8 Fiscal Innovations and Urban Governance

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8 Contents

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I INTRODUCTION: EXPLORING THE CONNECTIONS BETWEEN FINANCE AND GOVERNANCE

Numerous studies have been carried out in recent years on the finances of local governments in the developing economies.[1] With few exceptions, these studies are focused on one single issue: what should be done to improve and strengthen the finances of local governments? What instruments should be used to make the local governments financially viable? What should be done to enhance their creditworthiness so that they can have access to the capital market and enter into such financial arrangements as would permit them to meet their growing expenditure responsibilities?

Mention should be made at the outset that the issue of the finances of local governments has historically been a matter of widespread concern in most developing economies, mainly on account of the extremely unsatisfactory state of their finances and their high level of dependency on the Central and provincial or state governments. Its growing importance in recent years has, however, been enhanced by a large scale reappraisal of the role of local governments that has taken place in a number of developing countries. Recent years have seen, almost universally, strong trends towards decentralization and consequential reallocation of functions and responsibilities between the different levels of governments.[2] In this context questions have been asked about the role, functions and responsibilities of local governments: should the local governments be concerned – as provided for in the classical formulation – with resource allocation functions such as the provision of public goods whose benefits are likely to be limited to local jurisdictions or should they assume responsibility for such functions as economic stabilization, income redistribution and poverty reduction?[3] Drawing justification from the principle of *subsidiarity*, many developing countries have favoured a decentralized organization of responsibilities where a function is assigned to a higher level of government when it is in a *better* position to carry it out compared to a lower level of government. With the application of this principle, local governments in many countries are experiencing fundamental changes in the division of authority *vis-a-vis* the higher levels of governments and *vis-a-vis* the market.

Box 1

The notion of subsidiarity

— just as it is wrong to withdraw from the individual and to commit to the community at large what private enterprise can accomplish, so it is likewise unjust and a grave disturbance of right order to turn over to a greater society of higher rank functions and services which can be performed by lesser bodies on a lower plane. This is a fundamental principle of social philosophy, unshaken and unchangeable. Of its very nature the true aim of all social activity should be to help members to the social body, but never to destroy or absorb them.

— Papal Encyclical Quadragesima Anno

In many countries, the role of local governments has undergone a major shift on account of the new fiscal realities facing them. These realities characterized by severe limitation of financial resources have led to *downloading* of a large number of functions and responsibilities to local governments, often unaccompanied by devolution of fiscal powers and financial resources.[4] As a result of both the trends toward decentralization and fiscal pressures, local governments have come to acquire, in a number of countries, economic and social responsibilities that are often *new* and *unanticipated*. These have led them to ask if these are their legitimate responsibilities, and what should the local governments do to generate resources in order to meet expenditure on such responsibilities? What kinds of new fiscal and other instruments should they bring into use?

A second development that has brought the issue of the finances of local governments to the forefront is the increased mobility of capital, technology and other factors of production across nations, combined with the worldwide trends toward globalization. Although theories about the local effects of globalization and global restructuring process are partial and far from robust, indications exist that there is considerable *local sensitivity* to such processes. In several instances, the fiscal problems of city governments have been compounded by global economic restructuring and shifting locations of labour and capital.[5] A few studies that have analyzed such effects have shown that globalization has, on the one hand, led to the reformulation of relations between the public and private sectors at the local level and, on the other hand, to increased competition between cities and city governments for domestic and external investments.[6] Cities in many developing countries are at the centre of globalization, and are being called upon to enhance their competitiveness and to respond to the challenge of the opening up of the national economies.[7] Globalization has accelerated the demand for city-based infrastructure and services, and has led the local governments to innovate new financial and other partnership arrangements for meeting the increased infrastructure and service requirements.

Yet another development that has made a vital impact on the finances of local governments is the global thrust towards *governance.* Governance has acquired a new meaning wherein it is seen as a process of setting priorities and sets of actions *not only* by the government but by other stakeholders as well—the non-governmental sectors, the business, industry and in fact, the civil society as a whole.[8] In its new formulation, governance is much more than making available to citizens certain social goods e.g., water supply, conservancy services, primary health, roads, and street lighting; it is concerned as much with the institutional arrangements (who does what), the financing modes (how are the different functions financed i.e., via tax, non-tax, grant or debt financing), cost recovery mechanisms, fixation of accountability and the like. Good governance requires a *proper choice* of fiscal instruments, choice clearly falling on those instruments that have a wider civil society acceptance and which are likely to lead to greater accountability and transparency. It has added a new dimension to the fiscal behaviour and responsibilities of local governments.

As these pressures have mounted, local governments in the developing countries have resorted to using a mix of fiscal instruments and arrangements for raising resources and better managing the patterns of expenditure. Experience in the developing countries indicates that these have typically included putting into use innovative sources of local revenues, improved efficiency in local tax collection, reduction in capital expenditure, new intergovernmental fiscal arrangements, selling local (municipal) assets, deferment of maintenance, expenditure control and management, and long-term borrowing. In many countries, strategies in this sphere have meant adoption of such options as privatization, public-private partnerships, and implementation of market-oriented cost recovery approaches.[9] Many countries have established municipal development funds (MDF) to compensate for the lack of long-term capital for urban infrastructure.

Changes of a somewhat similar nature have been observed in the system of local government financing in India.[10] As in the case of much of the developing world, the finances of local governments in India too have historically been in a dismal state. Recent estimates have shown that the locally-generated tax revenues comprise only 4.6 per cent of the total revenues raised by the Central government and 8.05 per cent of revenues raised by the state governments.[11] On a per capita basis, the municipal governments raise only about one-fifth of the revenues raised by the Central government. Considering the fact that the municipal areas produce over 50 per cent of the country's GDP, it is evident that the municipalities are not able to establish effective linkages with activities carried out within their own jurisdictions. Much of the GDP gains from city-based activities accrue to either the Central or state governments.[12] Furthermore, the municipal governments are able to finance no more than 60–65 per cent of their recurrent expenditure out of their own, locally-generated resources. For historical reasons, user charge as a principle for charging for services is applied, at best, on a limited scale.

TABLE 1. Revenues of the Central, State, and Municipal Governments 1991–92

Government	Total (Rs billion)	Per capita (Rs)
Centre	833.2	986.8
States	484.6	573.9
Municipalities	39.0	205.3

SOURCE. Finance of State Governments, 1993–94. Reserve Bank of India Bulletin 1994.

In the allocation of fiscal powers, the municipal governments in India have access to revenue sources that are characterized by low level of elasticity and buoyancy, with the more elastic of them constitutionally falling within the domain of the Central and state governments.[13] Moreover, the municipal governments enjoy little autonomy in adjusting the tax bases, tax rates and even the procedures for tax administration and enforcement. The entire local tax and non-tax system is thus obsolete and has seriously constrained the efficient functioning of cities and their governance.

The municipal governments in India have encountered increasing demographic and social pressures in recent years. During the census decades 1971–91, for instance, urban population in the country increased at annual rates varying between 3.1 to 3.8 per cent, and doubled from 109.1 to 217.6 million persons. This demographic expansion was accompanied by a phenomenal increase in the number of persons below the poverty line, which rose from 60.1 million in 1973-74 to 83.3 million in 1993-94. This phenomenon which is also associated with the growth of slums and squatter settlements has placed an enormous financial strain on local governments.[14]

Parallel to the developments in the other parts of the world, cities and city governments in India have come to also face the multiple challenges of decentralization, globalization, and governance. The Constitution (seventy-fourth) Amendment Act, 1992 has ushered in the country an era of democratic decentralization incorporating specific provisions for the empowerment of local governments.[15] The Amendment Act has laid down in the 12th Schedule of the Constitution a list of functions that it considers *appropriate* to be performed by the municipal governments. Many of these functions e.g., planning for economic and social development, urban poverty alleviation, urban forestry, and protection of the environment are ***new and unanticipated***, and carry important redistributional and interjurisdictional implications. The Amendment envisions, over a period of time, a major vertical and horizontal restructuring in the state-municipal fiscal relations. Questions have thus arisen as to who, and which level of government, should finance such services as economic and social planning, and poverty alleviation, and what should be the respective roles of the Central, state, and local governments in their financing? The idea of decentralization to the local level as a way of improving government responsiveness and accountability is very much related to the notion of fiscal responsibility, which requires that governments making decisions on expenditure programmes should assume responsibility for taxing those who benefit from them. Decentralization is expected to also generate greater efficiency in service delivery and lower public spending.

Box 2

Defining horizontal and vertical restructuring

- Horizontal restructuring refers to the redefinition of public-private and reconstitution of local government roles *vis-a-vis* the market.
- Vertical restructuring refers to revising the functional and fiscal relations between the different governmental levels.

