Guidelines for Collating the Fiscal Package

The primary objective of Article 243 Y of the Constitution (seventy-fourth) Amendment Act, 1992 is to bring about an improvement in the delivery and performance of municipal services. The aim of the fiscal package is to ensure achievement of the objective. In this study, an attempt is made to lay out the steps that are integral to developing such a fiscal package. The steps as outlined in earlier sections comprise:

Review the macro-economic environment within which the municipalities in India operate

- functions, powers, and authority;
- limits and constraints within which the municipalities are permitted to function; and
- degree of autonomy granted to municipalities.

Undertake an appraisal of the finances of municipalities

- changes and shifts in the fiscal health of municipalities, referring to revenue and expenditure growth and performance;
- trends in the volume and nature of transfers; and
- key issues in making fuller use of revenue resources and reordering expenditure priorities.

Estimate the revenue gap of municipalities

- trends in gap between revenue-raising capacity and expenditure needs; and

Workpage

- assessment of the level of municipal underspending.

Project the expenditure needs into the future

- assumptions in respect of the expenditure responsibilities;
- norms and standards for services and activities;
- accounting for revenue gaps and level of underspending; and
- needs arising out of the fiscal disabilities of municipalities.

Determine a fiscal package for financing future expenditure needs

- principles for assignment of taxes, duties, tolls and fees;
- principles for revenue-sharing and grants-in-aid;
- degree of access of municipalities to the divisible pool of state resources;
- supplementing the revenue resources with grants-in-aid; and
- pre-conditions for making the fiscal package productive.

Beyond the Fiscal Package

The scope of the Article 243 Y of the Constitution is not limited to determining the constituents of the fiscal package for municipalities. It extends to evolving measures that would improve the financial position of municipalities. It extends to developing strategies that would contribute to the sound finance of municipalities. In many ways, Articles 243 Y (b) and (c) are by far the most important as these permit an examination of the functioning of municipalities with a view to suggest measures that would result in a long term, sustainable improvement in the finances of municipalities. The Constitutional amendment implies that the efficiency of the fiscal package can be significantly enhanced if it is accompanied by supplementary measures for improving the finances of municipalities.

Using the provisions under Article 280(3)(c), the Eleventh Finance Commission (EFC) has proposed that the state governments should review the existing accounting heads under which funds are being transferred to local bodies, and create for each major/sub-major head, three minor heads for the panchayati raj institutions and urban local bodies. It has further suggested that the Comptroller and Auditor General should lay down the formats for the preparation of budgets and keeping of accounts for municipalities.

These provisions have afforded an opportunity for determining the–

- soundness of the existing system of property taxation;
- appropriateness of the existing system of municipal accounting, i.e., whether it is able to adequately capture the expenditure and receipts of municipalities and the need and relevance for introducing a double entry, accrual based accounting system; and
- feasibility of privatisation of municipal services and activities.

Several states have taken initiatives in these spheres. The Government of India (Ministry of Urban Development) has circulated a set of guidelines for property tax reforms. *Inter-alia*, the guidelines have proposed that a tax on built-up property may be linked to such factors as (a) location, (b) type of construction, (c) use of property, and (d) carpet area of property. The states of Andhra Pradesh, Gujarat, Tamil Nadu and Uttar Pradesh and cities such as Patna have begun to use area-based methods for taxing properties.

In an attempt to improve the municipal accounting system, the Institute of Chartered Accountants of India (ICAI) have published a technical guide on Accounting and Financial Reporting by Urban Local Bodies. Considering that proper financial information and standardized accounting practices are central to undertaking municipal credit ratings, developing commercially viable urban infrastructure projects, and involving the private sector in the delivery of urban services, the Government of Tamil Nadu has introduced a double entry, accrual based accounting system for municipalities.

Using a variety of options such as service contract, management contract, lease, build, operate and transfer (BOT), and concessions, many city governments have begun to engage the private sector in the provision of municipal services. The most prominent of these are solid waste management, management of street lights, public toilets and gardens, operation and maintenance of sewage pumping stations, billing and collection of service charges, and selectively local tax collection. That private sector participation in the delivery of municipal services can help achieve cost savings and improve operational efficiency is borne

Tax Free Municipal Bonds

The insertion of clause (vii) to section 10(15) of the Income Tax Act, 1961 vide the Finance Act, 2000 has laid down procedures for municipalities to issue tax free bonds. Among others, the procedures require the municipalities (and other local authorities) to (a) prepare an investment plan, (b) ensure that the project is financially viable, (c) create an Escrow account for debt servicing of bond proceeds with earmarked revenue, (d) maintain a separate account of the amount raised from the tax free municipal bonds, and (e) obtain an investment grade rating from a RBI approved credit rating agency.

out by experiences from several cities.

Yet another initiative that has an important bearing on the finances of municipalities relates to the issuance of municipal bonds. In 1998, the Ahmedabad Municipal Corporation issued the country's first municipal bond without a state guarantee, signalling an important milestone in local resource raising and mobilization. For cities that face an increasing demand for services, and simultaneously a decline in transfers from state governments, such bonds are an important instrument for tapping the capital market to finance municipal infrastructure. Bonds represent an approach to capital market borrowing by municipal governments that presents a number of benefits over the traditional financing approaches. Recognizing the emerging role of bonds in financing urban infrastructure, the Government of India has inserted a new clause (vii) to section 10(15) of the Income Tax Act, 1961, whereby interest income from bonds issued by local authorities will be exempted from income tax. The use of funds raised from the tax free municipal bonds is restricted to capital investments in urban infrastructure comprising potable water supply; sewerage or sanitation; drainage; solid waste management; roads, bridges and flyovers; and urban transport, if it is a municipal function. The maximum amount of tax free municipal bonds as a percentage of the total project cost (excluding interest during construction) is 33.3 % or Rs. 500 million whichever is lower. The debt-equity ratio of such bonds is not to exceed 3:1.

Incentives are crucial for municipal governments to initiate reform and improve their functioning. The role of incentives has been recognized and underlined by the Eleventh Finance Commission (EFC), which has recommended 20% of the grant amount to be allocated on the basis of the progress achieved by states on decentralisation as visualised in the Constitution (seventy-fourth) Amendment Act, 1992. Setting aside such sums as incentives or creation of dedicated incentive funds are important measures for accelerating the implementation of the different provisions of the Constitution (seventy-fourth) Amendment Act, 1992.

The task of the finance commissions of states is to review the relevance and appropriateness of such initiatives and incorporate them in the reform package for municipalities to enable them improve their functioning and financial viability.

Workpage

The Constitution (seventy-fourth) Amendment Act, 1992 on municipalities constitutes a major step towards strengthening of municipal governments, and operationalising the Directive Principles of State Policy. The provisions with respect to their finances are crucial to the strengthening of municipal governments. The manner in which these tasks are carried out, will determine the journey on the road to effective decentralisation.

Workpage