6. India

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INTRODUCTION

Urban infrastructure and services in India have historically been financed by direct budgetary support. Few, if any, of the institutions responsible for infrastructure provision have been able to generate surpluses for financing them. Faced with resource compression and growing economy-wide demands on urban infrastructure and services, important initiatives have been taken in recent years, which, on the one hand, have introduced new modes and instruments of financing infrastructure and, on the other hand, focused on creating an environment for enhancing efficiency and equity in managing urban development. This chapter provides case studies of three such initiatives. Table 6.1 provides relevant national statistics.

The first case study is concerned with the issuance of bonds by municipal governments, using the strength of the potential revenue streams. The second looks at substituting the rental basis of assessing property values by area characteristics, assumed to be closer to the market prices; and the third considers wide-ranging structural and systemic reforms, with the purpose of eliminating those impediments that have constrained the functioning of land and housing markets and the flow of private investments into urban infrastructure.

COUNTRY CONTEXT

India is a union of 28 states and seven centrally administered territories. In this Union, the functions, subjects, and powers of the center and states are laid out in the seventh schedule of the Constitution of India, in what are known as the union list, state list, and concurrent list. The functions of the central Government, laid out in the union list, are generally those required to maintain macroeconomic stability, and those assigned on grounds of the economies of scale and cost-efficient provision of public services. Currency and coinage, operation of the central bank of the country, foreign relations, international trade, defense, railways and airports, core and strategic industries,

Table 6.1: Country Urban Development Profile, India

Human Development Index rank of 177 countries (2003)^	127
GDP growth (annual %, 2004)	6.91
GNI per capita, Atlas method (current $, 2004)	620
GNI, Atlas method (current $ billion, 2004)	674.6
GDP per capita PPP ($, 2003)^	2,892
GDP PPP ($ billion, 2003)^	3,078.2
Population growth (annual 2005–2010 %) #	1.35
Population, total (million, 2005)#	1,096.92
Urban population, total (million, 2005)#	315.28
Urban population percent of total population (2005)#	29
Population largest city: Mumbai (2005, million)	18.34
Population growth: 242 capital cities or agglomerations > 750,000 inhabitants 2000#	
- Est. average growth of capital cities or urban agglomerations 2005–2015 (%)	25
- Number of capital cities or urban agglomerations with growth > 50%, 2005–2015	6
- Number of capital cities or urban agglomerations with growth > 30%, 2005–2015	67
Sanitation, % urban population with access to improved sanitation (2002)**	58
Water, % of urban population with access to improved water sources (2002)**	96
Slum population, % of urban population (2001)**	56
Slum population in urban areas (2001, million)**	158.42
Poverty, % of urban population below national poverty line (2000)**	24.7
Aid (Net ODA received; $ million, 2003)^	942.2
Aid as a share of Country Income (Net ODA/GNI, 2003 %)*	0.2
Aid per capita (current $, 2003)^	0.9

GDP = gross domestic product, GNI = gross national income, ODA = official development assistance, PPP = purchasing power parity.

Sources: See Footnote Table 3.1, World Bank (2005); OECD (2003); United Nations (2004, 2005).

and operation of the stock exchanges are some of the key functions of the central Government.

The state governments are responsible for public order, police, public health, education, agriculture, irrigation, land rights, and industries and minerals other than those that are in the central Government (union) list. The state governments also have jurisdiction over functions provided in the concurrent list; however, in the event of a conflict, the central Government has overriding powers in respect of such subjects.

The distribution of tax powers between the center and state government is based on the principle of "separation," in that the tax objects are either assigned to the center or the states. Most of the broad-based and productive taxes—comprising taxes on income and wealth from nonagricultural sources, corporation tax, excise duty on manufactured goods (excluding those on alcoholic liquors, opium, hemp, and other narcotics), and custom duty—fall within the tax powers of the central Government. Tax powers assigned to states comprise tax on sale and purchase of goods, land revenue, taxes on agricultural income, taxes on land and buildings, excise duties on alcoholic liquor, taxes on vehicles, taxes on goods and passengers carried by road or inland waterways, taxes on luxuries and entertainment, stamp duties, and taxes on trades, professions, and callings.

