	Kollam	Kozikode	Payannur	Bhopal	Jabalpur	Ujjain	Chindwara	Dhar	Lucknow	Aligarh	Bahraich	Muzaffarnagar	Azamgarh	Jaipur	Kota	Bhilwara	Jhunjhunu	Jaisalmer
Hospital/medical colleges/health (fees & charges)	■	■										■	■				■														
Building developmemt charges			■		■	■	■	■	■		■						■	■		■											
Road cutting charges	■			■		■	■	■	■	■	■		■				■	■	■	■	■		■				■	■	■	■	■
Special development contribution charge							■																								
Theatre hall charge		■				■																									
Charge/fees on circumstances of property	■									■									■												
Water supply charges	■		■			■	■	■			■						■	■		■			■	■	■						
Sanitation/conservancy charge+ sewerage+SWD	■						■	■				■	■	■			■	■	■				■	■			■				
Rain water storage charge							■		■		■																				
Commercial liscence charge																							■								
Transfers charges																	■														
Empanelment & registration charges							■										■							■							
Fire fighting charges		■															■	■													
Charges from demolition							■											■				■									
Swimmimg pool charges																		■													
Crematorium charges							■											■		■											
Connection /dis connection charges							■																								
Quality control charges							■																								
Nazul charge		■																													
Fee for Slaughter house	■	■		■		■	■	■		■	■	■	■	■	■		■	■	■	■		■	■	■	■	■	■	■	■		■
Fee for cost of tender	■	■		■		■	■	■	■	■	■	■	■	■	■		■	■		■	■	■		■			■	■		■	■
Fees from market /shops/complex/building	■	■					■					■	■	■	■	■	■		■	■	■		■	■	■	■	■	■		■	

Tax Revenue Instruments for 2007/08	Maharashtra						Andhra Pradesh					Kerala					Madhya Pradesh					Uttar Pradesh					Rajasthan				
	Mumbai	Amaravati	Panvel	Jalna	Malegaon	Baramati	Hyderabad	Vijaiwada	Kodapa	Karimnagar	Nizamabad	Thiruvananthapuram	Palakkad	Kollam	Kozikode	Payannur	Bhopal	Jabalpur	Ujjain	Chindwara	Dhar	Lucknow	Aligarh	Bahraich	Muzaffarnagar	Azamgarh	Jaipur	Kota	Bhilwara	Jhunjhunu	Jaisalmer
Fees for parking/bus stand	■						■		■		■	■	■	■	■	■	■	■	■		■					■					
Fees for birth/death registration	■						■	■	■	■	■	■	■	■	■	■	■		■												
Fees for dangerous & offensive trade license	■						■		■	■		■	■	■	■				■												
Fees for guest house/town hall		■			■		■	■				■	■	■	■					■											
Fees for contract registration act							■	■	■			■	■	■					■		■										
Registration fees for thela, riksha, cycle												■	■	■				■				■	■			■	■			■	
Registration fees marriage act			■									■	■	■		■															
Fees for educational institutional		■				■	■					■	■	■				■		■	■	■									
Registration fees for private hospital												■	■	■					■												
Fees for cattle pound							■	■				■	■				■	■		■	■						■	■	■	■	■
Fees for demand notice, warrant & destriant		■		■	■	■	■					■	■					■		■											
Fees for stadium					■		■					■	■			■		■													
Fees for encroachment			■				■		■		■	■	■					■			■										
Fees for town planning act					■		■	■				■	■				■														
Fees for advertisement							■	■				■	■				■	■	■				■	■			■	■		■	■
Factory construction benefit fees												■																			
Contractors licence fees													■				■	■					■								
Animal registration fee (dogs)																		■	■	■	■										
Fees for colony registration & inspection	■			■														■	■	■											
Fees for trade licensing		■	■	■		■		■			■							■	■	■	■										
Compounding fee/penalty	■	■					■	■		■	■				■		■	■	■	■	■	■	■	■	■		■	■		■	■
Betterment fees	■						■										■		■												
Food licence fee					■														■	■	■										
Fees for ambulance		■																■													

Tax Revenue Instruments for 2007/08	Maharashtra						Andhra Pradesh					Kerala					Madhya Pradesh					Uttar Pradesh					Rajasthan				
	Mumbai	Amaravati	Panvel	Jalna	Malegaon	Baramati	Hyderabad	Vijaiwada	Kodapa	Karimnagar	Nizamabad	Thiruvananthapuram	Palakkad	Kollam	Kozikode	Payannur	Bhopal	Jabalpur	Ujjain	Chindwara	Dhar	Lucknow	Aligarh	Bahraich	Muzaffarnagar	Azamgarh	Jaipur	Kota	Bhilwara	Jhunjhunu	Jaisalmer
Fees for construction material storage																															
Fees for house tax appeal																															
Fees for house tax transfers																															
Fees for environment development																															
Fees for public toilet																															
Fees from pond																															
Fees from slums																															
Fee from railgari, merry go round																															
Fee from pipeline																															
Hospital fees / dispensary fee & charges																															
Architect license fee																															
Debris removal fees																															
Land notice fee																															
Fee for fire services																															
Fair fees																															
Fee from park/garden																															
City entry tax fees																															
Permit fee for cowdung																															
Right to information fees																															
Park Entrance Fee/gardens																															
City managers training fees																															
Water saling fee																															
Service charge fees																															
Stamp duty fee																															
Fine as per municipal act & other act																															

Tax Revenue Instruments for 2007/08	Maharashtra						Andhra Pradesh					Kerala					Madhya Pradesh					Uttar Pradesh					Rajasthan				
	Mumbai	Amaravati	Panvel	Jalna	Malegaon	Baramati	Hyderabad	Vijaiwada	Kodapa	Karimnagar	Nizamabad	Thiruvananthapuram	Palakkad	Kollam	Kozikode	Payannur	Bhopal	Jabalpur	Ujjain	Chindwara	Dhar	Lucknow	Aligarh	Bahraich	Muzaffarnagar	Azamgarh	Jaipur	Kota	Bhilwara	Jhunjhunu	Jaisalmer
Income from prevence of food adulteration act & rules																												■	■	■	■
Rent from municipal land & building	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■		■	■	■	■	■	■	■	■	■			■	■		
Rent from municipal vehicle												■	■	■				■	■					■					■		
Rent on school building		■																													
Rent from markets			■		■	■		■	■	■	■						■	■	■	■	■			■		■		■			■
Rent From Stadium								■										■													
Rent for water tanker			■					■		■	■						■	■					■								
Rent from lakshmanmela																						■									
Lease from boats & ferry														■		■		■													
Lease of parking places								■																							
Lease/contract money from salege farm																							■								
Lease of advertisement Rights							■	■																							
Income from cutting / sale of plant /sale of trees			■									■	■	■			■	■						■							
income from sale of land																						■	■						■	■	
Income from transfer of leasehold land																		■	■												
Income from dead animals																	■										■			■	■
Income from transports																		■									■				■
Income from telephone company																		■	■												
Income from business																											■				
Income from sewere line																											■				
Income from rent & tahbazari										■	■													■			■	■	■		■
Income from borewell		■																													
sale of store item							■	■	■								■	■		■		■									
Sale of garbage, manure & compost					■		■				■						■	■		■							■				■
Sale of house number plates								■																							

Tax Revenue Instruments for 2007/08	Maharashtra						Andhra Pradesh					Kerala					Madhya Pradesh					Uttar Pradesh					Rajasthan				
	Mumbai	Amaravati	Panvel	Jalna	Malegaon	Baramati	Hyderabad	Vijaiwada	Kodapa	Karimnagar	Nizamabad	Thiruvananthapuram	Palakkad	Kollam	Kozikode	Payannur	Bhopal	Jabalpur	Ujjain	Chindwara	Dhar	Lucknow	Aligarh	Bahraich	Muzaffarnagar	Azamgarh	Jaipur	Kota	Bhilwara	Jhunjhunu	Jaisalmer
Sale of grass																															
Property tax surcharge																															
Old property sale																															

IMFR

THE FINANCES OF MUNICIPALITIES – I
URBAN POPULATION

States	2003	2004	2005	2006	2007	2008
Andhra Pradesh	21,382	21,661	21,935	22,205	22,470	22,730
Assam	3,653	3,761	3,871	3,983	4,097	4,213
Bihar	9,026	9,194	9,359	9,520	9,678	9,833
Chattisgarh	4,454	4,591	4,729	4,869	5,011	5,155
Goa	707	738	772	808	848	893
Gujarat	19,895	20,379	20,864	21,351	21,839	22,328
Haryana	6,567	6,801	7,039	7,281	7,527	7,778
Himachal Pradesh	626	641	656	672	687	703
Jammu & Kashmir	2,637	2,698	2,761	2,823	2,886	2,950
Jharkhand	6,269	6,403	6,536	6,669	6,802	6,933
Karnataka	18,778	19,188	19,599	20,012	20,426	20,842
Kerala	8,390	8,450	8,508	8,565	8,621	8,675
Madhya Pradesh	16,768	17,167	17,567	17,969	18,370	18,772
Maharashtra	43,195	44,270	45,359	46,456	47,565	48,688
Orissa	5,776	5,905	6,035	6,166	6,298	6,430
Punjab	8,722	8,958	9,198	9,439	9,683	9,930
Rajasthan	13,817	14,120	14,423	14,725	15,025	15,326
Tamil Nadu	29,300	30,218	31,140	32,063	32,988	33,918
Uttar Pradesh	2,300	2,362	2,425	2,488	2,553	2,619
Uttarakhand	36,337	37,261	38,198	39,146	40,106	41,080
West Bengal	23,110	23,431	23,744	24,052	24,352	24,642
All India urban population	300,043	307,111	314,234	321,400	328,616	335,891

Per Capita Gross State Domestic Product (GSDP) at Current Prices (Rs)

States	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Andhra Pradesh	21,503	24,170	26,641	29,823	34,140	39,799
Assam	15,890	17,066	18,686	20,282	22,297	24,461
Bihar	7,592	7,595	8,307	8,804	10,867	12,315
Chattisgarh	15,183	17,799	19,547	22,466	27,891	33,652
Goa	56,443	63,060	75,636	85,495	100,517	109,787
Gujarat	27,177	31,747	35,153	41,524	47,359	53,951
Haryana	33,213	37,203	41,204	45,978	55,257	64,271
Himachal Pradesh	30,050	32,387	35,448	38,781	42,407	46,955
Jammu & Kashmir	19,554	21,025	22,642	24,398	26,307	28,407
Jharkhand	13,688	15,050	17,905	18,848	21,385	23,078
Karnataka	22,400	23,967	28,237	32,825	36,327	41,902
Kerala	26,900	29,670	33,539	37,880	43,382	49,184
Madhya Pradesh	13,935	16,190	16,503	17,837	19,834	21,949
Maharashtra	30,137	33,734	37,663	42,121	48,937	56,849
Orissa	13,256	16,088	18,700	20,255	24,300	30,091
Punjab	32,800	35,274	37,160	41,012	44,921	52,510
Rajasthan	15,176	18,754	19,330	20,810	24,359	27,533
Tamil Nadu	24,972	27,452	31,417	36,166	42,319	46,267
Uttar Pradesh	21,187	23,053	26,315	28,580	33,724	38,138
Uttarakhand	12,059	12,973	13,949	15,235	16,869	18,937
West Bengal	20,506	22,820	24,962	27,031	30,844	35,529
All India urban population	21,415	23,677	26,425	29,678	33,684	37,969

THE FINANCES OF MUNICIPALITIES – I

ALL STATES

KEY INDICATORS

Indicators Per capita	2007-08	CAGR 2002-03 to 2007-08
Revenue Income		
Own tax revenue	485	11.6
Own non-tax revenue	262	13.2
Devolution, assignment and grants	471	20.2
Central government transfers	75	50.7
Finance Commission grants	27	25.9
Others revenues	90	19.9
Total revenue income	1410	16.3
Revenue Expenditure		
Revenue expenditure	903	12.6
Capital expenditure	590	25.6
Total expenditure	1493	16.8
Gross state domestic product (GSDP)	37,969	13.8

THE FINANCES OF MUNICIPALITIES – I

ANDHRA PRADESH

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. crore	Per Capita Rs	Amount Rs. crore	Per Capita Rs	
Revenue Income					
Own tax revenue	436.76	204	1035.45	456	18.84
Own non-tax revenue	380.84	178	665.74	293	11.82
Devolution, assignment and grants	478.39	224	977.47	430	15.36
Central government transfers	59.78	28	69.59	31	3.08
Finance Commission grants	0.00	0	37.40	16	0.00
Others	44.10	21	124.56	55	23.08
Total revenue income	1399.87	655	2910.21	1280	15.76
Expenditure					
Revenue expenditure	1031.87	483	2409.52	1060	18.48
Capital expenditure	433.71	203	1438.24	633	27.09
Total expenditure	1465.58	685	3847.77	1693	21.29
Gross state domestic product (GSDP)	167096	21503	326547	39799	14.34
Own tax as % of GSDP	0.26		0.32		
Municipal expenditure as % of GSDP	0.88		1.18		

THE FINANCES OF MUNICIPALITIES – I

ASSAM

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. crore	Per Capita Rs	Amount Rs. crore	Per Capita Rs	
Revenue Income					
Own tax revenue	15.11	41	32.52	77	16.57
Own non-tax revenue	30.47	83	27.86	66	-1.78
Devolution, assignment and grants	3.89	11	41.98	100	60.95
Central government transfers	2.52	7	54.18	129	84.75
Finance Commission grants	0.48	1	0.50	1	0.70
Others	0.27	1	0.95	2	28.40
Total revenue income	52.73	144	157.99	375	24.54
Expenditure					
Revenue expenditure	51.58	141	86.31	205	10.85
Capital expenditure	8.76	24	97.61	232	61.96
Total expenditure	60.34	165	183.93	437	24.97
Gross state domestic product (GSDP)	43407	15890	71625	24461	10.54
Own tax as % of GSDP	0.03		0.05		
Municipal expenditure as % of GSDP	0.14		0.26		

IMFR

THE FINANCES OF MUNICIPALITIES – I

BIHAR

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. crore	Per Capita Rs	Amount Rs. crore	Per Capita Rs	
Revenue Income					
Own tax revenue	67.89	75	64.04	65	-1.16
Own non-tax revenue	10.10	11	39.19	40	31.14
Devolution, assignment and grants	8.25	9	514.82	524	128.60
Central government transfers	0.00	0	0.00	0	0
Finance Commission grants	0.00	0	42.60	43	0
Others	10.70	12	48.32	49	35.18
Total revenue income	96.95	107	708.96	721	48.87
Expenditure					
Revenue expenditure	95.63	106	698.76	711	48.85
Capital expenditure	37.47	42	0.00	0	
Total expenditure	133.10	147	698.76	711	39.33
Gross state domestic product (GSDP)	64965	7592	114616	12315	12.02
Own tax as % of GSDP	0.10		0.06		
Municipal expenditure as % of GSDP	0.20		0.61		

THE FINANCES OF MUNICIPALITIES – I

CHATTISGARH

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. crore	Per Capita Rs	Amount Rs. crore	Per Capita Rs	
Revenue Income					
Own tax revenue	64.60	145	108.13	210	10.85
Own non-tax revenue	35.87	81	85.95	167	19.10
Devolution, assignment and grants	191.29	429	727.45	1411	30.62
Central government transfers	3.53	8	338.25	656	149.05
Finance Commission grants	6.60	15	4.90	10	-5.78
Others	6.00	13	107.84	209	78.21
Total revenue income	307.89	691	1372.52	2663	34.84
Expenditure					
Revenue expenditure	172.18	387	746.95	1449	34.11
Capital expenditure	219.60	493	653.14	1267	24.36
Total expenditure	391.78	880	1400.09	2716	29.01
Gross state domestic product (GSDP)	32493	15183	79418	33652	19.57
Own tax as % of GSDP	0.20		0.14		
Municipal expenditure as % of GSDP	1.21		1.76		

THE FINANCES OF MUNICIPALITIES – I

GOA

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. Crore	Per Capita Rs	Amount Rs. Crore	Per Capita Rs	
Revenue Income					
Own tax revenue	9.22	130	10.71	120	3.04
Own non-tax revenue	10.84	153	14.51	162	6.01
Devolution, assignment and grants	14.66	207	14.54	163	-0.16
Central government transfers	0.01	0	0.00	0	0.00
Finance Commission grants	0.14	2	0.00	0	0.00
Others	1.98	28	3.88	43	14.41
Total revenue income	36.85	521	43.64	489	3.44
Expenditure					
Revenue expenditure	24.16	342	35.76	400	8.16
Capital expenditure	3.48	49	10.54	118	24.81
Total expenditure	27.64	391	46.30	518	10.87
Gross state domestic product (GSDP)	8100	56443	17215	109787	16.27
Own tax as % of GSDP	0.11		0.06		
Municipal expenditure as % of GSDP	0.34		0.27		

THE FINANCES OF MUNICIPALITIES – I

GUJARAT

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. Crore	Per Capita Rs	Amount Rs. Crore	Per Capita Rs	
Revenue Income					
Own tax revenue	1285.39	646	1844.34	826	7.49
Own non-tax revenue	255.81	129	564.75	253	17.16
Devolution, assignment and grants	399.66	201	1334.59	598	27.27
Central government transfers	0.00	0	0.00	0	0.00
Finance Commission grants	7.20	4	82.80	37	62.98
Others	30.00	15	88.33	40	24.11
Total revenue income	1978.06	994	3914.81	1753	14.63
Expenditure					
Revenue expenditure	1557.24	783	2535.06	1135	10.24
Capital expenditure	499.40	251	1755.63	786	28.59
Total expenditure	2056.64	1034	4290.69	1922	15.84
Gross state domestic product (GSDP)	141534	27177	306813	53951	16.74
Own tax as % of GSDP	0.91		0.60		
Municipal expenditure as % of GSDP	1.45		1.40		

THE FINANCES OF MUNICIPALITIES – I

HARYANA

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. Crore	Per Capita Rs	Amount Rs. Crore	Per Capita Rs	
Revenue Income					
Own tax revenue	69.46	106	78.20	101	2.40
Own non-tax revenue	107.76	164	140.49	181	5.45
Devolution, assignment and grants	25.47	39	106.99	138	33.25
Central government transfers	0.00	0	142.18	183	0.00
Finance Commission grants	9.05	14	18.20	23	15.00
Others	0.00	0	166.30	214	0.00
Total revenue income	211.74	322	652.36	839	25.24
Expenditure					
Revenue expenditure	221.16	337	254.98	328	2.89
Capital expenditure	16.25	25	369.02	474	86.74
Total expenditure	237.41	362	624.00	802	21.32
Gross state domestic product (GSDP)	72528	33213	154231	64271	16.29
Own tax as % of GSDP	0.10		0.05		
Municipal expenditure as % of GSDP	0.33		0.40		

THE FINANCES OF MUNICIPALITIES – I

HIMACHAL PRADESH

Finances	2002-03		2006-07		CAGR Amount %
	Amount Rs. crore	Per Capita Rs	Amount Rs. crore	Per Capita Rs	
Revenue Income					
Own tax revenue	23.47	375	40.89	595	14.89
Own non-tax revenue	0.00	0	0.00	0	0.00
Devolution, assignment and grants	28.70	458	41.91	610	9.93
Central government transfers	3.95	63	1.16	17	-26.39
Finance Commission grants	0.77	12	1.60	23	20.06
Others	0.00	0	0.00	0	0.00
Total revenue income	56.89	909	85.56	1245	10.74
Expenditure					
Revenue expenditure	53.79	859	82.31	1198	11.22
Capital expenditure	0.00	0	0.00	0	0.00
Total expenditure	53.79	859	82.31	1198	11.22
Gross state domestic product (GSDP)	18905	30050	28591	42407	10.90
Own tax as % of GSDP	0.12		0.00		
Municipal expenditure as % of GSDP	0.28		0.00		

IMFR

THE FINANCES OF MUNICIPALITIES – I

JAMMU & KASHMIR

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. crore	Per Capita Rs	Amount Rs. crore	Per Capita Rs	
Revenue Income					
Own tax revenue	2.17	8	3.08	10	7.26
Own non-tax revenue	5.97	23	22.71	77	30.63
Devolution, assignment and grants	43.15	164	231.97	786	39.99
Central government transfers	1.72	7	0.00	0	0.00
Finance Commission grants	0.00	0	0.00	0	0.00
Others	0.00	0	3.92	13	0.00
Total revenue income	53.01	201	261.68	887	37.62
Expenditure					
Revenue expenditure	53.43	203	133.36	452	20.07
Capital expenditure	13.23	50	61.00	207	35.75
Total expenditure	66.66	253	194.36	659	23.86
Gross state domestic product (GSDP)	20326	19554	31793	28407	9.36
Own tax as % of GSDP	0.01		0.01		
Municipal expenditure as % of GSDP	0.33		0.61		

THE FINANCES OF MUNICIPALITIES – I

JHARKHAND

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. crore	Per Capita Rs	Amount Rs. crore	Per Capita Rs	
Revenue Income					
Own tax revenue	29.49	47	59.94	86	15.24
Own non-tax revenue	0.00	0	0.00	0	0.00
Devolution, assignment and grants	107.48	171	150.35	217	6.94
Central government transfers	0.00	0	85.85	124	0.00
Finance Commission grants	0.00	0	0.00	0	0.00
Others	0.00	0	0.00	0	0.00
Total revenue income	136.97	218	296.14	427	16.67
Expenditure					
Revenue expenditure	45.37	72	93.11	134	15.46
Capital expenditure	91.00	145	203.03	293	17.41
Total expenditure	136.37	218	296.14	427	16.78
Gross state domestic product (GSDP)	37967	13688	69253	23078	12.77
Own tax as % of GSDP	0.08		0.09		
Municipal expenditure as % of GSDP	0.36		0.43		

THE FINANCES OF MUNICIPALITIES – I

KARNATAKA

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. Crore	Per Capita Rs	Amount Rs. Crore	Per Capita Rs	
Revenue Income					
Own tax revenue	489.18	261	615.86	295	4.71
Own non-tax revenue	293.17	156	520.44	250	12.16
Devolution, assignment and grants	423.02	225	1905.28	914	35.12
Central government transfers	74.16	39	208.53	100	22.97
Finance Commission grants	5.08	3	75.74	36	71.67
Others	8.09	4	0.00	0	0.00
Total revenue income	1292.70	688	3325.85	1596	20.80
Expenditure					
Revenue expenditure	949.75	506	1563.41	750	10.48
Capital expenditure	303.29	162	1995.28	957	45.76
Total expenditure	1253.04	667	3558.69	1707	23.22
Gross state domestic product (GSDP)	120889	22400	238348	41902	14.54
Own tax as % of GSDP	0.40		0.26		
Municipal expenditure as % of GSDP	1.04		1.49		

THE FINANCES OF MUNICIPALITIES – I

KERALA

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. Crore	Per Capita Rs	Amount Rs. Crore	Per Capita Rs	
Revenue Income					
Own tax revenue	160.15	191	170.75	197	1.29
Own non-tax revenue	70.55	84	114.28	132	10.13
Devolution, assignment and grants	280.92	335	367.36	423	5.51
Central government transfers	35.47	42	37.73	43	1.24
Finance Commission grants	15.05	18	29.81	34	14.65
Others	2.52	3	1.28	1	-12.67
Total revenue income	564.66	673	721.21	831	5.02
Expenditure					
Revenue expenditure	228.31	272	448.34	517	14.45
Capital expenditure	175.23	209	315.02	363	12.45
Total expenditure	403.54	481	763.36	880	13.60
Gross state domestic product (GSDP)	86895	26900	165722	49184	13.78
Own tax as % of GSDP	0.18		0.10		
Municipal expenditure as % of GSDP	0.46		0.46		

IMFR

THE FINANCES OF MUNICIPALITIES – I

MADHYA PRADESH

Finances	2002-03 Amount Rs. Crore	2002-03 Per Capita Rs	2007-08 Amount Rs. Crore	2007-08 Per Capita Rs	CAGR Amount %
Revenue Income					
Own tax revenue	73.17	44	126.53	67	11.58
Own non-tax revenue	79.49	47	99.80	53	4.66
Devolution, assignment and grants	497.84	297	1621.13	864	26.63
Central government transfers	6.84	4	31.20	17	35.46
Finance Commission grants	25.41	15	78.45	42	25.29
Others	0.00	0	0.00	0	0.00
Total revenue income	682.75	407	1957.11	1043	23.44
Expenditure					
Revenue expenditure	857.83	512	1873.89	998	16.91
Capital expenditure	190.24	113	581.61	310	25.04
Total expenditure	1048.07	625	2455.50	1308	18.56
Gross state domestic product (GSDP)	86832	13935	142500	21949	10.41
Own tax as % of GSDP	0.08		0.09		
Municipal expenditure as % of GSDP	1.21		1.72		

THE FINANCES OF MUNICIPALITIES – I

MAHARASHTRA

Finances	2002-03 Amount Rs. Crore	2002-03 Per Capita Rs	2007-08 Amount Rs. Crore	2007-08 Per Capita Rs	CAGR Amount %
Revenue Income					
Own tax revenue	4437.57	1027	8692.86	1785	14.39
Own non-tax revenue	2103.08	487	3963.75	814	13.51
Devolution, assignment and grants	740.65	171	1765.54	363	18.97
Central government transfers	41.82	10	701.11	144	75.75
Finance Commission grants	62.31	14	107.02	22	11.42
Others	554.34	128	1405.99	289	20.46
Total revenue income	7939.76	1838	16636.28	3417	15.94
Expenditure					
Revenue expenditure	5711.29	1322	10890.43	2237	13.78
Capital expenditure	1847.40	428	6505.34	1336	28.63
Total expenditure	7558.69	1750	17395.78	3573	18.14
Gross state domestic product (GSDP)	299479	30137	590995	56849	14.56
Own tax as % of GSDP	1.48		1.47		
Municipal expenditure as % of GSDP	2.52		2.94		

THE FINANCES OF MUNICIPALITIES – I

ORISSA

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. Crore	Per Capita Rs	Amount Rs. Crore	Per Capita Rs	
Revenue Income					
Own tax revenue	7.60	13	17.69	28	18.41
Own non-tax revenue	3.21	6	6.89	11	16.50
Devolution, assignment and grants	141.11	244	266.49	414	13.56
Central government transfers	6.55	11	167.73	261	91.28
Finance Commission grants	8.01	14	42.05	65	39.32
Others	1.00	2	48.62	76	117.45
Total revenue income	167.48	290	549.47	855	26.82
Expenditure					
Revenue expenditure	115.72	200	260.10	405	17.58
Capital expenditure	51.76	90	289.37	450	41.09
Total expenditure	167.48	290	549.47	855	26.82
Gross state domestic product (GSDP)	49713	13256	119066	30091	19.09
Own tax as % of GSDP	0.02		0.01		
Municipal expenditure as % of GSDP	0.34		0.46		

THE FINANCES OF MUNICIPALITIES – I

PUNJAB

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. Crore	Per Capita Rs	Amount Rs. Crore	Per Capita Rs	
Revenue Income					
Own tax revenue	535.69	614	807.63	813	8.56
Own non-tax revenue	151.76	174	233.72	235	9.02
Devolution, assignment and grants	22.28	26	50.94	51	17.99
Central government transfers	3.29	4	4.77	5	7.71
Finance Commission grants	12.33	14	22.84	23	13.12
Others	9.06	10	49.32	50	40.34
Total revenue income	734.41	842	1169.22	1177	9.75
Expenditure					
Revenue expenditure	550.97	632	913.69	920	10.65
Capital expenditure	131.29	151	232.59	234	12.12
Total expenditure	682.26	782	1146.28	1154	10.93
Gross state domestic product (GSDP)	82249	32800	144309	52510	11.90
Own tax as % of GSDP	0.65		0.56		
Municipal expenditure as % of GSDP	0.83		0.79		

THE FINANCES OF MUNICIPALITIES – I

RAJASTHAN

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. Crore	Per Capita Rs	Amount Rs. Crore	Per Capita Rs	
Revenue Income					
Own tax revenue	25.35	18	23.12	15	-1.83
Own non-tax revenue	211.13	153	569.32	371	21.94
Devolution, assignment and grants	27.61	20	57.85	38	15.94
Central government transfers	21.05	15	208.06	136	58.12
Finance Commission grants	9.94	7	22.00	14	17.22
Others	409.83	297	619.83	404	8.63
Total revenue income	704.92	510	1500.17	979	16.31
Expenditure					
Revenue expenditure	407.19	295	685.52	447	10.98
Capital expenditure	299.20	217	575.03	375	13.96
Total expenditure	706.39	511	1260.55	822	12.28
Gross state domestic product (GSDP)	88550	15176	176420	27533	14.78
Own tax as % of GSDP	0.03		0.01		
Municipal expenditure as % of GSDP	0.80		0.71		

THE FINANCES OF MUNICIPALITIES – I

TAMIL NADU

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. Crore	Per Capita Rs	Amount Rs. Crore	Per Capita Rs	
Revenue Income					
Own tax revenue	583.53	199	877.06	259	8.49
Own non-tax revenue	293.28	100	465.56	137	9.68
Devolution, assignment and grants	1062.60	363	1585.27	467	8.33
Central government transfers	43.41	15	306.91	90	47.87
Finance Commission grants	38.57	13	114.44	34	24.30
Others	57.32	20	146.05	43	20.57
Total revenue income	2078.71	709	3495.29	1031	10.95
Expenditure					
Revenue expenditure	1526.90	521	2256.41	665	8.12
Capital expenditure	722.04	246	1662.99	490	18.16
Total expenditure	2248.94	768	3919.40	1156	11.75
Gross state domestic product (GSDP)	158155	24972	304989	46267	14.04
Own tax as % of GSDP	0.37		0.29		
Municipal expenditure as % of GSDP	1.42		1.29		

THE FINANCES OF MUNICIPALITIES – I

UTTAR PRADESH

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. Crore	Per Capita Rs	Amount Rs. Crore	Per Capita Rs	
Revenue Income					
Own tax revenue	205.19	56	238.23	58	3.03
Own non-tax revenue	134.56	37	147.09	36	1.80
Devolution, assignment and grants	849.09	234	2112.05	514	19.99
Central government transfers	0.00	0	0.00	0	0.00
Finance Commission grants	45.57	13	103.40	25	17.81
Others	0.00	0	0.00	0	0.00
Total revenue income	1234.41	340	2600.77	633	16.07
Expenditure					
Revenue expenditure	908.53	250	1007.56	245	2.09
Capital expenditure	793.13	218	863.79	210	1.72
Total expenditure	1701.66	468	1871.35	456	1.92
Gross state domestic product (GSDP)	206855	12059	344346	18937	10.73
Own tax as % of GSDP	0.10		0.07		
Municipal expenditure as % of GSDP	0.82		0.54		

THE FINANCES OF MUNICIPALITIES – I

UTTARAKHAND

Finances	2002-03		2007-08		CAGR Amount %
	Amount Rs. Crore	Per Capita Rs	Amount Rs. Crore	Per Capita Rs	
Revenue Income					
Own tax revenue	10.31	45	12.51	48	3.94
Own non-tax revenue	19.10	83	17.99	69	-1.19
Devolution, assignment and grants	70.74	308	106.89	408	8.61
Central government transfers	0.00	0	0.00	0	0.00
Finance Commission grants	4.75	21	2.22	8	-14.11
Others	0.00	0	0.00	0	0.00
Total revenue income	104.90	456	139.61	533	5.88
Expenditure					
Revenue expenditure	57.38	249	86.53	330	8.56
Capital expenditure	7.13	31	17.63	67	19.85
Total expenditure	64.51	280	104.16	398	10.06
Gross state domestic product (GSDP)	18473	21187	35592	38138	14.02
Own tax as % of GSDP	0.06		0.04		
Municipal expenditure as % of GSDP	0.35		0.29		

IMFR

THE FINANCES OF MUNICIPALITIES – I

WEST BENGAL

Finances	2002-03 Amount Rs. crore	2002-03 Per Capita Rs	2007-08 Amount Rs. crore	2007-08 Per Capita Rs	CAGR Amount %
Revenue Income					
Own tax revenue	302.04	131	441.74	179	7.90
Own non-tax revenue	234.15	101	529.88	215	17.74
Devolution, assignment and grants	477.69	207	829.11	336	11.66
Central government transfers	0.00	0	0.00	0	0.00
Finance Commission grants	21.72	9	78.60	32	29.34
Others	0.00	0	0.00	0	0.00
Total revenue income	1035.59	448	1879.32	763	12.66
Expenditure					
Revenue expenditure	1042.79	451	1413.47	574	6.27
Capital expenditure	86.33	37	939.59	381	61.20
Total expenditure	1129.12	489	2353.05	955	15.82
Gross state domestic product (GSDP)	168000	20506	307895	35529	12.88
Own tax as % of GSDP	0.18		0.14		
Municipal expenditure as % of GSDP	0.67		0.76		

