Appraising the Finances of Municipalities

Appraising the finances of municipalities is central to addressing the mandate embodied in Articles 243 Y and 280(3)(c) of the Constitution. Appraisal shows the fiscal health and performance of municipalities. It shows the level of efficiency of municipalities in managing their finances. It lays the groundwork for estimating the future financial requirements and determining the fiscal jurisdiction of municipalities.

An important objective of appraisal is to assess the revenue gap, i.e., the gap or the difference between the own resources of municipalities and their total revenue expenditure on a common and comparable basis. A revenue gap may arise on account of asymmetry in expenditure and revenue assignments or for reasons of fiscal and cost disabilities among municipalities. A revenue gap may be large or small, depending on what expenditure responsibilities are assigned to municipalities and what resource raising powers they possess. The nature and extent of the gap determines the course of action that could be taken to bring about greater correspondence between the fiscal powers and authority and the expenditure responsibilities of municipalities or, more specifically, to determine the changes that may need to be made in the assignment of taxes, duties, tolls and fees, in revenue-sharing arrangements, the size of the grants-in-aid, or in the expenditure profile of municipalities, in order to close the gap.

Expenditure Appraisal

An appraisal of the finances of municipalities is an extremely complex exercise, involving an estimation of all expenditures incurred by municipalities including the expenditures that are attributable to them as also the committed but yet to be incurred expenditures. These expenditures are the result of the quantity of service used by the population served by a municipality and the average rate of use, on the one hand, and the cost of providing each unit of service which is

Cost of providing a municipal service may differ on account of the differences in the (a) type and standard of service, (b) administrative processes and efficiency with which services are delivered, and (c) cost of service provision.

influenced by the cost of inputs and other costs associated with service provision, on the other. The level of expenditure thus arrived at is indicative of the level of services, even when there may not exist a statistical correspondence between the levels of expenditures and service levels across municipalities. This is a fundamental assumption which underlies any appraisal of the finances of municipalities.[5]

For reasons of the existing accounting systems, most expenditure assessments are able to capture only a part of the expenditures that are attributable to municipalities, and are therefore, incomplete assessments. The municipal budgets and accounts also do not permit an estimation of the cost of services. The purpose of the appraisal is to capture, as accurately as possible, all expenditures attributable to municipalities, and analyse them in a way that it helps to–

- assess the adequacy of expenditure in relation to the established norms and expenditure;
- estimate the cost of providing services, including the cost disabilities with which municipalities may suffer;
- determine the degree of flexibility that a municipality may have in altering the structure of expenditure, specifically the flexibility in changing the relative proportions of the discretionary and the non-discretionary components of expenditure; and

Municipal expenditure consists of–

- direct expenditure incurred by municipalities on establishment, administration, and enforcement of regulations and municipal bye-laws; interest payments; and operations and maintenance of services;
- expenditure attributable to municipalities but incurred or absorbed by state governments, e.g., salaries of selected staff, and pension contribution and terminal benefits;

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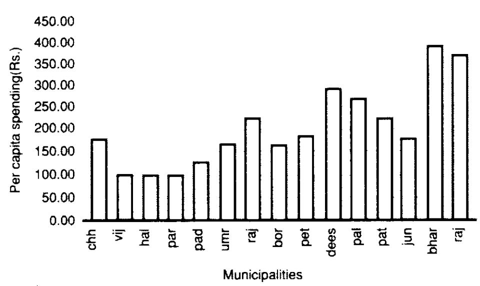
[5]A statistical correspondence may not exist, as on the cost side there are historical costs, and on the revenue side, services are added tot he existing systems. A correspondence may not also exist on account of inefficiencies in operating and maintaining the services.

For the reason that many municipal services are labour intensive and have a high wage component, wages and salaries constitute a major component of municipal expenditure. It accounts for approximately 60-65 percent of total revenue expenditure, and leaves little discretion with municipalities for changing the pattern of expenditure.