Several cities in India are faced with the challenge of globalization. Recent estimates indicate that cities, particularly the larger cities, have become the major destination for foreign direct investment (FDI). Several of such cities are in direct competition for attracting such investment. This has accelerated, in a significant way, the demand for developed land, housing, roads, power, water supply, sewerage systems, and other linked services and infrastructure. Indeed, the fruition of such investments is linked directly to the availability of infrastructure and services in cities and towns. Given the increasing recognition that traditional sources (e.g., public sector financing) are unlikely to be adequate for meeting the city-linked infrastructural needs, questions have arisen as to what the local governments should do in order to attract investment for the provision and upgradation of city-based infrastructure and services? What sources should they tap for raising new capital resources for financing infrastructure and services?

Mainly as an outgrowth of the provisions of the Constitution (seventy-fourth) Amendment Act, 1992, recent years have also seen, in the country, an increasing discussion on governance, in particular, on the relationship of elected representatives, bureaucracy, and the civil society. What role should these stakeholders play in the governance of cities? Who should be responsible for determining local priorities? Implicitly, these discussions have brought in issues of accountability and of instruments that would be able to finance services for which the municipal governments in the new set-up are responsible. Pressures have mounted on local governments *albeit* in different ways, leading them to consider how to better use the given tax bases, improve financial performance and management, apply more appropriate pricing systems, and enter into financial partnerships in order that the infrastructure and services needs of cities can be effectively met.

These changes in the role and responsibilities of local governments are accompanied by important initiatives that are designed towards local fiscal strengthening, the most important of these being the earlier referred to Constitution (seventy-fourth) Amendment Act, 1992. This initiative has enabled the states with a unique opportunity to redesign a system of local governance and finance that is coherent and adapted to today's needs. Specifically, it contains a provision for the setting up in each state of a Finance Commission to determine the principles governing:

- the distribution between the state and the municipalities of the net proceeds of the taxes, duties, tolls and fees leviable by the state, which may be divided between them and the allocation between the municipalities at all levels of their respective shares of such proceeds;
- the determination of the taxes, duties, tolls and fees which may be assigned to, or appropriated by the municipalities;
- the grants-in-aid to the municipalities from the Consolidated Funds of the states.

Independent of the Constitution (seventy-fourth) Amendment Act, attempts have been made in different states and cities, so far selectively, to improve and strengthen the finances of municipal governments as also to enable them to raise additional resources and involve other partners in the provision of what have traditionally been labelled as municipal infrastructure and services. In several parts of the country, the basis of property taxation has come under major review and restructuring. Property taxes as would be shown later, have been an important and stable source of revenue for municipal governments but in recent years have suffered on account of a highly constrained system of valuation and assessment and poor administration and enforcement. Several states and cities are now attempting to reform the property tax system in order to enhance the revenue-yielding capacity of this important source. Several municipal governments have introduced changes in the system of financial accounting and management in order to be able to streamline and better manage municipal expenditures. A major development in recent years has been to privatize municipal services and involve the private sector in their provision, delivery and management. Similarly, a few municipal governments (e.g., Ahmedabad, Pune and Nagpur) have taken steps to access the capital market for financing their growing infrastructure needs.

While these actions are still limited to a few municipal governments, yet these are important landmarks in the history of municipal finance in India. The issue is: are these actions and fiscal instruments serving revenue-raising goals and also leading to better governance of cities? To what extent have the fiscal initiatives led to or promoted accountability, transparency and participation? Have these been designed in a way that these have wider popular acceptance? Is there any link between fiscal innovations and governance?[16] The issue ranges over a wide spectrum of public finance concerns, including the nature of taxes that should be raised within cities and their distributional impact, questions of fiscal responsibility, accountability and control, debt financing, and how local finance might be improved to limit economic decline and social disparities within cities.

This study is designed to look at such issues. The study consists of a documentation of fiscal initiatives[17] in respect of:

- reform of property taxation in Andhra Pradesh
- issuance of bonds by the Ahmedabad Municipal Corporation
- public-private participation in the provision of infrastructure to Tirupur (Tamil Nadu).

The documentation comprises a description of these initiatives, the forces that led to them, and a set of observations on the extent to which these initiatives have contributed to what may seem to be good governance characteristics. Part II of the study is devoted to a description of the initiatives. Part III of the study provides a set of observations on the interconnections between sound local finance and urban governance.

II CASES OF FISCAL INNOVATIONS

Case 1: Reform of Property Taxation in Andhra Pradesh

Property taxation is perhaps the most widely-used source of revenue for local governments throughout the developing and developed world. It has been long favoured as the principal source of revenue for local governments, mainly due to the perception that it possesses the characteristics of a benefit tax. Unlike other forms of taxation, property tax is said to be particularly suitable as a local tax because of its immobility. As a consequence, property tax is seen as promoting accountability in local government decision-making—local governments being answerable to those who bear the cost of their actions, i.e., the citizens.

The theoretical framework of property taxation is well articulated in public finance literature. This tax is to be associated with a number of distinct advantages. These are:

- The object of taxation, i.e., the property is immobile, at least in the short run, and therefore, taxation of property is difficult to avoid or even shift.
- A tax on property provides no *direct* competition to other taxes that are typically imposed by the Central and state governments.
- It allows the application of the benefit principle because local services are, in some degree, capitalized into property values. Property taxes are ways to allow owners and occupants to contribute towards the cost of local services.
- It is relatively stable in times of economic slowdown. Also, the effects of price movements on property taxes are minimal.
- It can be responsive to economic growth provided it is accompanied by good property tax policy and administration.
- It causes only minor distortions in resource allocation.[18]

Given these theoretical and practical advantages, it is surprising that property taxes in India have not been adequately mobilized for raising resources in the country.[19] Indeed, these do not form a part of the country's tax policy, nor has the *reform* of these taxes been considered an integral part of the ongoing tax reform process. The result is that property taxes, despite their being the primary source of revenue for municipal governments, remain *minor* in terms of revenue yields. In 1990–91, property taxes in India are estimated to have generated only about Rs 14,250 million of revenues, forming 2.6 per cent of the total tax revenues of the Central and state governments, and 0.25 per cent of the country's gross domestic product (GDP). These shares have changed little over the years, notwithstanding an extraordinarily large increase in land and property values, and a dramatic increase in the share of construction sector in the country's GDP.

TABLE 2. Revenue Significance of Property Taxes (1990–91)

Estimated yield from property taxes (Rs million)	14,250
Property tax yield as a % of GDP	0.25
Property tax yield as a % of total tax revenues	2.6
Property tax yield as a % of total municipal revenues	40–45
Property tax yield as a % of total municipal expenditure	25–28
Per capita property tax yield (Rs)	65

SOURCE. NIPFP (1995), Redefining State-Municipal Fiscal Relations: Options and Perspectives for the State Finance Commissions.

Property taxes in Andhra Pradesh[20]—the state of this case study—constitute an extremely important source of revenue for the municipal governments. In 1991–92, the total yield from property taxes amounted to Rs 400.7 million or 50.9 per cent of the total internal resources generated by municipal governments. It formed 0.1 per cent of the state's gross domestic product. The productivity of property taxes in the state as measured in terms of yield per capita (Rs 55) was lower than the All-India average.

Until the property tax system in Andhra Pradesh was changed in 1993, assessment of properties for tax purposes was based on the annual rateable value (ARV) of land and buildings. The annual rateable value was defined as the gross annual rent at which a property may reasonably be expected to be let out from year to year. In this sense, annual rateable value was a hypothetical rent or a notional rent, held as a proxy for market rent of the concerned property. In the case of rented properties, annual rateable value was assessed on the basis of the actual rent excepting for those properties where a "fair rent" had been fixed under the Andhra Pradesh (Lease, Rent and Eviction) Control Act, 1960.

The Andhra Pradesh Municipalities Act, 1965 which contains procedures for levying this tax, provided for a revaluation of properties and consequently of tax liabilities, once in five years. Similarly, the Act provided that annual rateable value of properties was subject to different kinds of deductions and rebates, these being rebate related to owner-occupied houses, rebate for repairs and maintenance, depreciation for the age of the building, rebate on early payment, and vacancy remission. Exemption from local property taxation also constituted an important ingredient in Andhra Pradesh. Thus, properties used for public worship, educational purposes, charitable hospitals, irrigation works, and buildings whose ARV was below a threshold were exempted from payment of property taxes. The underlying considerations in granting exemptions were social justice, compensation to those properties which provided, directly or indirectly, those services which had characteristics of merit or public goods, and high administrative and collection cost in tax collection, particularly from low tax-yielding properties.