THE FINANCES OF MUNICIPALITIES – I

ALL STATES (21 States)

Finances	2002-03 Amount Rs. crore	2002-03 Per Capita Rs	2007-08 Amount Rs. crore	2007-08 Per Capita Rs	CAGR Amount %
Revenue Income					
Own tax revenue	8833.34	314	15260.38	485	11.55
Own non-tax revenue	4431.14	157	8229.93	262	13.18
Devolution, assignment and grants	5894.48	209	14805.04	471	20.22
Central government transfers	304.09	11	2361.25	75	50.67
Finance Commission grants	272.98	10	864.57	27	25.93
Others	1135.22	40	2815.20	90	19.92
Total revenue income	20871.26	741	44336.36	1410	16.26
Expenditure					
Revenue expenditure	15663.06	556	28393.16	903	12.63
Capital expenditure	5929.94	210	18566.46	590	25.64
Total expenditure	21593.00	767	46959.63	1493	16.81
Gross state domestic product (GSDP)	1995046	21415	3802360	37969	13.77
Own tax as % of GSDP	0.44		0.40		
Municipal expenditure as % of GSDP	1.08		1.24		

THE FINANCES OF MUNICIPALITIES – II

Finances	ANDHRA PRADESH Percent of the Total 2002-03	ANDHRA PRADESH Percent of the Total 2007-08	ASSAM Percent of the Total 2002-03	ASSAM Percent of the Total 2007-08
Revenue Income				
Own tax revenue	31.20	35.58	28.64	20.58
Own non-tax revenue	27.21	22.88	57.78	17.63
Devolution, assignment and grants	34.17	33.59	7.37	26.57
Central government transfers	4.27	2.39	4.77	34.30
Finance Commission grants	0.00	1.29	0.92	0.32
Others	3.15	4.28	0.52	0.60
Total revenue income	100.00	100.00	100.00	100.00
Expenditure				
Revenue expenditure	70.41	62.62	85.49	46.93
Capital expenditure	29.59	37.38	14.51	53.07
Total expenditure	100.00	100.00	100.00	100.00

THE FINANCES OF MUNICIPALITIES – II

Finances	BIHAR Percent of the Total 2002-03	BIHAR Percent of the Total 2007-08	CHATTISGARH Percent of the Total 2002-03	CHATTISGARH Percent of the Total 2007-08
Revenue Income				
Own tax revenue	70.03	9.03	20.98	7.88
Own non-tax revenue	10.42	5.53	11.65	6.26
Devolution, assignment and grants	8.51	72.62	62.13	53.00
Central government transfers	0.00	0.00	1.15	24.64
Finance Commission grants	0.00	6.01	2.14	0.36
Others	11.04	6.82	1.95	7.86
Total revenue income	100.00	100.00	100.00	100.00
Expenditure				
Revenue expenditure	71.85	100.00	43.95	53.35
Capital expenditure	28.15	0.00	56.05	46.65
Total expenditure	100.00	100.00	100.00	100.00

THE FINANCES OF MUNICIPALITIES – II

Finances	GOA Percent of the Total		GUJARAT Percent of the Total	
	2002-03	2007-08	2002-03	2007-08
Revenue Income				
Own tax revenue	25.02	24.54	64.98	47.11
Own non-tax revenue	29.42	33.25	12.93	14.43
Devolution, assignment and grants	39.78	33.32	20.20	34.09
Central government transfers	0.03	0.00	0.00	0.00
Finance Commission grants	0.38	0.00	0.36	2.12
Others	5.37	8.90	1.52	2.26
Total revenue income	100.00	100.00	100.00	100.00
Expenditure				
Revenue expenditure	87.41	77.23	75.72	59.08
Capital expenditure	12.59	22.77	24.28	40.92
Total expenditure	100.00	100.00	100.00	100.00

THE FINANCES OF MUNICIPALITIES – II

Finances	HARYANA Percent of the Total		HIMACHAL PRADESH Percent of the Total	
	2002-03	2007-08	2002-03	2006-07
Revenue Income				
Own tax revenue	32.80	11.99	41.26	47.79
Own non-tax revenue	50.89	21.54	0.00	0.00
Devolution, assignment and grants	12.03	16.40	50.45	48.98
Central government transfers	0.00	21.79	6.94	1.36
Finance Commission grants	4.27	2.79	1.35	1.87
Others	0.00	25.49	0.00	0.00
Total revenue income	100.00	100.00	100.00	100.00
Expenditure				
Revenue expenditure	93.16	40.86	100.00	100.00
Capital expenditure	6.84	59.14	0.00	0.00
Total expenditure	100.00	100.00	100.00	100.00

THE FINANCES OF MUNICIPALITIES – II

Finances	JAMMU & KASHMIR		JHARKHAND	
	Percent of the Total		Percent of the Total	
	2002-03	2007-08	2002-03	2007-08
Revenue Income				
Own tax revenue	4.09	1.18	21.53	20.24
Own non-tax revenue	11.26	8.68	0.00	0.00
Devolution, assignment and grants	81.40	88.65	78.47	50.77
Central government transfers	3.24	0.00	0.00	28.99
Finance Commission grants	0.00	0.00	0.00	0.00
Others	0.00	1.50	0.00	0.00
Total revenue income	100.00	100.00	100.00	100.00
Expenditure				
Revenue expenditure	80.15	68.61	33.27	31.44
Capital expenditure	19.85	31.39	66.73	68.56
Total expenditure	100.00	100.00	100.00	100.00

THE FINANCES OF MUNICIPALITIES – II

Finances	KARNATAKA		KERALA	
	Percent of the Total		Percent of the Total	
	2002-03	2007-08	2002-03	2007-08
Revenue Income				
Own tax revenue	37.84	18.52	28.36	23.68
Own non-tax revenue	22.68	15.65	12.49	15.85
Devolution, assignment and grants	32.72	57.29	49.75	50.94
Central government transfers	5.74	6.27	6.28	5.23
Finance Commission grants	0.39	2.28	2.67	4.13
Others	0.63	0.00	0.45	0.18
Total revenue income	100.00	100.00	100.00	100.00
Expenditure				
Revenue expenditure	75.80	43.93	56.58	58.73
Capital expenditure	24.20	56.07	43.42	41.27
Total expenditure	100.00	100.00	100.00	100.00

THE FINANCES OF MUNICIPALITIES – II

Finances	MADHYA PRADESH Percent of the Total 2002-03	MADHYA PRADESH Percent of the Total 2007-08	MAHARASHTRA Percent of the Total 2002-03	MAHARASHTRA Percent of the Total 2007-08
Revenue Income				
Own tax revenue	10.72	6.47	55.89	52.25
Own non-tax revenue	11.64	5.10	26.49	23.83
Devolution, assignment and grants	72.92	82.83	9.33	10.61
Central government transfers	1.00	1.59	0.53	4.21
Finance Commission grants	3.72	4.01	0.78	0.64
Others	0.00	0.00	6.98	8.45
Total revenue income	100.00	100.00	100.00	100.00
Expenditure				
Revenue expenditure	81.85	76.31	75.56	62.60
Capital expenditure	18.15	23.69	24.44	37.40
Total expenditure	100.00	100.00	100.00	100.00

THE FINANCES OF MUNICIPALITIES – II

Finances	ORISSA Percent of the Total 2002-03	ORISSA Percent of the Total 2007-08	PUNJAB Percent of the Total 2002-03	PUNJAB Percent of the Total 2007-08
Revenue Income				
Own tax revenue	4.54	3.22	72.94	69.07
Own non-tax revenue	1.92	1.25	20.66	19.99
Devolution, assignment and grants	84.25	48.50	3.03	4.36
Central government transfers	3.91	30.53	0.45	0.41
Finance Commission grants	4.78	7.65	1.68	1.95
Others	0.60	8.85	1.23	4.22
Total revenue income	100.00	100.00	100.00	100.00
Expenditure				
Revenue expenditure	69.09	47.34	80.76	79.71
Capital expenditure	30.91	52.66	19.24	20.29
Total expenditure	100.00	100.00	100.00	100.00

THE FINANCES OF MUNICIPALITIES – II

Finances	RAJASTHAN Percent of the Total 2002-03	RAJASTHAN Percent of the Total 2007-08	TAMIL NADU Percent of the Total 2002-03	TAMIL NADU Percent of the Total 2007-08
Revenue Income				
Own tax revenue	3.60	1.54	28.07	25.09
Own non-tax revenue	29.95	37.95	14.11	13.32
Devolution, assignment and grants	3.92	3.86	51.12	45.35
Central government transfers	2.99	13.87	2.09	8.78
Finance Commission grants	1.41	1.47	1.86	3.27
Others	58.14	41.32	2.76	4.18
Total revenue income	100.00	100.00	100.00	100.00
Expenditure				
Revenue expenditure	57.64	54.38	67.89	57.57
Capital expenditure	42.36	45.62	32.11	42.43
Total expenditure	100.00	100.00	100.00	100.00

THE FINANCES OF MUNICIPALITIES – II

Finances	UTTAR PRADESH Percent of the Total 2002-03	UTTAR PRADESH Percent of the Total 2007-08	UTTARAKHAND Percent of the Total 2002-03	UTTARAKHAND Percent of the Total 2007-08
Revenue Income				
Own tax revenue	16.62	9.16	9.83	8.96
Own non-tax revenue	10.90	5.66	18.21	12.89
Devolution, assignment and grants	68.79	81.21	67.44	76.56
Central government transfers	0.00	0.00	0.00	0.00
Finance Commission grants	3.69	3.98	4.53	1.59
Others				
Total revenue income	100.00	100.00	100.00	100.00
Expenditure				
Revenue expenditure	53.39	53.84	88.95	83.07
Capital expenditure	46.61	46.16	11.05	16.93
Total expenditure	100.00	100.00	100.00	100.00

IMFR

THE FINANCES OF MUNICIPALITIES – II

	WEST BENGAL	
Finances	**Percent of the Total**	
	2002-03	**2007-08**
Revenue Income		
Own tax revenue	29.17	23.51
Own non-tax revenue	22.61	28.20
Devolution, assignment and grants	46.13	44.12
Central government transfers	0.00	0.00
Finance Commission grants	2.10	4.18
Others		
Total revenue income	100.00	100.00
Expenditure		
Revenue expenditure	92.35	60.07
Capital expenditure	7.65	39.93
Total expenditure	100.00	100.00

THE FINANCES OF MUNICIPALITIES – II

	ALL 21 STATES	
Finances	**Percent of the Total**	
	2002-03	**2007-08**
Revenue Income		
Own tax revenue	42.32	34.42
Own non-tax revenue	21.23	18.56
Devolution, assignment and grants	28.24	33.39
Central government transfers	1.46	5.33
Finance Commission grants	1.31	1.95
Others	5.44	6.35
Total revenue income	100.00	100.00
Expenditure		
Revenue expenditure	72.54	60.46
Capital expenditure	27.46	39.54
Total expenditure	100.00	100.00

THE FINANCES OF MUNICIPALITIES – III

Properties as a Percent of Total Properties for the Sample ULBs

Year	Assessed properties paying taxes	Un assessed properties	Exempted properties	Free riders
2005/06	55.95	44.05	8.62	35.43
2006/07	55.45	44.55	9.66	34.89
2007/08	62.53	37.47	8.84	28.62

Break-up of unassessed properties for the Sample ULBs (percent)

Year	Exempted properties	Free riders
2005/06	19.57	80.43
2006/07	21.69	78.31
2007/08	23.60	76.40

Property tax collection efficiency for the sample ULBs

Year	Total Demand (Rs.Crore)	Total Collection (Rs.Crore)	Collection efficiency
2005/06	2594.71	1157.33	44.60
2006/07	2904.46	1324.15	45.59
2007/08	3881.62	1786.61	46.03

Year	Loss incurred in the Sample ULBs (Rs.Crore)			Total Loss in Demand (Rs. Crore)
	Exemptions	Low Collection	Free Riders	
	A	B	C	D=A+B+C
2005/06	372.67	1437.38	1515.87	3325.92
2006/07	393.45	1580.31	1324.79	3298.56
2007/08	455.51	2095.01	1107.32	3657.84

Year	Desired demand had there been no inefficiency in the Sample ULBs (Rs.Crore)				Actual Demand of the 31 sample ULBs (Rs. Crore)
	Exemptions	Low Collection*	Free Riders	Total Demand	
2005/06	2967.38	2594.71	4110.58	4483.25	2594.71
2006/07	3297.91	2904.46	4229.25	4622.70	2904.46
2007/08	4337.13	3881.62	4988.94	5444.45	3881.62

Note: Desired Demand= Actual Demand + Demand lost due to the factor
*In an ideal situation Demand for Property Tax=Collection of Property tax

Year	Demand lost due to inefficiencies as a percent of the desired property tax demand for the sample ULBs for the concerned factor			
	Exemptions	Low Collection	Free Riders	Total Demand
2005/06	12.56 (8.31)	54.16 (32.06)	36.88 (33.81)	73.47
2006/07	11.93 (8.51)	54.07 (34.19)	31.32 (28.66)	71.14
2007/08	10.50 (8.37)	53.81 (38.48)	22.20 (20.34)	67.07

Note: Figures in parenthesis imply the percentage loss in demand for the factor as a percent of total desired demand including all factors.

THE FINANCES OF MUNICIPALITIES – IV

Composition of Staff

Municipality	Grade I	Grade II	Grade III	Grade IV
Palakkad	0.66	6.14	35.31	57.89
Bhopal	0.58	0.98	25.53	72.91
Jabalpur	0.47	0.20	23.76	75.57
Ujjain	0.44	1.27	28.39	69.89
Dhar	0.00	1.28	25.96	72.77
Chhindwara	0.32	0.81	22.24	76.62
Amrawati	1.04	0.89	37.43	60.64
Lucknow	0.38	0.56	14.07	84.98
Aligarh	1.27	1.27	28.05	69.41

IMFR

MUNICIPAL FINANCE IN FEDERAL OECD COUNTRIES

Enid Slack

Indian cities are under increasing pressure to provide more and better public services and infrastructure. To meet these growing demands, they need to overcome a series of municipal finance challenges, as outlined in other chapters in this book as well as in other papers such as (Rao & Bird, 2010). In particular, there is a lack of clarity in the division of responsibilities among levels of government even though the 74th Constitutional Amendment (Twelfth Schedule) assigns 18 functions to local governments. Federal and state governments are not allocating the revenue tools to local governments that are needed to meet their expenditure responsibilities, resulting in unfunded mandates at the local level. Property taxes and user fees are under-utilized relative to cities in other countries and, in turn, local governments are highly dependent on intergovernmental transfers. Indian cities levy a large number of small "nuisance" taxes that bring in little revenue but distort economic behavior.

These challenges, though probably different in magnitude, are similar to problems faced by cities in many other countries. Is there something to be learned from the experience of other countries that would be useful in addressing any of these challenges? As Richard Bird frequently points out, the path dependent and context-specific nature of each country implies that we have to be very careful about transporting policies from one country to another (Bird R. M., 2010). Yet, even he agrees that there is some value in understanding how others have dealt with similar problems.

This chapter provides a brief review of the experience of local governments in federal OECD countries (and, in particular, Canada). Although there is no consistent or uniform approach to local government finance in federal countries, the examples from international experience and the literature on municipal finance point to some general directions for a sound municipal finance system. The outline of the chapter is as follows: the first part compares expenditure responsibilities of local governments and the financial instruments used to pay for them in selected federal OECD countries. The second part focuses on the municipal finance system in Canada and identifies some of the issues and challenges faced by Canadian municipalities. The third part reviews some of the findings from the literature on financing local services and infrastructure in federal systems. The fourth part provides some final comments on municipal finance in federal OECD countries.

Municipal Finance in Federal OECD Countries

The following description of municipal expenditures and revenues in OECD countries focuses on federal countries because India is a federal country with a central government, 28 state governments, and seven union territories.

Municipal Expenditures

Table 1 shows local government expenditures as a percentage of GDP for selected federal OECD countries.[1] Local government expenditures range from 2.3 percent of GDP in Australia where many local functions (such as roads and policing) are carried out by the state governments to Switzerland where local governments are heavily involved not only in "property-related" services such as roads but also in "people-related" services such as health, education and social protection. By comparison,

[1] The choice of countries in each table reflects data availability.

municipal expenditures are estimated to be less than 1 percent of GDP in India (Mathur, 2010, p. 14), significantly less than any of the federal OECD countries in Table 1.

Table 1: Local Government Expenditures as a Percent of GDP, Selected Federal OECD Countries, 2007

Country	Local Government Expenditures as % of GDP
Australia	2.3
Austria	7.4
Belgium	6.9
Canada	7.2
Germany	7.2
Spain	6.4
Switzerland	9.7

Notes: Information for Austria, Canada, and Spain is preliminary for 2007. Information for Switzerland is for 2006. Information for Belgium is preliminary for 2006.
Source: International Monetary Fund, *Government Finance Statistics*, Yearbook, 2008, Table 7 and OECD, Revenue Statistics 1965-2008, 2009, Table 36.

Table 2 shows local government expenditures as a percentage of total government expenditures (including federal, state/provincial, and local). As in Table 1, local government expenditures are relatively small in Australia at 5.7 percent of total expenditures and range up to 22 percent in Switzerland.[2]

[2] Comparable information was not provided for India.

Table 2: Local Government Expenditures as a Percent of Total Government Expenditures, Selected Federal OECD Countries, 2007

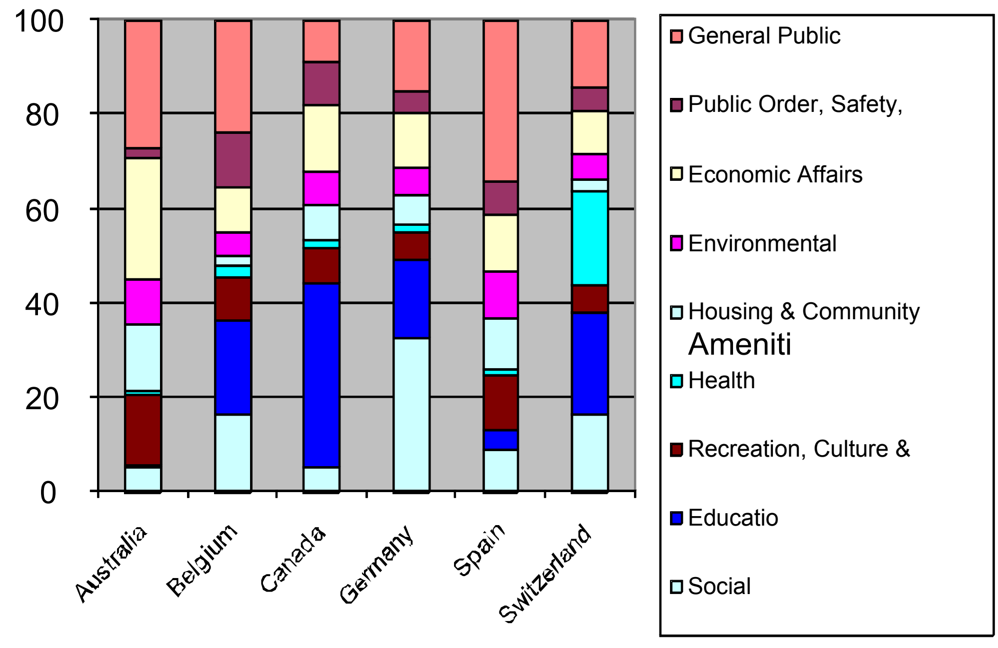
Country	Local Government Expenditures as % of Total Government Expenditures
Australia	5.7
Austria	13.6
Belgium	11.2
Canada	15.6
Germany	14.8
Spain	13.6
Switzerland	22.0

Notes: Information for Austria, Canada, and Spain is preliminary for 2007. Information for Switzerland is for 2006. Information for Belgium is preliminary for 2006.

Source: International Monetary Fund, *Government Finance Statistics*, Yearbook, 2008, Table 7.

Figure 1 shows the breakdown of local government expenditures by function for selected federal OECD countries. This Figure reveals the diversity in OECD practices on expenditure assignments. Property-oriented services, such as public order and safety, environment (water, sewers, and garbage collection and disposal), and economic affairs (mainly transportation) are provided at the local level in most countries. There is more variation in people-related services, however. For example, there is no local role in education in Australia but a major role for education in the other OECD federal countries in Figure 1. There is no local role in health in Australia but there is a major local role in health in Switzerland and a minor local role in the rest of the OECD countries. A high proportion of expenditures at the local level are accounted for by expenditures on social protection in Germany, Belgium, and Switzerland but not in the other countries in Figure 1.

Figure 1: Distribution of Local Government Expenditures, Selected Federal Countries,



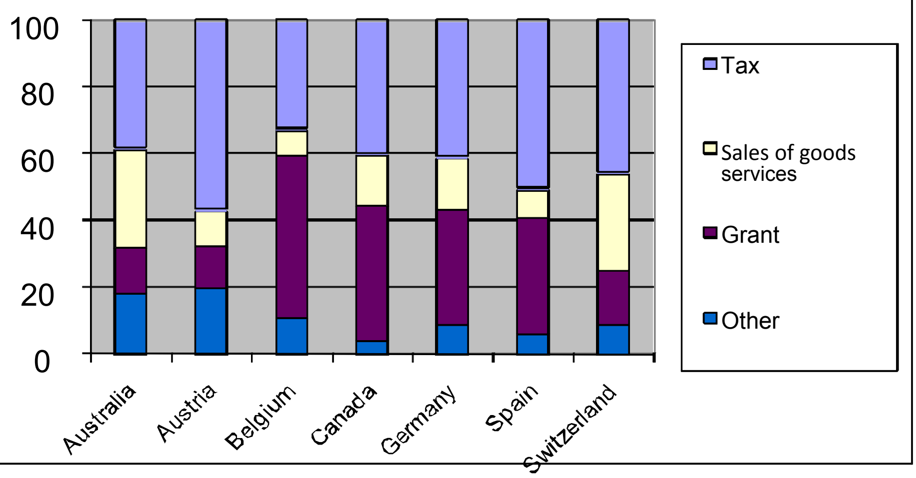
Source: Source: International Monetary Fund, *Government Finance Statistics*, Yearbook, 2008, Table 7.

Municipal Revenues

Local governments generally rely on four major sources of revenue: taxes, sales of goods and services (user fees), intergovernmental transfers, and other revenues (for example, investment income, license fees, etc.). As with expenditures, Figures 2 and 3 show great diversity in the amount and types of revenues under local control in federal OECD countries. Local governments rely on intergovernmental transfers for a significant percent of revenues in most countries, with the exception of Australia where, as noted earlier, the state government delivers many local services thereby reducing the need for transfers.

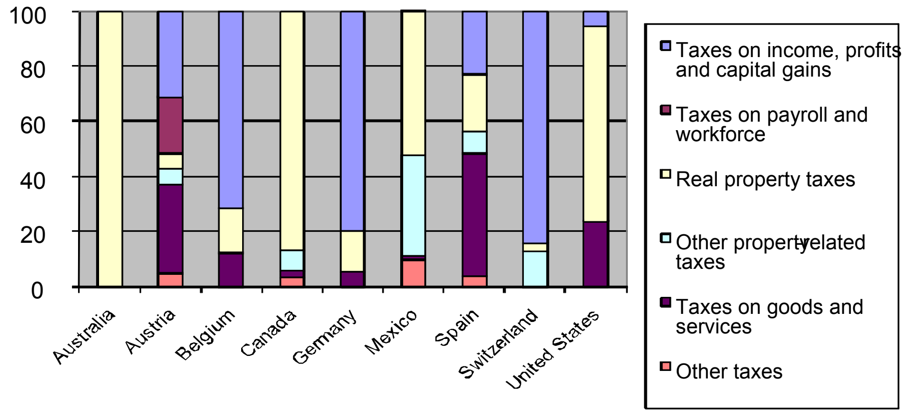
There is also considerable variation in the number of local taxes across countries. More than 80 percent of local tax revenues are derived from personal and corporate income taxes in Belgium, Germany, and Switzerland. More than 80 percent of local government tax revenues in Australia, Canada, and the US derive from property taxes. Sales taxes are levied mainly by cities in the US and there is a mix of local taxes in Austria and Spain (40 percent of local tax revenues from the sales tax in Spain and almost 30 percent in Austria).

Figure 2: Sources of Local Government Revenues, Selected Federal OECD Countries, 2007



Source: OECD, *Revenue Statistics 1965-2008*, 2009, Tables 139-198 and OECD, *Revenue Statistics 1965-2006*, 2007, Tables 141, 157, 165.

Figure 3: Distribution of Local Government Tax Revenues, Federal OECD Countries, 2007



Source: OECD, *Revenue Statistics 1965-2008*, 2009, Tables 139-168 and OECD, *Revenue Statistics 1965-2006*, 2007, Table 157

No country raises more than 10 percent of total taxes from the property tax, even though the property tax is considered to be a good tax for local governments (Bird R. M., 2001).[3] Countries that rely on income taxes (such as Belgium, Germany, and Switzerland) tend to spend more on social protection than other countries. In almost all OECD countries, decisions on what revenue instruments local governments can use are decided by a higher level of government or a national constitution.

User fees are charged by local governments in every country but they are a particularly significant percent of revenues in Australia and Switzerland. User fees are charged for the use of airports, transit, parking, water, sewers, solid waste collection and disposal, and recreational facilities.

---

3 Some of the reasons for the underutilization of property taxes include: the unpopularity of a very visible tax, the erosion of the tax base through exemptions and limits, the inelasticity of the tax base, and poor administration.

In federal countries, local governments may receive transfers from the federal or provincial/state government. Federal transfers to local governments generally have to go through provincial/state governments (e.g. Canada, Germany). General purpose grants dominate in most OECD countries (for example, they represent 70 percent of grants to local governments in Germany). Equalization transfers are not common in the US but there is a comprehensive system of equalization transfers in Germany. Specific purpose transfers have to be spent on specific expenditures, for example, roads, parks, or some other local service. Specific purpose transfers are prevalent in Canada (where they are 85 percent of grants) and the US.

Summary of observations on federal OECD countries

In terms of expenditure assignment, there are considerable differences among federal OECD countries. Although property-oriented services tend to be a local responsibility in most countries, there is more variation in local responsibility for people-oriented services such as education and health. Local governments in federal OECD countries in Europe tend to have greater responsibility for health and social services than federal OECD countries in other parts of the world. Expenditure responsibilities differ across countries for many reasons including history, constitutional provisions, politics, and cultural factors.

The level of local taxation is driven, at least to some extent, by the type of expenditure responsibilities assigned to local governments. For example, local governments that levy fewer taxes as a percentage of total taxes (federal, provincial/state, and local) generally have fewer expenditure responsibilities. Local governments in Australia, for example, rely solely on the property tax and are not responsible for health or education. Local governments with a wide range of taxes, especially income-based taxes, tend to have more responsibilities (for example, Belgium, Germany, and Switzerland). Property taxes account for a larger portion of total taxes in Commonwealth countries (for example, Canada and Australia); heavy reliance on income taxes is more prominent in Nordic countries. Where local taxes are a relatively large percentage of total taxes, local governments tend to depend more heavily on local income taxes. In addition to the expenditure responsibilities assigned to local government, local access to specific taxes depends on their capacity to administer the tax, the willingness of senior governments to assign taxes to local governments, and constitutional and legislative requirements.

Municipal Finance in Canada

The previous section provided a general overview of the municipal finances of federal OECD countries. This section goes into a bit more detail for one country – Canada – and considers some of the issues and challenges faced by local governments. Canada is a federation with three levels of government: the federal government, ten provincial and three territorial governments, and about 4,000 local governments. Canada's *Constitution Act, 1982*, lists the jurisdictions over which federal and provincial governments have lawmaking authority. Local governments are only mentioned in the Constitution as one of the responsibilities of provincial governments and provincial legislation sets out the powers of municipal governments.

Unlike the relationship between the federal government and provinces, local governments in Canada are highly controlled and tightly constrained by provincial governments (Bird & Tassonyi, 2003). Indeed, local governments are often referred to as “creatures of the provinces” because they have no original powers in the Constitution and enjoy only those powers that are delegated to them by the provinces. In reality, provincial governments in Canada establish local governments and their geographic boundaries, mandate their expenditure responsibilities, set standards for local service provision even for services that are not mandated, limit their own-source revenues largely to property taxes and user fees, set the rules around levying the property tax, require that municipalities not incur a deficit in their operating budget, and determine the extent to which municipalities can borrow to meet capital requirements. At the same time, the province influences municipal expenditures through its specific purpose grant programs.

The high degree of provincial control over local governments in Canada means that there cannot be any visible fiscal crisis at the local level: municipal governments are strictly held to balanced budgets for operating purposes and their borrowing for capital expenditures is constrained by provincial legislation and regulations. Municipal governments in Canada have only very limited fiscal autonomy, however, and are constrained from solving any fiscal problems they may have.[4]

Municipal Expenditures

Municipal expenditures per capita, on average across Canada, were approximately $2,000 CAD in 2007. As can be seen in Figure 4, more than half of all municipal expenditures are for transportation (roads, streets, snow removal, public transit), protection (police and fire), and environment (water, sewage, solid waste collection and disposal). Social service expenditures (social assistance and services such as homeless shelters, women's shelters, immigration settlement, and food banks) accounts for almost 9 percent of total municipal spending but, when Ontario is excluded,

[4] A few cities (for example, Toronto, Vancouver, Winnipeg, Montreal, Halifax, and Saint John) are governed by separate Charters or other special legislation that confer powers and duties (but few, if any, extra revenue tools) additional to those of other municipal governments. For example, the City of Toronto Act, 2006 gives Toronto greater authority and autonomy than other municipalities in the province. In terms of taxes other than the property tax, however, it is restricted to selective taxes on vehicle registrations, alcohol, entertainment, and tobacco as well as a land transfer tax. It has used its powers to levy a land transfer tax and a vehicle registration tax (both piggybacked onto the respective provincial taxes) and a billboard tax.

social services only accounted for less than 1 percent.[5] Health expenditures are the responsibility of provincial governments except for land ambulance in Ontario, parts of the province of Alberta, and in the City of Winnipeg. Relatively limited municipal expenditures are also made on public health (e.g. anti-smoking campaigns, restaurant inspections, etc.) in some provinces. Expenditures on recreation and culture are 13 percent of municipal expenditures. Debt charges for capital projects account for 3 percent and this amount has fallen dramatically over the last two decades reflecting a drop in interest rates and a reduction in municipal borrowing.

In most provinces, elementary and secondary education is delivered by local school boards that are funded wholly, or in part, by the provincial government.[6] Provincial governments levy property taxes in nine provinces, but provincial property taxes are only dedicated to education in six provinces.[7] In Ontario and Nova Scotia, for example, the education property tax rate is set by the province, collected by municipalities, and remitted to school boards. School boards have not had taxing powers in Ontario since the provincial takeover of education funding in 1998.

Municipal Revenues

Figure 5 indicates that own-source revenues (mainly property taxes and user fees) form the largest portion of municipal revenues in Canada. Intergovernmental transfers, mainly from the province, account for 20 percent of municipal revenues.

5 Social assistance is a provincial financial responsibility in every province except Ontario where costs are shared between the provincial and municipal governments. The uploading of social service costs to the province in Ontario is slated to begin in 2010 and be completed by 2018.