Level of spending on core services is uniformly below the established norms and standards, affecting the quality of life in the urban areas.



Source: A Sample Survey. *NIPFP. 1999*

Municipal capacities to raise resources differ on account of the differences in (a) the range and scope of taxes and charges imposed, (b) the rates of taxes and charges, and (c) the fiscal capacity of municipalities.

- expenditure unrelated to municipal functions but incurred by municipalities on behalf of the state governments; and

- outstanding liabilities.

Municipal expenditure can be grouped and examined in different ways:

- ***Grouping 1.*** Expenditure on establishment and administration; interest payments; and operations and maintenance. This grouping shows the relative proportions of the discretionary and non-discretionary constituents of expenditure, and helps in determining the degree of discretion a municipality may be able to exercise in realigning the pattern of expenditure. Wages and salaries and interest payments are the non-discretionary components of municipal expenditure.

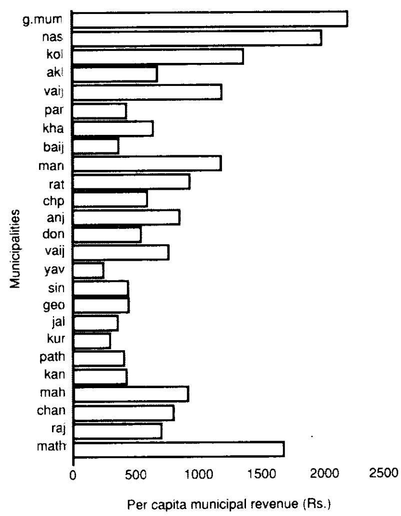
- ***Grouping 2.*** Expenditure on the operation and maintenance of core services such as water supply, sewerage and drainage, conservancy and sanitation, municipal roads, and street lighting vis-a-vis the non-core components of municipal activities.. The Eleventh Finance Commission (EFC) has laid stress on the proper maintenance of such services as primary education, primary health care, safe drinking water, street lighting, sanitation including drainage and scavenging facilities, maintenance of cremation and burial grounds, public conveniences, and other common property resources. Organisation of municipal expenditure data this way helps to assess the adequacy of expenditure on the maintenance of core services as also in ascertaining the unit cost of service provision.

- ***Grouping 3.*** Expenditure on general administration, public health, public works, public instruction, public safety, development and planning, and regulatory functions.

Revenue Appraisal

Parallel with an assessment of expenditure and its long and short run behavior is an analysis of the revenue position of municipalities. It represents the supply side of resources and reflects what the users pay for the services used. Revenue appraisal identifies and accounts for all

Municipal revenue, Maharashtra



Source: A sample survey. NIPFP. 1999.

Own Revenue of Municipality/Own Revenues of States

RE_{Ai} = OR_{Ai} / SOR_{Ai}

RE_{Ai} = Rev. effort of municipality A in the state in year i

OR_{Ai} = Own revenue collection of municipality A in the state in year i

SOR_{Ai} = State's own revenues in year i

i = 1995/96, 1996/97, and 1997/98

Own Revenue of Municipality/State's non-agricultural GSDP

RE_{Ai} = OR_{Ai} / $GSDP_{Ai}$

RE_{Ai} = Rev. effort of municipality A in the state in year i

OR_{Ai} = Own revenue collection of municipality A in the state in year i

$GSDP_{Ai}$ = State's GSDP (excluding primary sector) in year i

i = 1995/96, 1996/97, and 1997/98

revenue account receipts and income, including the income which is due but yet to accrue to them.