Recognizing that the assignment of functions and tax power could result in imbalances between revenue capacities and expenditure needs of states, and that the extent of imbalances could vary between them because of the differences in their capacities and needs, the Constitution provides for a mandatory sharing of the net proceeds from noncorporate income tax, and optional sharing of the proceeds of the union excise duty. In addition, Article 275 of the Constitution recognizes the need for grant-in-aid to the states. Intergovernmental transfers are an accepted and integral component in India's multi-tiered governmental finance.

The powers to constitute local governments, both rural local bodies and municipalities (urban local bodies), rest with the state governments. They derive their powers from the state rural local bodies and municipal acts. The Constitution does not lay down either the functions or powers of the local governments. Thus, out of the state list of subjects, state municipal acts assign such functions as public health and sanitation, and functions relating to water, land, prevention of diseases, and many others to municipalities.

Similarly, they also assign the tax powers enjoyed by them under the seventh schedule, such as taxes on land and buildings, the entry of goods into a local area for consumption, and use or sale therein to municipal governments. The entire subject falls within the state government's domain. Each state government has its own act (or acts). Thus, local government roles, responsibilities, and economic functions differ in several respects between states. One state may devolve a large number of functions and responsibilities to local governments, and may decide either to give them adequate tax powers or mete out the expenditure responsibilities via a system of transfers. Another state may opt to take a different route. The discretion and autonomy of states in determining the powers and functions of municipal bodies explain the existence of very large differences in the role that transfers play in different states.

While management of cities and towns, urban development, and provision of urban services are direct concerns and responsibilities of state governments, the central Government undertakes, from time to time, policy and program initiatives in matters that it considers important from a national perspective. The central Government provides financial aid to state-level agencies for urban poverty reduction programs, including housing for low-income urban households, as well as support for the development of urban infrastructure.

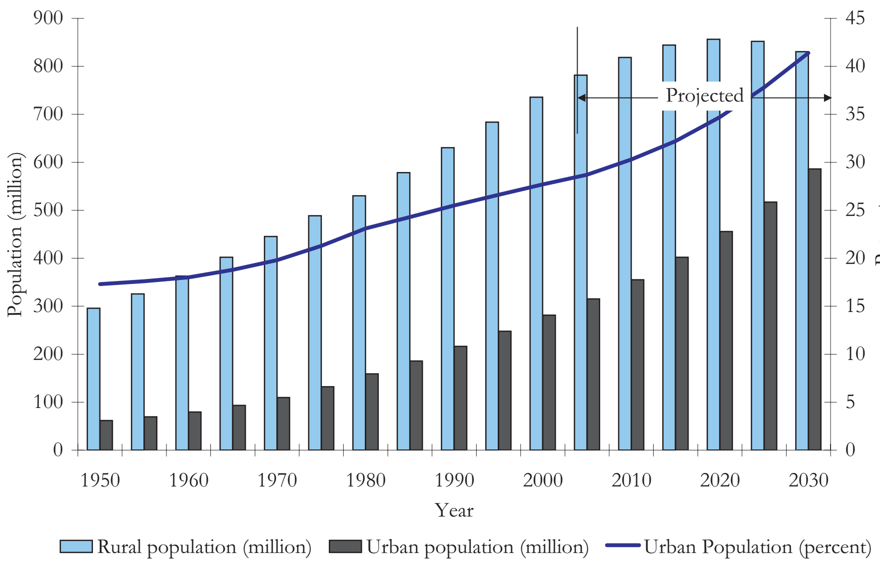
Table 6.2: Urban Population and Annual Growth Rates in India

Year	Urban Population		Growth Rate (%)	
	Total (million)	% to Total Population	Change Over Previous Decade	Average Annual
1961	78.9	18.0	26.4	2.3
1971	109.1	19.9	38.2	3.2
1981	159.5	23.3	46.1	3.8
1991	217.2	25.7	36.2	3.1
2001	285.5	27.8	31.1	2.7

Source: Census of India 2001 and earlier censuses.