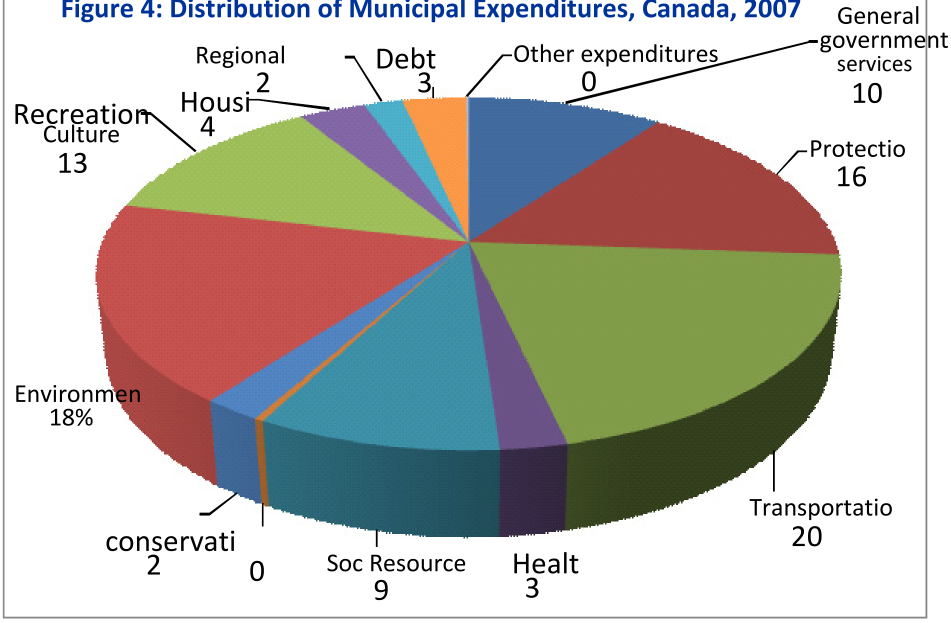
6 These data are not included in the municipal finance data in the figures in this chapter.

7 Provincial property taxes are not specifically earmarked for education in New Brunswick, Prince Edward Island, and Newfoundland and Labrador.

Property taxes

Every province has legislation calling for the assessment of real property at market value. The practice over the past twenty years has been to move towards more frequent and up-to-date reassessments. Some provinces are on annual reassessment cycles; others are on three to five year cycles. After years of trying to update their assessment system, Ontario reached annual reassessments in 2004. In 2006, however, the province announced that all assessments would be frozen for two years and in 2007, announced a move to a four-year reassessment cycle.[8]

Figure 4: Distribution of Municipal Expenditures, Canada, 2007



Source: Statistics Canada, CANSIM Table 385-0024 - Local general government revenue and expenditures, current and capital accounts, year ending December 31.

---

8 For more information on the property tax reform in Ontario, see (Bird & Slack, 2004).

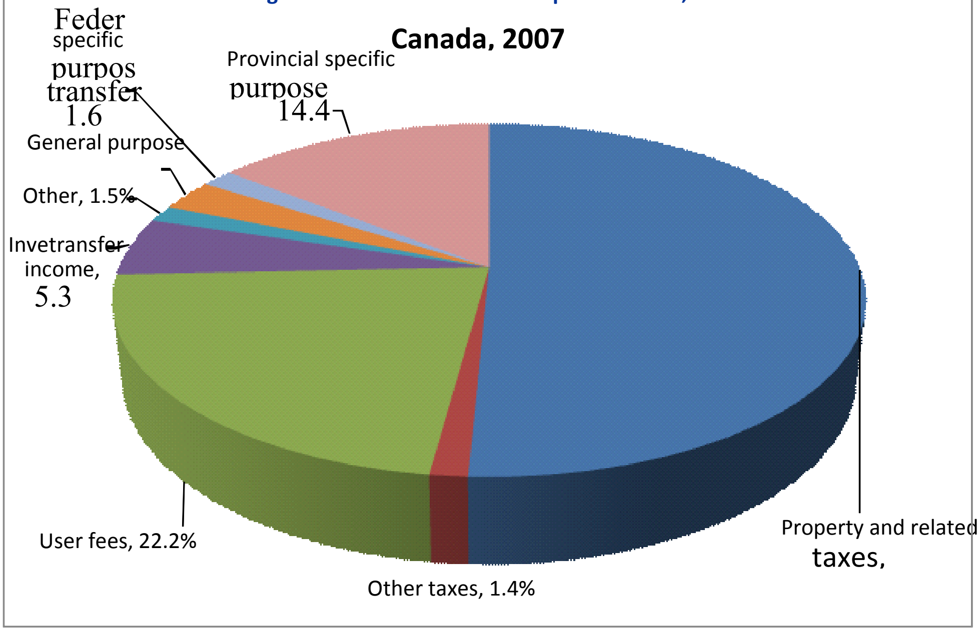


Figure 5: Distribution of Municipal Revenues, Canada, 2007

Source: See Figure 4.

In terms of tax rates, municipalities in some provinces can apply only a single tax rate to all classes of property; others can apply different rates to different property classes (for example, residential, commercial, industrial, farmland, etc.). Where tax rates vary, the rates for residential and farm properties are always lower than the rates for commercial and industrial properties. Individual property tax relief schemes vary across Canada but generally take the form of exemptions of certain properties, preferential assessment and differential tax rates associated with some properties (for example, residential and farm properties), or direct property tax relief programs for individual taxpayers.

User fees

As with property taxes, there is considerable range in the relative importance of user fees across Canada. In most provinces, user fees fund at least a portion of the costs of city water and sewer systems, public transit, solid waste collection and disposal, recreation programs and facilities, and parking garages.

The extent to which municipalities across Canada rely on user fees depends on a variety of factors. Tradition often plays a role – if they have not been used in the recent past, there is often resistance to adopting them. The level of property taxes also plays a role - the lower the property tax, the less the likelihood of introducing user fees because the property tax can fund the service. Opposition to user fees often arises because they are alleged to be regressive (that is, they absorb a higher percentage of lower income individuals' or households' income when compared with higher income individuals or households). In some cases, they are resisted because cost data are not collected and recorded in a way that permits an estimation of unit costs. For example, there are problems allocating joint costs with other services such as in assigning general government expenses to individual services. There is often political and sometimes, administrative reluctance to alter funding structures that have been around for a long time. Even where user fees are charged, it is often very difficult to increase the fee when costs increase.

Intergovernmental transfers

Intergovernmental transfers account for less than 20 percent of municipal revenues and these are largely from provincial governments. Over the last 20 years, the relative importance of own-source revenues has grown, in large part, because transfers have fallen. The decline has mainly been for general purpose (non-earmarked) transfers; specific purpose transfers have increased slightly. The largest transfers are earmarked for transportation (roads and transit) and the environment (water, sewers, solid waste). Transfers for these two functions have been increasing over the last two decades. Federal transfers to municipalities have historically been fairly small and all federal grants are earmarked for specific purposes.

Although this summary suggests that Canadian municipalities are enjoying greater local autonomy than in the past because they are more dependent on their own resources, the reality is that municipalities have been and continue to be heavily dependent on provincial governments. Transfers represent a small percentage of municipal revenues but most of these grants are specific purpose grants designed to finance specific services at levels and standards which are set by the province but delivered by local governments (Slack, 2009).

Other taxes

In addition to the property tax, local governments levy some small additional taxes in selected parts of the country. For example, the City of Toronto levies a land transfer tax and a vehicle registration tax (both piggybacked onto provincial taxes), and a billboard tax. Municipalities in two provinces levy a land transfer tax. Sales taxes (including taxes on hotels, entertainment, restaurant meals, and liquor) and amusement taxes are levied by municipal governments in a number of provinces. Municipalities in one province (Newfoundland and Labrador) levy a poll tax. To pay for capital expenditures associated with growth, municipalities in several provinces levy development charges.

Borrowing

Since municipalities are not permitted to budget for operating deficits, the annual budget must include sufficient revenues to cover all operating expenditures. If expenditures exceed revenues in a particular year, the resulting deficit must be covered in the following year's budget.[9] Borrowing is permitted, however, for capital expenditures with the repayment of borrowed funds from operating revenues (property taxes, user fees). Municipalities (with the exception of the City of Toronto) can only issue general obligation bonds (not revenue bonds). Each province sets out borrowing guidelines for municipalities. For example, debt charges cannot exceed 25 percent of own-source revenues for municipalities in Ontario.[10] Pooling of debt through provincial financing authorities is generally used for smaller municipalities to lower borrowing costs.

Issues and Challenges

Cities around the world complain that they do not have sufficient revenue tools to meet their expenditure requirements. Canadian cities are no exception. A series of events over the last 20 years have had an important impact on the municipal fiscal environment in Canada and the ability of cities to respond to expenditure demands: offloading of services to local governments, the need to be internationally competitive, and the costs of sprawl. At the same time, they have experienced no diversification in revenue sources.

Offloading of services

The "offloading" of services by the federal and provincial governments has meant increased responsibilities for municipalities throughout the country. In some cases, federal and provincial governments have shifted expenditure responsibilities directly to municipalities (such as social services and social housing in Ontario in 1998). In other cases, offloading has meant that provincial governments have reduced transfers to municipalities and, in effect, increased municipal funding requirements. In still other cases, offloading has meant that federal and provincial

[9] The Province of Ontario has become more flexible in recent years, permitting municipalities to balance their budgets over a two to five-year period.

[10] The City of Toronto does not face provincial borrowing restrictions.

governments have downsized their own responsibilities in areas such as immigration settlement at the federal level and education in some provinces. Municipalities, in most of these cases, have felt the need to fill the void left by other governments. Finally, federal and provincial requirements have mandated that cities meet certain requirements (for example, water quality standards) without providing the funds to meet those requirements. In all of these cases, pressure has been placed on municipalities to increase expenditures (and revenues).

Need to be competitive internationally

As in most countries, the future of Canada is increasingly linked to the fortunes of its large cities and city-regions where employment, wealth, and productivity growth are generated. In the new global environment, cities have to compete in the international marketplace to attract business and skilled labor. To do this, they not only have to provide sophisticated transportation and communications infrastructure but they also have to deliver services that enhance the quality of life in their communities. These services include, for example, parks, recreational and cultural facilities, social services, public health services, and police protection. The need to provide this wide range of services has placed added pressure on municipal finances.

Costs of sprawl

Municipalities that are facing rapid growth are also, in many cases, experiencing the higher costs associated with urban sprawl. The literature on the costs of sprawl in both Canada and the US suggests that infrastructure and service costs are higher in sprawl developments than compact developments (Slack, 2002). The higher cost of sprawl places financial pressures on growing municipalities.

No diversification of revenue sources

At the same time that municipalities are facing and will continue to face increased pressures on the expenditure side of their budget, there has been no parallel diversification of their revenue sources in Canada. To a large extent, municipal revenues have not kept pace with the rapidly changing expenditure needs of municipalities. Unlike many other cities around the world, municipalities in Canada continue to rely primarily on property taxes and user fees to finance service provision. The property tax has been a strikingly inelastic tax in some cases because of the way it is administered. In these cases it has not grown with the economy in the same way as the income tax, and to a lesser extent, the sales tax.

Infrastructure deficit

Notwithstanding the pressure on municipal finances in Canadian municipalities over the past decade, they have not run deficits in their operating budgets because they are not permitted to do so under provincial legislation. Few municipalities, if any, have borrowed excessively to pay for capital expenditures because the amount of borrowing is also constrained by provincial governments. Few municipalities have raised property taxes significantly; few have run up large tax arrears. Overall, municipalities in Canada have also become less reliant on provincial grants. From a fiscal perspective, Canadian municipalities appear to be quite healthy.

It may be, however, that the overall health of municipalities has less to do with balancing their budgets, which they are required to do by law in any event, than with the adequacy of the services that are being provided and the current state of municipal infrastructure. If municipal governments in Canada appear fiscally healthy because they have under-invested in services and infrastructure essential to their economic health (transportation, roads, sewers, recreational facilities, for example), the seeds of a serious future crisis may already be sown in terms of the overall health of municipalities.[11]

Restoring Fiscal Balance

To restore fiscal balance, some authors have argued that municipalities in most provinces simply need to raise property taxes (on residential properties but not on commercial and industrial properties because they are already over-taxed in most jurisdictions)[12] and user fees to solve the problem.[13] There is some truth to this argument at the municipal level – residential property taxes have not increased dramatically over the last 20 years and user fees could probably be expanded to include a few more services. Correct pricing, in many cases, would also result in reduced demand for services and infrastructure and remove some of the pressure on expenditures. Many Canadian municipalities could also borrow more to pay for infrastructure. Nevertheless, all of these measures are still likely to fall short of meeting existing expenditure requirements (Courchene, 2005).

Other ways to restore the balance between expenditure responsibilities and revenues include transferring responsibility for some expenditures to the provincial or federal governments ("uploading"); transferring revenue-raising power (tax room) to municipal governments (such as an income tax or selective sales taxes); and transferring funds

---

11 One study of the municipal infrastructure deficit suggests that Canada has used up 79 per cent of the service life of its public infrastructure and sets the price for eliminating the municipal infrastructure deficit at $CAD123 billion (Mirza, 2007).

12 See, for example, (Bird & Slack, 2004).

13 Mintz and Roberts note two important exceptions to this recommendation, however: Alberta where municipal user fees are relatively high and Ontario where the cost of social services is shared with municipalities. In those two provinces, the authors recommend consideration of a new tax on earned income. See (Mintz & Roberts, 2006).

from the federal and provincial governments to municipal governments through specific or general purpose grants.

The Literature on Financing Cities

The literature on financing cities tells us that the major role of local governments is to provide goods and services within a particular geographic area to residents who are willing to pay for them.[14] To the extent that the benefits and costs of particular services are confined to local jurisdictions, so that the actions of one municipality have no effect on other municipalities, efficiency is enhanced because the mix and level of services can vary according to local preferences. Moreover, local officials are often thought to be in a better position to respond to local tastes and preferences than are central government officials.[15] The efficient provision of services also calls for clarity of expenditure assignments among levels of government. Without this clarity, accountability is blurred and citizens do not know who is responsible.

Once responsibilities have been assigned to local government, the financing tools need to be appropriate to the types of expenditures that local governments are making -- finance follows function. For services with private good characteristics (such as water, sewers, garbage collection and disposal, transit, and recreation), user fees are appropriate to fund at least some portion of the costs. User fees are appropriate where there is a clear

[14] Local governments should not redistribute income because their efforts will likely result in the movement of high-income groups and businesses to low-tax areas and low-income groups to high-tax areas (Inman R. P., 2005). Nevertheless, local governments do in practice invariably engage in some redistribution.

[15] Although the major role for cities is thus to provide services to residents, they do not have to produce the goods and services themselves. Municipalities may, for example, contract out service delivery to another government or to the private sector. Indeed, as noted in (Osborne & Gaebler, 1992), experience suggests that most local governments need to concentrate more on 'steering' (policy making) and less on 'rowing' (service delivery).

relationship between the fees charged and the benefits received, the taxpayer has the choice about the extent to which he or she uses the service, it is possible to collect the charge at a reasonable cost, and equity concerns can be addressed (for example by lowering or waiving fees for low-income users). User fees can play an important role in municipal finance by ensuring that governments do what people want and are willing to pay for.

Services with public good characteristics (for example, police and fire protection, local parks, local streets, and street lighting) have collective benefits that are enjoyed by local residents but which cannot easily be assigned to individual beneficiaries. These services are more difficult to charge for and require some form of local benefit-based taxation such as property or income taxes. Services that generate externalities may require an intergovernmental transfer to cover part of the costs. Externalities occur when the benefits (or costs) of some services spill over municipal boundaries (for example, regional highways). Externalities can result in an under-allocation of resources because the municipality providing the service bases its expenditure decisions on the benefits captured within its jurisdiction and not the benefits to those outside. A specific purpose, matching grant (a Pigouvian subsidy) would provide an incentive to allocate more resources to the service generating the externality. The grant should be earmarked for the service which generates the externality and should be matching to reflect the extent of the externality. The matching rate may be different in different jurisdictions reflecting that there are greater externalities in some places than in others (Bird & Smart, 2002).[16]

---

[16] Although the notion of a matching rate to reflect spillovers works in theory, the extent to which the grant will induce municipalities to spend more on the subsidized service depends on the matching rate, the responsiveness of spending to a lower price, and whether the grant stimulates new spending or replaces spending that would have occurred anyway (Bahl, 2000). In practice, governments do not know the magnitude of spillovers for specific services (Bird R. M., 2000) and empirical evidence suggests that the scope of externalities is limited and thus cannot justify the high matching rates that are generally used (Blochliger & Petzold, 2009).

The literature on financing cities also tells us that, as much as possible, each government should finance expenditures out of own revenues. The result is that municipalities enjoy some local autonomy, are responsible and accountable for their expenditure and revenue decisions, and benefit from stable and predictable revenues (because they have control over them). Nevertheless, there are cases where intergovernmental transfers are appropriate. In addition to externalities, the traditional fiscal federalism literature sets out two other rationales for intergovernmental transfers: vertical fiscal imbalance and horizontal fiscal imbalance. Vertical fiscal imbalance occurs when municipalities have inadequate own-source revenues to meet their expenditure responsibilities. The resulting fiscal gap can be closed with a general purpose (non-earmarked) transfer. The amount of the transfer allocated for this purpose can be determined in three ways (Bird & Smart, 2002, p. 900): as a fixed proportion of the revenues of the donor government (known as revenue sharing); on an ad hoc basis; or on the basis of a formula (for example, as a percentage of specific local government expenditures or population).

Horizontal fiscal imbalance refers to the difference in resources among governments at the same level: some municipalities are unable to provide an adequate level of service at reasonable tax rates whereas other municipalities can. This inability to provide an adequate level of service may occur because the costs of services are higher, the need for services is higher, and/or the tax base is smaller. Equalization grants, based on expenditure needs and fiscal capacity, can ensure that those municipalities with small tax bases and greater costs and needs are able to levy tax rates that are comparable to other jurisdictions.

The second generation theory provides other reasons why transfers are given, for example to subsidize activities that are a high priority for the donor government but a low priority for the recipient government.[17] Non-

[17] For a further discussion of the rationales for intergovernmental transfers, see (Shah, 2007), (Slack, 2007) and (Bird & Smart, 2002).

matching specific purpose grants are appropriate to subsidize activities that are a high priority for the donor government (Boadway & Shah, 2009). These transfers provide incentives for local governments to act as agents of the donor government.

Notwithstanding the reasons for transfers, however, they can create problems for local governments (Slack, 2009). Transfers can interfere with the efficient delivery of services because there is no incentive to use proper pricing when grants cover a large proportion of costs. Transfers can distort local decision-making.[18] Transfers blur accountability because the level of government making the spending decisions (municipalities) is not the same as the level of government that is raising the revenues to pay for them (provincial or federal governments). Transfers are rarely stable and predictable, making it difficult for municipalities to plan expenditures from year to year.

A mix of taxes

Local governments benefit from a mix of taxes. A mix of taxes gives them more flexibility to respond to local conditions such as changes in the economy, evolving demographics, and shifting expenditure needs. Property taxes are not effective at linking the costs and benefits of services when people commute to work from one jurisdiction to another but income and sales taxes do capture these benefits. Taxes that grow with the economy (such as income and sales taxes) provide cities with an incentive to make the kinds of investments (in infrastructure, for example) that stimulate economic growth. Finally, any tax is almost certain to create local

[18] The extensive literature on the flypaper effect ("money sticks where it hits") suggests that grants will be effective at stimulating local spending in the areas for which they are earmaked rather than merely crowding out spending that would have occurred anyway (Inman R. P., 2008). Yet, specific purpose grants can be fungible in the sense that, even though they come with strings attached, there is no guarantee that the recipient will spend the funds on what the donor government intended. They are less fungible, however, if their receipt is conditioned on meeting performance standards and compliance is monitored.

distortions (for example, the property tax discourages investment in housing) but a mix of taxes could mean that the distortions created by one tax will be offset by other taxes.

Financing infrastructure

In addition to property taxes, user fees, and intergovernmental transfers, municipalities can also engage in borrowing and levy development charges to pay for infrastructure.[19] Local governments in most countries are not permitted to borrow to meet operating expenditure requirements but they are often permitted to borrow to make capital expenditures. Where the benefits of a capital investment (for example, the construction of a water treatment plant) are enjoyed over a long period of time, say 25 years, it is both fair and efficient to pay for the project at least in part by borrowing so that the stream of benefits matches the stream of costs through the payment of debt charges. Borrowing can also be seen as a way to smooth taxes over time when a large investment is needed. Rather than increasing taxes for a few years and then lowering them, borrowing permits local governments to keep taxes relatively stable over time.

Provided there is no central subsidization of such borrowing (e.g. through guarantees, explicit or implicit), financing capital investment in this way is a good idea in principle. In practice, however, some countries have run into substantial difficulties as a result of imprudent local and regional borrowing and have had to impose tight restrictions. When local governments expect that a higher-level government will bail them out in the event of a future fiscal crisis, they are less responsive to negative shocks than governments with no bailout expectations and the result can be large

[19] Public-private partnerships are a way to get private financing into public ventures but only government funding is considered here.

debt burdens and inefficiently large local spending (Rodden, Litvack, & Eskeland, 2003). In Germany, for example, equalization grants have created expectations for bailouts in recipient *Lander* and two (Bremen and Saarland) avoided expenditure cuts in the 1980s as a result. Expenditures increased as did the debt crisis. In Brazil, bailouts to Rio de Janeiro and São Paulo meant that the deficit acted as an implicit subsidy to current spending (Inman R. P., 2005).

Local access to capital markets is often heavily restricted, particularly in less developed countries (Rodden, Litvack, & Eskeland, 2003). Even in countries with well-developed capital markets, smaller municipalities may only be able to borrow through a financing authority or state/provincial body. Pooling the borrowing requirements of several municipalities reduces borrowing costs and achieves economies of scale in administrative costs.[20] In countries in which local governments can borrow directly, a municipality's bond rating largely dictates the rate of interest (and other features) necessary to make its bonds marketable. These ratings involve detailed assessments of municipal capacity to bear debt and to raise revenue even in depressed economic circumstances.

A second approach to pay for infrastructure that is widely used in North American jurisdictions is development charges, sometimes called lot levies or exactions. A development charge is a one-time levy imposed on developers to finance growth-related capital costs associated with new development (or, in some cases, redevelopment). These charges are levied for works constructed by the municipality, and the funds collected are used to pay for the infrastructure made necessary by the development. The rationale for charging developers for such costs is that "growth should pay for itself" and not be a burden on existing taxpayers.

---

[20] In the US, for example, municipal bond banks permit municipalities to pool their borrowing requirements. In Canada, provincial finance authorities borrow on behalf of municipalities. In Western Europe, autonomous agencies run on commercial principles assist local borrowing.

Who ultimately pays development charges – the new buyer, developers, or pre-development landowners – depends largely upon the demand and supply conditions in the market for new housing (Slack & Bird, 1991). Over the long term, however, it seems likely that most charges imposed for new housing developments are borne by buyers. If properly implemented, such development charges can act, in effect, as a form of marginal cost pricing and hence induce more efficient development patterns and discourage urban sprawl (Slack, 2002). To do so, charges have to be differentiated by location to reflect the different infrastructure costs. Unfortunately, few instances of such appropriately differentiated charges can be found in practice.

Final Comments

The review of municipal finance experience in federal countries in the OECD in general, and Canada in particular, highlighted the diversity in institutional arrangements, expenditure assignments, and tax assignments. In terms of expenditure assignment, local governments in most OECD countries deliver property-related services such as water, roads, and garbage collection and disposal; in a few countries, local governments also deliver people-related services such as health, social services, and education. There is no consistent or uniform approach to local government taxation --few countries rely on only one local tax; some rely on two taxes; and still others have three taxes. Generally, broader spending responsibilities come with a greater diversity of taxes.

From the fiscal federalism literature, we learn that there is a need for clarity of expenditure assignments among levels of government and that, as much as possible, each government should finance its expenditures out of its own revenues. By doing so, there will be more accountability and local government will have more fiscal autonomy. Having more own-source revenues also means that local governments will have some control over their revenues. The type of revenues depends on the nature of the services being delivered – user fees are appropriate for services with private good characteristics; taxes are appropriate to pay for good with collective benefits where the individual beneficiaries cannot be determined; transfers are needed for services that spill over municipal boundaries. The property tax is a good tax for local government because property cannot move and there is a relationship between taxes and benefits received. To finance infrastructure, borrowing and development charges are appropriate.

Differences between Indian cities and cities in federal OECD countries in terms of history, culture, population size, population density, the quality of service delivery, the size of the infrastructure deficit, and other factors mean that care has to be taken in adopting any of these findings to Indian cities. Nevertheless, Rao and Bird suggest some avenues that are worth pursuing in the Indian context (Rao & Bird, 2010). These include property tax reform to increase utilization of the tax to pay for local services, greater use of user fees both to increase revenues and to alter economic behaviour, and improvements to central and state transfer programs. With respect to infrastructure finance, they recommend better use of development charges to pay for the growth-related infrastructure costs associated with new development, increased use of municipal borrowing so that the stream of benefits from infrastructure investment matches the stream of costs over time, and better use of public-private partnerships in some areas. Each of these suggestions would go a long way in helping Indian cities deliver services and infrastructure.

Getting city finances right is not only important for cities but it is also critical to meeting national goals such as international competitiveness, economic growth, and productivity. Local governments have an important role to play in providing the infrastructure and services that businesses and residents need to meet these goals. How local governments are financed and governed will affect their ability to provide services and infrastructure.

IMFR

References

Bahl, R. 2000. *Intergovernmental Transfers in Developing and Transition Countries: Principles and Practice.* Washington, DC: The World Bank.

Bird, R. M. 2010. *Local Government Finance: Trends and Questions.* Paper presented at the 6th Symposium on Fiscal Federalism, Financing Local Governments, June 14-5, Barcelona.

Bird, R. M. 2000. Setting the Stage: Municipal and Intergovernmental Finance. In M. Freire, & R. Stren, *The Challenge of Urban Government: Policies and Practices* (pp. 113-28). Washington, DC: World Bank Institute.

Bird, R. M. 2001. *Subnational Revenues: Realities and Prospects.* Washington, DC: World Bank Institute.

Bird, R. M., & Slack, E. 2004. *International Handbook on Land and Property Taxation.* Cheltenham, UK: Edward Elgar.

Bird, R. M., & Smart, M. 2002. Intergovernmental Fiscal Transfers: International Lessons for Developing Countries. *World Development , 30* (6), 899-912.

Bird, R. M., & Tassonyi, A. 2003. Constraining Subnational Fiscal Behavior in Canada: Different Approaches, Similar Results? In J. A. Rodden, G. S. Eskeland, & J. Litvack, *Fiscal Decentralization and the Challenge of Hard Budget Constraint.* Cambridge: Mass.: MIT Press.
Blochliger, H., & Petzold, O. 2009. *Taxes or Grants: What Revenue Source for Sub-Central Governments?* Paris: OECD.

Boadway, R., & Shah, A. 2009. *Fiscal Federalism: Principles and Practices of Multiorder Governance .* New York, NY: Canbridge University Press.

Courchene, T. J. 2005. *Citistates and the State of Cities: Political-Economy and Fiscal-Federalism Dimensions.* Montreal: Montreal: Institute for Research on Public Policy.

Inman, R. P. 2005. *Financing Cities.* Cambridge, Mass. : National Bureau of Economic Research.

Inman, R. P. 2008. *The Flypaper Effect.* Cambridge, Mass.: National Bureau of Economic Research.

Mathur, O. P. 2010. *India Municipal Finance Study: Preliminary Results and Conclusions.* Presentation at a Rountable on India Municipal Finance Study, Seoul, Korea.

Mintz, J. M., & Roberts, T. 2006. *Running on Empty: A Proposal to Improve City Finances.* Toronto: C.D. Howe Institute.

Mirza, S. 2007. *Danger Ahead: The Coming Collapse of Canada's Municipal Infrastructure.* A report prepared for the Federation of Canadian Municipalities.

Osborne, D., & Gaebler, T. 1992. *Reinventing Government - How the Entrepreneurial Spirit is Transforming the Public Sector.* Reading, Mass.: Addison-Wesley Publishing Co. Inc.

Rao, M. G., & Bird, R. M. 2010. *Urban Governance and Finance in India.*

Rodden, J., Litvack, J., & Eskeland, G. 2003. *Fiscal Decentralization and Hard Budget Constraints.* Cambridge, MA: MIT Press.

Shah, A. 2007. A Practitioner's Guide to Intergovernmental Fiscal Transfers. In R. Boadway, & A. Shah, *Intergovernmental Fiscal Transfers, Principles and Practice* (pp. 1-53). Washington, DC: The International Bank for Reconstruction and Development/The World Bank.

Slack, E. 2007. Grants to Large Cities and Metropolitan Areas. In R. Boadway, & A. Shah, *Intergovernmental Fiscal Transfers, Principles and Practice* (pp. 453-81). Washington, DC: The International Bank for Reconstruction and Development/The World Bank.

Slack, E. 2002. *Municipal Finance and the Pattern of Urban Growth.* Toronto: C.D. Howe Institute.

Slack, E. 2009. *Provincial-local fiscal transfers in Canada: Provincial control trumps local accountability.* Paper prepared for the Conference on General Grants vs. Earmarked Grants: Theory and Practice, September 17-18, 2009, Copenhagen.

Slack, E., & Bird, R. M. 1991. Financing Urban Growth Through Development Charges. *Canadian Tax Journal , 39* (5).

MUNICIPAL FINANCE MATTERS

Michael A. Cohen

The study of municipal finance from the national perspective is frequently justified in terms of the needs of the finance system and the public sector. These needs include greater revenue mobilization, improved efficiency of public expenditures, and positive impacts of local capacity on development. While these are important issues, they are not the motivating reasons for this India Municipal Study. Rather, as presented in this chapter, the significance of municipal finance in India at this time is much greater than for financial issues alone.

Improving municipal finance is central to the achievement of India's national development objectives and to the country's ability to meet serious coming challenges in the medium and longer term. To assume that macro-economic growth will "solve" problems at the municipal level - almost in a manner analogous to trickle-down economics - is neither realistic nor prudent. Indeed, even if macro-economic growth were to exceed 20 percent per year, there is no likelihood that growth alone could improve the performance of municipal institutions. In fact, such unlikely growth would actually further demonstrate their role as an obstacle to achieving national development objectives.

This study therefore places municipal finance within a national development framework with the following key features:

- India's large and growing population
- Continuing growth of the urban share of total population

- A large poverty population, particularly in rural areas with expectations of continued rural to urban migration
- Significantly higher rates of economic growth since early 1990s
- Shifting composition of economic growth towards increasingly urban-based economic activities
- Continued and increasing global competition in the goods and services produced by India
- Growing official and civic awareness of constraints on growth of productivity, employment, and income due to limitations of urban infrastructure
- Increasing vulnerability of climate-induced changes and disasters for urban populations
- Concern about the effectiveness of the institutions responsible for urban governance

This well-known list of features of the current scene provides the context for understanding municipal finance in India. Improving municipal finance is not an end in itself, but rather is an important instrument in addressing these bigger and more pressing national challenges. For the purposes of this Report, these challenges can be divided into three categories: economic, social, and environmental.

Municipal Finance and the Macro-economy

The first fact to recognize is that already ___ percent of the Indian economy is in urban areas. Increased urban demographic growth has combined with the changing composition of the economy from rural and agricultural production to urban-based economic activities, from manufacturing, to financial services, and to other services. Over time this trend will continue, as in all countries where income growth has been closely correlated with the share of population living in urban areas. In 109 countries with populations over one million, both urbanization and per capita income growth rose between 1960 and 2003; in the majority of these countries, income per capita grew more rapidly than urbanization.[1] Projections for future economic growth in all countries demonstrate that the trend towards greater concentration of economic activity will occur in urban areas of all sizes. For more than a generation it has been recognized that all countries generate more than half of their GDP in urban-based economic activities.[2]

This is more than an accidental correlation, but rather a clear relationship between the efficiencies and productivity of agglomeration economies and location. Agglomeration when accompanied by growing density and proximity allows the reduction of costs of production of goods and services and growing consumption by an ever-wealthier urban labor force. The process of value creation itself is a quintessential process of bringing factors of production together in time and space. Economies of scale generate higher productivity as shown in studies in Brazil which concluded that productivity increased roughly 1 percent for every 10 percent increase in the number of workers employed in an industry or in a city. This is a very large increase, reflected, for example, in the conclusion that by growing from a city of 1,000 workers to one with 10,000 workers, productivity would increase by a factor of 90.[3]

Given these processes, the question to be posed is what are the constraints to achieving higher productivity from urban-based economic growth? Studies of many countries show that these constraints include,

---

1 Michael Spence, Patricia Clarke Annez, and Robert Buckley, eds. *Urbanization and Growth*, (Washington: Commission on Growth and Development, 2008), p.7

2 Michael A. Cohen, *Urban Policy and Economic Development: An Agenda for the 1990s*, (Washington: The World Bank, 1991)

3 Work of Vernon Henderson in Brazil in 1986 cited in Spence, Annez, and Buckley, *op.cit.*, p.15

among others, infrastructure deficiencies, regulatory costs and inefficiencies, weak institutional performance at state and local levels, and scarcity of key human and economic resources. The two principal impacts of these constraints are the low productivity of capital and labor.