The property tax system in Andhra Pradesh as in the other states of the country, however, was choked in each of its components and sub-components. For instance, the method of assessing property values on the basis of ARV, i.e., rent at which a property may reasonably be expected to be let out from year to year, proved to be *ad hoc*, discretionary and subject to varying interpretation (see Box 3). Similarly, serious problems were noted in using the 'actual rents' for assessing property values as in practice, actual rents were made up of a number of components (a lump sum payment, a monthly rent, and monthly rent divided into rent for space and rent for fixtures), making assessment on that basis, an extremely difficult exercise. The properties which were under rent control hardly yielded any tax revenue. The problem was compounded further as, notwithstanding the provision in the Andhra Pradesh Municipalities Act, only a few municipalities undertook periodic revaluation of properties which resulted in large scale inequities in the system, retarding the yield from property taxes.[21] Field evidence showed that as a result, the differences between the assessed value and market value of properties widened, and led to large scale stagnation in the revenues from property taxes. The various types of exemptions and rebates further constricted the tax base. The system of door-to-door tax collection promoted rent seeking collusion between the assessor, tax collector and tax payer resulting in massive leakages and corruption. Giving monetary values to the lost income on account of these infirmities of the system (e.g., inability of the annual rateable value to capture the market rents, of large scale rebates and exemptions) is a hazardous exercise, but the facts that (i) assessment to market rent ratios were in the range of 50–60 per cent, (ii) only about 30–35 per cent of the total number of properties constituted the tax base, (iii) rebates were substantial, and (iv) rent control acts significantly limited the annual rateable value, the loss to the total property tax yields could be as high as 150–175 per cent of the actual collections on this account.

Box 3

A description of the rental system

The rent prescribed by the statute is a hypothetical rent, as hypothetical as the tenant. It is the rent which an imaginary tenant might be reasonably expected to pay to an imaginary landlord for the tenancy of this dwelling in this locality, on the hypothesis that both are reasonable people, the landlord not being extortionate, the tenant not being under pressure, the dwelling being vacant and available to let, not subject to any control, the landlord agreeing to do the repairs, and pay the insurance, the tenant agreeing to pay the rates, the period not too short nor yet too long, simply from year to year.[22]

It is in this background that the Government of Andhra Pradesh undertook to reform the property tax system, clearly with the objective of better tapping this source of revenue and eliminating the deficiencies of the prevalent system. *Significantly, the initiative for the reform emanated from the chief political executive of the state who found the entire system inefficient, stagnant, discretionary, and administratively loose.*

The key to the reform process lay, at the outset, in identifying a method of assessment that would best reflect the value of a property. Three main methods of valuation, namely, rental value, capital value, and site area are generally used in the different parts of the world. The main advantage of the rental value is that it is based on the income concept and is easier to comprehend. This system yields good results where the size of the property rental market is large. On the other hand, the capital valuation system is effective in situations where property sale and purchase transactions are common. The issue was as to which of the three would yield better results. For the state, the issue was: should the existing method of using a "hypothetical rent", or 'actual rent', or 'fair rent' be continued for assessing the value of a property? Or, should it be jettisoned in favour of using the capital value? Or, should it be done on some other basis such as the site or area valuation using characteristics of the site/area? There were other issues as well, particularly as these related to the overall tax incidence, rebates, exemption, and collection system but these were secondary to the prime issue of assessment and valuation.

In its totality, the Andhra Pradesh property tax reform whose foundations were laid in 1989, was driven by the following objectives:

- To evolve a scientific method of assessment and levy of property tax by incorporating in it the principles of equity, objectivity, fairness and simplicity.
- To levy property taxes uniformly in respect of buildings similarly situated;
- To delink the operation of Rent Control Act from the assessment of property tax.
- To reduce the discretion of the assessor and avoid arbitrariness in assessment.
- To make tax administration efficient, transparent and effective in the levy of property tax.
- To improve buoyancy in the property tax revenues.

Taking the first objective as being central to the reform process, the Government of Andhra Pradesh weighed the relative advantages of the three alternative systems, and considered their feasibility in the light of (i) political acceptance, (ii) compatibility with the legal framework, and (iii) the revenue generating goals. The choice was made in favour of the site/area based system under which the annual rental value of properties could be fixed with reference to the characteristics of the area, using such indicators as location, type of construction, plinth area, age of the building, and the nature of use. The Andhra Pradesh government adopted this method as it, *prima facie*, seemed to possess such advantages as objectivity in assessment, procedural simplicity, standardized methodology, and better clientele appreciation and cooperation.

The new method of property assessment involved several interconnected steps:

- division of the city into convenient, contiguous and largely homogeneous areas/zones, based on three factors, namely: (a) availability of services like water supply, street lighting, roads and drains; markets and shopping centres; educational institutions; banks, postal services and public offices; medical facilities; and factories and industries; (b) nature of construction of properties; and (c) the nature of use of properties (e.g. residential, shops, industry, offices and banks, educational institutions, hospitals and nursing homes, cinema theatres, hotels and restaurants, godowns and others);

- a sample survey of 20 per cent of all properties in each zone to determine the prevalent rental values and to fix the rental ranges in each zone/area;
- issuance of a draft public notification showing the division of the city into zones and the rental ranges, for inviting objections from the public: it marked a significant departure from the earlier practices when no such consultations were considered essential;
- issuance of a final notification giving the maximum and minimum rental values for each of the zones/area.

The reform process also included decisions in respect of the rebates and exemptions, and tax payment procedures. Considering the fact that the reform process must be gradual, issues pertaining to the rebates and exemptions were left untouched, meaning that rebates extended earlier on account of owner-occupancy, age of the building, and repairs were permitted to be continued in the new system. Similarly, exemptions were not only continued but their scope was expanded to cover those owner-occupied residential buildings whose property tax burden was below a threshold level. In order to limit the incidence of the new system, the increase in property taxes was capped so as not to exceed 75–100 per cent of the previous tax level.

The new system incorporated two other innovative features. The first related to the procedure for property tax payment. Unlike in the past where a door-to-door collection was prevalent, the new system brought the banking sector into the local tax system. As an incentive to the banking sector, arrangements were made with the banks that they could retain and use for limited periods, the property tax payments. A second feature of the new system was the introduction of an incentive grant wherein, municipal bodies were given fixed amounts ranging between Rs 1.5 million and Rs 4.0 million if they were able to raise tax collection efficiency to 85 per cent of tax demanded.

Consequent upon the decision of the Andhra Pradesh government to introduce the new system, several municipal bodies passed resolutions to adopt it and set up committees to suggest strategies for putting it into practice. Other municipal bodies extensively communicated with tax payers, the details of the new system. The new system came into effect on 1 April 1993. As a result, property tax yields have risen dramatically in Andhra Pradesh, and the expectation is that when all municipal bodies including the three corporations which are still resisting its extension, the increase in property tax yield may be 100 per cent over the previous periods.

The area-based method constitutes in recent times the most important initiative taken in the country to eliminate the arbitrariness from which the system of estimating the ARV has historically suffered[23]. The approach is effectively a formula for property valuation where a property is defined by a vector of specific attributes. Hence, conceptually, what has been tried in Andhra Pradesh is that the value of a property has been determined as a discrete function of six attributes:

V = f (plinth area; land area; location; type of construction; type of use; age)
where f(.) is a linear combination of these attributes.

Putting the new system into effect has meant a process involving:

- an explicit recognition by the state government that the earlier system of property taxation was arbitrary and non-performing
- a political decision to replace it with a system which could narrow down the gap that existed under the old system between the assessed value of properties and market value of properties
- wider acceptance of the system by municipal governments and tax payers
- broad understanding on the zoning and classification of cities, notwithstanding the problems that are inherent in any such exercise
- use of measurable norms in the assessment and valuation, irrespective of the basis of assessment, thus ensuring that such a standardization would be equitable and be able to withstand the rigors of the law
- simplicity and transparency in the application of the new system, enabling individuals to calculate the ARV and the property tax burden
- use of the banking sector in the tax collection strategy.

The impact on account of the restructuring of property tax assessment is particularly noted in two areas: on the revenues of the municipalities, and tax payers' acceptability. The growth trends of property tax revenues during the pre- and post- reform period are presented in Table 3. There has been a 61 per cent increase in demand on residential assessment and more than 90 per cent in non-residential assessments. Given the fact that the new system provides for incentives to efficiency considerations, the prognosis is that the growth trends in revenues may persist in the future.