Table 6.2 shows the changes and projected profile of urban and rural populations in India. In 1961, the urban population of India was 78.9 million or 18.0% of total population. By 2001, it had reached 285.5 million or 27.8% of the total population. Urban populations are predicted to rise to 550 million by 2030 or 42.0% of total population (Figure 6.1). Since 1961, the rates of growth in urban populations to the present have varied between 2.3% and 3.8% per annum. This level of urbanization is significantly lower than those in other Asian nations, such as the People's Republic of China and Indonesia. While the level of urbanization may be lower, cities in India are among the most densely populated in Asia, with Mumbai having a density of 378 persons per hectare (Angel 2005). Table 6.3 gives the population and growth rates of the 15 largest metropolitan cities in India.

Figure 6.1: Trends in Urban and Rural Population, India



Urban growth in India, combined with rapid growth in the economy as a whole, has placed immense strain on infrastructure and services and the institutions responsible for their provision. The Census of India (2001) reported that approximately 50% of urban households did not have access to tap water at their premises, and 43% lacked toilet facilities. Land and housing markets have come under severe pressure, with the result that a substantial proportion of the urban population lives in slums and unauthorized settlements. Even with a marginal decline in urban poverty, nearly 24% of the urban population lives under conditions of absolute poverty, which is a source of serious concern. Most cities are exposed to air and water pollution, problems posed by inadequate solid and liquid waste management, large-scale use of low-grade domestic fuels, and occupation of environmentally sensitive lands.

The finances of municipal governments—the key institutions responsible for urban development and growth and development of cities and towns—are in bad condition. For reasons attributable to the narrow and inelastic tax base and its indifferent application, municipalities in India are not able to generate sufficient resources to meet even the operating and maintenance costs of services they provide. Only a few municipal administrations can apply such principles as user-pays for recovering the costs of services. Effectively, it has meant large-scale subsidization of civic services, which has increased the dependence of city administrations on the higher tiers of government.

Table 6.3: Growth Rates of Metropolitan Cities in India

State	Population 1991	Population 2001	Average Annual Growth Rate (1991–2001)
Greater Mumbai	9,925,891	11,978,450	1.9
Calcutta	4,399,819	4,572,876	0.4
Delhi	8,471,625	12,696,367	4.1
Chennai	3,841,396	4,343,645	1.2
Bangalore	3,302,296	4,301,326	2.6
Hyderabad	3,058,093	3,637,483	1.7
Ahmedabad	2,954,526	3,520,085	1.8
Pune	1,566,651	2,538,473	4.8
Surat	1,505,872	2,433,835	4.8
Kanpur	1,879,420	2,551,337	3.1
Jaipur	1,458,483	2,322,575	4.7
Lucknow	1,619,115	2,185,927	3.0
Nagpur	1,624,752	2,052,066	2.3
Patna	956,417	1,366,444	3.6
Indore	1,109,056	1,474,968	2.9
Vadodara	1,061,598	1,306,227	2.1

Source: Census of India, 1991–2001.

A recent study has estimated that financial transfers from higher tiers account for 35–50% of the total resources of city governments. Based on these characteristics, it is often contended that cities in India are unsustainable.

Given that infrastructure constraints in cities, insufficiency of urban lands and housing, and continuing fluctuations in the land market could hurt the prospect of achieving the national growth and poverty reduction targets, different tiers of government have undertaken initiatives to improve the functioning and fiscal base of municipalities. In 1992, the central Government introduced a broad-based amendment to the Constitution that aimed at providing constitutional recognition and legitimacy to municipal governments and strengthening and empowering them with new responsibilities and powers. This was followed by amendments to the Income Tax Act to allow municipalities to issue tax-free bonds for financing their infrastructure.

As late as 2005, the central Government released an urban renewal mission, which by all accounts, may be the most ambitious such intervention in urban development. Under this mission, the central Government proposes to extend grant assistance to municipalities for improving urban infrastructure and governance, requiring them to undertake structural reforms that would eliminate constraints to the land and housing market, align infrastructure prices with the cost of provision, and bring greater transparency and accountability in local decision making. Many state governments have initiated steps to shift from cash-based, single-entry to an accrual-based, double-entry accounting system to obtain a better assessment of the finances of municipalities. With limited potential for securing financial assistance from state governments, a few city governments have begun to tap into the capital market for financing urban infrastructural services. A summary of the shifts noted in recent years is illustrated in Table 6.4.

Although too few to make any sustainable impact on urban development, these initiatives signal a recognition on the part of the central, state, and municipal governments of the contribution of cities to national growth and poverty reduction objectives.