The low productivity of capital in urban areas is readily illustrated by the impact of infrastructure deficiencies by which investors are required to provide their own services to compensate for the lack of public goods such as water, electricity, public transport, or waste collection, and thus use a significant share of their gross capital investment on providing these services. The costs of poor or absent municipal provision of services are transferred to private firms and residents. This syndrome, found in Mumbai, Calcutta, and many second and third tier cities in India, is similar to the situations found in Lagos, Bangkok, and Jakarta during the 1990s where entrepreneurs used 35%, 20%, and 12% of their capital respectively to finance needed infrastructure services. As a result, their profits were lower, firms did not grow, their work forces stagnated, and overall scale of operations was limited, thus reducing the opportunity to achieve economies of scale, employment growth, and profits.[4]

This "tax" on private urban investment has significant consequences by reducing economic multipliers of all kinds in India's urban areas and thus reduces the productivity of capital. In effect, private capital investment does not achieve expected financial and economic rates of return, because it does not generate economies of scale and potential economic benefits through important multiplier effects including employment, incomes, private investment, and private savings.

This tax also affects the productivity of public capital investment. Finishing construction of one project by a para-statal institution is just the

---

4 Alex Anas, Kyu Sik Lee, Gi-Tak Oh, "Costs of Infrastructure Deficiencies in Manufacturing in Indonesia, Nigeria, and Thailand", World Bank Policy Research Working Paper No. 1604, 1996

beginning of a now common Indian experience of whether local, municipal institutions will have the capacity to operate and maintain what has been built. In some cases, the efficacy of these projects is compromised by the absence of other "links" in a network which were to be built by urban local bodies. In effect, the productivity of scarce public capital resources is undermined and as a result, its poor performance distorts the overall allocation of public capital. Public capital investment itself is under-performing because the enabling conditions needed to assure a reasonable subsequent flow of benefits are not present. Even though the JNNURM is itself contingent on policy and institutional reforms and is intended to address some of these issues, it is highly likely that its intended accomplishments in the targeted 65 cities and towns will also be undermined by these same processes. The focused attention on completing investment and physical construction does necessarily imply that capacities to operate and maintain such facilities are in place, thus demonstrating the difference between output and outcome.

Cities lacking adequate municipal infrastructure services also reduce the productivity of their people. The productivity of labor is affected by shortages of water and sanitation services, poor health conditions, and flooding in both places of work and residence. Well-known impacts of "lost days" due to health problems are reflected in lower than to be expected worker productivity.[5] Poor urban transport is reflected in long times commuting in poor conditions which further reduce labor productivity at the work place.

Poorly-functioning municipalities, presented in subsequent chapters of this report, have both wide and deep impacts on the macro-economy and the local economy. Moreover, poor local performance also cumulatively increases the financial, economic, and institutional burdens on the public sector.

5 World Bank, *World Development Report on Health*, (Washington: The World Bank.

Social Impacts: The Urbanization of Poverty

While it was commonly understood in India for many generations that India's poor lived primarily in rural areas, there is now growing understanding of the urban poor and the cumulative disadvantages which they face: low wages, high costs for essential services including water and food, insecurity, and low human capital investments. It is also widely understood that the phenomenon of slums *per se* is not an indicator of the low disposable incomes of slum residents but rather also a result of inefficient urban land use regulations such as the Urban Land Ceiling Act and building standards for FSI which distort markets for urban land and housing by reducing supply and thus increasing the cost of urban housing. While many of these regulations are not formally legislated at the municipal level but rather come from the states, they contribute to poor municipal performance.

Municipal policy and institutional performance in the poor provision of needed infrastructure and municipal services thus contributes to the growth of urban poverty and most regrettably, not to its alleviation.

This pattern of impacts also results in the worsening of three kinds of inequality:

- Inequality between states
- Inequality between urban areas within states
- Inequality within specific urban areas

The first type of inequality affected by poor municipal performance is the emergence of growing differences between states which are able to urbanize in ways which take the economic advantage of the agglomeration processes of urbanization. Those states which provide infrastructure and better manage urban areas will have higher rates of growth and over time further distinguish themselves from weaker-performing states. States such as Gujarat, Karnataka, and Tamil Nadu have been notably more successful than some others. If differences between states in other sectors such as education, as in the case of the differences between Kerala and Bihar, are causes of historic concern for India's development policy, it can be argued that how individual states actually manage their municipal sector will over time become as determinant of their overall level of welfare as education or health. Does the Central Government really want to have an urban equivalent of Kerala in education which will bring new forms of inequality and disequilibria into the political system?

A second type of inequality is within individual states, where more effectively managed urban areas will contribute more to the overall state economy, but can also upset the political, economic, and demographic balance in the state by becoming new poles of attraction for investment and migrants. While productivity in the short-term is welcome, emerging differences and changes over time may not be, depending on the state. The political and economic management of so-called "lagging regions" within states has been a major political issue in India for many years. It will be exacerbated by differences in municipal performance within states. Given the fact that many second and third tier urban areas are growing much faster than their first tier counterparts within the same states, there is a growing mismatch between demand for services and municipal capacity to provide them. Indeed, the issue of increasingly evident inefficiency and risks in secondary and tertiary urban areas is very likely to become evident over time.

The third type of inequality is intra-urban inequality which already has become very visible in Indian urban areas. While some differences result from investment in human capital and the employment success of individuals in the urban labor market, many of these differences come from the lack of public investment in providing needed infrastructure and services. Differences in intra-urban public expenditures mark Indian urban areas most strikingly. Indeed, intra-urban inequality is one of the most visible negative results of accelerated Indian macro-economic growth since the 1990s.

Underperformance by municipal institutions therefore will keep the urban population poorer longer, and create more and different forms of inequality, with the likelihood that these issues will have increasingly evident political impacts as well.

Rising Urban Environmental Vulnerability

An increasingly visible aspect of urban India is the rising vulnerability for urban populations due to increased urban population concentration and inadequate municipal capacity and services to assure their safety and security. Indian urban areas are increasingly susceptible to various forms of negative externalities including both so-called natural disasters and man-made disasters. These threats include natural disasters, such as floods such as the Mumbai monsoon floods of 2005 and 2006, whose heavy loss of life and huge financial losses resulted in large part from poor municipal maintenance of urban drainage. They also include the likelihood of sea-level rise which will affect cities such as Mumbai, Kolkata, Chennai, and many others.

Vulnerability also comes from man-made hazards such as fires, acute pollution of air and water, industrial accidents, and mass transportation and traffic accidents. The incidence and impacts of these problems depends significantly on the effective capacity of municipal institutions. As suggested earlier, these issues are likely to occur in rapidly-growing secondary and tertiary urban areas having less urban management capacity to address them. Knowing that these increased vulnerabilities are present as “unaddressed urban liabilities” suggests that a high priority reason for strengthening municipal capacity is to prevent future problems which can bring very high costs.

A second dimension of this issue concerns the urgent need for Indian cities – like cities the world over – to improve the efficiency of their use of environmental resources such as water and energy. Becoming "green" at the local level in India will become an increasingly obvious priority as the marginal cost of water supply continue to increase and as solid waste management becomes a larger scale problem beyond simple recycling and includes industrial, medical, and nuclear waste. These are all questions which will have to be resolved at the municipal level.

Given this list of compelling problems, it is not unfair to suggest that urban local bodies in India are in the emergency room, not at the hospital for a routine visit. The gap between weak institutional capacity and unsatisfied needs and demand is growing, in part due to population growth but also to the demands implied by concentration and agglomeration. These impacts will have growing macro-economic and development impacts for the country as a whole. The on-going simultaneous densification and extension of cities and towns are challenge existing municipal capacity to respond. India is under-performing in part because it is held back by the weak management of its cities and towns.

Finally, this situation presents an intriguing and promising opportunity. As in many development challenges faced by India, the answer does not lie in a single solution. Rather, given the number, diverse histories, resource endowments, locations, and institutional capacities of the country's cities and towns, the only possible solution is to identify a policy and institutional framework which acknowledges these differences and which promotes growing local capacity to solve local problems in different ways. This was recognized in the 74th Amendment to the Indian Constitution. Reforming the systems of municipal finance should be a priority of both the national government and the states, both of whom will increasingly depend on the ability of cities and towns to be the sites of accelerated productivity growth and reduction of poverty. Municipal performance matters!

LOCAL PUBLIC FINANCE IN KOREA

Junghun Kim

Introduction

The size of local public sector in Korea is quite large with its total expenditure being larger than that of the central government. However, many local governments, especially small ones, rely heavily on intergovernmental transfers. Even big cities, except those in Seoul capital region, receive a large amount of intergovernmental transfers from the central government. The heavy financial dependence of local governments on the central government has been a long-time characteristic of the intergovernmental fiscal relations in Korea. Interestingly, fiscal dependence of local governments on central government has increased since the start of decentralization in the middle of 1990s.

From economic and fiscal decentralization perspectives, Korea has two distinctive characteristics. Firstly, although the size of local public sector is quite large, management of local public finance has been tightly controlled by the central government. As in many other countries, both centralizing and decentralizing forces coexist in Korea but the balance between such contradictory forces has been toward fiscal centralization as far as taxing and expenditure powers are concerned. Secondly, Korea has been enjoying almost highest economic growth rate in the world for the past 40 years or so. Given the impressively successful economic performance in Korea, it will be fair to say that public sectors in Korea, both at central and local levels, have played a positive role in economic development and growth. In a sense, a balance between centralizing and decentralizing forces has been achieved in a way that it doesn't become a bottleneck in the economic development and growth.

A key question with respect to the current status of fiscal decentralization in Korea is whether such a balance will in the future successfully reflect changing economic and political environments. Korea is going through a rapid phase of economic, political, and social changes which will bring about the need for changes in intergovernmental relations. From this perspective, it is not unlikely that what has been good so far for the economy and management of local public sector in Korea many not be so in the future. This is because there is an increasing political demand for decentralization as the political and economic systems of Korea become more mature. The current status of fiscal decentralization in Korea is not mature at all since local public sector is in many ways tightly controlled by the central government. Therefore the challenge that lies ahead for local public sector in Korea is how to become more independent, more responsible and more responsive despite the long tradition and embedded inertia of heavy reliance on the center.

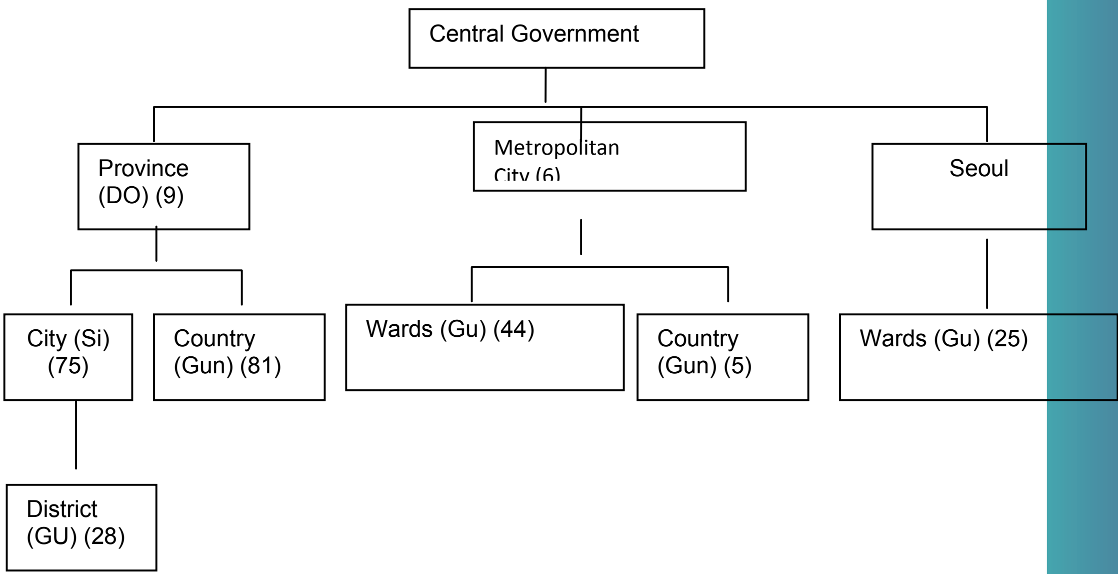
The paper is organized as follows. Section 2 overviews the structure of local governments and local public finance in Korea. In section 3 local tax system is explained. Section 4 concludes the paper.

Structure of Local Governments and Local Public Finance

Local governments

The total area of Korea is 100,208 square kilometers and the total population as of 2010 is 49.77 million. Local governments in Korea consist of prefectures and municipalities. Prefectures, which are upper-level local governments, consist of special metropolitan city (Seoul), six metropolitan cities (Busan, Daegu, Incheon, Gwangju, Daejeon, and Ulsan), and nine provinces (Gangwon, Kyonggi, Chungbuk, Chungnam, Jeonbuk, Jeonnam, Gyeongbuk, Gyeongnam, and Jeju). Lower-level local governments consist of cities (Si), counties (Gun), and wards (Gu).

Figure 1. Korean Local Government System (2010. 1)



Note: Korean terms are in italics and number of units is in brackets. Source: Ministry of Public Administration and Security (MOPAS).

Cities have a population of 50,000 or more and counties have a population of 50,000 and under. Wards are municipalities under big cities. The wards under the seven biggest cities are autonomous bodies and their heads are elected by votes. Other cities whose populations are over 500,000 can have non-autonomous wards as administrative arms of the cities. Currently, there are 75 cities, 86 counties, and 69 wards, making the total number of lower-level local governments 230. Combining both upper-level and lower-level local governments, there are currently 246 local governments in Korea.

Local public finance

In 2009, the GDP of Korea was 832.5 billion dollar. In comparison, the GDPs of India and China in 2009 were USD 1,310 billion and USD

4.985.5 billion. The GDPs of major industrialized countries such as US, Japan, Germany, France, UK, Italy were, respectively, USD 1.412 trillion, USD 5069.0 billion, and USD 3330.0 billion, USD 2649.4 billion, USD 2174.5 billion, and USD 2112.8 billion.

Table 1. GDP of Selected Countries (2009, Billion Dollar)

Korea	US	China	Japan	India	German	Franc	UK	Italy
832.5	14119.0	4985.4	5069.0	1310.1	3330.03	2649.3	2174.5	2112.78

Source: World Bank Database.

The size of local public sector in 2009 was 139.9 trillion Won, which was about 14% of GDP[1]. Out of this total budget, the amount of own-source was 79.4 trillion Won, and that of intergovernmental grants was 55.25 trillion Won. The size of local debt in Korea is negligible with its amount being 5.17 trillion Won in 2009. On average, the share of own-source revenue of local governments is about 56 percent, and 46 percent comes from intergovernmental grants.

Table 2. Revenue of local governments (Trillion Won)

	2008	2009	2010
Total	125.00	137.50	139.90
Own Revenue	73.65	80.84	79.43
Transfers	47.82	53.01	55.25
Local Debt	3.50	3.69	5.17

Source: Ministry of Public Administration and Security (MOPAS).

The size of the total expenditure of local governments is somewhat lower than that of the total revenue of local governments because of carry-overs, with its size being about 123.5 trillion Won in 2010. The size of local

[1] The exchange rate of 1 USD is about 1,150 Won.

expenditures in Korea is quite large, with the share of local expenditures being larger than that of central government expenditure, which was 110.5 trillion Won in 2010. Local governments in Korea have always played an important role in terms of public expenditures but it is a recent phenomenon that the size of local expenditures has become greater than that of the central government. In 2005, the share of local expenditures in total government expenditure was 35.9 percent while that of the central government was 50.5 percent. In 2005 therefore the size of central government expenditure was far higher than local expenditures. However the size of local expenditures has increased quite fast in recent years. In 2008 the share of local expenditures became 40.5 percent, which was closer to the share of central government expenditure, which was 46.1 percent. In 2009, the balance was reversed with the share of local expenditures becoming greater than that of the central government.

It needs to be noted that the budget account local education is separately managed from those of the central and local governments. This is because local education is administrated by local education offices which are an independent local governance body. Local education offices do not collect taxes and rely on the central government's transfers (general grants) and transfers from local governments (tax revenue of Local Education Tax). The share of local education expenditures in total government expenditure was 13.6 percent in 2005 and 14.6 percent in 2010.

Table 3. Expenditures of central and local governments (Trillion Won, %)

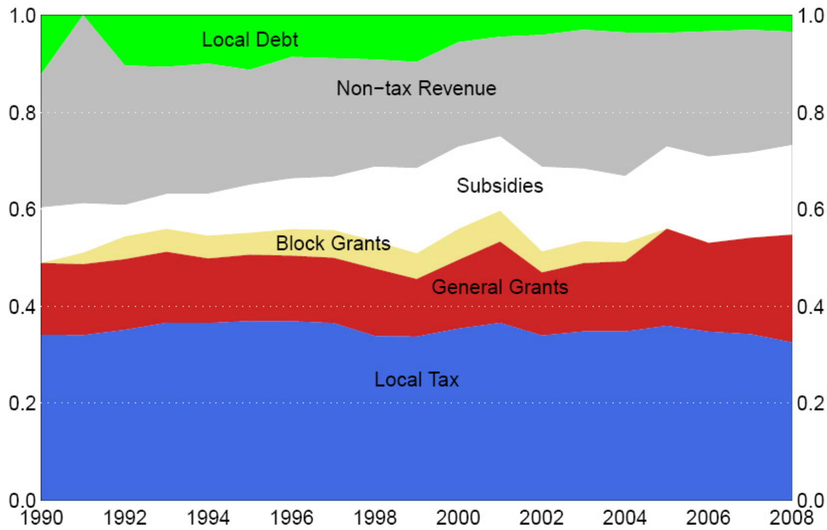
	2005	2006	2007	2008	2009	2010
Central (share)	105.45 (50.5)	105.91 (48.4)	108.55 (47.2)	111.13 (46.1)	104.85 (42.3)	110.55 (40.3)
Local (share)	74.88 (35.9)	82.64 (37.7)	88.89 (38.6)	97.61 (40.5)	108.05 (43.6)	123.52 (45.1)
Education (share)	28.32 (13.6)	30.45 (13.9)	32.76 (14.2)	32.47 (13.4)	35.08 (14.1)	39.99 (14.6)

Source: Ministry of Public Administration and Security (MOPAS).

The composition of local governments' own revenue has been relatively stable for the past twenty years with the share of local tax revenue in total local revenue moving around 35 percent throughout this period. If we examine its trend, however, it's level peaked at around 37 percent in 1995, the year when local autonomy started in Korea. Since then its level has steadily declined, reaching about 32.5 percent in 2008. The share of non-tax revenue shows a similar pattern albeit to a less extent. It was higher than 25 percent before the middle of 1990s, but then it has steadily declined, reaching about 23.4 percent in 2008.

The share of intergovernmental grants is a mirror image of the share of own source revenue and has been steadily increased since the middle of 1990s. The structure of intergovernmental grants has been also significantly changed during this period. The share of general grants (Local Allocation Tax) was less than 15 percent of total local revenue in the 1990s, but it rapidly increased from late 1990s and its current share in the total local revenue is around 22 percent. From 1991 and 2004, there was a kind of block grants for local roads and local environmental facilities. This grant was separated from specific grants (National Subsidies) in 1990 and then a major part of it, grants for local roads, was absorbed into general grants from 2005. It is notable that the share of local debts was greater than 10 percent in the early 1990s, but it is quite negligible now. Also notable is the trend of the share of specific grants. It has been steadily increasing since late 1990s. A major reason for this change is because many of the rapidly increasing welfare programs are administered by local governments with subsidies from the central governments.

Figure 2. Compositions of local government revenue



The total or average size of local revenues that have been shown so far hide a very important aspect of local public finance in Korea. In 2008, the average share of own source revenue (local tax and non- tax revenue) was about 57 percent. However, the variance of its distribution is quite large. Out of 246 upper-level and lower-level local governments, the share of own source revenue was higher than 70 percent only for seven local governments. These rich local governments are mostly located in Seoul capital region. For the remaining local governments, the share of own source revenue was higher than 50 percent for 28 local governments. Thus only 35 out of 246 local governments enjoy more than average own source revenue share. For as many as 152 local governments, the share of own source revenue is less than 30 percent. Therefore the average share of own source revenue of local governments, which is about 57 percent, highly overestimates the fiscal conditions of many local governments in Korea.

It should be also noted, however, that the number of local governments is not an accurate indicator to measure the distribution of fiscal capacities of local governments. This is because quite a large number of people live in a few rich local governments such as the capital city of Seoul and Kyonggi province which surrounds Seoul. In terms of population, therefore, more than 40 percent live in the local governments which enjoy relatively high level of fiscal autonomy.

Table 4. Distribution of share of own source revenue (2010)

	Total	Upper Level	Cities	Towns	Wards
Total	246	16	75	86	69
Below 10%	9	-	1	8	-
10%-30%	143	7	31	71	34
30%-50%	59	2	24	7	26
50%-70%	28	5	19	-	4
70%-90%	7	2	-	-	5

Source: Ministry of Public Administration and Security (MOPAS).

In Table 5, the composition of local expenditures as of 2010 is shown. Among eleven expenditure categories, welfare programs have the highest expenditure share at about 19 percent. Next biggest expenditure items are transportation, environment protection, and regional development with their shares being, respectively, 11.77 percent, 10.66 percent, and 9.18 percent. Table 5 also shows that environmental expenditures are largely managed by special account which covers about 63.5 percent of total environmental expenditures. The expenditure shares of special accounts for transportation and regional development are also relatively high.

In Table 6, revenue sources of local expenditures are shown. This table shows that, out of 140 trillion Won of local expenditures, 30 trillion Won come from the central government, implying that the central government's contribution for local expenditures is about 21.47 percent of the total amount. But this interpretation is relevant only for specific grants since general grants are counted as own source revenue in Table 6. In this table, it can be confirmed that the matching rate for welfare programs is highest at around 52.5 percent. The matching rate for agriculture & marine is also high at around 43.9 percent.

Table 5. Composition of local expenditures (2010, million Won)

	Total		General Account		Special	
	Amount	%	Amount	%	Amount	%
Total	1,398,565	100	1,064,995	100	333,570	100.00
Administration	119,620	8.55	89,840	8.44	29,779	8.93
Security	21,758	1.56	21,229	1.99	529	0.16
Education	81,385	5.82	78,040	7.33	3,345	1.00
Culture and Tourism	77,949	5.57	65,628	6.16	12,321	3.69
Environment	149,026	10.66	54,357	5.10	94,669	28.38
Welfare programs	265,342	18.97	212,451	19.95	52,891	15.86
Health	22,250	1.59	19,230	1.81	3,020	0.91
Agriculture & Marine	97,237	6.95	94,013	8.83	3,224	0.97
Industry and SMEs	30,172	2.16	26,444	2.48	3,727	1.12
Transportation	164,648	11.77	106,649	10.01	58,000	17.39
Regional	128,440	9.18	75,275	7.07	53,165	15.94
Science	4,375	0.31	1,810	0.17	2,565	0.77
Reserve Fund	21,964	1.57	20,489	1.92	1,475	0.44
Others	214,400	15.33	199,541	18.74	14,859	4.45

Source: Ministry of Public Administration and Security (MOPAS).

Table 6. Revenue source of local expenditure (2010, million Won)

	Total	Central Gov.	%	Upper-level	%	Lower-level	%
Total	1,398,565	300,287	21.47	503,500	36.00	571,817	40.89
Administration	119,620	1,234	1.03	61,247	51.20	57,138	47.77
Security	21,758	6,102	28.04	9,291	42.70	6,340	29.14
Education	81,385	231	0.28	71,824	88.25	9,330	11.46
Culture and Tourism	77,949	11,502	14.76	30,555	39.20	35,888	46.04
Environment	149,026	26,839	18.01	42,654	28.62	79,432	53.30
Welfare programs	265,342	139,300	52.50	72,270	27.24	53,773	20.27
Health	22,250	6,471	29.08	7,432	33.40	8,346	37.51
Agriculture & Marine	97,237	42,730	43.94	15,017	15.44	39,422	40.54
Industry and SMEs	30,172	6,754	22.38	13,195	43.73	10,221	33.88
Transportation	164,648	33,984	20.64	73,417	44.59	57,159	34.72
Regional development	128,440	23,500	18.30	38,901	30.29	66,031	51.41
Science	4,375	515	11.77	3,802	86.90	58	1.33
Reserve Fund	21,964	80	0.36	7,487	34.09	14,397	65.55
Others	191,743	1,045	0.55	56,407	29.42	134,280	70.03

Source: Ministry of Public Administration and Security (MOPAS).

Local Tax System

The Korean tax system consists of fourteen national taxes and seventeen local taxes as of 2010[2]. The national tax is categorized into Internal Tax, customs duties, and earmarked taxes. The definition of Internal Tax exists for the sake of defining the bases of general grants given to local governments and local education offices: 19.24 percent of the Internal Tax is the basis of general grants to local governments; another 20 percent of it is the basis of education general grants. Therefore 49.24 percent of the Internal Tax is automatically transferred to local governments and local education offices. The earmarked taxes are not the basis of

[2] Some changes take place in local tax system from 2011, which will be explained later.

general grants, and consist of excise tax on fuels, Education Tax[3], and Special Tax for Rural Development. It is worth noting that this structure creates an incentive for the central government to prefer earmarked taxes: when one Won of earmarked tax is collected, one Won belongs to the central government, while only 0.576 Won of Internal Tax revenue belongs to the central government.

Among the fourteen national taxes in Korea, thirteen taxes are the types of taxes that are commonly found in many other countries, except a national property tax, which is called Comprehensive Real Estate Holding Tax (CREHT) in Korea. This tax was created in 2005 as a result of splitting local property taxes (Aggregate Land Tax and Property Tax) into a local property tax (Property Tax) and a national property tax (CREHT)[4].

The local taxes are collected by metropolitan cities, special districts, provinces and cities/towns. The metropolitan cities (Seoul and other six cities) collect all fourteen local taxes. Special districts under the seven major cities collect three local taxes -- License Tax, Property Tax and Business Place Tax. Cities and counties collect nine taxes such as Inhabitant Tax, Property Tax, Automobile Tax, Motor Fuel Tax, Tobacco Consumption Tax, Agricultural Income Tax, and Butchery Tax, Urban Planning Tax and Business Place Tax.

For the past 10 years, there have been several changes in the system of local taxes. Local fuel tax (Motor Fuel Tax) was introduced in

---

[3] Education Tax is rather complicated. It is levied on gross receipts of banking and insurance business with the rate of 0.5 percent, and levied on, as surtaxes on three national taxes, Individual Consumption Tax (such as on cars, cameras, etc.) with the tax rate of 30 percent, excise taxes (on many different types of fuel) with the tax rate of 15 percent, and liquor tax with the rate of 10 percent.

[4] Before 2005, tax bases of property taxes in Korea were separated into land (Aggregate Land Tax) and structure (Property Tax). After 2005, Property Tax is levied, for residential properties, on a combined value of land and structure. For lands without structures, Property Tax is levied instead of Aggregate Land Tax.

2000 as a shared tax with the central government's Transportation Tax. In 2001, Local Education Tax was introduced. Before 2001, there was an Education Tax as a national tax, which was a combination of the current Education Tax and surtaxes on seven local taxes. The part of Education Tax on local taxes became Local Education Tax in 2001. As previously discussed local property taxes were divided into a national and local property taxes in 2005. Finally, Local Consumption Tax, a tax sharing of 5 percent of VAT revenue, was introduced in 2010.

Table 7. National Tax System (2010)

Direct taxes	Indirect taxes	Earmarked taxes
Income Tax Corporation Tax Inheritance Tax Gift Tax National Property Tax	Value-added Tax Individual Consumption Tax Liquor Tax, Stamp Tax Securities Transaction Tax Customs Duty	Transportation· Energy· Environment Tax Education Tax Special Tax for Rural Development

Table 8. Local Tax System (2010)

Province taxes		City & County taxes	
Ordinary taxes	Earmarked	Ordinary taxes	Earmarked
Acquisition Tax Registration Tax Leisure Tax License Tax	Community Facility Tax Regional Dev. Tax Local Education Tax	Inhabitant Tax, Property Tax Automobile Tax Motor Fuel Tax Tobacco Consumption Tax Agricultural Income Tax Butchery Tax	Urban Planning Tax Business Place Tax

The revenue of national taxes in 2009 was 157.9 trillion Won and that of local taxes was 45.17 trillion Won. Therefore the share of local tax revenue in total tax revue was about 22.36 percent. This figure is somewhat higher than the shares of local tax revenue that have prevailed for the past five years. From 2005 to 2008, the shares of local tax revenue were, respectively, 21.84 percent, 21.33 percent, 20.99 percent, 21.31 percent. Due to the economic crisis in 2008, both national and local taxes recorded revenue losses for 2009. The revenues of national taxes from 2005 and 2008 were, respectively, 122.3 trillion Won, 132.7 trillion Won, 155.4 trillion Won, and 160.7 trillion Won. It then dropped by 1.73 percent to 157.9 trillion Won in 2009. The loss of local tax revenue in 2009 mainly came from two most important revenue sources of local governments: Resident Tax and Registration Tax. The revenue of Resident Tax, a surtax on national income taxes (Individual and corporate) with the tax rates of 10 percent, was 8.16 trillion Won in 2008 but dropped by 7.5 percent to 7.55 trillion Won in 2009. The revenue of Registration Tax, the second biggest tax item in local taxes, was 6.92 trillion Won in 2008 but dropped by 3.9 percent to 6.64 trillion Won in 2009. As a result, the local tax revenue decreased by 0.7 percent in 2009.

Table 9. Local tax revenue (Trillion Won, %)

	2002	2004	2005	2006	2007	2008	2009
Total	37.53	34.20	35.98	41.29	43.52	45.48	45.17 (-0.7)
Acquisition Tax	5.28	5.37	6.65	7.67	7.26	6.92	6.64 (-3.9)
Registration Tax	7.50	6.72	6.78	7.95	7.25	7.14	7.13 (-0.2)
License Tax	0.06	0.07	0.07	0.08	0.08	0.07	0.07 (1.2)
Leisure Tax	1.08	0.77	0.69	0.69	0.86	0.99	1.00 (1.3)
Common Facilities Tax	0.37	0.46	0.45	0.52	0.54	0.59	0.59 (0.5)
Regional Dev. Tax	0.10	0.11	0.11	0.17	0.10	0.09	0.09 (-1.9)
Local Education Tax	3.96	4.08	3.84	4.34	4.51	4.86	4.79 (-1.4)
Resident Tax	3.90	491	5.50	6.21	7.41	8.16	7.55 (-7.5)
Property Tax	0.82	1.02	2.59	3.11	3.76	4.41	4.42 (0.3)
Automobile Tax	1.75	1.79	1.90	2.13	2.37	2.61	2.83 (8.5)
Motor Fuel Tax	1.06	1.75	2.29	2.71	3.27	3.08	3.29 (6.7)
Agriculture Income Tax	**0.00**	**0.00**	**0.00**	**-**	**-**	**-**	**-**
Butchery Tax	**0.05**	**0.04**	**0.05**	**0.05**	**0.05**	**0.05**	**0.06 (6.4)**
Tobacco Cons. Tax	**2.24**	**2.72**	**2.45**	**2.70**	**2.76**	**2.92**	**3.01 (3.1)**
Aggregate land Tax	**1.41**	**2.03**	**0.00**	**0.01**	**0.01**	**0.00**	**0.00 -**
City Planning Tax	**0.89**	**1.19**	**1.35**	**1.61**	**1.88**	**2.18**	**2.27 (4.0)**
Workshop Tax	**0.47**	**0.57**	**0.62**	**0.68**	**0.73**	**0.80**	**0.81 (1.1)**
Carry Over	**0.58**	**0.59**	**0.63**	**0.67**	**0.67**	**0.59**	**0.60 (1.2)**

Source: Ministry of Public Administration and Security (MOPAS).

In terms of the composition of local tax revenue, the property-related taxes are the most important revenue source for local governments in Korea. The property-related taxes consist of property transaction taxes and recurring or annual property taxes. Among these two types of property-related taxes, property transaction taxes have been predominantly important revenue sources for local governments in Korea. As can be seen from Table 9, 30.5 percent of local tax revenue was from property transaction taxes (Acquisition Tax and Registration Tax). The importance of these taxes was much greater several years ago. The share of the revenue from property transaction taxes in total local tax revenue was 35.3 percent in 2005 and as high as 40.5 percent in 2002. The revenue importance of annual property taxes is relatively less than property transaction taxes. In 2002, the share of property taxes (Common Facilities Tax, Property Tax, Aggregate land Tax, and City Planning Tax) in total local tax revenue was about 11.1 percent. Since then it has steadily increased. From 2004 to 2009, the shares of property taxes in total local tax revenue were, respectively, 13.74 percent, 12.2 percent, 12.7 percent, 14.2 percent, and 15.8 percent.

