# GST IMPACT ON LOCAL (URBAN) GOVERNMENT FINANCE

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## **ABSTRACT**

Absorption of octroi/entry taxes into GST is said to have adversely affected the finances of local (urban) governments. This proposition is examined here, referring to (i) the steps taken by the Government of Maharashtra to neutralise the loss incurred by urban local governments (ULBs) on account of the absorption of octroi into GST and (ii) the scale to which other states are directly compensating the ULBs on this account. Additionally, the impact of a number of initiatives taken in recent decades to reset ULBs in the country's intergovernmental fiscal framework has also been included in this presentation.

## A THREE-POINT PRESENTATION

- Impact of the absorption of octroi/entry taxes into GST on ULBs finances.
- Initiatives taken to reset local (urban) governments in the emerging intergovernmental fiscal framework and their impact on ULBs finances.
- 3. New Questions, Unfinished Agenda.

# IMPACT OF THE ABSORPTION OF OCTROI/ENTRY TAXES INTO GST ON ULBs FINANCES

- Revenue importance of octroi in ULBs finances (51.5 percent in municipal own revenues in 1986-87) versus its economy-wide adverse impacts; its gradual abolition linked, in a major way, to grants under several centrally-sponsored schemes and urban reform agenda.
- GST Act 2017 and the enactment of Maharashtra Goods and Services Tax (Compensation to the Local Authorities) Act, 2017. Applicable to 27 municipal corporations in the State, this Act provides that the base year revenue for the municipal corporations shall be the revenue collected in the base year, and further provides it to increase by 8 percent annually.

- Other states levying octroi compensate ULBs directly (fixing the compensation often arbitrarily) on account of the inclusion of octroi in GST. Punjab created a statutory Municipal Fund consisting of a share of VAT (replaced by GST) and excise on IMFL and beer and auction money from liquor vendors to compensate for the loss of revenue on account of the abolition of octroi (octroi was abolished in Punjab in 2006).
- None of these measures have proved to be adequate to match the buoyancy that octroi had, propelling a case for GST-sharing with local governments.

#### RBI's data on Octroi

Octroi Levies\*, 2017-18 (Actuals), 2018-19 (RE) Sample of 201 Municipal Corporations)

Corporation	Percent to Own Tax Revenue	
	2017-18 (Actuals)	2018-19 (RE)
Chattisgarh	3.2	4.5
Gujarat	5.4	4.7
Jharkhand	1.5	4.6
Kerala	<1.0	<1.0
Maharashtra	31.9	15.4
Odisha	<1.0	<1.0
Punjab	41.0	33.9
Rajasthan	87.2	78.2
West Bengal	<1.0	<1.0
All States	11.4	12.8

Reserve Bank of India. November 2022. Report on Municipal Finances

The inclusion of octroi/entry tax in GST has financial implications for the Municipal Corporations in Maharashtra, which were levying this tax. All other States, however, had abolished it at different points in time. To protect the interest of the MCs in Maharashtra, after several rounds of negotiations, the government passed the Maharashtra Goods and Services (Compensation to Local Bodies) Act, 2017, which guarantees compensation for the loss of revenue following the abolition of octroi. See the RBI Report, November 2022.

# INITIATIVES TAKEN TO RESET LOCAL (URBAN) GOVERNMENTS IN THE EMERGING INTERGOVERNEMNTAL FISCAL FRAMEWORK AND THEIR IMPACT ON ULBs FINANCES

- Constitutional-led initiatives
  - Incorporation of Articles 243 I and 243 Y (SFCs) and insertion of (3)(c) into Article 280 (CFC) of the Constitution -- new institutional set-up for determining a fiscal framework for ULBs to work with
- Statutorily-driven changes
  - Amendment to Article 10(15) of the Income Tax Act to enable ULBs access the capital market; and
  - SEBI (Issue and listing of Debt Securities by Municipalities) Regulations, 2019.
- Project linked initiatives relating to budgeting and accounting systems.