Revenue assessment is a process that involves consideration of at least the following:

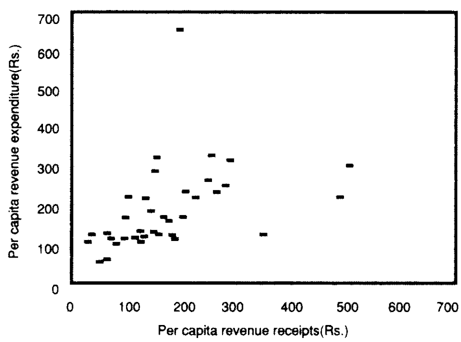
- nature and structure of the municipal revenue base;
- autonomy of municipalities in making use of the revenue base, e.g., determining exemptions, rebates, and rates of taxes, duties, and other levies;
- level of effort and efficiency in revenue generation; and
- extent to which the internally generated resources are able to finance the municipal expenditure, and the degree of municipal dependence on external resources for meeting the expenditure.

Municipal revenues consist of the internally generated resources and resources that are externally provided. The former comprises, on the one hand, taxes on property, octroi where levied, and other minor taxes, and a large mix of charges, fees, rents, levies, and interest earnings. Tax revenues form 50-75 percent of the internally generated resources; the non-tax component, i.e., direct charging for services sold is in its infancy and constitutes one of the weak links in the finances of municipalities. Likewise, fees and rents charged by municipalities bear no relation to the cost incurred by them on different services.

A key component of the appraisal lies in assessing the structure and buoyancy of the municipal revenue base. Perceived as inferior in comparison with revenue bases of the higher governmental tiers, and narrow with only a small percentage of population paying for municipal services, the purpose of the appraisal becomes one of measuring the capacity of municipalities to make use of the assigned or devolved revenues. The Eleventh Finance Commission (EFC) has proposed that the own revenue effort of municipalities be measured in relation to (a) own revenues of the state, and (b) non-agricultural gross state domestic product (GSDP). Own revenue collection of municipalities in each state is measured against the own revenue collection of the state for three

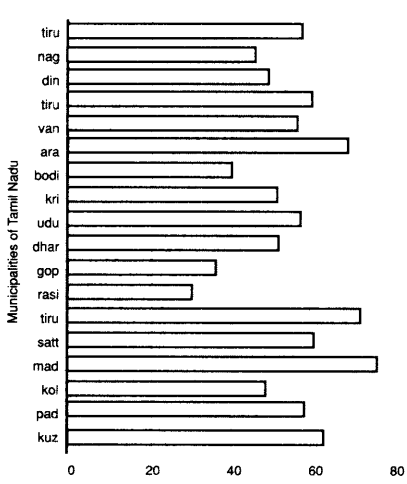
Own resources of municipalities are dismally low. In several states, own resources of municipalities are not able to meet even the wages and salaries component. Own resources are severely constrained on account of the absence of autonomy and poor tax administration.

Per capita municipal income & expenditure, U.P.



Source: A sample survey. NIPFP.
1999

Transfers as a % of municipal revenue



Source: A sample survey. NIPFP.
1999

years, viz, 1995/96, 1996/97 and 1997/98, and the average of these ratios is weighted by the urban population of 1991 to arrive at the share of each state. Similarly, the own revenue collection of municipalities in each state is measured against the state's non-agricultural GSDP for three years, and the average of the ratios is weighted by the urban population of 1991 to arrive at the share of each state. Here, the purpose of the appraisal is to measure the own revenue effort of each municipality in relation to (a) own revenues of the state, and (b) non-agricultural GDP of that state. In addition to measuring revenue generation capacity, appraisal is designed to also measure the efficiency in revenue collection, by examining the ratios of tax assessed, tax demanded, and tax collected.

Appraising Transfers

The externally provided resources constitute a significant component of municipal revenues. Representing in most cases the difference between own resources and revenue account expenditure of municipalities, transfers play an extremely important role in meeting the vertical gap of municipalities. Transfers enable the municipalities to continue to maintain services, or as is often said, make the cities and towns function. Transfers are extensively used for meeting the sector objectives and contributing towards the reduction of fiscal imbalances. Barring transfers of a statutory nature, that is, those which are extended in fulfillment of the requirements of such statutes as the land revenue codes, transfers are perceived by municipalities as entitlements and a legitimate component of their revenues.