The steady shift of the balance between property transaction taxes and annual property taxes toward the latter is due to recent changes in property tax system in Korea. Since 2005, the tax rates of property transaction taxes have been continuously reduced. As can be seen from Table 10, the nominal tax rate of Acquisition Tax was 2 percent and that of Registration Tax 3 percent before 2005. In 2005, the tax rate of Registration Tax was reduced to 2 percent. In addition to the change of statutory tax rates, reductions of property transaction taxes have been introduced for three times and are still effective. In 2005, the tax rate of Acquisition Tax was reduced from 2 percent to 1.5 percent. The tax rates of Acquisition Tax and Registration Tax were reduced further to 1.5 percent and 1 percent, respectively, in early 2006. In late 2006, the tax rate of Acquisition Tax was reduced to 1 percent, making the total nominal tax rate of property transaction taxes reduced to 2 percent.

Table 10. Changes of property transactions taxes

	Before 2004	2005
Tax base	Land: official land value Buildings: standard market value	Land: official land value Buildings: NTS standard market value
Tax rate	Individual: 5% - Acquisition Tax: 2% -Registration Tax: 3% - Corporation: 5%	Individual: 4% - Acquisition Tax: 2% - Registration Tax: 2% - Corporation: 4%

	Since 2005 (temporary reduction)		
	05. 1. 5	06. 1. 1	06. 9. 1
Tax base	Actual transaction price		
Tax rate	Individual: 3.5% - Acquisition Tax: 2% -Registration Tax: 1.5%	Individual: 2.5% - Acquisition Tax: 1.5% - Registration Tax: 1.0%	Individual: 2% -Acquisition Tax: 1.0% -Registration Tax:1.0%

Along with the changes in property transaction taxes, a major change also took place with annual property tax system. As discussed before, local property taxes (Aggregate Land Tax and Property Tax) were split into a local property tax (Property Tax) and a national property tax (CREHT) in 2005. As a result of this change, Property Tax is levied on residential property, and three different types of land - - vacant land, commercial-purpose land, and special type of land such as farmland, gold club land, etc. As is shown in Table 11, the tax rates of Property Tax in Korea have progressive rate structures. On residential property, four progressive property tax rates (0.1%, 0.15%, 0.25%, and 0.4%) are applied. Likewise, various tax rates of Property Tax are applied on lands.

Table 11. Tax rate structure of Property Tax

	Residential Property	Land		
		Vacant land	Commercial	Farmland, golf club, etc.
Tax base	Assessed value	Assessed value	Assessed value	Assessed value
Tax rates	0.1%, 0.15% 0.25, 0.4%	0.2%, 0.3% 0.5%	0.2%, 0.3% 0.4%	0.07%, 0.2% 4.0%

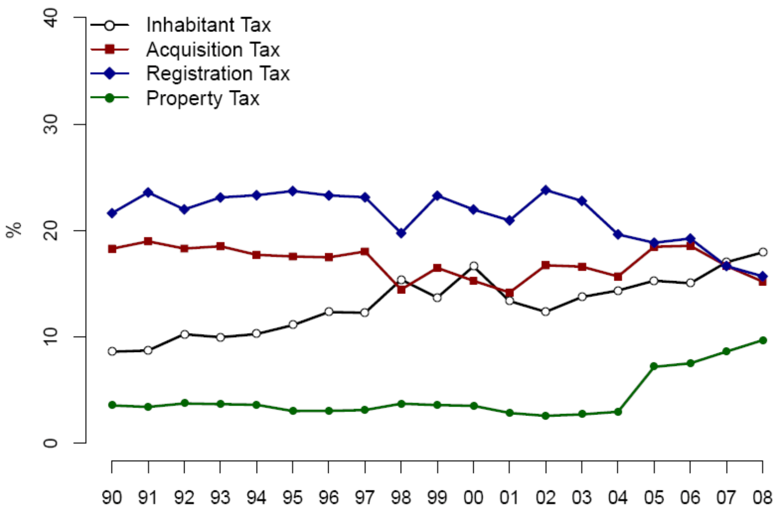
The most significant and politically controversial changes that took place since the property tax reform in 2005 was the introduction of national property tax called Comprehensive Real Estate Holding Tax (CREHT). CREHT has a distinctive feature as a property tax since it is levied by the central government. With a few exceptions such as Sweden and UK, property tax is exclusively levied by state or local governments. It is also politically controversial since the tax rate structure of CREHT is very progressive. First of all, as Table 12 shows, CREHT is levied on residential properties whose value is greater than 600 million Won. From that value on, progressive tax rates of 0.5 percent, 0.75 percent, 1 percent, 1.5 percent and 2.0 percent are applied on residential properties. Moreover, the assessed value of property tax base (both for Property Tax and CREHT) is quite close to market value. Since most of property tax payers only pay Property Tax with tax rates of 0.1 percent or 0.15 percent, CREHT is clearly a very heavily progressive tax. Because of these controversial characteristics of CREHT, the effective tax rate of CREHT was significantly reduced from 2009. As a result the tax revenue of CREHT dropped to 0.977 trillion Won in 2009 from 2.77 trillion Won in 2007 and 2.33 trillion Won in 2008.

Table 12. Tax Rate Structure of CREHT

	Residential House	Land (type 1)	Land (type 2)
Tax base	Assessed value	Assessed value	Assessed value
Threshold	Above ₩600m	Above ₩500m	Above ₩8bn
Tax rates	0.5%, 0.75%, 1%, 1.5%, 2.0%	0.75%, 1.5%, 2.0%	0.5%, 0.6%, 0.7%

Along with major changes in property taxes, it should be also noted that revenue importance of income tax (Resident Tax) has been steadily increased. Before 2000, the share of Resident Tax in local tax revenue was third largest, following Registration Tax and Acquisition Tax. The revenue of Resident Tax has steadily increased since then, and its share is now largest among seventeen local taxes.

Figure 3. Trend of shares of major local taxes



Apart from the issue of property tax reform, there have been two other issues that have occupied the discussions of local tax reform in Korea. As can be seen in Table 9, the revenue importance of consumption tax in local tax system is much less than in national tax system which has VAT and various excise taxes. After a long period of debates on pros and cons of VAT sharing between central and local governments, it was decided that from 2010 five percent of VAT be transferred to local governments in the form of tax sharing. VAT sharing is called in Korea as Local Consumption Tax, but this name can be misleading since revenue from Local Consumption Tax is almost disproportional to local consumption base. More specifically, VAT sharing is disproportional to fiscal capacities with higher distributional weights given to poorer local governments. The distributional weights of Local Consumption Tax are, respectively, 100 percent for upper-level local governments in Seoul capital region, 200 percent for metropolitan cities outside Seoul capital region, and 300 percent for non- metropolitan provinces.

Since the number of local taxes in Korea is seventeen, there have long been discussions on the way to simplify local tax system. As a result, from 2011, major changes take place in the system of local tax in a way to reduce overlapping tax bases and the number of local taxes. Firstly, the part of Registration Tax that is levied on purchases of properties is combined with Acquisition Tax. Secondly, Urban Planning Tax, a kind of property tax levied in the urban area is absorbed into Property Tax. Thirdly, License Tax, which is levied on many types of business operations, is absorbed into Acquisition Tax, which is now levied only on registration of properties that does not involve purchases. Fourthly, Community Facility Tax and Regional Development Tax are combined into Regional Resource Facilities Tax. Fifthly, Automobile Tax and Motor Fuel Tax are combined into Automobile Tax. Finally, Butchery Tax is abolished.

Conclusion

In this paper, key features and recent changes in local public finance and local tax system in Korea were explained. On average, the share of intergovernmental transfers in total local revenue is about 40 percent. Depending on one's viewpoint, this figure may imply that local governments in Korea do not have enough fiscal independence. However, local governments in Seoul region, which have a large number of population, enjoy relatively a high level of fiscal autonomy.

Despite this fact, the most common argument raised in the debate on local public finance reform in Korea is the need for an increase in local tax revenue. There have been many efforts to do so and, as a significant change in this direction, Local Consumption Tax, a kind of tax sharing between central and local governments, was introduced in 2010. The structure of this tax, however, reflects the difficulties of enriching local tax base since Local Consumption Tax is very much like a general grant rather than a pure local tax.

What is perhaps more important than enriching local tax base is to ensure fiscal responsibilities of local governments since the size of local public sector is now larger than that of the central government. This task, however, doesn't seem to be easily achieved. Since 1995, the year when local autonomy was introduced, the share of intergovernmental grants has increased rather than decreased. There are several reasons behind this trend, one of them being the rapidly increasing welfare expenditures of local governments. Therefore finding out an efficient and equitable way to finance increasing expenditure responsibilities of local governments is a significant challenge that lies ahead for both central and local governments in Korea.

MANAGING MUNICIPAL FINANCE IN FEDERAL COUNTRIES: A REVIEW OF RECENT LITERATURE

Mitchell Cook

Abstract

This paper reviews recent literature on the management of municipal finance systems in the United States, Germany, Australia, Mexico and Brazil. It does so by focusing on four main components: revenue enhancement, expenditure management, intergovernmental transfers and market financing of municipal infrastructure. Facing increasing demands for local public goods and services, local governments are prompted to increase their efficiency in service delivery through a range of strategies. The recent literature on municipal finance in federal countries suggests that local and national historical and economic specificities continue to shape local choices in expenditure management, intergovernmental finance and market financing of urban infrastructure. There is a striking convergence in revenue systems, in that, as a result of tax and expenditure limits, cities are increasingly dependent on intergovernmental transfers to finance service delivery and infrastructure provision. This convergence indicates a possible binding constraint to service delivery and infrastructure provision, and consequently economic and human development, in the form of structural fiscal gaps.

Introduction

This paper surveys recent literature on the management of municipal finance systems in five federal countries: the United States, Germany, Australia, Mexico and Brazil. Despite an historical awareness and acceptance of the economic and social benefits from the devolution of administrative and financial responsibility to the local level, over the past decade these federal countries have experienced significant volatility in the stock of financial resources available to municipalities to manage the multidimensional process of urban development. The impact of globalization has resulted in intense interurban competition to attract productive firms in leading economic sectors. Paradoxically, much of the discourse during the 1990s on the role of government in economic development advised a near absolute retreat of the state despite an increasing demand schedule for public goods and services in cities around the world. Structural changes in local revenue systems led invariably to a general imbalance between municipal revenue and expenditure responsibilities in most countries at the turn of the century. Consequently, municipalities were increasingly forced to rely on intergovernmental grants and debt finance to fund revenue gaps, not only for capital expenditures but also to service current accounts. It is in this broad context that the novel strategies of local public financial management elaborated in this paper were developed and deployed by local governments.

Early models of fiscal federalism delineated a limited field of fiscal intervention at the local level, namely allocation of the local budget to enhance social welfare at the local level (Musgrave 1959; Tiebout 1956; Oates 1968; Oates 1972; Olson 1969). These initial assignments of the distribution of responsibilities between levels of government were derived from the literature on public finance and focused almost explicitly on the provision of public goods by a single unit of government. As such, they were limited by their rigidity in considering certain local public goods that created interjurisdictional spillovers and the particular level of government that should be responsible for providing them. What became the normative model of fiscal federalism was built on pure assumptions of economic efficiency and the beneficence of public officials to identify market failures in the provision of collective goods. Initially, these models were not inclusive of socio-political influence within the public decision-making process, a field of inquiry subsequently developed through public choice theory and since applied to the operation of federal systems (Buchanan 1975; Mueller 2003; Howell-Moroney 2008). However, as Bird points out, "much has been written about the virtues of decentralized government…however, little progress has been made with respect to articulating these arguments in either normative or positive terms in the conventional fiscal federalism analysis" (Bird 2005, 147). Following these limitations, the fiscal federal framework for deciding local financing choices has been extended to satisfy four criteria: economic efficiency, national equity, administrative feasibility and revenue adequacy (Shah and Shah 2006, 11). Oates (2005) believes a consensus is building around what he calls a second generation of fiscal federalism theory inclusive of the behavior of political agents and problems of asymmetrical information in collective choice institutions.

While the intent of this paper is not to provide an account of the evolution of fiscal federalism theory within public finance literature, it is useful to employ fiscal federalism theory to denote briefly from where the numerous permutations of municipal finance policy originate. As the most decentralized fiscal institution in the public finance system, cities by definition exist within a multidimensional matrix of intervening variables. Empirical evidence has shown that in practice, municipal finance systems are vulnerable to a broad range of both endogenous *and* exogenous conditions that influence performance and efficiency in the provision of local public goods. This vulnerability is exhibited at the municipal level in the presence of cascading effects that inhibit the capacity of local governments to respond to local demand, for example, from periodic external shifts in policy or changes in the domestic and international economy.[1] Thus, the evolution of an *optimal* municipal finance system entails a broader consideration of *efficiency* within the public finance system that is sensitive to both the utility-maximizing interests of socio-political institutions and also the structure of the economy in which the public sector is embedded (Gordon and Li 2009, cited in Gordon 2010).

The rest of the paper proceeds as follows. In the next section, I survey new developments in four components of municipal finance systems in the United States, Australia, Germany, Mexico and Brazil: revenue enhancement, expenditure management, intergovernmental transfer systems and market financing of municipal infrastructure. Recognizing the tendency towards "isolation of process from context and outcome" in urban studies (Fainstein 2005, 121), the review also annotates the role of municipal government in financing redistribution activities such as slum upgrading, the provision of low-income housing, education and other distinctly local public goods through budgetary expenditures and tax credits. As the paper covers multiple components of the recent municipal finance experience within five federal countries, a field of inquiry marked by tremendous regional and international variation, it does not presume to be an exhaustive analysis of management strategies but is necessarily limited to highlighting new developments within broad trends while providing references to local examples. The paper concludes with a brief review of similarities and differences across country experiences.

International Experience

The five countries selected for this review have developed distinct municipal finance systems embedded within the larger fiscal federal system, as a result of the dynamic process of fiscal decentralization. With

---

[1] For example, policy shifts in intergovernmental fiscal relations, the evolution of tax bases in relationship to increasingly mobile factors of production, and access to stable credit to finance capital expenditures are conditions that have complicated municipal budgetary performance but which are derived from processes outside the city.

widespread recognition of the contribution of cities to economic growth and development, there has been a recent spate of edited volumes on municipal finance systems in developing countries (UN-Habitat 2009; Shah 2007a; Shah 2007b; Shah 2006a). Bird and Slack (2004) elaborate a comprehensive list of fiscal issues faced by municipal governments and special districts, including local expenditures, taxes and user charges, intergovernmental transfers and the financing of infrastructure through structured debt, development charges and private participation. Shah (2006b) develops a comparative overview of local public financial systems in industrial countries by adopting conventional measurements of decentralization: the share of local expenditures in national GDP, total local revenue and revenue autonomy and local access to debt finance. However, as the country experiences show below, the mobilization and deployment of municipal fiscal resources depends not only on local government performance in fiscal management but also on the shifting fiscal position of cities in the public finance system.

The United States

The municipal sector in the United States plays a prominent role in both the financing and distribution of local public goods and services. From a comparative perspective, the structure of the fiscal federal system as it relates to urban finance in the United States is close to normative efficiency models of public finance: cities have access to a broad tax base, the freedom to diversify revenue streams, and are entirely responsible for financing purely local goods such as public safety and public utilities. A decomposition of local government expenditures for the year 2002-2003 shows primary expenditure priorities by local governments in the United States: education (37%), social services (10.7%), utilities (10.2%), public safety (9%), and transportation (5.6%) (Laubach 2005). There are over 89,000 units of local government, divided between general purpose local governments, school districts, and special purpose districts that focus on targeted economic development, though there is much interstate variation in the classification of local governments and assigned responsibilities (US

Census Bureau 2007). Despite variations in legal incorporation, structure and size of local governments across states, cities in the United States exercise revenue powers that are generally aligned with expenditure responsibilities.[2] In 2007, local governments collected approximately $1.3 trillion in general revenue ($834 billion in own source revenue) and totaled expenditure receipts of $1.5 trillion (Ibid.).

Revenue Enhancement

Due to a long trend in a declining share of revenue receipts from property taxes, local governments in the United States have increasingly turned to user and service charges and earned interest from deposits to enhance their revenue. The composition of municipal revenues changed drastically during the period 1970-present, with user and licensing fees increasingly substituted for decreased direct taxation. Over the period 1972-2005, income derived from property taxation dropped from 25.6 percent of own-source revenue to 16.6 percent and user charges and miscellaneous general revenue, primarily interest earned on deposits, increased from 4.6 percent to 8.8 percent (Ruben and Rosenberg 2008). As a result of the global economic crisis, declining sales tax revenues, lower property tax receipts and drastic cuts in state grants are likely to depress municipal revenue receipts for the budget cycles 2010-2012, leading to a projected budget shortfall of $56-$83 billion for the municipal sector (Hoene 2009). Absent tax policy changes, local governments are projected to face prolonged fiscal gaps through 2050 (GAO 2007).

Over the past decade, municipal revenue enhancement strategies have developed during a period in which a complete business cycle of municipal revenue has occurred, beginning with the recession of 2001 and ending with the current economic crisis. Revenue enhancement during this

[2] The particular application of “home rule” as a legal mechanism to define the scope of local autonomy varies across states but has important implications for the fiscal powers of local governments. For a detailed analysis of how home rule is applied in jurisdictions across American states, see Krane et. al. (2001).

period was also influenced by the evolving response of municipalities to constitutional and statutory limitations on the scope of local revenue powers, beginning in the 1970s with the passage of Proposition 13 in California and extended to local governments in almost every state through the 1990s. The growth and diffusion of tax and expenditure limits (TELs) did prove to constrain own source revenue of cities, particularly through limitations on the property tax growth rate which has generally been the main source of revenue to US cities (Skidmore 1999). Facing shrinking revenue streams from TELs, cities were forced to explore alternative financing strategies which resulted in the growth of user fees and charges and local option taxes, as non-tax revenue sources and voter-approved taxes are generally exempt from home rule limitations established by state governments.[3]

Reynolds (2004) categorizes the shift in revenue structure in American cities as a "get what you pay for" mentality within municipal finance that negatively impacts the distribution of public goods and services to poorer communities. Analyzing the compositional shift of municipal revenues away from the property tax, Krane et. al show that "in a dozen states charges and user fees are the 'main' source of city revenues, in six states the primary source is the local sales tax, state aid is the largest source in four states, and in one state business and commercial fees make up the bulk of city revenues" (2004, 525). Edwards (2006) provides a more comprehensive survey of the adoption of user fees and charges by US cities, showing that while there is broad employment of this alternative to property taxation, there is much variation in the degree to which it is applied to finance public services across counties, cities and special districts.[4] While there has been a nationwide trend in local revenue

---

3 For an analysis on the link between the legal incorporation of cities and their fiscal position, see Gillette (2008).

4 As of 2003, approximately 36% of local government own source revenues was derived from service and utility charges. The study found some variation in the reliance on user charges for own source revenue depending on the type of local government: counties (32.2%), municipalities and townships (39.5%) and

structures shifting away from property taxes, there are exceptions to the pattern. Dye (2008) looks specifically at municipal revenue systems in the New England region and shows that local governments rely heavily on property taxes, from 43-56% for total revenues, while charging for services comprises only 8%-13%.

Accompanying the increasing reliance on user charges and impact fees, the growth in use of local option taxes to finance new infrastructure provision suggests that an attendant result of the shift in revenue structure away from property taxes is increased transparency in the financing of municipalities. The National Conference of State Legislators in 1997 conducted a comprehensive study of the design of local option taxes, whose adoption by municipalities was rapidly advancing in the 1990s in efforts to recoup lost property tax revenues (Mackey 1997). Goldman and Wachs (2003) chronicle the historical development of local option transport taxation in the United States and how it has replaced user charges as the primary source of funding *new* transportation infrastructure, while gasoline taxes and various tolls continue to finance operations and maintenance.[5] On average local option taxes promote devolution of revenue authority and enhance the fiscal capacity of local governments. Green confirms these qualities and looks at how local option sales taxes (LOST) in California reshaped infrastructure finance in the state, “placing the onus on elected officials, and ultimately the people” (2006, 93). While local option taxes do entail a shift to more direct democracy by devolving revenue powers away

special districts (73.3%) (Edwards 2006, 11). See table 1 in the appendix for the share of particular fees in total fees levied by municipal governments for 2002-2003. For a review of the use of developer and impact fees and exactions, see Slack (2002).

5 Included in the study is an analysis of the types of local option taxes levied to finance transportation infrastructure. The authors find that local governments (cities, districts, counties) levy versions of local option taxes on vehicle license and registration in 18 states, gasoline taxes in 9 states, transportation capital projects in 17 states, for transit in 16 states, and on income and payroll taxes in 5 states.

from state to local governments and by allowing local constituents to decide by vote the level of local taxation, the consequences of local impact taxes go beyond just additional revenue for local governments. Lyons and Lav (2007) look at alternative sources of local revenue and find that, as a replacement to property taxes, local option sales taxes can be regressive. The urban poor are less likely to own property and so any reduction in use of the property tax that is replaced by local sales taxes will raise their tax burden. LOSTs also have distinctly spatial implications for the distribution of revenue resources within the urban system. Rogers (2004) uses localities in Oklahoma, a state with no restrictions on levels of LOST, to test the "urban bias" of local option sales tax policies, proving that the ability of smaller local governments to generate revenues from LOST depends highly on their proximity to large retail centers. In a study on LOST policy in 159 counties in the state of Georgia, Zhao and Hou (2008) find that local option taxes in the state exacerbated interurban fiscal disparities.[6]

Fiscal disparities between local governments also have materialized due to the proliferation of sublocal units of governance, a revenue enhancement strategy that municipalities deploy to levy additional taxes and fees and determine the provision of specific public goods and services. Briffault (1997) discusses the impact of the subdivision of local government and lists four types of sublocal structures: enterprise zones, tax increment finance districts, special zoning districts and business improvement districts. Tax increment financing (TIF) is used by municipalities in all 50 states to finance development from future property tax revenues from a geographically delimited area of the city. As such, it is a financial vehicle

[6] This study highlights the complexities of the relationship between local-state relations and revenue powers. The devolution of authority to levy local option sales taxes increased fiscal disparity among counties in the state. To offset the disparities, the authors propose that a new state sales tax could be levied with a distribution formula sensitive to both the local "option" tax but correcting the disparity it produces. However, any additional state sales tax would minimize the net devolution of revenue power to local governments were it to be implemented. Thus, the balance of revenue powers might be in constant fluctuation following state-level responses to the patchwork of LOSTs at the local level.

used to overcome deficits in state and local revenue by generating revenue "off-budget' or off balance sheet" (Leavitt et. al. 2008, 93). The central benefit of tax increment financing is that a proportion of the incremental tax generated after a TIF district gets proposed and a base property tax rate established for all taxing authorities within the district is returned to the municipality or the redevelopment agency. Financing for initial development of the district comes from borrowing or bonds issued against incremental revenue gains (Slack 2005).[7]

TIF is most successful when it is applied to areas of the city that have a high potential for rapid increases in the incremental value of land. Thus, its most popular use for cities is in revitalizing struggling neighborhoods and expanding development to areas of the city that are vacant. Additionally, the special zoning of TIF districts is usually granted for a period of 15-35 years and so the time horizon of opportunities for municipal planners to engage the private sector in developing the area is much longer. Weber and Goddeeris (2007) review the application of tax increment financing through case studies and look at the implications of TIF for employment, property values and the impact on overlapping jurisdictions.[8] In a case study on tax increment financing to attract high-tech businesses in Kalamazoo, Michigan (Kalamazoo Smartzone), they show how publicly owned land can be used to attract profitable business when the land is quickly converted to private use and minimal, targeted tax abatements to new industries are provided.[9] Tax increment financing along

[7] For a more detailed and comprehensive analysis on the relationship between TIF and economic development, see Johnson and Man (2001).

[8] Much analysis has been done on the impact of tax increment financing on property values in Chicago, for example in Smith (2006), Webber et. al. (2007), and Dye and Merriman (2000).

[9] As a method of developing low-use land, significant management risks accompany the use of tax increment financing. The Kalamazoo case illustrates this issue. TIF districts generally have minimal public services (e.g. police and fire stations), many of which do not pay property taxes and so must be provided without remuneration in the form of revenue from incremental property tax increases.

with the expanded use of local option taxing and a range of local charges, development fees and exactions has entailed a broadening of the revenue stream and for many cities, added complexity to a once uniform revenue system based primarily on the property tax. This trend in municipal finances in the United States has not been without consequences. In a regression analysis of both local revenue diversification and local revenue complexity in 28,185 cities during the period 1970-2002, Carroll (2009) shows that when revenue complexity accompanies local revenue diversification there is significantly greater risk for volatility in the revenue stream. Diverse and complex revenue systems for local governments in the United States have spurred necessary increases in investments in revenue forecasting. Likewise, the management of expenditures has become a major priority in the municipal sector.

Expenditure Management

Expenditure management by local governments in the United States centers on the processes and outcomes of the local budget.[10] All local governments are legally mandated to undergo regular audits of expenditures by state auditors and larger municipalities contract private accounting firms to manage the transparent review of their expenditure and revenue accounts. Local budget practices in the United States have evolved most recently from zero-based budgeting (ZBB) to performance-based budgeting (PBB). PBB focuses on establishing and achieving outcomes based on public demand, systematically measuring outcomes based on departmental objectives, linking appropriations to agency results, and allowing freedom of allocation in program management by stressing outcomes and not inputs (Hager et al. 2001, 10). As it has been applied in the United States, the objective of PBB is to move beyond pure models of financial accounting, such as line-item budgeting, to apply innovative

[10] For an analysis of the efficacy of US municipal governments in managing budget imbalances through expenditure adjustment, see Buettner and Waldasin (2006).

management strategies based on achieving specific development outcomes in the city. In their review of PBB for state and local governments, Kelly and Rivenbark (2003) hightlight that, in the case of bond performance, rating agencies consider variables such as the future projections of the local economic base and present management capacity to determine bond rating changes. By implementing performance-based budgeting, city governments are able to show not only how expenditures are allocated and the existence of revenue to fund them but also how current expenditures will impact future economic growth, ensuring access to credit through a good rating.

It is not possible to provide a systematic assessment of PBB in US cities in such a short space, but a specific case can illustrate how it is implemented in practice to manage municipal expenditures. Epstein et al. (2002) look at the case of Sunnyvale, California, which in 1996, shifted to a performance-based planning and management cycle. Sunnyvale has a population of approximately 130,000. Within Sunnyvale's planning and management system, city managers establish 20-year revenue and expenditure forecasts that are attached to two-year budgets from each department. The two-year budget is performance-based and outlays are determined based on desired service levels and outcomes. The city regularly makes cost comparisons with the private sector and the long-term planning combined with short-term establishment of budget priorities aligned with targeted outcomes has allowed the city not to have to make drastic cuts to programs by anticipating future costs and revenues. Performance based budgeting also has resulted in making municipal budgets more legible to citizens and enhancing accountability, as expenditure levels are tied to actual development in the city (Kelly and Rivenbark 2008).

An important technical area of expenditure management that has received recent attention in the literature is the issue of managing the capital budget. With direct expenditures by local governments on capital investment totaling over $214 billion for the year 2006-07, a figure that nearly matches the amount spent by local and state governments *combined* in 2002-03, the management of capital expenditures has become a critical component of expenditure management (US Census Bureau 2007). The critical components of a dynamic capital management system are long-run planning, capital budgeting and programming, project management and maintenance (Ammar et. al. 2001). Ebdon (2004) looks at innovative methods of capital management in 40 large counties and finds that over three-fourths have capital improvement plans of 5 or more years but that capital asset maintenance remains an area of weakness in the municipal sector. The lack of planning for capital maintenance is demonstrated in municipal accounting practices. In the past, local governments have not had to report the value of their infrastructure, allowing them to hide depreciation expenditures or ignore them completely. They now have to report capital depreciation expenses, a major development in capital budgeting (Ebdon 2007).

Intergovernmental Transfer System

With pressure on revenue streams due to tax and expenditure limits (TELs), the intergovernmental transfer system has become more active in financing municipal activities. Although there is no formal transfer system to balance vertical and horizontal fiscal disparities in the United States, targeted grants in the areas of healthcare, education and transportation make up the majority of service areas in which local governments rely on intergovernmental finance. In 2001, 26% of state revenue came from grants-in-aid from the federal government and 36% of local general revenues came from transfers from state governments (Tannenwald 2004). As of 2007, only 11.3% of total intergovernmental transfers to cities came from federal grants, suggesting that states continue to serve an intermediary function in transferring funds from the federal to the local government (US Census Bureau 2007). While there is much interstate variation in funding priorities within the transfer system, the degree to which local governments are dependent on intergovernmental grants depends most often on the fiscal capacity of cities to provide local services, particularly in the case of education.[11] Shroeder (2006) details the state-local transfer system for public education, in which five types of grants and various transfer formulae are utilized by states to funnel resources to city governments and local school districts. Because local governments are highly dependent on the property tax, which produces sizable variation in total revenue depending on local conditions, equalization of school funding across jurisdictions has been a consistent priority of the intergovernmental transfer system.[12] This priority to equalize across regions is confirmed by evidence from Moser and Rubenstien (2002) who show that national equality in public school district funding increased in the 1990s.

The intergovernmental finance system has undergone broad shifts in policy over the past 30 years. Federal aid to local governments now only accounts for around 4% of total local revenue (Brunori 2007, 97). Because of reductions in federal aid, local governments have become more dependent on state transfers, inducing a recentralization process within fiscal policy though, once again, the caveat of interstate variation applies. The composition of federal grant-in-aid to state and local governments shows that a consideration of local governments as creatures of the states continues to be the operating framework of fiscal federalism as it relates to municipal finance. In 2007, nearly 44% of federal transfers were earmarked for Medicare and Medicaid services, health-related programs operated by state governments (US Census Bureau 2007). Approximately 20% of federal funding to state and local governments was divided equally between the Department of Transportation (DOT) and the Department of Housing and Urban Development (HUD) (Ibid.).

Market Financing of Urban Infrastructure

[11] Over 50% of state aid to cities goes to financing public education (US Census 2007).

[12] For a more detailed analysis of the increasing role of states in funding local school districts, see Murray et. al. (2007). Baicker and Gordon (2006) argue that state aid to local governments has increased general revenue available for education expenditures, but intergovernmental finance for education comes at the expense of other local public welfare services.

Even while the majority of current expenditures by local governments are financed from local property tax revenue, the municipal sector in the United States has for nearly a century had access to debt financing in the form of municipal bonds to finance capital investment. The long-run presence of a sophisticated credit market has been the central force behind the market provision of urban infrastructure. The credit market for subnational debt is tightly managed by state government regulations and by principles of market discipline by lenders, both of which have contributed to comparatively low rates of municipal default. As of 2007 total outstanding debt for local governments was $1.4 trillion, over 95% being long-term (US Census Bureau 2007). There are two categories of municipal bonds, most of which are tax-exempt: general obligation bonds, which are backed by the full faith of state and local governments based on their tax authority; and revenue bonds, in which principle and interest payments are financed from future revenues from the project.[13]

Recent developments in the municipal bond market have generally revolved around financial innovation in the municipal bond market, particularly the use of municipal derivative securities to service non-recourse revenue bonds.[14] Stewart and Cox (2008) look at reporting of municipal derivative securities by local governments and find that by 2003 debt-related derivative activities by 23 large cities had totaled over $10.5 billion. Debt finance to municipalities in the form of floating rate bonds exploded over the previous decade. The market for auction rate municipal

[13] While general obligation and revenue bonds are the two categories of municipal bonds, there is a broad variety of municipal securities that fall under each category. For example, bonds issued to raise funds for discretionary expenditures such as stadiums or pension funds are considered taxable bonds and are not tax-exempt. The Bond Market Association of the United States has published an authoritative volume on municipal securities (Bond Market Association 2001).