TABLE 3. Property Tax Yields in Andhra Pradesh

Year	Property tax yields (Rs million)	Additional revenue due to restructuring of property taxes (Rs million)
1992–93	3753.3	—
1993–94	3979.4	226.1
1994–95	4848.1	868.7
1995–96	5909.0	1060.9

SOURCE. Naidu. ibid.

The other impact is on the tax payers' acceptability of the area-based taxation which constitutes, in different ways, one of its most crucial non-revenue gains. The process in which the new taxation system was introduced in the state has demonstrated that the citizens would accept a system which is simple, which is non-discriminatory, and which allows them to file objections. These are important gains and impinge heavily on the sustainability of the area based taxation. It has also been upheld by the judiciary on the ground that it maintained objectivity and rationality.[24]

Any reform process must recognize that property tax policy formulation is the responsibility of state governments, and the execution of policy that of the municipal governments. A prerequisite for reform lies in political will and political initiative and acceptance of the reform by the tax payers. A concomitant step is to demonstrate how *all* could gain from the property tax reform. For instance, the state governments may be able to reduce grants to municipal governments. The municipalities could increase revenue on property account and may secure greater autonomy in rate-setting. The tax payers could in the long run have lower tax rates due to the repealing or reduction of rebates and exemptions. The Andhra initiative demonstrates that it is possible.

Case 2: Issuance of Bonds by the Ahmedabad Municipal Corporation

One of the critical issues that India has in recent years been confronted with is how to finance and maintain municipal infrastructure and services. Municipal infrastructure and services have thus far been financed out of grants and loans from the state governments. Institutional financing has also made inroads into selected municipal infrastructure. The role of municipal bodies in creating infrastructural capital has been marginal, if not non-existent, principally on account of their inability to generate any revenues beyond what are necessary to operate and maintain such services as water supply, sewerage, roads, primary health, street lighting and the like. Indeed, most municipal bodies in the country have large revenue deficits which are met out of the existing system of intergovernmental transfers.

Note needs to be made of the fact that the statutory framework which lays down the powers of municipal bodies *also* does not provide to them any major role in the sphere of capital financing of infrastructure and services. Their borrowing powers are statutorily restricted, evidently for the reason that unlimited municipal borrowing could have serious repercussions on the macroeconomic fiscal balance and stability. In most states, municipal corporations are permitted to borrow only within certain limits which are defined generally in terms of the percentage of the annual rateable value of properties or of the value of the Corporations' physical assets.[25] Moreover, they can borrow only with the permission of the state governments.[26] There also exist detailed requirements for the creation of sinking funds, control on investments and monitoring by state governments. The key point is that the municipal corporations have not made use of even these limited powers for augmenting their infrastructure and services. Debt financing of municipal infrastructure remains far from being a common practice in Indian cities.[27]

The Ahmedabad Municipal Corporation (AMC) has recently completed the necessary formalities for raising a Rs 1,000 million loan from the market by issuing what are called municipal bonds. The issuance of municipal bonds by the Ahmedabad Municipal Corporation is the first case of its kind, and constitutes an extremely important fiscal initiative on the part of a local body in the country. This case describes how a medium-sized municipal corporation, faced on the one hand with deteriorating finances and declining levels of services, and on the other hand, with bleak prospects of raising loans from the traditional sources such as the state government, undertook major initiatives, initially to reform the tax system and procedures *but later used the improved revenue streams to enter the capital market on the strength of its own balance sheet.*

Located in the state of Gujarat[28], Ahmedabad is a large metropolis with a population of 3.5 million persons, growing at an annual rate of approximately 3–3.5 per cent. In the post-1991 period, Ahmedabad city has received substantial industrial investments on account of the generally progressive and forward-looking policies of the state of Gujarat. Ahmedabad's economic contribution to the state's GDP has also been substantial, and is reflected in the accelerated development of its industrial base and construction activity.

Ahmedabad city is run by the Ahmedabad Municipal Corporation (AMC) which was established in 1950 under the Bombay Provincial Municipal Corporation (BPMC) Act, 1949. The AMC's main functions under the Act are to provide water supply, sewerage, solid waste management, street cleaning, street lighting and public health. Although not obliged under the Act, the Ahmedabad Municipal Corporation runs hospitals, medical colleges, and local transport. The main sources of AMC's revenues are the taxes on property and octroi levies, which account for 80 per cent of its total revenues. Octroi is the main tax and contributes 72–75 per cent of the tax income. The Corporation can borrow in the market in accordance with the provisions laid down in the BPMC Act. The Act lays down the borrowing powers and the procedure by which the Corporation can raise, deploy and service the loans. The clarity in the borrowing powers and debt-servicing arrangements are a positive feature of the BPMC Act.

The Ahmedabad Municipal Corporation had a sound financial base until the early 1980s. However, the financial condition of the AMC started deteriorating in the latter part of the eighties, to the extent that at the close of the fiscal year 1993–94, the AMC had accumulated a deficit of approximately Rs 60 million on revenue account alone. The growth rate in the revenue yields of the two main taxes, namely, property taxes and octroi hardly reflected the rate at which the construction and other activities were expanding in the city. The non-tax component of the AMC was non-performing, and the administration and enforcement of municipal taxes were lax. Low level of education, poor work conditions, and inadequate training and support of the Corporation's staff contributed to the deficiencies in performance.

TABLE 4. Revenue Income and Expenditure of Ahmedabad Municipal Corporation

Year	Revenue income	Revenue expenditure	Cumulative balance (– or +)
1989–90	1354.5	1420.5	–178.7
1990–91	1486.6	1604.4	–296.5
1991–92	1746.6	1748.5	–298.4
1992–93	1988.8	1998.2	–308.8
1993–94	2197.6	2248.9	–359.1

SOURCE. Asnani, ibid.

NOTE. The outstanding balance at the commencement of the fiscal year 1989–90 was Rs 112.8 million.

The administrative leadership and management of the Ahmedabad Corporation was changed in 1994, and was immediately confronted with a host of questions: what should be done to stem the deterioration in the finances of the Corporation? Did the problems lie in tax structures, assessment or their administration and enforcement? What should be done to raise additional resources in order to meet the burgeoning financial requirements of city infrastructure? The administrative leadership fixed for itself the following priorities:

- restore balance and stability in the finances of AMC,
- build confidence in the public in respect of AMC's capacity to efficiently and equitably deliver services,

- assess the credit worthiness and risk level in the finances of AMC.
- put to effective use the existing statutory provisions for mobilizing additional resources.

Following the fixation of priorities, the Ahmedabad Municipal Corporation undertook bold measures to improve the administration and enforcement procedures in respect of property taxes and octroi, and simultaneously to project an image of the Corporation as a body which was sensitive to people's needs, aspirations and priorities. On the tax front, the AMC undertook to strengthen the property tax base and collection procedures. The collection of property tax in Ahmedabad had been extremely tardy, with the collection being less than 30 per cent of the tax demanded. A primary reason for this was lack of transparency in the valuation of ARV which almost invariably was contested in courts, leading to delays, deferment, reassessment and the like. In 1994, the AMC introduced a series of measures to improve property tax collection which included:

- disconnection of water supply and drainage lines on non-payment of property tax
- advertisement of names of major defaulters in newspapers
- attachment of property of major defaulters
- restructuring and strengthening of the property tax administration
- reorganization of the data bank on property taxes, particularly in respect of tax demand and collection from individual properties
- regular monitoring of tax collection

On somewhat similar lines, the AMC focused on the preparation of a valuation manual for the levy of octroi and a series of steps to locate and plug those points from where funds were being siphoned off. These comprised the following:

- formation of vigilance squads to monitor the octroi checkposts
- creation of a data bank on the prices of goods which were subject to octroi levy
- establishment of a market research wing to continually update the data bank on prices

- induction of professionals for checking the valuation of goods at major octroi collection points.

The impact of these measures was immediate: collection to demand ratio in respect of property taxes rose from 28.3 per cent in 1993–94 to 32.9 per cent in 1994–95, and in the subsequent year, to 44.6 per cent. In the aggregate, property tax revenues increased from Rs 442 million in 1993–94 to Rs 800 million in 1995–96—posting an increase of nearly 80 per cent in two years. Revenue from octroi levies also witnessed an increase of a similar order, from Rs 1296 million in 1993–94 to Rs. 2030 million in 1995–96. The sum result of the different measures including those which covered the non-tax component of AMC's revenues was that the AMC's continuing deficit on revenue account turned into a surplus in 1994–95. This surplus which was Rs 18.7 million in 1994–95 rose to Rs 518 million in 1994–95, and immediately helped to restore the citizens' confidence in the AMCs capacity to effectively administer the local tax structure and prevent leakages and corruption.