GOOD PRACTICE CASE STUDIES

The following describes three initiatives that have the potential for making the most impact on cities and urban development: (i) issuance of bonds by the Ahmedabad Municipal Corporation (AMC), an initiative to tap into the capital market, which apart from raising finances was meant to open up a new channel for infrastructure financing; (ii) property tax reform initiatives taken

Table 6.4: Local Government Finance - A Paradigm Shift

From	To
Rents to form the principal basis for estimating annual rateable value and property taxation	Area characteristics or capital valuation to form the basis for property taxation
Grant financing of local/municipal infrastructure	Debt financing of local/municipal infrastructure
Finances and functioning of municipalities based on directions of the higher tier of government	Incentive funds for municipal governments to undertake reforms for improving finances and functioning
Municipal provision of services	Public-private partnership in the provision of municipal services and infrastructure
Land treated as fixed assets	Sale of land-use rights for raising recourses
Other municipal assets held on books	Assets to be leveraged for mobilizing resources
Negotiated intergovernmental transfers	Rule or formulae based intergovernmental transfer to allow financial stability and predictability to local governments
Subsidized prices of basic municipal infrastructure and services on grounds of externality	Application of the principle of cost recovery for pricing municipal infrastructure and services

by the State Government of Andhra Pradesh, an across-the-state initiative to put property taxation on a sound footing; and (iii) a broad-based program of structural and system reforms put out by the central Government to eliminate the bottlenecks that have impeded investment in urban infrastructure and make municipalities efficient, equitable, and accountable.

Issuance of Municipal Bonds, Ahmedabad

GOOD PRACTICE	
Good Governance	✓
Urban Management	✓
Infrastructure/Service Provision	✓
Financing and Cost Recovery	✓
Sustainability	
Innovation and Change	✓
Leveraging ODA	

One of the critical issues in recent years is how to finance and maintain municipal infrastructure and services. Municipal infrastructure and services have 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 infrastructure capital has been marginal or even nonexistent, principally due to their inability to generate revenues beyond those necessary to operate and maintain such services as water supply, sewerage, roads, primary health, and street lighting. Indeed, most municipal bodies in the country have large revenue deficits, which are met out of the existing system of intergovernmental transfers.

Figure 6.2: Map Showing Location of the Case Studies

The statutory framework, which lays down the powers of municipal bodies, does not provide them with any major role in capital financing of infrastructure and services. Their borrowing powers are restricted, evidently for the reason that unlimited municipal borrowing could have serious repercussions on macroeconomic fiscal balance and stability. In most states, municipal corporations are permitted to borrow only within certain limits, which are defined in terms of a percentage of the annual rateable value (ARV) of properties or of the value of municipal physical assets. Moreover, they can borrow only with the permission of the state governments. 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 uncommon in Indian cities.

In 1996, AMC decided to raise a loan of Indian rupees (Rs)1,000 million ($28 million) from the market by issuing bonds. This was the first issuance of its kind in the country, and constituted an extremely important fiscal initiative on the part of a local body. This example shows a major initiative by a medium-sized municipal corporation, faced with deteriorating finances and declining levels of services, and with bleak prospects of raising loans from the traditional sources. Initially, the tax system and procedures were reformed and later the improved revenue streams were used to enter the capital market.

Located in the state of Gujarat, Ahmedabad is a large metropolis with a population of 3.5 million, growing at an annual rate of approximately 3.0–3.5%. In the post-1991 period, Ahmedabad received substantial industrial investments due to the generally progressive and forward-looking policies of the state. Ahmedabad's economic contribution to the state's GDP is substantial, and is reflected in the rapid development of its industrial base and construction activity.

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

AMC had a sound financial base until the early 1980s. However, its financial condition started deteriorating in the late 1980s (Table 6.5); at the close of the fiscal year 1993–1994, AMC had accumulated a deficit of approximately Rs60 million (about $1.5 million) in the revenue account alone. The growth rate in the revenue yields of the two main taxes—property taxes and octroi—hardly reflected the rate at which construction and other activities were expanding in the city. The nontax component of AMC was not performing, and the administration and enforcement of municipal taxes were lax. Low levels of education, poor working conditions, and inadequate training and support of AMC's staff contributed to the deficiencies in performance.