[14] Floating rate municipal bonds are generally auction rate bonds (muni ARS) in which interest and dividend rates are reset periodically by auction or variable rate demand obligations in which a floating interest rate is adjusted periodically. Non-recourse revenue bond obligations make up 60%-70% of the total municipal bond market (Peterson and Chihfield 2000, 12).

bonds grew from roughly $2.5 billion in 2000 to over $20 billion in 2005 at its peak before falling to $12 billion in 2007 and then collapsing completely during the financial crisis of 2007 (Han and Li 2008). These two trends combined to threaten many of the foundations of the municipal bond market in the United States with the onset of the financial crisis. With growth in floating rate bonds, municipal bond issuers sought credit enhancement from many of the largest international monoline insurers and financial guarantors transferred their AAA ratings to non-recourse municipal securities. When the financial crisis caused a downgrading in the credit ratings of insurers that were backing floating rate bonds, interest rates soared and municipalities were unable to service their debt (US House of Representatives 2009). Peterson (2009) cites the example of Jefferson County, in which the county government switched a fixed-rate 30 year municipal bond for capital investment in the sewer system into an adjustable-rate demand note upgraded to AAA rating by a monoline insurer. Once the financial crisis had fully materialized, the insurer's credit rating was downgraded and with it the municipal bond, raising interest rates to 10% and giving bond holders the right to accelerate payment. Payments due on the debt ballooned to $636 million and the county nearly defaulted.

Social Reproduction Functions

The National League of Cities recently conducted a national survey of city managers' perceptions on urban poverty. In the survey, the authors asked two questions in regards to municipal fiscal policy facilitating redistribution of resources: if city government has a responsibility to reduce poverty and which level of government has the most responsibility. Eighty percent of the respondents stated that reducing poverty is an "important part of a city government's responsibility" but 67 percent of city officials responded that the federal government should have the most responsibility (Furdell 2008, 15). These perceptions reflect closely the public finance system as it relates to poverty: municipal governments have important service delivery functions but rely almost entirely on the intergovernmental transfer system for the provision of social services and income maintenance, administered by the state and funded jointly with the federal government. Gais details the public welfare system in the United States and the fiscal role of state and local governments in the provision of social services, finding that

> *Most of the dollars spent by state and local governments on social welfare functions came from revenues raised by the federal government, which typically passed the money down to state and local public agencies through intergovernmental grants, such as Medicaid, Temporary Assistance for Needy Families (TANF), or the Child Care and Development Block Grant (CCDBG). Of total social welfare spending in 2006, 61 percent ($224.2 billion) came from federal sources. State and local governments funded the remaining 39 percent ($144.3billion) out of their own revenue sources (Gais 2009, 559).*

Much of the reasoning behind federal funding of social welfare functions lies with the design of the urban system in the United States. For example, labor markets are often intersected by county divisions which complicate the assignment of fiscal responsibility for social services at the local level (Katz and Allen 2001).[15]

Local governments, however, are increasing their fiscal role in the provision of affordable public housing through the use of public housing trust funds, which operate as independent accounts funded by dedicated revenue streams. Scarcity of federal subsidies has constrained the once dominant federal program of financing community development block grants (CDBG) to local governments for use on public housing and

[15] The author cites the case of Atlanta, where over 20 counties operate welfare systems within a single labor market, illustrating how the diverse system of administrative units impacts local fiscal policy.

neighborhood improvement initiatives (Schwartz 2006). This decline prompted local citizens and officials to consider other financing structures for solutions to providing housing for the urban poor. Housing trust funds come from a variety of revenue sources – property taxes, developer fees, sales taxes, and matching grants from states – and allow cities greater flexibility than intergovernmental grants as they exercise exclusive control over the appropriation of revenues. Housing trust funds are not a new phenomenon in municipal finance in the United States, but their growing use over the past decade is striking. Their numbers have tripled over the past four years, with now over 550 city, county and regional housing trust funds across the United States (Brooks 2007).[16]

Australia

Local government in Australia is established through State and Territory legislation. There are over 700 local government units throughout the country though their size and distribution are subject to much regional variation.[17] Expenditure responsibilities are assigned by State governments and have historically entailed a narrow field of intervention, namely the delivery of essential services and construction and maintenance of local roads. At the national level, a decomposition of local government expenditure by function shows expenditure patterns in 2005-06: housing and community amenities (23.4%), transport and communications (21.5%), general public services (19.8%), and recreation and culture (14.1%) (Australian Government 2009, 18). However, over the

16 The report highlights a high degree of variation in revenue systems and allocation priorities across states and localities in their use of housing trust funds. The report states that, among others, housing trust funds are commonly used to finance affordable rental housing, new housing stock construction, neighborhood and community revitalization, transitional housing, and even public education if it relates to housing issues.

17 The Australian Council of Local Government (ACLG) classifies local bodies between into 6 categories, 4 urban and 2 rural. The two rural categories make up 43% of local councils but only 9.5% of the total population (PricewaterhouseCooper 2006).

past two decades, there has been a general trend of city governments drifting into new expenditure categories, as a result of local demand signaling, without devolution of increased funding or broader tax authority. While serving an important role in public service provision, the fiscal sustainability of local governments in Australia has come under new pressure, making local fiscal policy reform a national priority.

Revenue Enhancement

Although expenditure responsibilities in the municipal sector comprise only a small percentage of the total primary sector, the municipal sector has slowly progressed toward structural deficits, particularly in transport infrastructure provision and maintenance. In 2006-07, local government expenditures accounted for 2.16% of GDP (Ibid, 3). To finance these expenditures, local governments generate and manage revenue from three main sources: property taxation (rates), user charges and fees, and intergovernmental grants. The most recent data on municipal revenue show that Australian cities are highly dependent on own-source revenues for their financing. In 2006-07, revenue from property rates accounted for 37% of total revenue, fees and charges contributed to 30.1% of total revenue, and interest and other revenue accounted for 23.7% (Government of Australia, 3). However, state differences including distribution of population, policy differences and expenditure responsibilities influence the degree to which local governments are reliant on own-source revenue.[18]

Local revenue enhancement strategies in Australia generally rely on increasing the occurrence and price of local fees and charges and shifts in intergovernmental fiscal policy. The limited policy space for revenue enhancement is a result of three structural trends in the composition of

[18] Local councils in the Northern Territory, a largely rural region, for the period 1998-2006, only generated on average between 46-51% of their total revenue (Australian Government 2008, 29).

municipal revenue: the share of local tax revenue in national tax revenue, which dropped from approximately 6% in 1970-71 to 4.28% in 2003-04; the falling value of Commonwealth Financial Assistance Grants (FAGs), which as a percentage of the current budget have declined from 1.18% in 1993-94 to now less than one percent; and the continued forced reliance on the property tax as the only source of tax revenue for local government (Dollery et. al. 2006).[19] Local property tax revenue, as a percentage of GDP, decreased from 1% to 0.9% during the period 1990-2006 (Australian Government 2008, 7). Declines in local tax revenue during the period were augmented, in part, by the increasing assignment of user charges and fees

---

[19] For a description of methodology of property tax rate-setting on a state-by-state basis, see PricewaterhouseCooper (2006, 47-48).

IMFR

to finance service provision.[20] Despite a growing imbalance between expenditures and revenue at the local level, the literature on the demand for revenue enhancement is mixed and reflects many of the underlying pressures of a centralizing subnational fiscal policy.

The shifting composition of expenditures beyond essential services and the legal constraints on the local tax regime suggest that revenue enhancement in Australian cities is more a function of recalibrating the existing revenue system than of diversifying the revenue stream, as in the United States.[21] The Australian Government (2008, 87) found that urban councils are raising approximately 85% of possible revenues, suggesting there is some potential for own-source revenue enhancement when controlled for intergovernmental transfers. Johnson (2003, 52) reviews the state of local finances and concludes that, "while setting rates at a realistic and sustainable level to fund demands facing local government should be

---

20 This category of revenue saw the largest growth out of all revenue sources since 1974-75, growing 13 percent annually (Dollery et al. 2006, 73). The council share of revenue from fees and charges varies depending on the jurisdiction but is generally aligned with state-mandated service provision. Cities in Queensland, Tasmania and New South Wales are principally responsible for the provision of water and sewerage services while local councils in other states and territories are not. The share of revenue from user charges in total revenue for local councils in these states is 45.0%, 41.1% and 33.8% respectively, higher than the national average. See McBride and Moege (2005).

21 Local government revenue enhancement in Australia cannot be divorced from the expanded profile of services it is providing. According to the Commonwealth Grants Commission (2001), the expenditure pattern of local governments has changed dramatically over the past 40 years. As a percentage of total outlays, expenditures on local roads have declined to around 25% from 49% in 1961-62 while expenditures on education, health, welfare, and public safety have grown from 3.8% in 1961-62 o 11.6%. Likewise, other human development expenditure categories like recreation and culture have grown from 7.9% to 18.3% over the same period. A discussion on how the nature of these public goods should influence the composition of local revenue and whether or not the shift in revenue composition satisfies axioms of public finance is outside the purview of this literature review. For a review of these issues in the context of Australia, see Dollery et. al. (2006).

given a priority, it will not solve the funding constraints faced by local government in its entirety". The Australian Local Government Association estimates that the national funding gap to address local infrastructure backlogs is $2.16 billion, or 9% of municipal revenues, and recommends higher user charges and rates and increased support from higher tiers of government (PricewaterhouseCooper 2006, 112).[22] Stimulating the adoption of user charges and fees and limiting the use of property taxes can play an important role in achieving important infrastructure provision targets while directly limiting the environmental impact of unconstrained spatial development (Neutze 1995). However, as has been the case internationally, the shift towards user charges and fees is not without consequences. In the case of Australia, Crase and Doller (2005) warn of the illusion of local fees and charges as revenue enhancement, particularly if they are applied to general services, when in reality their application is a response to continuing tax limitations on local bodies. Holmes et. al. (2008) show the intergenerational impact of the shift away from property taxes to user fees and charges, forcing young consumers of public goods to finance infrastructure upfront instead of over their lifetime and the life of the capital asset. The authors reference the case of sewerage costs in Melbourne, where former residents were able to pay indirectly through the property tax while new residents are forced to fully finance provision through private charges.

Expenditure Management

At the national level, the most prominent expenditure management strategy for Australian cities has been the policy of amalgamation. Council consolidation has occurred since the beginning of the Commonwealth but its acceleration since 1991 sparked a national debate on the merits of local

[22] The statutory regulation of charges and fees varies depending on the state and is outlined in Australian Government (2008, 207). Major differences by state exist in cost recovery levels and the pricing of services. For example, Western Australia limits fees and charges to cost recovery but in New South Wales, most charges except for waste management can be set at prices above full cost recovery.

structural reform.[23] In general, consolidation has taken two forms: regional cooperation and absorption by a larger city. In both cases, theoretically, economies of scale in service provision from amalgamation benefit both local consumers and the city government's balance sheet. Dollery et. al. (2007a, 12) test the policy rationale given by proponents in Australia of amalgamation, which include increased administrative capacity derived from larger municipal units and an economization of direct administrative costs, against fiscal data and find "no systematic relationship between council size and council sustainability, at least in the South Australian local government milieu". Dollery et al. (2007b) look at recent national and regional reviews of local government sustainability to assess perceptions on the operational efficiency gains from council amalgamations in New South Wales, Queensland and Victoria and conclude that, contrary to historical precedent, a new movement against amalgamation is building among policy makers.

At the local scale, there is much regional variation in expenditure management strategies. Expenditure management is broadly regulated by performance monitoring at the state level. Because the states and territories have an interest in maintaining a local hard budget constraint, systematic oversight of local government "sustainability" includes review of local government's financial performance. Murray and Dollery (2005) examine the performance monitoring criteria for local governments in New South Wales, in which four of the seven key financial indicators relate to expenditure management. Regarding local budget management processes, the use of program budgeting is used throughout Australia. Kluvers (2001) surveys local officials in Victoria to assess the impact of planning programming budgeting (PPB) on the public sector and finds that program budgeting's specific impact on the municipal sector has allowed them to better distinguish between direct and allocated costs and that PPB better controlled costs than any other budgeting framework.

---

23 According to the Australian Government (2005), the total number of councils has decreased by 27% since 1991.

IMFR

Intergovernmental Transfer System

The intergovernmental finance system in Australia has played an important role in augmenting local government finances and in financing the administration of state and territory programs in Australian municipalities. Because of the small share of total national tax revenue controlled by cities, grants are disbursed to states and territories on the condition that they distribute them to local governments. Commonwealth grants to local governments are intended to achieve both vertical and horizontal fiscal equalization.[24] States and territories also administer transfer programs, each tailoring grant formulae and priorities to match the specificities of local government functions in the state or territory. Because of the wide variation in state grant programs, this section will only focus on issues related to Commonwealth grants. While the intergovernmental finance system has maintained a consistent presence in local government finances, its importance to urban local governments varies but is, in general, coming under increasing pressure as broader demand for local goods and services stretches own-source local financial capacity.

Because of the revenue structure of local governments, the distribution of grant funding pivots more on municipal population than any other factor.[25] The Commonwealth distributes two forms of transfers:

---

24 The Local Government (Financial Assistance) Act 1995 Section 3 states that grants are given to the States for the purposes of improving "the financial capacity of local governing bodies; and the capacity of local governing bodies to provide their residents with an equitable level of services; and the certainty of funding for local governing bodies; and the efficiency and effectiveness of local governing bodies; and the provision by local governing bodies of services to Aboriginal and Torres Strait Islander communities."

25 Worthington and Doller (2000) review the methodology adopted by state-based Local Government Grant Commissions (LGGC) to determine Commonwealth grant distribution, which in short, channels higher outlays to more populated cities. However, this is only in the aggregate. In New South Wales, grant revenue as a percentage of total local revenue in 2003-04 was

Financial Assistance Grants (FAGs) and Specific Purpose Payments (SPPs). FAGs come in two forms, general purpose funds and untied road funds, and are distributed first as tied grants to state governments to be given to local governments without conditions. The Commonwealth Grants Commission (CGC) disburses a lump sum of FAGs according to a discrete amount equal to the previous year's outlay multiplied by expected population change and consumer price index (CPI).[26] SPPs are tied, targeted grants assigned by the CGC to specific functions, distributed to local governments both directly and through the state and territory governments.[27] The total volume and value of SPPs has grown to now represent 20% of general purpose FAGs funding (Australian Government 2009, 56). The growth of SPPs, interventions by Commonwealth government into local affairs in the form of tied discretionary grants, has created new opportunities of political interference in the intergovernmental finance system. Worthington and Dollery (1998) design a model of political influence on the transfer system and find empirical evidence that political factors in Australia do effect the distribution of Special Purpose Payments. SPPs can also negatively impact state budgets by limiting state control. Even though SPPs constitute around 15% of state's total revenues, through conditionalities they can control over double that amount by mandating specific matching budget outlays (Warren 2006, 6).

1.8% for Sydney City, 9.8% for metropolitan developed local councils, and 31.9% for rural local councils (LGSA 2006, 196).

[26] As of 2000, the financing pool for Commonwealth grants comes from Goods and Services Tax (GST) revenue. Australian Government (2009, 27) details the process of determining Commonwealth grant outlays and the value of outlays over the past decade. States and territories work with local government grant commissions to determine funding needs and forward projections to the Commonwealth Grant Commission for final approval. While general purpose funds are determined on a per capita basis, the state's share of the local road fund is fixed.

[27] Direct outlays of SPPs to local governments include road grants in the program *Roads to Recovery*. SPPs are also distributed to finance local subsidies targeting social welfare functions such as child care and care for the disabled (Australian Government 2006).

A central issue in the intergovernmental finance system has been the trend of increased cost shifting of Commonwealth and state and territory government functions to local governments.[28] Even though local own-source revenue has maintained its share in total local revenue, expenditure assignments at the local level have increased. Data from the Commonwealth Grants Commission (2001) also indicate that the share of state and territory aid in local revenue has declined. LGSA (2006, 90) lists different ways in which cost shifting occurs both on an ad-hoc basis, for example in the devolution of expenditure responsibilities for airports to local government without funding, or on a long-term basis, through incremental reductions in grant funding for council libraries. The issue of cost shifting, though, has structural implications beyond revenue-expenditure alignment for the position of cities in the federal system as

28 The Australian Local Government Association, following research by that cost shifting contributes to an additional $500 million to $1.1 billion in annual local expenditures (ALGA 2010). Additionally, with the rate of annual increase for FAGs tied to inflation, many local governments claim that increases in grant revenue do not match increases in expenditures.

creatures of the states. [29] Survey evidence from Brown (2002) suggests that these challenges are coming at a time when local government officials feel they should expand service provision to new expenditure categories outside traditional local functions.

Market Financing of Urban Infrastructure

The historical use of administrative controls to limit local government access to capital markets in Australia in the 1980s continued to influence the use of debt financing among municipalities a decade later, when local governments were encouraged to operate debt free. Despite cost shifting and a growing backlog on infrastructure upgrading, local government public debt ratios in Australia are substantially lower than other OECD countries. The rising use of developer exactions and user charges suggests that capital market financing of urban infrastructure in Australia will remain conservative in the medium-term. Local governments, on average, operate from a net surplus position, though, as of the end of fiscal year 2006, local councils in two states – Queensland and South Australia – operated from net debt position (Australian Government 2009). From a national standpoint, public debt transactions as a percentage of total expenditures for local governments range from 0.3% in the Northern Territory to 3.3% in Queensland (Ibid., 18). In per capita terms, this amounts to, on average, only $19.45 being spent by local governments on public debt annually (Ibid., 19). Though historical and institutional barriers

[29] There have been other recent attempts to clarify the terms of engagement between national-state-local and state-local governments in rationalizing intergovernmental service agreements and adding transparency to expenditure and funding responsibilities. These agreements are not legally binding but intended to establish principles for increased intergovernmental coordination to address cost shifting. The *Inter-governmental Agreement Establishing Principles Guiding Inter-governmental Relations on Local Government Matters* was signed by all major states and territories in 2006 and since then many states have established guidelines in formal agreements for state-local relations. For example, the *Victorian State-Local Agreement* (2008) dictates that local governments will consult the state government before entering into a financing agreement with the Commonwealth government that could impact state expenditures or revenues.

exist to increasing the use of debt finance by local governments, their current financial position puts them in good position to access credit at a favorable price. As of 2006 in Western Australia, local governments' cash reserves ($628 million) were nearly double that of borrowed funds ($326 million) on balance sheets (WALGA 2008, 31).

A number of recent studies have advocated for an increase in the external debt position of local governments to more efficiently finance urban development (Allen Consulting Group 2003; Access 2006; LGSA 2006). The primary rationale for the increased use of debt financing vehicles in these reports is twofold: to adequately address the large backlog of infrastructure renewal and to address issues of intergenerational equity in the provision of new capital infrastructure. Byrnes et. al. (2007) propose an alternative to external borrowing and outline how this might be achieved in Australia by establishing a municipal bond market. The authors show how a New South Wales local water utility could mobilize revenue from user charges to finance a low-risk revenue bond issue that would address both a $955 million infrastructure backlog and achieve intergenerational equity. The model largely fits with the transition to increased application of user charges and fees occurring within local governments, suggesting it would be broadly applicable to cities in other states.

Social Reproduction Functions

The two trends of local governments drifting into new expenditure categories outside their conventional functional domain and the incremental process of cost shifting have been salient features of the municipal finance system over the past decade. Local government's responsibility in financing local activities that promote redistribution is limited in Australia, but cities are primarily responsible for administering Commonwealth and state welfare programs. For the fiscal year 2005-06, local government revenue devoted to welfare expenditures totaled $0.6 billion; and for the period 1998-2006, local governments funding comprised

1.8% of all welfare expenditures in Australia (Australian Institute of Health and Welfare 2007, 14). Because the proportion is so small, no systemic evidence for local expenditure patterns exists though, following Commonwealth and state patterns, it is reasonable to suspect that the largest expenditure category was the elderly. The largest impact local governments have on financing redistribution is indirect and mainly achieved through rate and fee concessions in the building of the public housing stock. Pinnegar et al. (2009) outline planning mechanisms for affordable housing in Australia and include fee discounts for privately-developed affordable housing stock and mandatory impact fees if new construction reduces or impinges indirectly on levels of affordable housing. The authors also highlight the case of the City of Salisbury in South Australia which provides joint-equity loans to individuals (Ibid., 65). The program is administered by HomeStart, a statutory corporation under the South Australian government. Gurran (2003, 402) assesses the activities of local governments in New South Wales, Queensland and Victoria as it relates to housing and found that while cities in these states had numerous administrative and planning responsibilities in the housing sector, their primary funding responsibilities entailed "donating of funds or land for the development of social housing; establishment of a trust fund for social housing ventures; and grants/rate relief to sustain financial viability of low cost accommodations."

Germany

It has been observed that one of the many strengths of municipal fiscal policy in Germany, characterized by two distinct regional variations in revenue systems, is that it operates in a perpetual state of reform.[30] With nearly 15,000 municipalities, 112 districts and 3 city-state units distributed across 16 federal states (Länder), local government in Germany exercises a considerable amount of administrative authority while having the constant backing of a strong fiscal equalization system. Municipalities in western Germany are less dependent on transfers than eastern Germany but with economic contraction and recent reforms of the local business tax, all municipalities are facing a period of austerity in own-source revenue. Expenditures in 2006 by the municipal sector totaled approximately 7.15% of GDP and comprised 15.6% of all primary sector expenditures (OECD 2009). Municipalities have expenditure responsibilities for water, waste, sewage and other essential services, construction and maintenance of local roads and primary schools.[31] Following the international pattern, cost shifting of expenditures once fully under the purview of the states and federal government is an immediate challenge to the municipal finance system.

Revenue Enhancement

The narrow space for revenue enhancement in German local governments is shaped by the institutional context of the shared revenue system and restricted municipal tax revenue authority. Nearly 50% of local tax revenues come from shared revenue arrangements (personal income tax and value-added tax) over which municipal governments have no rate-

---

[30] This propensity towards reform of fiscal policy in Germany is elaborated in Moore et. al. (2008). Recent piecemeal reforms adopted in 2006, which were not explicitly fiscal federal reforms, set new precedents that will impact the fiscal federal system. For example, it was determined that the federal government cannot transfer expenditure responsibilities to municipalities, but that this right is explicitly reserved to the state governments. Additionally, the reforms of 2006 established increased grants-in-aid for local governments to finance economic growth.

[31] The composition of total local expenditures in 2006 show expenditure priorities in the municipal sector: social protection (33.3%), education (16.2%), economic affairs (11.4%) and housing and community amenities (6.4%) were the highest categories (OECD 2009).

setting authority. Municipal taxing authority, therefore, is limited to managing the trade tax and real property tax, of which the trade tax represents the most flexible own-source revenue stream.[32] While there is interregional variation, municipalities derive approximately 77.9% of local tax revenue and 29.3% of total revenue from the business tax; property taxes represent 17.4% of tax revenue and 6.5% of total local revenue (Feld and von Hagen 2007, 143). While these percentages are significant, in practice, any increase in the municipal business tax to generate new revenue threatens to offset the local economic base by inducing firm relocation. Therefore, adjusting the trade tax to increase local revenue is a central but risky strategy for German municipalities that rely heavily on the business tax.[33]

Following a drastic decline in tax revenue and a contraction of capital expenditures, a number of reforms for local tax administration were proposed during 2000-2003. Werner (2006) takes account of the leading reform proposals, focusing on two that have gained the most traction. The German Association of Chemical Industry (VCI) and the Federal Association of German Industry (BDI) partnered to lobby for a new model that centers on levying a surcharge on municipal income and corporate profit. In contrast, the Jarass and Obermair model, supported by national municipal associations, sought to revitalize the trade tax by converting it into a broad-based tax on business. As the primary source of municipal revenue autonomy, the implications for reform of the trade tax have a direct impact on revenue stabilization for German cities. Similarly, the debate over local trade tax reform in Germany suggests that business and political

[32] The trade tax is also referred to as the business tax and the two will be used interchangeably in this section.

[33] Following the model developed by Buettner (2001), a number of variables influence the choice of the municipal corporate tax rate. Using panel data from 1000 municipalities, the author found that large cities set higher rates, effectively charging a premium for market access. Reliance on the trade tax causes interregional tax competition and as the primary source of municipal own source revenue, rate increases in the trade tax are sensitive to reductions in intergovernmental grants and levels of debt service.

interests supportive of sustaining global capital mobility will continue to challenge local tax policy reform and will test the German model of a high-tax country financing broad social expenditures.

In 2008, the tax code was officially amended to reduce the municipal trade tax rate from 5% to 3.5% (Lawall 2008). The base rate is regulated by the federal government but the effective tax rate is assessed by municipalities based on a local multiplier. The federal tax code limits the local multiplier to a range of 200% to 490% of the tax rate but municipalities have flexibility in selecting their specific multiplier. The impact of reform on aggregate municipal tax revenue is inconclusive due to multiple contingencies that could develop as a result of the recent change, though the average change in revenue is likely to be minimal. Theoretically, the intent of the reform of the trade tax was to broaden the tax base by minimizing firm migration and encouraging global business location in the country. A broader tax base and a removal of the deductibility of trade tax expenses would also strengthen revenues (Ditsch 2008). Because the same principles apply, except at an expected lower rate, the impact on municipal revenue autonomy is also likely to be minimal. By reducing the corporate tax rate, the expectation is that economic growth will accelerate by increasing the attractiveness of investing in Germany but there is risk that a reduction in the business tax rate could be inefficient in the long-term. The challenge to municipalities will be to finance and maintain local infrastructure to support future demand for local public goods and services.

Expenditure Management

For the past two decades municipalities in Germany have been at the forefront of public sector management reform. Responding to business cycle revenue shocks throughout the 1980s and 1990s, local governments were prompted to increase productivity during a period of subnational fiscal austerity. Out of this process, the New Steering Model (NSM) of public administration was introduced. The New Steering Model was promoted by KGSt, a powerful municipal sector lobby, and entailed a restructuring of local government management to increase freedom for local resource management and align costs with outputs through cost-achievement accounting (Wollman 2000). Though the reforms were not instituted evenly, and there were initial hurdles to the implementation of NSM, not the least of which was the cost of restructuring, the model was adopted by approximately 80% of German cities with a population of at least 10,000 (Kuhlmann 2008). Ultimately, the NSM contributed to two major shifts in expenditure management by local governments: privatization and marketization of municipal services and new accounting systems.

The formation of municipal corporations for the delivery of public services was a major response to the general austerity experienced during the 1990s and the rising influence of the New Steering Model. Grossi and Reichard (2008, 603-604) provide recent data on the extent of municipal corporatization in Germany: large cities have, on average, 90 municipal corporations; municipal corporations employ over 50% of the local public sector workforce; and social, health and cultural services are increasingly outsourced to municipal corporations. Evidence of the efficiency of the reforms in reducing costs is mixed, with decidedly market-oriented services like water and trash collection experiencing success but, in the case of social functions being outsourced to welfare associations, there was no reduction on expenditures (Reichard 2002, 74).[34] The public sector reform experienced in German municipalities during the 1990s also extended to municipal accounting practices and local financial management in an attempt to add transparency and stretch budgets. The leading reform has been the New Local Financial Management (NKF), developed in the state of North Rhine-Westphalia, introducing output budgeting and a modified accrual accounting system to municipalities in the state (Ridder et. al 2005).[35] A state law was passed in 2005 mandating implementation of NKF in all municipalities by 2009. One other trend that is reshaping the expenditure management process in German municipalities is the implementation of double-entry accounting inclusive of the value of the local capital stock. By 2016, all local governments in 12 out of the 16 federal states will have instituted this accounting methodology (Zipfel 2010).

Intergovernmental Transfer System

The German intergovernmental transfer system plays an important role in stabilizing municipal finances, while at the same time, because of its design, generating a number of incentives that shape the local tax regime. The transfer system in Germany is characterized by both vertical transfers

---

[34] The issue of transaction costs in terms of contracting out of services is also addressed by the author and merits significant consideration in light of the reduction in expenditures promised by proponents of outsourcing of municipal services. Reichard states, "One argument for higher transaction costs among others may be that public sector organizations tend to a higher degree of formalization of all processes related with contracting, tendering, delivering and monitoring services if they are produced by external providers. This is due to existing tendering rules and because of strong procedural controls by law courts…Thus transaction costs should be the subject of economic reflection. It may easily happen that these costs compensate a large part of the productivity gains if services are contracted-out" (2002, 75).

[35] Much like municipal budget reform in the United States, under NKF municipalities are obligated to link financial resources with specific outputs (products). See figure 1 in the appendix for a diagram of the NKF management process.

to address fiscal gaps in the financing of state and municipal expenditures and horizontal transfers to equalize revenue and promote uniformity of living conditions. Indeed, local governments are responsible for approximately 11% of tax revenue and 22% of total public expenditures (Reissert 2006, 161). The framework for the intergovernmental transfer system is discussed in detail in Seitz (2000) and Buettner (2008). This section will not focus on the specificities of the system though a brief review from the perspective of municipalities is merited. Municipal governments share in 15% of the national personal income tax and 2.1% of the value-added tax. Municipalities also receive a share of state tax revenue through obligatory transfers which vary by state. They also receive a facultative transfer that comes from the equalization scheme in which the states participate, which fills the gap between tax capacity and a per capita-based fiscal need. Because the intergovernmental transfer system is a gross system (i.e. all tiers of government participate) a municipality can be a net contributor to the system if their tax revenue exceeds their standardized fiscal need.

Following the immediate period after reunification, though to some extent even now, much of the reform debate surrounding the intergovernmental transfer system focused on the politics of fiscal redistribution (Ziblatt 2002). There has been, however, a more recent and growing body of literature (and possibly consensus) that focuses on the incentive effects of the fiscal transfer system on municipal tax design and effort. This literature has exposed deficiencies in the design of the intergovernmental transfer system and has arrived at significant policy implications for municipal revenue systems and regional inequality if the status quo is maintained. Following the theoretical literature on capital tax efficiency and fiscal equalization of Koethenbuerger (2002), Buettner (2006) uses empirical data on 185 municipalities to test the impact of equalization transfers on tax competition in Germany and finds a positive correlation between the percentage of equalization transfers and the local tax rate. Egger et. al. (2007) use data from 1994-2004 for municipalities in Lower Saxony to test the impact of equalization transfers on the selected business tax rate and are met with the same results – the absolute equalization achieved in the transfers system in Germany shields municipalities from any lost tax revenue from reductions in the tax base due to a high trade tax rate. There are also incentive effects on the expenditure side as a result of equalization. Hauptmeier (2007, 20) uses a regression discontinuity approach to test the incentive effects of equalization on expenditure policy from 1990-2003 of 1,111 municipalities in Baden-Württemberg and finds that "a higher marginal contribution rate to the redistributive grant system induces local governments to reduce their budgetary share of infrastructure spending on the local road network and basic school expenditures." The impacts from these distortions raise questions about the real cost of municipal fiscal equality and suggest that minimizing negative incentive effects should be a top priority for reform of the fiscal transfer system.

Market Financing of Urban Infrastructure

The recent international literature on market financing of urban infrastructure in Germany has been limited, most likely because while state debt levels have threatened macroeconomic stability nearly all municipalities have worked within the hard budget constraint. Historically, municipalities have been conservative in utilizing capital market debt to finance urban infrastructure but this trend is slowly reversing, as local government revenue comes under strain from increased expenditures. There are some generalizations that can be made about municipal debt in Germany. First, the conventional approach to municipal financing of infrastructure has been to rely heavily on tax revenue first and to approach local development banks after all other resources have been exhausted, instead of strategic borrowing. As of the fourth quarter of 2007, local government debt comprised only 7.4% of total public sector debt at approximately €1.16 billion (Bundesbank 2010). Second, almost all local debt is financed through direct loans from local savings banks though the use of bond issues is growing in western Germany. In terms of debt service, municipalities in western Germany average around 4% of total revenues and 3.5% for cities in eastern Germany. State regulation of municipal debt does not provide for local government bailouts but all states maintain special funds for municipalities that encounter fiscal hardship (Seitz 2000).

One recent development in revenue enhancement techniques in German municipalities might explain why local governments in Germany have not turned to debt financing for infrastructure. Haug and Nerré (2005; 2006) use data that show an association in the rise of local public utility profits and local public expenditures and argue from a public choice framework that a two step process has been occurring in the levying of local user fees and charges. First, local politicians respond to pressure and shift the composition of revenue away from taxes to indirect fees and charges in order to create "fiscal illusion" and ameliorate voter resistance. The increasingly intense use of user charges and fees leads to an appreciable rise in local utility profits. Finally, these profits are transferred back to municipalities off-budget to finance public expenditures.