Accruing in the form of shared revenues and grants-in-aid, transfers are used for meeting the financial requirements of municipalities which are fiscally handicapped or which have cost disadvantages. They represent an outgo from the consolidated fund of a state and are, therefore, of direct concern to state governments. Often, the proportion of transfers is understated as the state governments directly absorb a part of the expenditure of municipalities, e.g., the salaries of their staff and contribution towards their provident fund, pension and retirement benefits. It is important that such transfers are brought within the scope of the appraisal exercises.

Appraising the role of transfers is crucial in assessing the financial

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position of municipalities. It relates to the—

- purpose of transfers, i.e., whether transfers are extended to meet the vertical gap or designed to compensate the municipalities for actions taken at the level of states, e.g., salary revision or increase in dearness allowance, or pension and terminal allowance adjustments, or called in to compensate for the spillover effects of the fiscal operations of municipalities and the extent to which the transfers are able to meet the purpose or purposes for which these are made;
- basis of transfers, i.e., the basis on which the state governments determine the amount that should be transferred. There exists no clarity whether transfers are determined on the basis of the gap between what the municipalities need and what they are able to raise, or are negotiated between the state and municipalities, or simply determined on the basis of past, historical trends. Additionally, transfers are characterised by unpredictability making it difficult for municipalities to plan out their activities; and
- effect of transfer. It is crucial that the appraisal exercise analyses the effect of the externally-provided funds not only on the purposes for which these funds are advanced, but on the internal revenue generation as well, to ascertain whether such funds have substituted the locally-raised resources, or distorted the state-local fiscal relations in any way.

The extent to which transfers actually impart efficiency and equity is an important aspect of the appraisal exercise. Key variables in this regard are the methods employed for determining the amount to be transferred, criteria used to allocate resources, the conditions attached to the use of transfers, and the manner in which transfers are made to municipalities.

Use of Indicators for Appraising the Finances of Municipalities

The primary objective of appraisal is to realistically capture the financial strengths and weakness of municipalities and use the results for estimating the future financial requirements of municipalities. It means collection of key finance data of municipalities for about five years and putting them together in a manner which can bring out the fiscal strengths and weaknesses of municipalities. An illustrative set of indicators which are

Use of Indicators for Appraisal

Indicators relating to	Years t_1–t_5	Annual average % change
Municipal Expenditure		
Municipal income		
Transfers to municipalities		
Efficiencies in revenue generation and collection		
Efficiency in expenditure		
Others		

useful for appraisal is given below:

- per capita level of revenue expenditure;
- proportion of expenditure on wages and salaries to total municipal expenditure;
- proportion of expenditure on interest payments to total municipal expenditure;
- proportion of expenditure on operations and maintenance to total municipal expenditure;
- expenditure on core services as a proportion of (a) total municipal expenditure, and (b) the norms of expenditure on core services;
- per capita expenditure on core services expressed in physical units, e.g., per 1 km of road; per 100 street lights; per 1000 kg of solid waste; and the like;
- per capita level of revenue receipts and income;
- proportion of own revenues to total municipal revenues;
- proportion of tax revenues to total own revenues;
- revenues from property taxes as a proportion of tax revenues;
- proportion of non-tax revenues to total own revenues;
- proportion of externally-provided, i.e., state resources to the total municipal revenues;
- proportion of shared revenues to the externally-provided resources;
- proportion of grants-in-aid to the externally-provided funds;
- proportion of conditional grants to the total grants-in-aid;

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- cost of collecting taxes and other non-tax charges as a proportion of total own revenues;

- proportion of municipal expenditure covered by own revenues (i.e., vertical gap); and

- own revenues as a proportion of revenue assessed and revenue demanded.

Time series data on the above are crucial for assessing the financial position of municipalities. These alone can indicate whether the finances of municipalities have improved or deteriorated over time, and assist in formulating a strategy for addressing the financial issues confronting the municipalities. A well-designed appraisal is an indispensable exercise in understanding the state-municipal fiscal relations.

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