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

- restore the financial balance and stability of AMC;
- build confidence in the public with respect to AMC's capacity to deliver services efficiently and equitably;
- assess the creditworthiness and risk level of AMC finances; and
- put to effective use the existing statutory provisions for mobilizing additional resources.

AMC next undertook bold measures to improve the administration and enforcement procedures with respect to property taxes and octroi, and simultaneously to project an image of the corporation as a body that was sensitive to people's needs, aspirations, and priorities. The collection of property tax

Table 6.5: Revenue Income and Expenditure of Ahmedabad Municipal Corporation (Rs million, $ million)

Year	Revenue Income	Revenue Expenditure	Cumulative Balance (– or +)
1989–90	1,354.5 ($75.2)	1,420.5 ($78.9)	–178.7
1990–91	1,486.6 ($82.6)	1,604.4 ($89.1)	–296.5
1991–92	1,746.6 ($67.7)	1,748.5 ($67.7)	–298.4
1992–93	1,988.8 ($75.9)	1,998.2 ($76.3)	–308.8
1993–94	2,197.6 ($70.9)	2,248.9 ($72.5)	–359.1

Note. The outstanding balance at the commencement of the fiscal year 1989–1990 was Rs112.8 million.

in Ahmedabad had been extremely tardy, with the collection being less than 30% 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, and reassessment. In 1994, AMC introduced a series of measures to improve property tax collection, which included

- disconnection of water supply and drainage lines on nonpayment of property tax;
- advertising names of major property tax 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 with respect to tax demand and collection from individual properties; and
- regular monitoring of tax collection.

AMC also prepared a valuation manual for the levy of octroi and a series of steps to locate and prevent leakage of funds:

- formation of vigilance squads to monitor the octroi check posts,
- creation of a data bank on the prices of goods subject to octroi levy,
- establishment of a market research wing to continually update the data bank on prices, and
- 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 with respect to property taxes rose from 28.3% in 1993–1994 to 32.9% in 1994–1995, and in the subsequent year to 44.6%. In the aggregate, property tax revenues increased from Rs442 million ($13.4 million) in 1993–1994 to Rs800 million ($22.7 million) in 1995–1996—an increase of nearly 80% in 2 years. Revenue from octroi levies increased from Rs1,296 million ($41.3 million) in 1993–1994 to Rs2,030 million ($57.7 million) in 1995–1996. The result of the different measures, including those that covered the nontax component of AMC's revenues, was that AMC's continuing deficit in the revenue account turned into a surplus by 1994–1995 (Table 6.6). This helped restore citizens' confidence in AMC's capacity to effectively administer the local tax structure and prevent leakages and corruption.

The changed financial situation enabled AMC to undertake small capital projects of high priority to both meet people's needs and aspirations and to instill confidence among its clientele that it could deliver. However, Ahmedabad City's capital requirements were large. The new administrative leadership

Table 6.6: Revenue Income and Revenue Expenditure of the Ahmedabad Municipal Corporation (Rs million, $ million)

Year	Revenue Income	Revenue Expenditure	Surplus/Deficit (+/–)
1993–94	2,197.6 ($70.0)	2,248.9 ($71.6)	–359.1
1994–95	2,854.6 ($90.9)	2,476.7 ($78.9)	+18.7
1995–96	3,748.1 ($106.5)	3,248.9 ($92.3)	+517.9

also needed further evidence of the fiscal strength of AMC, particularly as to whether the increase in revenues was a short-term phenomenon or sustainable.

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 generated over a 2-year period and the initiatives that it had taken to reform its main revenue sources, AMC could put to use such innovative instruments as municipal bonds. India had no tradition of municipal bonds but was aware of municipal bonds as one of the most important revenue sources for municipal and local governments in the United States. Securing long-term financing like bonds, however, was essentially a function of faith in the system responsible for spending and management. Did 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. Credit rating considers factors on the creditworthiness of the borrowing municipal government—the economic base of the city, current financial position of the city government, debt-related factors, legal and administrative issues, and project-specific issues. AMC proposed to raise Rs1,000 million ($28 million) from the capital market. 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 a bond—meaning that there is adequate safety for the timely payment of interest and principal. This process has been of particular interest: it makes the evaluation of credit risk public, and it is also a public announcement to investors that the state government will not bear any losses on the investment.