Social Reproduction Functions

German municipalities have historically been very active in financing social expenditures of a redistributional nature. A decomposition of expenditures in 2002 shows the relative weight of these outlays, particularly in comparison with the federal and state governments. Two of the highest expenditure categories were social assistance and housing and community amenities, 19.8% and 17.6% of total expenditures respectively (Seitz and Kempkes 2007, 390). In the area of social housing, Knorr-Siedow (2008) argues that a retreat of the state in the early 2000s left innovation in social housing to the private sector, however, municipal governments are now beginning to respond to the pullback of the federal government in the area of public housing. Munich and Hamburg have both developed models that include selling land at below-market prices if it is developed to meet the housing needs of targeted populations and providing additional municipal social housing funding to builders who meet the targets. Municipal governments, more so than many OECD countries, are responsible for a sizable percentage of welfare expenditures, including covering standard health risks of the local population regardless of age and running labor market programs to train and increase local employment, often through direct hire (Bonker and Wollman 2006).

Brazil

Following the national reforms of 1988 and stabilization of the economy a decade later, the local delivery of public goods and services continues to be strengthened by the ongoing process of expenditure decentralization in Brazil. Clear tax assignments are outlined in the constitution, public financial resources have been extended to the municipal sector, and a series of reforms during the 1990s clarified the regulation of local borrowing and the composition of local social expenditures. These structural shifts have helped many of the 5,500 municipalities increase their involvement in the provision of public services. Municipal revenues as a share of total revenues have risen from 10.8% in 1988 to 16.1% in 2003 (Rezende and Garson 2006). Despite these improvements, there are multiple challenges the municipal sector still faces in meeting the rapidly growing demand for infrastructure and local public services. Brazil’s large territory and pattern of economic development perpetuate both vertical and horizontal imbalances and complicate coordination within the intergovernmental finance system. Additionally, even as Brazil’s economy grows, municipalities are constrained by rigid regulations on their ability to access credit and so face increasing deficits in long-term infrastructure investment with little prospects for a matching devolution of resources from the federal government and states.

Revenue Enhancement

Municipalities in Brazil have autonomy to administer, set and adjust the tax rate on the three taxes they are assigned under the Constitution of 1988: services (ISS), property tax (IPTU) and the tax on the transfer of real estate (ITBI).[36] A review of the shifting composition of municipal revenues during the period 2002-2006 shows the general pattern of revenue enhancement being pursued by local governments (Receita Federal 2007). Two trends stand out in particular. First, there has been a growing reliance on the tax on services. During this period, revenues from ISS increased from 38.8% of total municipal revenue to 45.1%. It seems as though, contrary to international experience but with some exceptions mentioned below, a local tax on economic growth has served as a hedge against the incentive effect of lower revenue effort by municipalities in countries with a strong transfer system. Second, the contribution of municipal fees to local revenue is declining. In 2002, total revenue derived from local fees was R$ 2,393.56 million, or 11.7% of local revenue. By 2006, the share of revenues from fees in total revenue had dropped to 9%. Revenues from the property tax increased 52.9% from 2002-2006 but as a percentage of total revenue, dropped from 31.9% to 29.2%. Because of the high reliance on the tax on services (ISS), levels of own-source municipal revenue vary widely depending on the strength and composition of the specific municipal or regional economy.[37]

Consequently, the ISS has led to a number of challenges to a regionally balanced tax burden while empowering only the largest local governments that are able to generate increased own-source revenue off of dynamic urban economies. A heavy reliance on the ISS by large cities and fiscal transfers by smaller ones has allowed administration of the property tax to remain poor. Of property tax collections in 81% of municipalities in Brazil, a study done by IBGE (IBAM 2001) found that

[36] The ISS tax is applied the gross amount of revenue generated by businesses at varying rates, at the discretion of the municipality, depending on the economic activity. The federal government sets a minimum rate of 2% and as of August of 2003, a maximum of 5%.

[37] For example, less than one percent of municipalities (31) are responsible for over two-thirds of total national revenue from the ISS (Rezende and Garson 2006, 26). According to Afonso and Araújo (2000), São Paulo collects more revenue from the municipal ISS tax than 17 states combined from the state value-added tax (cited in Souza 2003).

approximately 68% of were unable to collect more than 60% of the bills issued (Souza 2003). There is also a growing awareness that the overlapping tax bases between for ISS and the state value-added tax (ICMS) has led to tax competition between states and municipalities at the expense of municipal revenue. The ICMS levies taxes on revenue from telecommunication and transportation services which are two categories that include specific services, for example internet connection, that are taxable under the ISS (Guardia and Sonder 2004). The reforms of 2003 that reduced the maximum rate at which the ISS tax could be levied to 5% were an effort to keep the ISS tax while minimizing the cascading effect of double-taxation from the ISS and ICMS. The ISS is regularly a subject of tax reform but political support for its existence in Brazil's largest municipalities has consistently acted as a barrier to its reform and inclusion in the state ICMS tax. Werneck (2008, 7) looks at ten years of debate and action on tax reform and in regards to the ISS tax concludes that "this inefficient and somewhat chaotic multi-level value-added taxation system is by far the weakest part of Brazil's tax system."

Expenditure Management

There are two general components to the recent experience of municipal expenditure management in Brazil and much regional variation in implementation: the use of the municipal budget as a local economic policy tool and the promotion of participatory budgeting for the equitable allocation of public funds for infrastructure investment. Martell's (2007) qualitative analysis on accountability in the municipal sector reveals many of the trends in local expenditure management policies in Brazil. Rio de Janeiro has instituted expenditure caps on both current account and investment expenditures so as to broadly stabilize municipal expenditures. Celina Souza defines three patterns of municipal management that have emerged since reforms began over two decades ago and merits quoting at length:

> *The first "paradigm" follows the Anglo-Saxon path, more concerned with the efficient delivery of local services, in*

which policy results are more important than political processes. The PFL (Party of the Liberal Front) is close to this "paradigm," and its "demonstration effect" includes the cities of Curitiba and Salvador. The second "paradigm" is associated with the PT (Worker's Party). The main concern of the local administration is to introduce participatory policies, following the idea of local self-government, in particular in budgeting. The case of Porto Alegre is best known and widely praised by multilateral organisations and others. The third "paradigm," still alive in large and small cities, in wealthy and in poor communities, can be described as anti-democratic, marked by patron-client relationships and by vested interests" (Souza 2003, 10).[38]

There is some momentum to address issues of corruption in municipal governance in Brazil. State government is constitutionally responsible for auditing municipal accounts and municipalities themselves have an incentive to self-audit to improve credit ratings. There have also been efforts by the federal government to institute a national level anti-corruption program focused on municipal finances through the public release of municipal audits. Ferraz and Finan (2007) find that a marginal increase in corruption before an election in a city that both had been audited and had a radio station was associated with a 40 percent

[38] Complementing Souza's research, Brannstrom (2004) looks at the multiple decentralizing frameworks that have been adopted by the Brazilian state for the efficient management of water resources. These frameworks impact the way municipalities manage expenditures differently, depending on specific arrangements of power between state, local governments and NGOs contracted in the process. She categorizes the three frameworks as: "deconcentration and top-down influence" (Bahia), "mandatory civil service participation" (São Paulo) and "prioritising water users" (Paraná). Brazil challenges the notion of a uniform pattern of decentralization.

decrease in the probability of local reelection.[39] This is not to say that the impact of expenditures on a local politician's probability of election is always negative. Sakurai and Menezes-Filho (2008) find that higher expenditures, particularly capital expenditures, throughout a mayoral term has a statistically significant effect in increasing the chances of reelection or holding the position for the same party.

A review of expenditure management in Brazil cannot dismiss the impact of participatory budgeting (PB) on the transparency and efficiency of municipal governments. Souza (2001) reviews the literature on PB from a participatory perspective, but what is interesting from a financial perspective is how PB shapes local public finance. Because PB creates conditions of external accountability for the capital budget, it often adds layers of planning and management that otherwise might not have existed. For example, in local participatory budgeting schemes in Porto Alegre, Belo Horizonte and Santo Andre, the previous-year budget performance is where the PB process begins (IADB 2005). PB, in practice, establishes an annual baseline from which the management of the capital account proceeds throughout the year. By ensuring that long-term obligations are presented clearly to the public on an annual basis, an incentive is created for city officials and politicians to manage the budgetary process to increase the probability of reelection.

Intergovernmental Transfer System

Brazil in practice operates a centralized financing system for the provision of public goods. The biggest municipalities generally have access to a tax base large enough to cover their own current and capital

[39] The federal government's auditing program began in 2003 and release the audits of 60 municipalities publicly each month.

expenditures; however, a very large number of small and medium-sized cities are highly dependent on transfers.[40] The intergovernmental transfer system in Brazil is thus responsible for financing a large portion of municipal capital expenditures. It does this through three channels: revenue from federal tax-sharing of the tax on industrialized products (IPI) and income tax (IR), which finances the *Fundo de Participacao dos Municipios* (FPM); federal tax sharing from the Financial Operations Tax – Gold (IOF-Ouro) and tax on rural land and property (ITR); conditional grants through two federal programs, FUNDEB for education expenditures and SUS for health care expenditures; and states tax sharing of revenue from the VAT (ICMS) and IPVA (motor vehicles).[41]

In 2007, the education fund for universal primary education (FUNDEF) by constitutional amendment was replaced with FUNDEB, a national transfer program to equalize the minimum investment in students at all levels of basic education (pre-k, elementary and secondary). FUNDEF was a successful program that received international attention for its success in raising enrollment rates in primary and early-secondary education in Brazil (De Mello and Hoppe 2004). However, the FUNDEB program is more ambitious and seeks to guarantee education at all levels of basic education. Funding for FUNDEB has greatly exceeded that of the historical trend for FUNDEF and a funding advisory board has been established at the federal level to reassess the transfer formula on an annual basis to ensure efficient management, a common complaint regarding FUNDEF (Neri and Buchmann 2008). While an extensive appraisal of the SUS (health care) transfer program is not possible in such a condensed review, one descriptive statistic regarding the SUS merits mentioning in order to adequately describe the composition and nature of the intergovernmental transfer system as it relates to municipalities. Of all

[40] According to Afonso and Mello (2000, 4), around 6.2% of municipalities have own-source revenues that exceed transfers.

[41] See Rezende and Garson (2005, 27) for a complete breakdown of tax sharing ratios and transfer conditions. The formulae for distribution of the FPM favor, in general, smaller and poorer municipalities.

the transfers to municipalities with populations more than 500,000, SUS is the largest and surpasses the total value of outlays from the municipal fund (FPM) by 74%, equivalent to 19% of direct tax revenue and over 9% of total tax income in these cities (Afonso 2004, 148).

Afonso (2006) outlines the revenue responsibilities of each tier of government in the fiscal transfer system and sees growing per capita budget revenue distortions coming from distribution formulae of the FPM (Municipal Participation Fund) that privilege smaller municipalities. He cites the case of Borá, the smallest municipality in Brazil, which had three times the per capita revenue of São Paulo in 2004. However, distortions in the federal system do not just favor smaller cities. Afonso (2004) decomposes intergovernmental transfers since 1988 and finds a structural trend that has the potential to imbalance the transfer system towards larger municipalities by reducing funds to the FPM. During the eight year period from 1994-2002, the composition and level of federal revenue began to shift when tax revenues from social contributions began to match the level of revenues derived from the tax on industrialized products and income tax. Revenue from social contributions are not shared with municipalities and so over the decade, financial resources were increasingly centralized and the pool of funding, as a percentage of total revenue, began to shrink, so much so that in 2003 income from social contributions exceeded federal tax revenue by 13% (Ibid., 141).

Market Financing of Urban Infrastructure

Municipal governments in Brazil face a number of historical and institutional constraints in the market financing of urban infrastructure. Indeed, as Martell (2003) points out, the supply-side approach to subnational debt in Brazil has led to a number of distortions in price and distribution and created conditions in which capital finance operates according to non-market principles. Two general institutional arrangements have shaped the recent experience of municipalities seeking capital market finance in Brazil. First, following a decade of state bailouts, achieving stabilization of subnational debt could only occur through tightly regulated debt ratios that were created through the Fiscal Responsibility Law in 2000. Second, when municipalities have sought capital finance they have most frequently approached public financial institutions and development funds which have extended direct loans at below-market rates, significantly limiting the ability of private banks to compete. This has created a certain path dependence from which the municipal sector has yet to break free. Even as large municipalities have increased access to capital from private banks, they still borrow proportionally more from public banks than do small cities (Zabala and Giovanelli 2004).

In the case of Brazil, even though market discipline and regulation to manage subnational debt has been established, the legacy of stabilization from the 1990s still influences municipal debt finance. On the whole, municipal sector debt is small – the total value of municipal debt is approximately 2.1% of GDP, one-seventh that of state governments (Afonso and Araújo 2006). Ninety-five percent of subnational debt is held by the federal government (Afonso 2004). According to Platz and Schroeder (2007), because of the strict regulations set by the Fiscal Responsibility Law, most cities have approached the limit or are completely banned from issuing municipal bonds for infrastructure. It appears as though policy makers in Brazil are willing to trade an active subnational capital market for macroeconomic stability, though international experience suggests that this position is unsustainable in the long-term.

Social Reproduction Functions

Municipal governments in Brazil share responsibilities for financing a broad range of expenditures in local health, sanitation, education and slum upgrading. The majority of funding for social programs in Brazilian municipalities comes from shared revenues that are devolved to local governments, for example, the education tax, a national fund for social expenditures, FUNDEB, natural resource royalties, an export compensation fund (FPEx) and various discretionary transfers. Municipal governments are also mandated to spend 15% of their own revenues on local health expenditures (Rezende and Garson 2006). Larger municipalities have also begun to mobilize own-source revenues to match grant revenue in the area of slum upgrading and social housing policy while smaller cities continue to rely almost entirely on federal grants and official development assistance (Budds and Teixeira 2005). While vertical transfers have played an important role in funding social expenditures at the local level, municipalities continue to look horizontally for local-local institutional arrangements to maximize their revenue. Inter-municipal consortiums were first established in the 1980s and have since continued to pool own-source municipal revenues and achieve economies of scale in the delivery of education, health and anti-poverty services (Andrews 2004; Spink 2005).

Mexico

While rapid expenditure decentralization over the past two decades has increased the role of states and municipalities in the provision of public goods, a matching level of revenue decentralization to sustain this trend remains a crucial reform yet to be achieved. The 2,439 municipalities in Mexico, spread across 32 states and the Federal District, continue to operate in a fiscally centralized federal system, highly dependent on central government funding. Consequently, with little revenue-raising authority, municipal governments in Mexico have had to manage increasing demand for public services by raising efficiency in the local distribution of intergovernmental transfers, often through sub-optimal political alignment. Municipalities are responsible for expenditures on water and sewerage, public lighting, solid waste, public safety, local roads and maintenance of school buildings. While some local management reforms have gained support in various states and recent innovations in the subnational capital market have allowed municipalities to issue infrastructure bonds, in general, overreliance on the fiscal transfer system continues to stifle the development of a robust municipal sector in the country.

Revenue Enhancement

Municipalities in the Mexican federation, like cities in many other developing countries, face rising demand for local public goods and services which they primarily administer through intergovernmental grants. Though there are interregional variations in local fiscal capacity, the state of municipal finance in Mexico can be characterized by a heavy reliance on fiscal transfers. Per capita own-source revenue collections can range from less than 50 pesos in Chiapas to more than 700 in Baja California Sur (Webb and Gonzalez 2004, 9). The property tax, municipalities' only source of local tax revenue, makes up approximately 13% of revenue and local fees account for around 14% (Moreno 2003). While many local governments still struggle with property tax collection, municipalities have achieved improvements in the valuation and assignment of excises on public utilities, particularly in the area of water, an expenditure category which is almost completely under the purview of local government (Díaz-Cayeros and McClure 2000).

Because the property tax is the only tax available to municipalities, revenue enhancement has centered on making improvements to the administration of the tax. For many cities, improving the maintenance and management of the local cadastre is the only available channel to raise own-source revenues. However, in the case of Mexico, the updating of the municipal cadastre is sometimes subject to intense political interference, often leading to high levels of annual volatility in local revenue collection (Cohen 1999).[42] Enhancing municipal property tax collection also has an intergovernmental coordination component, in both technical issues and policy. In the case of Mérida in 1996, the Yucatan state government was led by an opposing political party and was slow to share the state cadastre

[42] The author highlights the case of Mexicali in which after instituting cadastre management reform in the early 1990s, the subsequent mayor gave in to political pressure and failed to update the cadastre until the final year of his term, causing year over declines in local revenue collection. Successive mayors have continued the cadastre reform agenda.

with local authorities. As the local cadastre only registered a population of 200,000 compared to the state's records that showed a population of 300,000, the city missed out on local revenues and state transfers that were determined by population (Turner 2002). While municipalities administer the property tax, they do not set the tax rate. Legal authority is held at the state government level which sets rate schedules based on the size of the municipality and the type of property, though municipalities can and do lobby for specific rate schedules (OECD 2003).

Expenditure Management

One of the central issues in municipal finance in Mexico is ensuring expenditure efficiency when so little of the municipal budget is financed by own-source revenue. Additionally, the demand schedule for public goods can vary extensively across regions, with high and complex demand in state capitals, the Federal District and cities near the northern border with the United States. These two qualities of the fiscal federal system in Mexico present a substantial risk for clientelism and electoral distortions and the literature on subnational governance in Mexico has focused on this issue (Kraemer 1997). But the research of Grindle (2007) and Ward (1998) shows that the picture is much more complex at the local level, with the evolution of local government administration in Mexico not only shaped by clientelism in the intergovernmental system but also through context-specific strategies that local governments have adopted to manage the complex demands put on them by decentralization.

Building the capacity of local governments to respond to the demands of expenditure decentralization has been a enduring constraint to increasing the efficiency of expenditure management. Grindle (2007, 109) lists four general strategies that have been adopted throughout the country to boost local governance capacity: "reorganizing town hall, including contracting out some activities formerly performed by the municipality; altering the profile of those appointed to public office; providing training and technical upgrading for carrying out municipal responsibilities; and introducing performance standards to measure the behavior of individuals and organizational units within the municipality." But often, and contrary to international experience, innovations in public administration are formed as much out of ad-hoc responses to local development than to regional or nation-wide strategic reform initiatives. Campbell and Katz (2004) look at the case of local governance in Tijuana in response to the flooding disaster of 1993. When the local government decided to rebuild, they developed an urban action program, marked by innovations in expenditure management and finance, which included a cadastre modernization program, financing through a betterment levy (a first in Mexico) and a public education/participation campaign. Though devaluation of the peso eventually derailed the program, the Tijuana case shows that, in the case of Mexico, the level of local development combined with the demands of decentralization have resulted in a patchwork of approaches to local government administration.

Intergovernmental Transfer System

With very little own-source revenue autonomy and an increasing share of total public sector outlays, dependence on the intergovernmental transfer system is a defining characteristic of the municipal finance system in Mexico. In contrast to the initial wave of decentralization reforms in the 1980s that strengthened local finances, the current arrangement has come about as a result of a recentralization process, beginning around 1994 with the Zedillio administration, in which the states gained increased fiscal authority while municipalities maintained their general administrative responsibilities in education, health care and infrastructure (Wilson 2006). With over 90% of tax revenue accruing to the central government and a recent tax reform in 2002 that further augmented state tax revenues, an equilibrium has been established in intergovernmental fiscal policy. Although Mexico has no formal fiscal equalization scheme, transfers have been shown to have an equalizing influence on fiscal capacity at the state level (Courchene and Díaz-Cayeros 2000). Transfers from the federal government flow through two programs: Ramo 28 (unconditional) and

Ramo 33 (conditional). The Ramo 28 contains the General Participation Fund (*Fondo General de Participaciones*) which contributes to over 40% of subnational revenues. Transfers from the General Participation Fund flow through state governments which are obligated to devolve 20% to local government. Ramo 33 consists of the conditional grant programs targeted to education (FAEB), health (FASSA), social infrastructure (FAIS), and municipal strengthening (FORTAMUN). The conditional transfer programs contribute to approximately 31% of total subnational revenue (OECD 2003).

The intergovernmental transfer system in Mexico covers a very large proportion of expenditure responsibilities at the municipal level beyond payroll. A small portion of the Ramo 33 (FORTAMUN) is even earmarked for municipalities that are struggling to cover current expenditures. All but the very largest municipalities continue to rely heavily on revenue sharing to finance local expenditures. Indeed, Mendoza and Martinez-Vazquez (2000) provide a detailed account of local expenditure patterns from intergovernmental revenues. They found that, at the beginning of the 1990s, medium-sized municipalities (13% of all municipalities) relied on revenue sharing for 40%-70% of total revenues while 70%-95% of smaller municipalities' (nearly 85% of total municipalities) total revenue came from federal resources (Ibid., 147). The Fund for Social Infrastructure (FAIS) is the fiscal transfer most important to municipalities, covering over 80 percent of their expenditures on social infrastructure. The transfer also has the added benefit of promoting local capacity and accountability. According to law, municipalities that receive FAIS funds are mandated to "inform the inhabitants of the respective jurisdictions regarding the scope, costs, and potential beneficiaries of each individual project financed by FAIS; promote community participation in the ex ante choice of projects, in their execution, and in their ex post evaluation; and inform the population at the end of the fiscal year of the results obtained" (World Bank 2006, 110).

Market Financing of Municipal Infrastructure

The past decade has been marked with major innovations in the subnational capital market in Mexico, particularly in light of the subnational debt crisis of 1994. Indeed, Mexico proves that the scope for market financing of municipal infrastructure does not have to be subject to tight regulatory administration, but can expand rapidly within a market-based policy framework. Though, on the whole, the market for municipal debt is still relatively small. Municipal debt is heavily concentrated in bank loans from commercial banks and the national development bank, Banobras. Total municipal debt as of September 2009 stood at MXN $22,690.9 million (US$ 1.84 billion) (SHCP 2010).[43] Almost all of the debt is divided equally between commercial loans (MXN $11,892.5 million) and loans from Banobras (MXN $10,587.0) with a fraction of total obligations in municipal bonds (MXN $211.4 million).

Following the failures in subnational debt management of the 1990s, the federal government adopted a number of policies to ensure macroeconomic stability and create a responsible capital market environment. By 2000, Mexico had ended federal repayment guarantees, banned the use of foreign currency loans, mandated that debt proceeds only be applied to capital investments, established a state-based framework for regulation of municipal borrowing and set penalties for municipalities that seek debt finance without having engaged in an official credit rating (Hochman and Valadez 2004). One of the many institutional developments that facilitated the expansion of the local capital market has been the creation of municipal trusts (*fideicomisos*) managed by institutional investors that, in effect, returned some autonomy to the local level by replacing the intercept payment system that the federal government operated during the 1990s. Municipalities have since used trusts to intercept tax-sharing revenue from the state and federal level and

---

[43] Provisional estimates.

service debt before the funds arrive at to the municipal government and, less frequently, to sell securities themselves. Utilizing a master trust shields revenue streams and debt service from political interference and ensures continuity of payment in the event of local government transition. Municipal trusts also have the added benefit of augmenting local government credit scores, averaging nearly 5 points higher in credit ratings than conventional general obligation ratings by municipalities (Leigland and Mandri-Perrott 2008).

The emerging market for subnational debt in Mexico is showing some signs of both maturity and diversity. The Federal District, the country's largest conurbation, in 2006 began using interest rate swaps to hedge against floating interest rate exposure on new bonds (Velázquez 2007). The growing sophistication of the subnational capital market is confirmed by Martell and Guess (2006) who observe a combination of market discipline, experimentation and increasing use of alternatives to direct borrowing.[44] One successful case of municipal bonding of debt is the Tlalnepantla Municipal Water Conservation Project in 2003 (Hofwegen 2006). The municipality of Tlalnepantla, a city of approximately 800,000 outside Mexico City, was able to issue a MXN $95.9 million (US $9.1 million) AAA unsecured revenue bond through partial guarantees from Standard and Poors and Moody's Mexico agencies with a 10-year maturity at an interest rate of UDIS + 5.5% to finance construction of a wastewater treatment and recycling plant. Though deals like these remain cost-prohibitive for smaller municipalities, the momentum and diversification in the subnational credit market in Mexico over the past decade suggests that the possibility of market financing of urban infrastructure in Mexico's smaller cities might not be far away.

Social Reproduction Functions

[44] The authors cite a municipal bond contract that includes a provision that allows the counterparty to exercise an option to accelerate repayment if the municipality misses a payment.

Systematic data on social expenditures from municipal own-source revenue is not generally available. However, as transfer revenue from the General Participation Fund (*participaciones)* is unconditional, to the extent that it is considered general municipal revenue, there is some scope for the municipal financing of local expenditures directed to addressing issues of urban poverty. In the context of targeted social expenditures, the overwhelming majority of local expenditures are financed through transfers that are conditional. Specifically, The conditional transfers from the social infrastructure fund (*Fondo de Aportaciones Para La Infraestructura Social*) of the Ramos 33 program are earmarked for various social expenditures, determined by federal formulae, for low income and poor sectors of the municipal population.[45]

Conclusion

This paper has reviewed the management of municipal finance systems in five federal countries: the United States, Australia, Germany, Brazil and Mexico. The paper focused on four components of municipal finance systems: revenue enhancement, expenditure management, intergovernmental transfers and market financing of municipal infrastructure. A brief review of the strategies developed within each component by country is found in the table below.

45 Approximately 87.9% of funding from the FAIS is devolved to the municipalities. For an extensive review of the FAIS fund and how it finances social infrastructure in Mexican municipalities, see Wellenstein et. al. (2006).

Recent Trends in the Management of Municipal Finance Systems in Federal Countries

	Revenue Enhancement	Expenditure Management	Intergovern-mental Finance	Market Financing of Municipal Infrastructure
United States	Increasing use of user charges and fees; local option taxes; tax increment financing	Performance-based budgeting; capital management reforms	No formal equalization scheme; federal and state transfers for education, healthcare and transportation	Municipal bonds; municipal derivative securities
Australia	Increasing use of user charges and fees; property tax (rates)	Council amalgamation; performance-based budgeting	Federal and state grants to achieve vertical and horizontal equalization	Minimal use of borrowing
Germany	Increasing use of user charges and fees; trade tax (business); shared revenue agreements	New Steering Model (NSM); privatization; output budgeting and modified accrual accounting	Gross transfer system (municipalities can be net contributors); vertical and horizontal equalization	Direct loans from local savings banks
Brazil	Tax on services (ISS); shared revenue agreements	Expenditure caps; participatory budgeting	Municipal participation fund (FPM); conditional grants for education and health care	Direct loans from state development bank
Mexico	Property tax reform	Local capacity building; city-specific management strategies	No formal equalization scheme; transfers have equalizing effect at state level	Municipal trusts

From a comparative perspective, the picture that emerges from the analysis is one of structural convergence in revenue systems but with continued variance in approaches to expenditure management, intergovernmental transfer systems and market financing of urban infrastructure. As briefly outlined below, these two trends have important implications not only for the technical practice of municipal financial management but also in terms of local government's ability to meet future targets for local economic and human development.

It can be observed that in all these federal countries, municipal governments face the daunting challenge of responding to increasing demand for local public goods and services while managing budget constraints and volatility frequently derived from conditions outside city hall. That national and local specificity continues to influence how each country responds to this problem through expenditure management, intergovernmental finance and market financing of urban infrastructure is no surprise. Political, economic and historical factors are still critical dimensions to determining the legislative opportunity set as it relates to the fiscal resources of municipalities. The fact that Brazil still tightly regulates subnational borrowing through the Fiscal Responsibility Act, despite over a decade of stability, is a case in point. Mexico, however, is an important counterpoint to the Brazilian case, illustrating that long-term market financing of infrastructure and economic stability can be achieved under the right conditions.

The convergence in local revenue strategies, in terms of the centralizing of local revenues through increased reliance on intergovernmental transfers, though should be cause for concern for policy makers because it suggests a transition from cyclical to structural fiscal gaps in the municipal sector. This trend gains added salience in light of the recent global economic crisis. Bird and Smart (2001, 3) list four methods for closing the fiscal gap at the local level outside of transfers: devolving revenue-raising authority, centralizing expenditure responsibility, or reducing local expenditures or raising revenue. Evidence from the past decade suggests that there is neither public nor political support for the first and third options. Furthermore, the second option has, for many reasons, become inefficient as increased interurban competition and diversification of local demand schedules as a result of globalization necessitate rapid deployment of municipal resources. Popular tax revolts and formal legislation limiting tax rates continue to be powerful constraints to local revenue authority. The impact of the global economic crisis on municipal finances in the United States, for example, has exposed a critical limitation in many public finance systems: the only area to cut expenditures is in what is considered “non-essential services,” which for nearly all cities and countries are actually quite essential (i.e. education-related expenses). Combined with chronic underfunding of capital maintenance, it can be assumed then that there is not much room for further expenditure cuts. Additionally, the centralization of expenditures entails an entirely new set of issues for urban residents, but of primary concern at the local level is facilitating expenditure responsibility.

From this analysis, one could argue that prolonged fiscal gaps could serve as a binding constraint to a robust, flexible and active municipal sector. Overreliance on transfers during a period when federal governments face increasing deficits as a result of a contraction in the global economy further reduces the municipal sector’s capability to respond to local demand. With financial markets facing prolonged volatility, cities are further limited in their ability to access credit to make long-term capital investments. These pressure points will induce new strategies for managing municipal finances and the cities that thrive will learn how to adapt under these conditions. However, the real risks to economic and human development will come from the cumulative effects of 30 years of shifting fiscal federal policy as it relates to municipalities. The status quo of cost-shifting to local governments who face rising demand with inadequate revenue resources seems to be an unsustainable path for the municipal sector. Only further rounds of reform will tell.

References

Afonso, José Roberto. 2004. The Relations Between Different Levels of Government in Brazil. *CEPAL Review* 84: 133-156.

Afonso, José Roberto and Erika Araújo. 2000. "A Capacidade de Gastos Dos Municípios Brasileiros: Arrecadação Própria e Receita Disponível." In *Os Municípios e as Eleições de 2000*, eds. Gleisi Neves et. al. São Paulo: Konrad Adenauer Stiftung.

Afonso, José Roberto and Erika Araújo. 2006. "Local Government Organization and Finance: Brazil." In *Local Governance in Developing Countries*, ed. Anwar Shah. Washington DC: World Bank.

Afonso, José Roberto and Luiz de Mello. 2000. *Brazil: An Evolving Federation*. Paper presented at "Conference on Fiscal Decentralization." Washington DC: International Monetary Fund." November 20-21. http://www.imf.org/external/pubs/ft/seminar/2000/fiscal/afonso.pdf.

Allen Consulting Group. 2003. *Funding Urban Public Infrastructure: Approaches Compared.* Report for the Property Council of Australia. http://www.allenconsult.com.au/publications/download.php?id=258&type=pdf&file=2.

Andrews, Christina W. 2004. Anti-Poverty Policies in Brazil: Reviewing the Past Ten Years. *International Review of Administrative Sciences* 70(3): 477-488.

Australian Government. 2005. *Local Government National Report 2003-2004.* Canberra: Department of Infrastructure, Transport, Regional Development and Local Government.

Access Economics Pty Ltd. 2006. *Local Government Finances in New South Wales: An Assessment.* Independent Review Panel. Sydney: Local Government Shires Association.

Australian Government. 2006. *Local Government National Report 2004-05.* Canberra: Department of Infrastructure, Transport, Regional Development and Local Government.

Australian Government. 2008. *Assessing Local Government Revenue Raising Capacity*. Canberra: Productivity Commission.

Australian Government. 2009. *Local Government National Report 2006-07*. Canberra: Department of Infrastructure, Transport, Regional Development and Local Government.

Australian Institute of Health and Welfare. 2007. Welfare Expenditure Australia 2005-06. *Health and Welfare Expenditure Series Number 31*. Canberra: Australian Institute of Health and Welfare.

Australian Local Government Association. 2010. *Fact Sheet 5: Cost Shifting*.
http://www.alga.asn.au/policy/ACLG/pdf/Fact_Sheet_5_Cost_Shifting.pdf
Baicker, Katherine and Nora Gordon. 2006. The Effect of State Education Finance Reform on Total Local Resources. *Journal of Public Economics* 90(8-9): 1519-1535.

Bird, Richard. 2005. "Fiscal Federalism." In *Encyclopedia of Taxation and Tax Policy,* eds. Joseph Cordes, Robert D. Ebel and Jane G. Gravelle. Washington DC: Urban Institute Press.