TABLE 5. AMC's Revenue Income and Revenue Expenditure (Rs million)

Year	Revenue Income	Revenue Expenditure	Surplus/ Deficit (+/–)
1993–94	2197.6	2248.9	–359.1
1994–95	2854.6	2476.7	+18.7
1995–96	3748.1	3248.9	+517.9

The changed financial scenario enabled the AMC to undertake smaller capital projects of high priority to both meet people's needs and aspirations and to instil confidence among its clientele that it can deliver. However, Ahmedabad city's capital requirements were large, needing substantial funding. The new administrative leadership also needed further evidence of the fiscal strength of the AMC particularly whether the spurt in revenues was a temporary, short-lived phenomenon, or a sustainable one. The AMC's leadership was also aware of the expansion that had taken place in the country's capital market offering an important potential source of resources. The issue was whether given the surpluses that the AMC had been able to generate over a brief two year period and given the initiatives that it had taken to reform its main revenue sources, AMC could put to use such innovative instruments as the issuance of municipal bonds. India has had no tradition of municipal bonds; at the same time, it was aware of municipal bonds as being one of the most important revenue sources for municipal and local governments in the USA. Securing long-term financing like bonds, however, was essentially a function of the faith in the system responsible for spending and management. Did the AMC possess this faith?

A useful instrument for assessing the creditworthiness of a body corporate such as a municipal corporation or of a specific debt obligation is *credit rating*. It is a rating of the relative safety of payment of interest and principal on a debenture, structured obligation, preference share, fixed deposits, or a short term instrument. Credit rating, in assigning a rating, considers a mix of factors that bear on the creditworthiness of the borrowing municipal government which include the economic base of the city, current financial position of the concerned city government, debt-related factors, legal and administrative issues and project-specific issues. The Ahmedabad Municipal Corporation decided to have its proposal to raise Rs 1,000 million from the capital market credit-rated. It entrusted this task to CRISIL, a credit-rating agency in India, which, after detailed investigation into the finances, liabilities and future prospects gave an A+ rating for the issuance of this Bond. An A+ rating means adequate safety of the timely payment of interest and principal. This process has been of particular interest: it has made the evaluation of credit risk to the public, and it is also a public announcement to investors that the state government will not bear any losses on the investment. In providing this rating, CRISIL observed that:

> The management, namely the executive and the executive wing, have been instrumental in improving the fiscal profile of the corporation, specifically with reference to tightening the tax assessment and collection mechanisms. The management has also been able to set the agenda for property-tax reforms, which would have far-reaching implications on AMC's fiscal status. Such measures have been supported by the State government and bureaucracy, which adds to the stability of these reforms. The management has also initiated measures to improve its own administration system by hiring consultants in specific areas, going in for increased computerization and recruiting professionals

directly into the Corporation at various levels.

The outlook for AMCs' finances, in the medium term, is positive as the Corporation has been able to upgrade the tax administration framework. In the long term, the Corporation's ability to implement the proposed property tax reforms would further strengthen the tax base of the Corporation. In addition, AMC has initiated efforts to diversify its revenue base by undertaking activities like commercial property development. These reforms are expected to be supported by the political and administrative wing at the state level, as they would add to the financial health and autonomy of municipal bodies in Gujarat.

Presently, there are significant demand-supply gaps for all core services extended by AMC. AMC is addressing this issue by undertaking multiplicity of projects in all core service areas. The implementation of the proposed capital projects would depend on its ability to enhance its resource base and sustain the growth in revenues. In addition, the Corporation's ability to exercise control over its expenditure would be of critical bearing. The prevailing policy framework would have to be sustained to achieve the desired results.[29]

The Ahmedabad Municipal Corporation is now poised to issue Municipal Bonds. The Bonds to be issued will be general obligation bonds; for their redemption, a portion of the revenue receipts has been pledged and earmarked. The Corporation proposes to open an account to ensure that the dedicated funds remain untouched and set aside exclusively for paying back the bond amount. Though the public at large has not been involved directly in decision-making on the issuance of Bonds, a survey conducted to ascertain the attitude of citizens has revealed a high degree of willingness on their part to invest in them. The willingness to invest in such Bonds which are fixed obligations and which could constrain local fiscal flexibility demonstrates that the funds so raised will be invested for meeting the citizens infrastructural priorities and needs.

Box 4

The typology of bonds

General obligation bonds pledge the full faith and credit of the issuing government. The issuing government makes an unconditional pledge of its powers of taxation to honour its liability for interest and principal repayment. Revenue bonds pledge only the earnings from revenue producing activities, often the earnings from the facilities being financed with the revenue bonds.

The steps taken by the Ahmedabad Municipal Corporation on the governance of the city have been very visible. The entire relationship between the Corporation and its citizens has changed. The citizens who viewed the Corporation as an inefficient organization, now look upon the Corporation as a body which can deliver the goods and services for which it is responsible. It has introduced a sense of partnership and participation among citizen groups.

Case 3: Public-private Participation in the Provision of Infrastructure to Tirupur

The provision and financing of municipal and city-based infrastructure and services in India have historically been a responsibility of the state and local governments. Special-purpose public undertakings have also invested substantially in the financing of such infrastructure as water supply and sewerage, and on a smaller scale, citywide roads. The underlying rationale in public sector financing lies in the fact that many of these infrastructural services are in the nature of 'natural monopolies', or characterized by 'externalities', 'non-excludability', and 'low price elasticity of demand', and have, as a result, been financed out of the publicly-raised resources.

Box 5

Characteristics of infrastructural services

Natural monopolies: Most urban infrastructure services are natural monopolies and their marginal cost declines over a very large range of output. As such, it has been feared that the private sector might exploit its monopolistic situation. Such services include water, waste water management, telephone, electricity, bridge, and road networks.

Externalities: Many services like sanitation and solid waste disposal have significant external economies. As a consequence, market-based systems may fail to provide the service in adequate quantity and quality.

Non-Excludability: It is difficult to exclude anyone from using, say, roads or public lighting. The consumer may refuse to pay for the service since he may be able to use it free of charge legally or otherwise.

Price elasticity of demand: Certain infrastructure services being necessities (like water) have almost inelastic demand. Private provision of these could result in exploitative pricing unless prices of regulated.

Requirement of heavy investment in capital equipment: This has discouraged private sector entry into certain infrastructure segments.

— The India Infrastructure Report, pp: 27–28 (1996: New Delhi)

Recent years have witnessed in the country a major shift in thinking about the financing modes of such infrastructure and services. For one thing, it is increasingly recognized that public sector resources may not be sufficient to meet the infrastructure investment requirements of cities and towns. The India Infrastructure Report, for instance, has estimated such requirements to be anywhere between Rs 800 billion to Rs 940 billion for the period 1996–2001.[30] Given the demand on public resources from other sectors, this scale of funding is unlikely to be available for urban infrastructure, thus opening it to other financing modes and alternatives. Secondly, the last few years have generated within the country a debate on the role of governments including that of local governments and what they should be concerned with. This debate has resulted in two related strands of policy: *privatization*, and the trend to an *enabling role for the government*. In a sense, privatization is an extension of the principle of subsidiarity which requires that the government should undertake functions only to the extent that it can do so better and more efficiently than the private sector. This line of argument has reinforced the need to distinguish between the provision of public goods and services and their production and delivery.[31] Better understanding and application of such distinctions or what Rakesh Mohan calls, the *unbundling of services*, has led to an increasing interest of the private sector in the provision of such services.

As distinguished from the concept of privatization, the term 'enabling government' has come into being to describe a situation where on the one hand, conditions are created for the participation of the non-governmental sector in the provision of services and infrastructure, and, where on the other hand, the non-governmental

Box 6

The issues of enabling government

- What size, level and structure of government is best suited to perform an enabling role ?
- How can government facilitate activity by the private and voluntary sectors in order to bring about pluralistic governance?
- How can higher levels of government facilitate lower levels of government in the discharge of their duties ?

sector is given the *right* to compete with the government for the production of these services. *These developments have ushered in the* *country an era of pluralistic type of governance*, and as a consequence, government as historically understood is being gradually substituted by a pluralistic range of *governance bodies* involving the public, private and voluntary sectors.

It is in the context of this policy shift that a small, but a highly specialized town called Tirupur compelled by the need to survive in a highly competitive global market, and actively supported by the different levels of government took the initiative of involving the private sector in the provision of a good which has historically been viewed as a natural monopoly, i.e., water supply. The key factor in the initiative, evidently an innovation in the Indian context was the economic compulsion: good quality water must be available in adequate quantities for the cotton knitwear garment industry if the industry is to remain competitive in the international market. Water was a crucial infrastructure input in garment production for purposes of washing, dyeing, bleaching and other processes. The existing modes of drawing water were become unreliable and constrained, and leading to negative externalities whose costs were too high for the industry to stay economically viable.