AMC issued municipal bonds in 1997. These were general obligation bonds; for their redemption, a portion of the revenue receipts, mainly the receipts from octroi, was pledged and earmarked. AMC opened an account to ensure that the dedicated funds were set aside exclusively for paying back the bond amount. Although the public was not involved directly in decision making on the issuance of bonds, a survey conducted to ascertain the attitude of citizens revealed a high degree of willingness on their part to invest in bonds. The willingness to invest in such bonds, which were fixed obligations and could constrain local fiscal flexibility, demonstrated that the funds so raised would be invested for meeting the citizens' infrastructure priorities and needs. The bonds were oversubscribed.

The steps taken by AMC on the governance of the city were visible. The entire relationship between the Corporation and its citizens changed. The latter began to look upon the Corporation as a body that could deliver the goods and services for which it was responsible. A sense of partnership and participation among citizen groups developed. Since then, AMC has gone to the market on two additional occasions to raise funds for financing infrastructure.

Reform of Property Taxation in Andhra Pradesh

GOOD PRACTICE	
Good Governance	✓
Urban Management	✓
Infrastructure/Service Provision	
Financing and Cost Recovery	✓
Sustainability	
Innovation and Change	✓
Leveraging ODA	

Property taxation is perhaps the most widely used source of revenue for local governments throughout the developing and developed world. It has been long favored 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.

Property tax is used solely to raise revenues for providing municipal services and has the following advantages:

- 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;
- the tax provides no direct competition with other taxes that are typically imposed by the central and state governments;
- it allows the application of the benefit principle because local services are, to some extent, capitalized into property values. Property taxes are a means of allowing owners and occupants to contribute to 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 if accompanied by good property tax policy and administration; and
- it causes only minor distortions in resource allocation.

Given these theoretical and practical advantages, it is surprising that property taxes in India have not been adequately mobilized for raising resources.

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 being the primary source of revenue for municipal governments, remain minor in terms of revenue yields. In 1997–1998, property taxes in India are estimated to have generated only about Rs27,640 million ($703.3 million), forming 0.18% of national GDP (Table 6.7). This share has changed little over the years, notwithstanding an extraordinarily large increase in land and property values and a dramatic increase in the share of the construction sector in the country's GDP.

Property taxes in Andhra Pradesh—the state dealt with in this case study—constitute the principal source of revenue for the municipal governments. In 1991–1992, the total yield from property taxes amounted to Rs400.7 million ($15.5 million) or 50.9% of the total internal resources generated by municipal governments. It formed 0.1% of the state's GDP. The profitability of property taxes in the state as measured in terms of yield per capita (Rs55 or $2.13) was lower than the All-India average.

Before the property tax system in Andhra Pradesh was changed in 1993, assessment of properties for tax purposes was based on ARV of land and buildings. ARV 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, ARV was a hypothetical or a notional rent, held as a proxy for market rent of the concerned property. In the case of rented properties, ARV was assessed on the basis of the actual rent except 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 of 1965, which contains procedures for levying this tax, provided for a revaluation of properties and, consequently, of tax liabilities, approximately once every 5 years. Similarly, the Act provided that ARV of properties was subject to different kinds of deductions and rebates, these being rebates to owner-occupied houses, rebates for repairs and maintenance, depreciation for the age of buildings, rebates on early payment, and vacancy remissions. Properties used for public worship, educational purposes, charitable hospitals, and buildings whose ARV was below a threshold were also exempted from payment of property taxes.

Table 6.7: Revenue Significance of Property Taxes (1997–1998)

Estimated yield from property taxes (Rs million)	27,640
Property tax yield (% of GDP)	0.18
Property tax yield (% of total tax revenues)	15.5
Property tax yield (% of total municipal revenues)	12.9
Per capita property tax yield (Rs)	105.7

Source: NIPFP. 2000. Options for Closing the Revenue Gap of Municipalities, 2000/01 to 2004/05.

The underlying considerations in granting exemptions were social justice, compensation to those properties that provided, directly or indirectly, services of merit or the public good, and high administrative cost in tax collection, particularly from low tax-yielding properties.