- Impact of such initiatives on the finances of local (urban) governments
  - Shifts in ULBs revenue composition
  - ii. Declining shares of own source revenues
  - iii. Rising shares of state and central government transfers in ULBs finances Central government share in ULBs revenues has risen from 2.9% in 2010-11 to 10% in 2017-18.
  - iv. 1% puzzle (Table)

As a percent of GDP

Year	Total municipal revenues	Own municipal revenues	Property tax revenues
2011-12	0.98	0.488	0.131
2015-16	1.06	0.510	0.146
2017-18	1.004	0.429	0.149

Source: ICRIER Prepared for the 15th Finance Commission

- v. Appropriation of local public goods (solid waste management, quality water supply, water conservation, water recycling and rejuvenation) as NATIONAL PRIORITIES
- vi. Emergence of a performance grant system for managing CFC grants to local governments.

## **NEW QUESTIONS, UNFINISHED AGENDA?**

- GST-sharing or aim BIG, DIVISIBLE pool sharing
  - Octroi compensation for ULBs ranges between 1.5% of CGST or 2.6% of the SGST.
  - Divisible Poor Sharing



# **NEW QUESTIONS, UNFINISHED AGENDA?**

- Property taxation Resuscitation
  - i. 0.14/0.15% of GDP
  - ii. 15<sup>th</sup> FFC new formula for stimulating property tax revenue in the midst of it frequently becoming a freebee.

$$PT_i = \sum_j t_{ij}. a_{ij}$$

Where tij is the rate of tax per unit of area in category j in the ith year and aij is the area under assessment in category j in the ith year.

If one is looking at the growth in property tax, the above would be translated into

$$G_p = \sum_{j} G_{tij} * \frac{t_{ij}a_{ij}}{\sum t_{ij}a_{ij}} + \sum_{j} G_{aij} * \frac{t_{ij}a_{ij}}{\sum t_{ij}a_{ij}}$$

\* Dr. Kavita Rao helped in developing this equation.



- iii. Insulating it from non-economic pressure
- iv. Conceptual issue unsettled

A benefit Tax

or

A tax on distorted market—driven property valuation

Capital market financing – whose debt is municipal debt?

# Autonomy, Performance Grants, and National Priorities

#### Conditions to be met in order to become eligible for FC grants

#### (a) 13<sup>th</sup> Finance Commission conditions

Condition	Verification Mechanism
<ul> <li>Service delivery</li> <li>Standards for service delivery</li> <li>A fire hazard response and mitigation plan</li> </ul>	<ul> <li>Gazette notification on service standards</li> <li>Gazette notifying the plan</li> </ul>
<ul> <li>Institutional improvement</li> <li>Independent local ombudsman</li> <li>Qualifications of CFC members</li> <li>Property Tax Board</li> </ul>	<ul> <li>A copy of the legislation and self-certification by the state</li> <li>A copy of the notification or legislation</li> <li>State government gazette or a legislation</li> </ul>
<ul> <li>Budget system improvement</li> <li>Supplement to the budget</li> <li>System of electronic transfers</li> <li>Copy of property taxation</li> <li>Audit system</li> </ul>	<ul> <li>Copy of the supplement to the budget and a certificate from the government</li> <li>Self-certification by the state government</li> <li>Self-certification by the state government</li> <li>Certificate from the CAG</li> </ul>

## (b) 14th Finance Commission

- Submit audited annual account that relate to the year not earlier than the two preceding years;
- Show an increase in own revenues over the preceding year, as reflected in the audited accounts; and
- Publish service local benchmarks relating to basic urban services for each year of the award.

## (c) 15<sup>th</sup> Finance Commission

- Outline availability in the public domain of both the unaudited account of the previous year and audited accounts of the year before the previous year; and
- Notifying of the floor rates of property taxes by amending the relevant Municipal and Municipal Corporations Acts, and showing consistent improvement in collection in tandem with the simple increase growth rate of the State's own GSDP in the most recent five years.

- Fiscal Rules for Local Governments How soon?
  - Standardization of fiscal and financial information
  - Guidelines for reporting and releasing of fiscal accounts

# Thank you