Tirupur is a special grade municipal town located 50 kms to the north-east of Coimbatore in Tamil Nadu in southern India.[32] In 1971, the town recorded a population of 113,302 which increased to 235,661 by 1991. By the turn of the century its population is projected to increase to over 300,000. The town has been experiencing an annual population growth rate of between 3.6 and 3.8 per cent. The economic base of the town is almost wholly linked with the manufacture of cotton knitwear garments. Often referred to as the *banian city* (the vest city), it initially produced vests and undergarments for the domestic market but later extended its production for the global markets. The growth and development of Tirupur as a consequence has been phenomenal. Tirupur today accounts for over three-fourths of India's cotton knitwear exports. In 1986, exports from the town were a mere Rs 0.18 billion. By 1992, the town exported garments of the value of Rs 15 billion. It is estimated that the value of exports will reach Rs 25 billion—Rs 30 billion in 1997. In 1986, there were only 10 to 15 leading exporters in the town but within a span of a decade the number of exporters has risen to nearly 400 (1996). This spectacular growth has been achieved notwithstanding the poor levels of support infrastructure such as water supply, effluent disposal, roads, power, and telecommunications.

The growth of population and industry has widened the gap between the demand for and supply of infrastructure and services. Water supply in the town is extremely inadequate. The main sources of water to the town are rivers and borewells. While the Tirupur municipality provides water for household consumption, garment industry uses non-municipal sources such as the private trucking of water and borewells for meeting its requirements. As such, the cost of water is extremely high. The town has no sewerage system and the only river that passes through the town called Noyil is, in fact, an open sewer. The industrial units do not have effluent treatment facilities. The bleaching and dyeing industries consume large quantities of water and dispose the same untreated into Noyil river. This water is carried to downstream villages which has affected their agriculture, human habitation and all forms of life. The haphazard growth of the town coupled with poor enforcement of environmental regulations by the municipality and the Tamil Nadu Pollution Control Board (TNPCB) have encouraged exporters to discharge effluents consisting of toxic chemicals and colours into the Noyil river. Many dyeing units discharge their effluent into any open water body or even on land. This has phenomenally increased health risks in the town and also affected the supply of potable water.

Tirupur town has a municipal body, and is governed for its functions and fiscal powers by the Tamil Nadu Municipalities Act, 1965. In 1994–95, it had a total revenue income of Rs 103.12 million and an expenditure of Rs 98.26 million on revenue account. The main sources of revenue for the municipality provided for in the Act are taxes on property, non-tax revenues such as fees and fines, income from municipal properties, and state government transfers on account of shared taxes, grants and loans on capital account. Property tax is the single largest source of revenue for the Municipality, and contributes anywhere between 30–40 per cent of the revenue income of the Tirupur municipality. The major heads of expenditure i.e., public health and sanitation, and water supply and drainage accounted for in 1994–95, 33.6 and 39.8 per cent of the total municipal revenue expenditure.

Measured in terms of the growth rate of revenue income and other financial ratios, the financial performance of Tirupur Municipality can be said to be creditable. However, the debt servicing of Tirupur Municipality has been far from satisfactory, with the result that it has a large accumulated debt of over Rs 330 million. With this financial position and the level of revenues that the Tirupur municipality is able to generate, it is not in a position to undertake any large scale expansion of infrastructure and services that it is responsible for.

Towards the end of the 1980s, the garment exporters of Tirupur formed an association, called the Tirupur Exporters Association (TEA) with the objective of bringing to the attention of the government the problems of the industry. The TEA represented to the Central government and the state government of Tamil Nadu to accord to Tirupur, the status of an Export Growth Centre and make special funding arrangements for infrastructural development. The TEA argued that investments in infrastructure were essential both to enhance the production and productivity of the garment industry as also to improve the quality of exports. Plans were accordingly formulated on the assumption that public sector financing would become available for the augmentation of infrastructure and services. However, on account of the scale of requirements, these plans made no progress. Public sector financing of this scale proved elusive.

The Tamil Nadu Corporation for Industrial Development (TACID) which had been set up in 1991 to advance the interest of the industry in the state made a similar assessment, and observed that in view of the non-availability of public funds other institutional and financial options should be explored. One option that was to be explored was that of involving the private sector in the provision of such services as water supply, sewerage, effluent disposal and roads. A key question was whether it was at all possible to develop a project covering these components which would be financially viable and able to pay for itself. Of these, water was the only component that lent itself to direct charging. Cost of the other components could be met only through taxation. Given this context, the issues that arose were: In what manner should the private sector be involved in this project? What should be the mode? Should the private sector be encouraged to develop, manage and operate it on an ownership or lease basis or on a Build, Operate and Transfer (BOT) format? What kinds of concessions will the private sector require in order to undertake such a project? The possibilities of private sector participation in the provision of such services also presented questions pertaining to the sources of financing, determination of a unit price, regulations, accountability and the like.

The entire exercise entailed several interrelated steps:

- Establishment of the feasibility and financial viability of the project covering water supply, sewerage and drainage facilities, industrial effluent collection and treatment system, and improvement and expansion of intra-city roads. The Infrastructure Leasing and Financial Services (ILFS), a private sector company, undertook the task of preparing the feasibility report, and presented what finally came to be known as the Tirupur Area Development Plan (TADP). The feasibility report provided details of the costs, pricing, and recovery mechanisms, establishing that the project was financially viable and that it could pay for itself. The Plan entailed an estimated investment of Rs 5,890 million. It is important to point out that this exercise was preceded by large scale field surveys, focusing on the willingness and ability of households and industry to pay for the services and on the environmental impact of the project on the neighbouring villages. The surveys constituted an extremely crucial input to the TADP exercise.

- Determination of the institutional responsibility for the project. A critical question was about the institutional framework that would be able to undertake responsibility for the project. Considering the fact that the implementation of the Tirupur Area Development Plan (TADP) would necessarily involve raising resources both in the domestic and international capital market and require expertise in entering into complex equity-debt arrangements, a decision was taken to create a special purpose vehicle (SPV), a joint venture company, called the New Tirupur Area Development Corporation Ltd (NTADCL). From a strategic, resource-raising and risk sharing point of view, creation of such a vehicle was considered to be the most effective option. Regulations of various types and internal management capacity of the Tirupur Municipality did not allow it to play this role. NTADCL was incorporated in 1995 and a memorandum of understanding signed between the State government of Tamil Nadu, TACID, ILFS, and TEA on the broad parameters on the design of such a project. It was an unique institutional format of pluralistic governance which included the governments, state-level parastatal agencies, a private sector financing company, and the exporters association which was the principal user or the beneficiary of the proposed project.
- Consideration of the financing options for the TADP. While it was generally understood that public sector financing of the

order envisaged was unlikely to be available, other questions concerning the debt-equity proportions and the mechanism of raising debts confronted such agencies as the ILFS and the state government. A broader equity base was considered essential and desirable in order to secure the cooperation of the participating agencies and timely completion of the project. As such, a decision was taken that NTADCL—the agency responsible for the implementation of the project, will have equity holders comprising the Government of India, TACID, TEA, ILFS and the Built-Operate-Transfer operator. The participation of TEA (Tirupur Exporters Association) was significant as it was the single most important beneficiary of the project. Similarly, the equity participation of the BOT operator was viewed as necessary for ensuring their continued attention to the operation and maintenance of the project. Debt, it was decided, will be raised from the financing institutions such as the World Bank, USAID, ILFS and supplier of equipments by the issuance of what are tentatively called the Water Bonds. Debt-equity ratio is envisaged to be 2.6:1. A linked but critical decision in this respect was to sell water on the principle of full cost recovery in the aggregate, meaning that the pricing could differentiate between different consumer groups according to their ability to pay. This principle alone could ensure the financial viability of the project.