Bird, Richard and Enid Slack. 2004. Fiscal Aspects of Metropolitan Governance. *ITP Paper 0401.* University of Toronto: International Tax Program.

Bird, Richard and Michael Smart. 2001. "Intergovernmental Fiscal Transfers: Some Lessons from International Experience. Paper prepared for Symposium on Intergovernmental Transfers in Asian Countries: Issues and Practices. Asian Tax and Public Policy Program. Hitosubashi University, Tokyo. February 2001.

Bond Market Association. 2001. *The Fundamentals of Municipal Bonds*. New York: Wiley & Sons, Inc.

Bönker, Frank and Hellmut Wollman. 2006. "Public Sector Reforms and Local Governments in Germany: The Case of Local Social Policy." In *State and Local Government Reforms in France and Germany: Divergence and Convergence*, eds. Vincent Hoffman-Marinot and Hellmut Wollman. Wiesbaden: GWV Fachverlage GmbH.

Brannstrom, Christian. 2004. Decentralising Water Resource Management in Brazil. *European Journal of Development Research* 16(1): 214-234.

Brooks, Mary E. 2007. *Housing Trust Funds Progress Report*. Center for Community Change. http://www.communitychange.org/our-projects/htf/other-media/HTF%2007%20final.pdf.

Brown, A.J. 2002. Subsidiarity or Subterfuge? Resolving the Future of Local Government in the Australian Federal System. *Australian Journal of Public Administration* 61(4): 24-42.

Brunori, David. 2007. *Local Tax Policy: A Federalist Perspective.* Washington DC: Urban Institute Press.

Buchanan, James M. 1975. Public Finance and Public Choice. *National Tax Journal* 28(4): 383-394.

Budds, Jessica and Paulo Teixeira. 2005. Ensuring the Right to the City: Pro-Poor Housing, Urban Development and Tenure Legalization in São Paulo, Brazil. *Environment and Urbanization* 17(1): 89-113.

Buettner, Thiess. 2001. Local Business Taxation and Competition for Capital: The Choice of the Tax Rate. *Regional Science and Urban Economics* 31(2): 215-245.

Buettner, Thiess. 2006. The Incentive Effect of Fiscal Equalization Transfers on Tax Policy. *Journal of Public Economics* 90(3): 477-497.

Buettner, Thiess. 2008. "Fiscal Equalization in Germany." In *Fiscal Federalism and Political Decentralization: Lessons from Spain and Germany*, eds. Núria Bosh and José María Durán. Northampton: Edward Elgar Publishing, Inc.

Buettner, Thiess. and D.E. Wildasin. 2006. The Dynamics of Municipal Fiscal Adjustment. *Journal of Public Economics* 90(6-7): 1115–1132.

Bundesbank. 2010. *Local Government Debt*. http://www.bundesbank.de/statistik/statistik_zeitreihen.en.php?lang=en&open=wirtschaftsdaten&func=row&tr=BQ3521.

Byrnes, Joel, Brian Dollery, Lin Crase and Phil Simmons. 2007. Financing the Australian Local Government Infrastructure Backlog through a Bond Issue on the Capital Market. *Center for Local Government Working Paper Series 14-2007.* Armidale: University of New England.

Campbell, Tim and Travis Katz. 2004. “The Politics of Participation in Tijuana, Mexico: Inventing a New Style of Governance.” In *Leadership and Innovation in Subnational Government: Case Studies from Latin America*, eds. Tim Campbell and Harald Fuhr. Washington DC: World Bank.

Carroll, Deborah A. 2009. Diversifying Municipal Government Revenue Structures: Fiscal Illusion or Instability? *Public Budgeting and Finance* 29(1): 27-48.

Cohen, Manuel Perlo. 1999. Tax Reform in Mexicali. *Land Lines* 11(5): 6-7.

Commonwealth Grants Commission. 2001. *Review of the Operation of the Local Government (Financial Assistance) Act 1995*. Canberra: Panther Publishing & Printing.

Courchene, Thomas and Alberto Díaz-Cayeros. 2000. “Transfers and the Nature of the Mexican Federation.” In *Achievements and Challenges of Fiscal Decentralization in Mexico*, eds. Marcelo Guigale and Steven Webb. Washington DC: World Bank.

Crase, L. and Brian Dollery. 2005. “A Critical Note on Local Government Charges in Australia: Have We Lost Sight of How to Fund Public and Merit Goods?” Unpublished paper presented to the 34th Conference of Economists, University of Melbourne. 28 September 2005.

de Mello, Luiz and Mombert Hoppe. 2005. Education Attainment in Brazil: The Experience from FUNDEF. *OECD Economics Department Working Papers No. 424*. Paris: OECD Publishing.

Díaz-Cayeros, Alberto and Charles E. McClure, Jr. 2000. “Tax Assignment.” In *Achievements and Challenges of Fiscal Decentralization in Mexico*, eds. Marcelo Guigale and Steven Webb. Washington DC: World Bank.

Ditsch, Stefan. 2008. Trade Tax Comes to the Fore. *International Tax Review* 19(7): 95-96.

Dollery, Brian, Lin Crase and Andrew Johnson. 2006. *Australian Local Government Economics*. Sydney: New South Wales Press Ltd.

Dollery, Brian, Lin Crase and Joel Byrnes. 2006. Local Government Failure: Why Does Australian Local Government Experience Permanent Financial Austerity? *Australian Journal of Political Science* 41(3): 339-353.

Dollery, Brian, Joel Byrnes and Lin Crase. 2007a. Is Bigger Better? Local Government Amalgamation and the South Australian *Rising to the Challenge* Inquiry. *Economic Analysis & Policy* 37(1): 1-14.

Dollery, Brian, Joel Byrnes and Lin Crase. 2007b. An Analysis of the New Perspective on Amalgamation in Australian Local Government. *Centre for Local Government Working Paper Series 02-2007*. Armidale: University of New England.

Dye, Richard F. 2008. The Dynamic Between Municipal Revenue Sources and the State-Local Relationship in New England. *New England Public Policy Center Working Paper 08-1*. Boston: Federal Reserve Bank of Boston.

Dye, Richard F. and David F. Merriman. 2000. The Effects of Tax Increment Financing on Economic Development. *Journal of Urban Economics* 47(2): 306-328.

Ebdon, Carol. 2004. Capital Management Practices in U.S. Counties. *Public Works Management & Policy* 8(3): 192-202.

Ebdon, Carol. 2007. “Underpinning Government: Capital and Infrastructure Management in State and Local Government.” In *In Pursuit of Performance: Management Systems in State and Local Government*, ed. Patricia W. Ingraham. Baltimore: John Hopkins University Press.

Edwards, Mary. 2006. State and Local Revenues Beyond the Property Tax. *Lincoln Institute of Land Policy Working Paper*. https://lincolninst.edu/subcenters/teaching-fiscal-dimensions-of-planning/materials/edwards-revenue.pdf.

Egger, Peter, Marko Koethenbuerger and Michael Smart. 2007. Do Fiscal Transfers Alleviate Business Tax Competition? Evidence from Germany. *CESifo Working Paper No. 1955.* http://www.cesifo-group.de/DocCIDL/cesifo1_wp1955.pdf.

Epstein, Paul D., Wilson Campbell and Laura Tucker. 2002. “Case Study: City of Sunnyvale, California” in *Use and the Effects of Using Performance Measures for Budgeting, Management, and Reporting*. Norwalk:

Government Accounting Standards Board. http://www.seagov.org/sea_gasb_project/case_studies.shtml.

Fainstein, Susan S. 2005. Planning Theory and the City. *Journal of Planning Education and Research.* 25(2): 121-130.

Feld, Lars P. and Jürgen von Hagen. 2007. "Federal Republic of Germany." In *The Practice of Fiscal Federalism: Comparative Perspectives*, eds. John Kincaid and Anwar Shah. Montreal: Queen's University Press.

Ferraz, Claudio and Frederico Finan. 2007. Exposing Corrupt Politicians: The Effects of Brazil's Publicly Released Audits on Electoral Outcomes. *IZA Discussion Paper No 2836.* Bonn: Institute for the Study of Labor.

Furdell, Phyllis, Michael Perry and Tresa Undem. 2008. Poverty and Economic Insecurity: Views from City Hall. *Research Report on the State of America's Cities*. Washington DC: National League of Cities.

Gais, Thomas L. 2009. Stretched Net: The Retrenchment of State and Local Social Welfare Spending Before the Recession. *Publius: The Journal of Federalism* 39(3): 557-579.

Gillette, Clayton P. 2008. Fiscal Home Rule. *Denver University Law Review* 86(4): 1241-2009.

Goldman, Todd and Martin Wachs. 2003. A Quiet Revolution in Transportation Finance: The Rise of Local Option Transportation Taxes. *Transportation Quarterly* 57(1): 19-32.

Gordon, Roger H. 2010. Public Finance and Economic Development: Reflections based on Experience in China. *Journal of Globalization and Development* 1(1): 1-27.

Gordon, Roger H. and Wei Li. 2009. Tax Structures in Developing Countries: Many Puzzles and a Possible Explanation. *Journal of Public Economics* 93(7-8): 855-866.

Green, Andrew D. 2006. Life in the Fast Lane: Transportation Finance and the Local Option Sales Tax. *State and Local Government Review* 38(2): 92-103.

Grindle, Merilee S. 2007. *Going Local: Decentralization, Democratization, and the Promise of Good Governance*. Princeton: Princeton University Press.

Grossi, Giuseppe and Christoph Reichard. 2008. Municipal Corporatization in Germany and Italy. *Public Management Review* 10(5): 597-617.

Guardia, Eduardo Refinetti and Daniel Sonder. 2004. *Fiscal Adjustment and Federalism in Brazil.* Paper presented at "IMF/NIPFP Conference on Fiscal Policy in India." New Delhi, January 16-17. http://www-bcc.imf.org/external/np/seminars/eng/2004/fiscal/pdf/guardia.pdf.

Gurran, Nicole. 2003. Housing Locally: Positioning Australian Local Government Housing for a New Century. *Urban Policy and Research* 21(4): 393-412.

Hager, Greg, Alice Hobson and Ginny Wilson. 2001. Performance-Based Budgeting: Concepts and Examples. *Research Report No. 302.* Frankfort: Legislative Research Commission.

Han, Song and Dan Li. 2008. Liquidity, Runs, and Security Design: Lessons from the Collapse of The Auction Rate Municipal Bond Market. Unpublished manuscript.

Haug, Peter and Birger Nerré. 2005. "Revenue Boosting Instruments in Municipal Finance From a Public Choice Perspective." In *Proceedings of the 98th Annual Conference on Taxation*, ed. John Diamond. Washington DC: National Tax Association.

Haug, Peter and Birger Nerré. 2006. Local Public Utilities' Profits and Municipal Expenses in Germany: An Empirical Analysis. Paper presented at 99th Annual Conference of the National Tax Association. Boston Nov 16-17 2006.

Hauptmeier, Sebastian. 2007. The Impact of Fiscal Equalization on Local Expenditure Policies – Theory and Evidence from Germany. *Discussion Paper No. 07-081.* Centre for European Economic Research. http://econstor.eu/bitstream/10419/24666/1/dp07081.pdf.

Hochman, Steven and Miguel Valadez. 2004. "Mexico." In *Subnational Capital Markets in Developing Countries: From Theory to Practice*, eds. Mila Freire and John Petersen. Washington DC: World Bank.

Hoene, Christopher W. 2009. City Budget Shortfall and Responses: Projections for 2010-2012. *Research Brief on America's Cities*. Washington DC: National League of Cities.

Hofwegen, Paul van. 2006. *Report on the Findings of the Expert Meetings Conducted to Support the Elaboration of Innovative Financing Models for Potable Water: Alternatives for Local Governments*. Washington DC: Inter-American Development Bank. http://idbdocs.iadb.org/wsdocs/getdocument.aspx?document=959238.

Holmes, Scott, Kerry London and Luke Sheehan. 2008. Housing Affordability in Australia: A Supply-Side Analysis. *Discussion Paper*. Challaghan: Australian Competition Policy Research Alliance.

Howell-Moroney, Michael. 2008. The Tiebout Hypothesis 50 Years Later: Lessons and Lingering Challenges for Metropolitan Governance in the 21st Century. *Public Administration Review* 68(1): 97-109.

Inter-American Development Bank. 2005. *Assessment of Participatory Budgeting in Brazil.* Washington DC: Inter-American Development Bank. www.iadb.org/sds/doc/ParticipatoryBudget.pdf.

Instituto Brasileiro de Administração Municipal. 2001. Evolução do Quadro Municipal Brasileiro no Período entre 1980 e 2001*. Special Studies Series No. 20.* Rio de Janeiro: IBAM.

Johnson, Andrew. "Financing Local Government in Australia." In *Reshaping Australian Local Government: Finance, Governance and Reform,* eds. Brian Dollery, Neil Marshall and Andrew C. Worthington. Sydney: University of New South Wales Press Ltd.

Johnson, Craig L. and Joyce Y. Man, eds. 2001. *Tax Increment Financing and Economic Development.* Albany: State University of New York Press.

Katz, Bruce and Katherine Allen. 2001. Cities Matter: Shifting the Focus of Welfare Reform. http://www.brookings.edu/articles/2001/summer_metropolitanpolicy_katz.aspx.
Kelly, Janet M. and William C. Rivenbark. 2003. *Performance Budgeting for State and Local Government.* Armonk: M.E. Sharpe, Inc.

Kelly, Janet M. and William C. Rivenbark. 2008. Budget Theory in Local Government: The Process-Outcome Conundrum. *Journal of Public Budgeting, Accounting & Financial Management* 20(4): 457-481.

Kluvers, Ron. 2001. An Analysis of Introducing Program Budgeting in Local Government. *Public Budgeting & Finance* 21(2): 29-45.

Knorr-Siedow, Thomas. 2008. "Innovations From Below? A New Concept for Social Housing in Germany." In *Social Housing in Europe II: A Review of Policies and Outcomes*, eds. Kathleen Scanlon and Christine Whitehead. London: London School of Economics.

Koethenbuerger, Marko. 2002. Tax Competition and Fiscal Equalization. *International Tax and Public Finance* 9(4): 391-408.

Kraemer, Moritz. 1997. Intergovernmental Transfers and Political Representation: Empirical Evidence from Argentina, Brazil and Mexico. *Office of the Chief Economist Working Paper 345.* Washington DC: Inter-American Development Bank.

Krane, Dale, Platon N. Rigos, and Melvin B. Hill Jr. 2001. *Hope Rule in America: A Fifty State Handbook.* Washington DC: CQ Press.

Krane, Dale, Carol Ebdon and John Bartle. 2004. Devolution, Fiscal Federalism, and Changing Patterns of Municipal Revenues: The Mismatch Between Theory and Reality. *Journal of Public Administration Research and Theory* 14(4): 513-533.

Kuhlmann, Sabine. 2008. Reforming Local Public Services: Trends and Effects in Germany and France. *Public Management Review* 10(): 573-596.

Laubach, T. 2005. Fiscal Relations Across Levels of Government in the United States. *OECD Economics Department working Papers No. 462*. OECD Publishing.

Lawall, L. 2008. German Tax Reform Has Benefits and Drawbacks. *International Tax Review* 19: 13-16.

Leigland, James and Cledan Mandri-Perrott. 2008. Enhancing the Creditworthiness of Municipal Bonds: Innovations from Mexico. *Gridlines* 39: 1-5.

Local Government and Shires Association of NSW. 2006. *Are Council's Sustainable? Independent Inquiry into the Financial Sustainability of NSW Local Government.* Sydney: New South Wales Government. http://www.lgsa-plus.net.au/www/html/1389-local-government-inquiry.asp.

Local Government Victoria. 2008. *Victorian State-Local Government Agreement.* Melbourne: Department of Planning and Community Development. http://www.localgovernment.vic.gov.au.

Lyons, Karen and Iris J. Lav. 2007. *Tax Problems with Property Tax Revenue Caps*. Washington DC: Center on Budget and Policy Priorities. http://www.centeronbudget.org/cms/index.cfm?fa=view&id=414.

Mackey, Scott. R. 1997. *Critical Issues in State-Local Fiscal Policy: A Guide to local Option Taxes*. Denver: National Conference of State Legislatures.

Martell, Christine R. 2003. Municipal Investment, Borrowing, and Pricing Under Decentralization: The Brazilian Case. *International Journal of Public Administration* 26(2): 173-196.

Martell, Christine R. 2007. Municipal Government Accountability in Brazil. *International Journal of Public Administration* 30(12-14): 1591-1619.

Martell, Christine R. and George M. Guess. 2006. Development of Local Government Debt Debt Finance Market: Application of a Market-Based Framework. *Public Budgeting & Finance* 26(1): 88-119.

McBride, Shaun and Sascha Moege. 2005. Interstate Comparison of Australian Local Government. *Adviser Brief*. Sydney: Local Government Inquiry Report.

Mendoza, Enrique Cabrero and Jorge Martinez-Vazquez. 2000. “Assignment of Spending Responsibilities and Service Delivery. In *Achievements and Challenges of Fiscal Decentralization in Mexico*, eds. Marcelo Guigale and Steven Webb. Washington DC: World Bank.

Moore, Carolyn, Wade Jacoby and Arthur B. Gunlicks. 2008. German Federalism in Transition? *German Politics* 17(4): 393-407.

Moreno, Carlos. 2003. Fiscal Performance of Local Governments in Mexico: The Role of Federal Transfers. *Working Paper No. 127.* Mexico City: Center for Research and Economic Teaching. http://www.presupuestoygastopublico.org/documentos/presupuesto/DT%20127.pdf.

Moser, Michele and Ross Rubenstein. 2002. The Equality of Public School District Funding in the United States: A National Status Report. *Public Administration Review* 62(1): 63-72.

Mueller, Dennis. 2003. *Public Choice III.* New York: Cambridge University Press.

Musgrave, Richard A. 1959. *The Theory of Public Finance*. New York: McGraw Hill.

Murray, David and Brian Dollery. 2005. Local Governemnt Performance Monitoring in New South Wales: Are "At Risk" Councils Really at Risk? *Economic Papers* 24(4): 332-345.

Murray, Sheila E., Kim Rueben and Carol Rosenberg. 2007. State Education Spending: Current Pressures and Future Trends. *National Tax Journal* 60(2): 325-345.

Neri, Marcelo and Gabriel Buchmann. 2008. From Dakar to Brasilia: Monitoring Unesco's Education Goals. Background paper prepared for "Global Monitoring Report 2008." Paris: United Nations Educational, Scientific and Cultural Organization. http://www3.fgv.br/ibrecps/discussao/EE2008_Quali_Final_Brazil_English.pdf.

Neutze, Max. 1995. "Financing Urban Services." In *Australian Cities: Issues, Strategies, and Policies for Urban Australia in the 1990s,* ed. Patrick Troy. Hong Kong: Cambridge University Press.

Oates, Wallace E. 1968. The Theory of Public Finance in a Federalist System. *Canadian Journal of Economics* 1(1): 37-54.

Oates, Wallace E. 1972. *Fiscal Federalism*. New York: Harcourt Brace Javanovich.

OECD. 2003. *OECD Territorial Reviews: Mexico.* Paris: OECD Publication Service.

OECD. 2009. "Government at a Glance 2009: Germany." www.oecd.org/dataoecd/39/48/43933791.pdf.

Olson, M. 1969. The Principle of "Fiscal Equivalence": The Division of Responsibilities Among Different Levels of Government. *American Economic Review* 59(2): 479-487.

Peterson, George E. 2009. Sub-National Debt Management: What Have We Learned from the Global Financial Crisis? Presentation to World Bank Urban Week 2009, May 9.
http://www.wburbanstrategy.org/urbanstrategy/?q=node/62.

Peterson, John and John B. Crihfield. 2000. Linkages Between Local Governments and Financial Markets: A Tool Kit to Developing Sub-Sovereign Credit Markets in Emerging Economies. *Urban and Local Government Background Series 21095*. Washington DC: World Bank.

Pinnegar, Simon, Hazel Easthope, Bill Randolph, Peter Williams and Judith Yates. 2009. *Innovative Financing for Homeownership: The Potential for Shared Equity Initiatives in Australia.* Canberra: Australian Housing and Urban Research Institute.

Platz, Daniel and Frank Schroeder. 2007. Moving Beyond the Privatization Debate: Different Approaches to Financing Water and Electricity in Developing Countries. *Occasional Paper No. 34.* New York: Friedrich Ebert Stiftung.

PricewaterhouseCooper. 2006. *National Financial Sustainability Study of Local Government.* Sydney: Australian Local Government Association.

Receita Federal. 2007. The Fiscal Load in Brazil. *Tax Statistics 19*. Brasilia: Ministry of Finance. http://www.receita.fazenda.gov.br/publico/estudoTributarios/estatisticas/Ingles/CTB20
06Ing.pdf.

Reichard, Christoph. 2002. Marketization of Public Services in Germany. *International Public Management Review* 3(2): 63-80.

Reissert, Bernd. 2006. "Public Finance as Drivers and Constraints for Public Sector Reform in Germany. In *State and Local Government Reforms in France and Germany: Divergence and Convergence*, eds. Vincent Hoffman-Marinot and Hellmut Wollman. Wiesbaden: GWV Fachverlage GmbH.

Rezende, Fernando and Sol Garson. 2006. Financing Metropolitan Areas in Brazil: Political, Institutional and Legal Obstacles and Emergence of New Proposals for Improving Coordination. *Revista de Economia Contemporânea* 10(1): 5-34.

Ridder, Hans-Gerd, Hans-Jürgen Bruns and Fabian Spier. 2005. Analysis of Public Management Change Processes: The Case of Local Government Accounting Reforms in Germany. *Public Administration* 83(2): 443-471.

Rogers, Cynthia L. 2004. Local Option Sales Tax (LOST) Policy on the Urban Fringe. *The Journal of Regional Analysis & Policy* 34(1): 27-50.

Ruben, Kim and Carol Rosenberg. 2008. State and Local Revenues. *Tax Notes.* Tax Policy Center, Urban Institute and Brookings Institution.

Sakurai, Sergio Naruhiko and Naercio Aquino Menezes-Filho. 2008. Fiscal Policy and Reelection in Brazilian Municipalities. *Public Choice* 137(1-2): 301-314.

Schroeder, Larry. 2006. “Local Government Organization and Finance: United States.” In *Local Governance in Industrial Countries*. ed. Anwar Shah. Washington DC: World Bank.

Schwartz, Alex F. 2006. *Housing Policy in the United States: An Introduction*. New York: Routledge.

Seitz, Helmut. 2000. Subnational Government Bailouts in Germany. *Research Network Working Paper #R-396.* Washington DC: Inter-American Development Bank.

Seitz, Helmut and Gerhard Kempkes. 2007. Fiscal Federalism and Demography. *Public Finance Review.* 35(3): 385-413.

Shah, Anwar, ed. 2006a. *Local Governance in Developing Countries*. Washington DC: World Bank.

Shah, Anwar. 2006b. “A Comparative Institutional Framework for Responsive, Responsible, and Accountable Local Governance.” In *Local Governance in Industrial Countries*, ed. Anwar Shah. Washington DC: The World Bank.

Shah, Anwar, ed. 2007a. *Local Budgeting*. Washington DC: World Bank.

Shah, Anwar, ed. 2007b. *Local Public Financial Management.* Washington DC: World Bank.

Shah, Anwar and Sana Shah. 2006. "The New Vision of Local Governance and the Evolving Roles of Local Governments." In *Local Governance in Developing Countries*, ed. Anwar Shah. Washington DC: The World Bank.

SHCP. Secretary of Finance and Public Credit. 2010. *Deuda Contrada por los Municipios con la Banca Comercial, de Desarrollo y Emisiones Bursátiles*.
http://www.hacienda.gob.mx/ UnidadCEF/Deuda/eo_m134.xls.

Skidmore, Mark. 1999. Tax and Expenditure Limitations and the Fiscal Relationships Between State and Local Governments. *Public Choice* 99(1-2): 77-102.

Slack, Enid. 2002. *Municipal Finance and the Pattern of Urban Growth.* Toronto: CD Howe Institute.

Slack, Enid. 2005. Municipal Financing of Capital Infrastructure in North America. *Journal of Property Tax Assessment and Administration* 2(5): 63-78.

Smith, Brent. 2006. The Impact of Tax Increment Finance Districts on Localized Real Estate: Evidence from Chicago's Multifamily Markets. *Journal of Housing Economics* 15(1): 21-37.

Souza, Celina. 2001. Participatory Budgeting in Brazilian Cities: Limits and Possibilities in Building Democratic Institutions. *Environment & Urbanization* 13(1): 159-183.

Souza, Celina. 2003. *Brazil's System of Local Government, Local Finance, and Intergovernmental Relations.* Building Municipal Capacity for Finance Budgeting. School of Public Policy, University of Birmingham, United Kingdom.

Spink, Peter. 2005. *The Inter-Municipal Consortia in Brazil: An Institutional Introduction*. Paper presented at "10th International Congress of CLAD on the Reform of the State and Public Administration." 18-21 October 2005. Santiago, Chile. http://www.chs.ubc.ca/consortia/references/Spink-Intermunicipal_consortia_Brazil-2005.pdf.

Steward, Louis J. and Carol A. Cox. 2008. Debt-Related Derivative Usage by U.S. State and Municipal Governments and Evolving Financial Reporting Standards. *Journal of Public Budgeting, Accounting & Financial Management* 20(4): 439-456.

Tannenwald, Robert. 2001. Are State and Local Systems Becoming Obsolete? *New England Economic Review* 4(1): 27-43.

Tiebout, Charles M. 1956. A Pure Theory of Local Expenditures. *The Journal of Political Economy* 64(5): 416-424.

Turner, Brian. 2002. Liberating the "Municipio Libre": The Normalization of Municipal Finance in Yucatan. *Mexican Studies* 18(1): 101-131.

United Nations Habitat. 2009. *Guide to Municipal Finance*. Nairobi: UN-Habitat. United States Census Bureau. 2007. Census of Governments. http://www.census.gov/govs/cog/GovOrgTab03ss.html.

United States Government Accountability Office. 2007. State and Local Governments: Persistent Fiscal Challenges Will Likely Emerge Within the Next Decade. *GAO-07-1080SP.* Washington DC. http://www.gao.gov/new.items/d071080sp.pdf.

United States House of Representatives Committee on Financial Services. 2009. "Municipal Finance: Testimony of David Wilcox. 111th Congress, 1st sess. 21 May 2009." http://www.house.gov/apps/list/hearing/financialsvcs_dem/111-37.pdf.

Velázquez, Alfonso Mendoza. 2007. Subnational Debt Swaps in Mexico, How Big is Risk Exposure? *Public Budgeting & Finance* 27(3): 110-129.

Ward, Peter M. 2008. From Machine Politics to the Politics of Technocracy: Charting Changes in Governance in the Mexican Municipality. *Bulletin of Latin American Research* 17(3): 341-365.

Warren, Neil. 2006. *Benchmarking Australia's Intergovernmental Fiscal Arrangements*. Sydney: NSW Government.

Webb, Steven B. and Christian Y. Gonzalez. 2004. Bargaining for a New Fiscal Pact in Mexico. *World Bank Policy Research Working Paper 3284.* Washington DC: World Bank.

Weber, Rachel, Saurav Dev Bhatta and David Merriman. 2007. Spillovers from Tax Increment Financing Districts: Implications for Housing Price Appreciation. *Regional Science and Urban Economics* 37(2): 259-281.

Wellenstein, Anna, Angélica Núñez and Luis Andrés. 2006. "Social Infrastructure: Fondo de Aportaciones Para La Infraestructura Social (FAIS)." In *Decentralized Service Delivery for the Poor Volume II.* Washington DC: World Bank.

Werneck, Rogério L. F. 2008. Tax Reform in Brazil: An Evaluation at the Crossroads. *Department of Economics Discussion Paper No. 558.* Rio de Janeiro: Pontifical Catholic University. http://www.econ.puc-rio.br/PDF/TD558.pdf.

Werner, Jan. 2006. "Local Government Organization and Finance: Germany." In *Local Governance in Industrial Countries*, ed. Anwar Shah. Washington DC: World Bank.

Western Australia Local Government Association. 2008. *The Journey: Sustainability into the Future.* West Perth: Western Australia Local Government Association.

Wilson, Robert H. 2006. *Decentralization and Intergovernmental Relations in Social Policy: A Comparative Perspective of Brazil, Mexico and the US*. Paper presented at "Interregional Conference on Social Policy and Welfare Reform." April 20-21. Austin: University of Texas.

Wollman, Hellmut. 2000. Local Government Modernization in Germany: Between Incrementalism and Reform Waves. *Public Administration* 78(4): 915-936.

World Bank. 2006. "Institutional Dimensions of Decentralized Service Delivery." In *Decentralized Service Delivery for the Poor Volume I.* Washington DC: World Bank.

Worthington, Andrew and Brian Dollery. 1998. The Political Determination of Intergovernmental Grants in Australia. *Public Choice* 94(3-4): 299-315

Worthington, Andrew and Brian Dollery. 2000. The Debate on Australian Federalism: Local Government Financial Interrelationships with State and Commonwealth Governments. *Australian Journal of Public Administration* 59(4): 12-22.

Zabala, Rodrigo, Trelle and Giovanni Giovanelli. 2004. "Brazil." In *Subnational Capital Markets in Developing Countries: From Theory to Practice*, eds. Mila Freire and John Petersen. Washington DC: World Bank.

Zhao, Zhirong J. and Yilin Hou. 2008. Local Option Sales Taxes and Fiscal Disparity: The Case of Georgia Counties. *Public Budgeting and Finance* 28(1): 39-57.

Ziblatt, Daniel F. 2002. Recasting German Federalism? The Politics of Fiscal Decentralization in Post-Unification Germany. *Politische Vierteljahresschrift* 43(4): 624-652.

Zipfel, Frank. 2010. "Double-Entry Accounting: A Big Change for Municipal Treasurers." *Talking Point.* Deutsche Bank. http://www.dbresearch.com/servlet/reweb2.ReWEB?addmenu=false&document=PROD0000000000253318&rdLeftMargin=10&rdShowArchivedDocus=true&rwdspl=0&rwnode=DBR_INTERNET_EN-PROD$WIPO&rwobj=ReDisplay.Start.class&rwsite=DBR_INTERNET_EN-PROD.

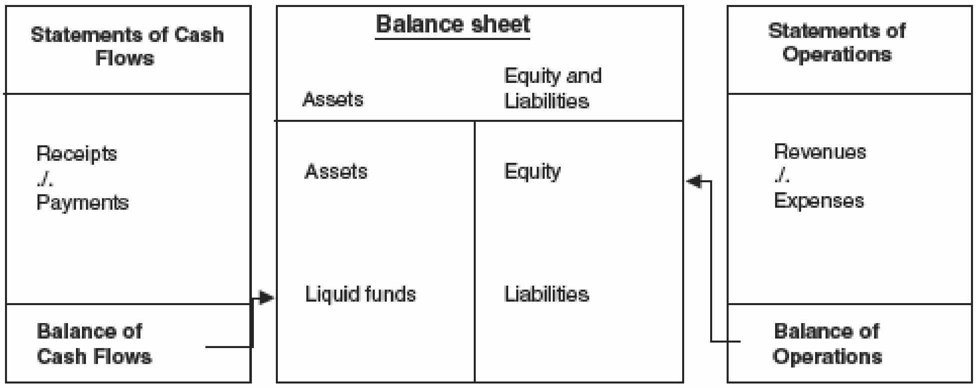
Appendix

Table 1: Current Charges as Percent of Total Current Charges in US Municipalities, 2002-2003

Activity	County	Municipal/Township	Special District	School District
Education	4.9	1.4	0.0	100.0
Hospital	39.7	11.4	46.0	0.0
Highways	1.0	2.1	3.6	0.0
Airports	3.9	10.1	10.3	0.0
Parking	0.2	2.2	0.2	0.0
Sea/Inland Port	0.4	1.6	2.5	0.0
Facilities	0.4	1.6	2.5	0.0
Natural Resources	0.0	0.0	2.5	0.0
Parks	2.1	6.6	3.2	0.0
Housing	0.4	2.8	5.6	0.0
Sewer	6.5	34.2	12.7	0.0
Solid Waste	7.4	10.9	2.5	0.0
Other	33.4	16.7	11.1	0.0
Total Current Charges	100.0	100.0	100.0	100.0

Source: Edwards (2006).

Figure 1: NKF Management Process



Source: Ridder et al. (2005).