- Selection of the Build-Operate-Transfer (BOT) operator. The key to the success of the project and, indeed, of the larger issue of the private sector participation in such projects as water supply and sewerage, is the operator who is to be responsible not only for creating the infrastructural capital but also for operating and maintaining the same for 30 years. The operator has to also secure adequate return on equity within a limited time period before transferring the project to NTADCL. In view of the planned financial participation of the international and domestic institutions in this project, it was decided to seek global tenders on the established BOT patterns and norms. The entire process of reviewing the tenders has since been conducted by experts unconnected with the participating institutions and other stakeholders in an open and transparent manner. The final selection is to be made shortly.[33]

The Tirupur project constitutes a major step in putting into practice the principles underlying privatization and enabling government, and a typical case of government facilitating activity of the private and other sectors. Given the parameters and scale of the project, the development of this project has taken several years which has seen wide-ranging consultations, involving public and private sector institutions, domestic and international financing companies, and the producers and consumers of services. It has demonstrated that there are diverse arrangements for financing municipal infrastructure and services of which Tirupur represents only one model. The Tirupur project is designed on the principle of transparency, i.e., the need to maintain the link between local benefits and local costs in a way to ensure taxpayers awareness.

III A SET OF OBSERVATIONS: EMERGING CONNECTIONS BETWEEN FISCAL INNOVATIONS AND GOVERNANCE

An attempt has been made in this study to explore, with three distinct examples, the interconnections between local fiscal innovations and governance: to ascertain whether these innovations led to, promoted or advanced in any way, what would seem to be the chief characteristics of good governance, i.e., decentralization, accountability, local initiatives, transparency, civil society movements and participation. The key to the study is to be found in the underlying proposition that sound local finances are an essential component of good governance, and governance can hardly be considered effective if the governments—be they Central, state or local—are unable to adhere to the canons of fiscal discipline, fiscal efficiency, and fiscal autonomy. The context of the study is significant in that the past few years have witnessed in India, as in several other developing countries, an unprecedented level of interest and debate on local governance, and wide-ranging actions to empower local governments to enable them to address the numerous challenges they are faced with. *The Central government's initiative to amend the Constitution in order to strengthen the foundations of democratic decentralization at local levels, efforts on the part of at least a few state governments to reform the local tax system, adoption by municipal governments of new modes of financing and resource-raising, and emergence of public-private partnerships in the provision of infrastructure are but a few examples in this direction.* The three cases documented in this study have shed further insights into the connections between fiscal innovations and governance. Although generalizations on them may be difficult to arrive at, the fiscal innovations provide interesting propositions through which local and state responses to the challenges they are faced with, can be better understood. For instance, the three cases show that:

- *A simple, transparent and undifferentiated tax system has a greater possibility of securing clientele acceptance and of being sustained, even if it entailed a higher tax burden.* The Andhra Pradesh initiative in respect of property tax reform strongly suggests that notwithstanding the general reluctance on the part of municipal councils to increase the tax burden on their constituencies, a system:

  - which is simple and comprehensible,
  - which is standardized, and which is designed to eliminate the discretion in estimating the annual rateable values (ARVs) or the property tax burden, and
  - which is transparent in that the tax rate ranges are known to the tax payers through gazettes, newspapers and media, will be widely acceptable.

- *Efficient administration and enforcement of tax system are crucial for securing public support on such issues as raising resources in the market, pledging revenue streams for redemption of loans, and the like.* The Ahmedabad case on the issuance of bonds shows that efficient administration and enforcement of a tax system, development of a data bank that updates information on the market prices of goods which are subject to tax levies, and taking up of steps that prevent leakages and corruption, are necessary to not only restore the confidence of the citizens and tax payers in the functioning of a local body, but also essential for local governments to use instruments such as the open market borrowings for raising resources. Public cooperation and good governance can not be expected to follow in the absence of an efficient and equitable tax administration.
- *Public sharing of credit-rating information is an important input to building alliances and partnerships with the non-governmental sector and other interest groups.* The credit-rating of a corporate body such as the Ahmedabad Municipal Corporation has shown that it is an extremely useful instrument not only for

determining the creditworthiness and risk-taking capacity of a local body, but for demonstrating to the citizens where the potentials lie, what part of the potentials are currently tapped or not tapped, and the local body's financial strengths and weaknesses. Such exercises and information sharing have led to the participation of industry and business in taking up projects (e.g., slum upgrading) that would ordinarily fall within the jurisdiction of local bodies.

- *Public financing of infrastructure is only one alternative; given the right price signals public-private partnerships are possible to be forged in the delivery of even those services which are characterized by 'externalities'.* The Tirupur case shows that there exists in practice an array of strategies and diverse arrangements to make use of the different stakeholders in the provision and delivery of services. It has demonstrated that the government itself can create conditions for the private and voluntary sectors to take up activities which are ideal for market-type pricing regimes, and thereby bring in pluralistic governance.
- *Commitment and leadership are critical to initiating changes in the local fiscal arrangements.* In Andhra Pradesh, initiative for change in the property tax system emerged from the highest political executive of the state who found the earlier system, constraining in terms of its revenue generating capacity, discriminatory and iniquitous , and opted for a system that was simple, open and non-discriminatory. The Ahmedabad initiative was led by the administrative leadership of the Corporation who put to effective use the existing statutory and other provisions for improving its finances. For long term and sustainable growth of the Corporation, the initiative included measures such as professionalization of the key functions of the Corporation, information sharing, and forging alliances with key stakeholders. In Tirupur, it was the Tirupur Exporters Association and its economic interest that led to institutional restructuring and public-private enterprise for the delivery of services. What is important to recognize is that leadership exists at all levels and need not necessarily emanate from the public sector.

Underlying in these propositions is the general theme that the challenges which the local governments in India have come to face with in recent years are being responded to in different ways and with varying degrees of success. Different modes appropriate to local conditions have been used to improve the level, quality and delivery of urban services. Citizens' acceptance of higher tax liability and new partnership arrangements in the expectation that they will be the eventual beneficiaries are important steps towards better governance of cities. As pressures on local governments mount and as they acquire new roles and responsibilities, these will have significant implications for local public finances with emphasis shifting to issues of choice, efficiency and accountability in the delivery of local services, many of which essentially are publicly-provided private goods. The challenge for the local governments will be to provide those services that citizens are prepared to pay for.

ANNEXURE 1. Taxation Heads Assigned to the Union and the States in the Constitution (As Listed in the Seventh Schedule of the Constitution)

Union		States	
Entry in List I of the Seventh Schedule	Head	Entry in List II of the Seventh Schedule	Head
82	Taxes on income other than agricultural income	45	Land revenue, including the assessment and collection of revenue, the maintenance of land records, survey for revenue purposes.
83.	Duties of customs including export duties	46	Taxes on agricultural income
84.	Duties of excise on tobacco and other goods manufactured or produced in India except: a. alcoholic liquors for human consumption; b. opium, Indian hemp and other narcotic drugs and narcotics; but including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.	47	Duties in respect of succession of agricultural land
85	Corporation tax	48	Estate duty in respect of agricultural land
86	Taxes on the capital value of the assets, exclusive of agricultural land of individuals and companies; taxes on the capital of companies	49	Taxes on lands and buildings

ANNEXURE 1 Contd...

Union		States	
Entry in List I of the Seventh Schedule	Head	Entry in List II of the Seventh Schedule	Head
87	Estate duty in respect of property other than agricultural land	50	Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development.
88	Duties in respect of succession to property other than agricultural land	51	Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India: a. alcoholic liquors for human consumption; b. opium, Indian hemp and other narcotic drugs and narcotics; but not including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.
89	Terminal taxes on goods or passengers carried by railway, sea or air; taxes on railway fares and freights.	52	Taxes on the entry of good into a local area for consumption, use or sale therein.

ANNEXURE 2. Twelfth Schedule Article 243W of the Constitution Seventy-Fourth Amendment Act 1992 on Municipalities

1. Urban planning including town planning
2. Regulation of land-use and construction of buildings
3. Planning for social and economic 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 sections of society, including the handicapped and mentally retarded
10. Slum improvement and upgradation
11. Urban poverty alleviation
12. Provisions of urban amenities and facilities such as parks, gardens, playgrounds
13. Promotion of cultural, educational and aesthetic aspects
14. Burial and burial grounds; cremations, cremation grounds and electric crematoriums
15. Cattle pounds; prevention of cruelty of 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

End Notes

1. All references to local governments in this study refer to *urban* local governments. These include municipal corporations, municipal bodies and other forms of city/town governments.

2. Recent studies have shown that as a political phenomenon, decentralization is widespread in developing and transitional economies. Of the 75 countries with population greater than 5 million, all but 12 claim to have embarked on some transfer of political power to local units of government. See, William Dillinger, ***Decentralization and its Implications for Urban Service Delivery***, The World Bank (1994: Washington D.C.), and Roy W. Bahl and Johannes F. Linn, ***Urban Public Finance in Developing Countries***, The World Bank (1992: Washington D.C.).

3. In the classical formulation, the public economics literature assigns three roles to the public sector: (i) macro stabilization, (ii) income distribution, and (iii) resource allocation. The public economics model assigns the first two of these roles to central government. Subnational governments enter the picture only with respect to the third role of government—resource allocation. See, R. Musgrave and P. Musgrave, ***Public Finance in Theory and Practice***, McGraw Hill (1984: New York). Views on fiscal federalism and decentralization in general are constantly changing between nations and, across time, within particular nations. See, Vito Tanzi, "Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects", ***Annual Bank Conference on Development Economics***, The World Bank (1995: Washington D.C.), and Wallace E. Oates, "Fiscal Decentralization and Economic Development", in *National Tax Journal*, Vol. 46, No. 2 (1993: Washington D.C.).

4. Such downloading is uniquely observed in transitional economies where budget cuts and public sector restructuring implemented by higher levels of government have trickled down to the local level. The fiscal pressures have created a chain reaction as one level of government undertakes to reduce its transfers to the next level of government. See for further discussion, ***Environment and Planning***, Vol. 12, 1994, and A.R. Hobson and France st-hilaire, ***Urban Governance and Finance: A Question of Who Does and What***, IRPP, (1997: Quebec).

5. Janice Caulfield, "Taxation and Equity within Metropolitan Areas", presented at the OECD/Sweden Workshop on *Governing Metropolitan*

Areas: Institutions, Finance and Partnerships (1997: Stockholm).

6. See Fu-chen Lo, "Changing Patterns of Global Production, Technologies, and the World City System", The United Nations University (1996: Tokyo), and Fu-chen Lo and Yue-man Yeung, *Emerging World Cities in Pacific Asia*, The United Nations University (1996: Tokyo).

7. See, Om Prakash Mathur, "Governing Cities: Facing Up to the Challenge of Poverty and Globalization", in Patricia McCarney (ed.), *Cities and Governance*. University of Toronto (1996: Toronto).

8. McCarney et.al., "Towards an Understanding of Governance: The Emergence of an Idea and its Implications for Urban Research in Developing Countries", in Richard E. Stren (ed.). *Urban Research in the Developing World* (1994: Toronto).

9. An interesting table on local choices of fiscal strategies is contained in Terry Nichols Clark (ed.), *Urban Innovation: Creative Strategies for Turbulent Times*. (1994: Sage Publications). Also, see Jeffrey I. Chapman. *Long-Term Financial Planning: Creative Strategies for Local Government*, ICMA (1967: Washington D.C.), and OECD, *Infrastructure Policies for the 1990s* (1993: Paris).

10. India is a federation of Union and states; the subject of local government falls within the domain of states who are responsible for their creation, constitution, and assignment of functions and fiscal powers.

11. See, National Institute of Public Finance and Policy, *Redefining State-Municipal Fiscal Relations : Options and Perspectives for the State Finance Commissions*. (1995: New Delhi).

12. The inter-governmental allocation of the sources of revenue is structured in a way that much of the gains from activities undertaken in cities accrue to the Central and state governments. (See Annexure 1)

13. The Constitution of India does not directly assign any tax powers to local governments. The state governments out of the tax powers that they enjoy under the Constitution allocate a few taxes to local governments (see Annex 1).

14. For a fuller discussion, see, Om Prakash Mathur, "State of India's Urban Poverty" (1994: Asian Development Review, Manila).

15. The Constitution (seventy-fourth) Amendment Act, 1992 assigns a constitutional status to local governments, meaning that they stand protected by the Constitution from arbitrary dissolution or suspension. It provides for regular elections at municipal levels, with provisions in respect of elections having been brought *at par* with those at the level of states and the Centre.

16. The ability of municipal governments to levy their own taxes, set and adjust user fees, and raise their own revenues with the approval of their own constituents is an essential, and often overlooked, aspect of effective participation democracy. See Mark H. Bidus, ***Municipal Development and Democracy in Central America***, U.S. Agency for International Development (1995: Washington D.C.).

17. There are other fiscal initiatives too; however, this paper is limited to studying these initiatives only.

18. R.J. Bennet summarizes the advantages of property taxation: "It undoubtedly has strong advantages in being cheap and easy to administer; it allows easy definition of the tax base, and relates local taxation to services that result from the distribution of property." See, Bennet (1980), ***The Geography of Public Finance***, pp 290.

19. Property taxes in India owe themselves to Entry 49 in List II of the Seventh Schedule of the Constitution of India which provides for the levy of taxes on lands and buildings. Taxes on land and property are, however, levied by municipal governments in accordance with the procedures laid down in the State municipal acts. The procedures lay down the tax bases, rate structures, rebate and exemption policies and measures for dealing with payment delays and defaults. The autonomy of municipal governments in formulating property tax policy is severely limited, and allowed at best in fixing the tax rates within certain ranges and often in designing collection strategies. Since property tax policies are determined by State governments, there is a large scale diversity in almost every sphere of property taxation. Thus, for instance, a tax on land and property is an ***obligatory*** tax in some States and an ***optimal*** tax in others, with the result that a number of municipalities have opted not to levy any property tax at all. Diversity is particularly sharp in the structure of tax rates.

20. Andhra Pradesh is one of the twenty six states of the Indian federation. In 1991, its population was 66.5 million persons. The total urban population of the state was 17.9 million or 26.9% of the state's total population.

21. The Andhra Pradesh Municipalities Act, 1965 mandates the revision of property tax every five years, but as revision invariably meant enhancement and consequent litigation and also a long process of appeal, the quinquennial revision did not take place regularly. Only 19 local governments out of the 109 in the state revised the assessment by 1981 and 50 undertook the revision between 1982 and 1989. There were no revisions in the remaining municipal bodies. See Naidu, *ibid.*

22. Taken from Rakesh Mohan (1983), "Indian Thinking on Property Tax Reform", in A. Datta, *Property Taxation in India*. Indian Institute of Public Administration, New Delhi.

23. Note should be made of the fact that there are other valuation systems too, such as the capital valuation which have not been experimented with so far. The capital valuation system is noted for its other advantages.

24. The merit of the Assessment Rules, 1992, is that they rid the house-owners of the harassment and the constant threats of revision of annual rental value by the concerned officials of the corporation. The earlier system of taxation left too much discretion in their hands. Now, the only thing that has to be ascertained is the carpet area of the house, the rest is determined by the Rules and the notifications. There is no question of the revision of annual rental value periodically on the ground that the rental value has gone up. A new system, with all good intentions is being tried out—a system designed in the interest of the body of house owners—tax payers as well as the corporation. May be, this is the trial and error method. Unless found to be offending the Constitutional or a statutory provisions, it must be allowed to be worked. One should start with the presumption that the corporation knows what is the better method of classification. It has chose to divide the Municipal corporation area with reference to roads for valuation of holdings. It is difficult for the court to substitute its opinion for that of the corporation nor can any one guarantee that if the municipal corporation area is divided on the basis of zones it will be a perfect classification and would eliminate all complaints and grievances of differential treatment. It is because of the inherent complex nature of taxation that a greater latitude and larger elbow room is conceded to the

legislature—or its delegate, as the case may be—in such matters. Judgement of the Supreme Court in the case of Patna Municipal Corporation Act—Assessment of Annual Rental Value of Holdings Rules (1994: Patna).

25. Municipal Corporations in India are larger municipal bodies (usually with over 300,000 population). These are governed by different statutes and enjoy comparatively wider powers and responsibilities. There are large-scale inter-state differences in the borrowing powers of municipal corporations. Municipal bodies do not enjoy these powers.

26. The state governments exercise strict controls over those municipal governments which are indebted.

27. Interestingly, the issuance of local debt was earlier considered synonymous with local irresponsibility. In fact, the opposite may be true now. A government that eschews debt issuance is acting irresponsibly. Since capital facilities provide services over a long period of time, it makes sense to pay for these facilities over a long period.

28. Gujarat is one of the twenty six states in the country. In 1991, it had a total urban population of 14.3 million, forming 34.5 per cent of the state's total population.

29. The Credit Rating Information Services of India Limited (CRISIL), Credit Rating of Municipal Bonds: Rating Report on Ahmedabad Municipal Corporation (1996: New Delhi)

30. Government of India, *The India Infrastructure Report: Policy Imperatives for Growth and Welfare* (1996: New Delhi). The report is popularly known as the Rakesh Mohan Committee Report.

31. Traditionally, one factor that has influenced the structure of government and the division of functions has been the extent of the economies of scale in the production of services. Once provision and production functions are dissociated, these services can be produced by whichever sector is able to achieve the scale economies.

32. Tamil Nadu is one of the twenty-six states in the country. In 1991, it had a total urban population of 19.1 million which formed 34.1 per cent of its total population.

33. Final selection is to be made by October 1997.