The property tax system in Andhra Pradesh as in other states of the country, however, was choked in each of its components and subcomponents. 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. Similarly, serious problems were noted in using the "actual rents" for assessing property values because 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 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. 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 collusion between the assessor, tax collector, and taxpayer resulting in massive leakages and corruption.

Assessing the lost income due to all these infirmities of the system is difficult because (i) assessment-to-market-rent ratios were 50–60%, (ii) only about 30–35% of the total number of properties constituted the tax base, (iii) rebates were substantial, and (iv) rent control acts significantly limited ARV. The loss to the total property tax yields could be as high as 150–175% of the actual collections on this account.

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 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—rental value, capital value, and site area—are generally used in different parts of the world. The issue was 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 favor 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? The primary concern of the government was that the preferred method should be such that

- it is able to incorporate into assessment of property taxation the principles of equity, objectivity, fairness, and simplicity;
- property taxes are uniform with respect to buildings similarly situated;
- the new system is able to "de-link" the operation of the Rent Control Act from the assessment of property tax and reduce the discretion of the assessor and avoid arbitrariness in assessment;
- it is able to make tax administration efficient, transparent, and effective in the levy of property tax; and
- it will improve buoyancy in property tax revenues.

The state government 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 favor of the site/area-based system under which ARV of properties could be fixed with reference to the characteristics of the area, using indicators such as location, type of construction, plinth area, age of the building, and nature of use. The area-based method constitutes the most important initiative taken in the country in recent times to eliminate the arbitrariness from which the system of estimating ARV has historically suffered. The approach is effectively a formula for property valuation, where a property is defined by a vector 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.

The Government of Andhra Pradesh adopted this method because, prima facie, it 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: (a) availability of services, (b) nature of construction of properties, and (c) the nature of use of properties;

- a sample survey of 20% of all properties in each zone to determine the prevalent rental values and to fix the rental ranges for 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; and
- issuance of a final notification giving the maximum and minimum rental values for each zone/area.

The reform process also included decisions with respect to the rebates and exemptions, and tax payment procedures. Considering that the process had to be gradual, issues pertaining to rebates and exemptions were left untouched, meaning that the rebates extended earlier on account of owner-occupancy, age of the building, and repairs continued in the new system. Similarly, exemptions were not only maintained but their scope was expanded to cover owner-occupied residential buildings whose property tax burden was below a threshold level. Also, the increase in property taxes was capped so as not to exceed 75–100% 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 so they could retain and use—for limited periods—the property tax deposits. A second feature of the new system was the introduction of an incentive grant wherein municipal bodies were given fixed amounts ranging between Rs1.5 million and Rs4.0 million (about $50,000–130,000 in 1993) if they were able to raise tax collection efficiency to 85% of tax demanded.

Several municipal bodies passed resolutions to adopt the new system and set up committees to suggest strategies for putting it into practice. Other municipal bodies communicated extensively with taxpayers about the new system, which came into effect on 1 April 1993. As a result, property tax yields have risen dramatically in a number of municipalities, often registering an increase of over 20–25% annually.

The National Urban Renewal Mission

On 28 February 2005, the central government announced the launch of the National Urban Renewal Mission (NURM), with a proposed outlay of Rs500 billion ($11.5 billion), arguing that India was faced with the challenge of urbanization that had to be met by providing "urban facilities of satisfactory standards." NURM aims to respond directly to the myriad problems that cities

GOOD PRACTICE	
Good Governance	
Urban Management	
Infrastructure/Service Provision	
Financing and Cost Recovery	✓
Sustainability	
Innovation and Change	✓
Leveraging ODA	

and towns in India had faced in recent decades. The urban transition—even in early stages—has not been accompanied by a corresponding increase in the supply of basic urban services, such as water supply, sewerage and drainage network, garbage disposal facilities, city-wide roads, public safety systems, and pedestrian pathways. Nor has the supply of land and housing kept pace with the increase in urban population. The result of this unbalanced growth is a familiar one: households without services, slums, and widespread poverty.

Until the end of the 1980s, the approach to responding to such problems centered on programs and projects that aimed at providing support for infrastructure development in small- and medium-sized cities, environmental improvement of urban slums, and basic services for the urban poor. Almost the entire direction of such support was based on the perception that the nature of urban infrastructure and services—characterized as they were with externalities—was such that it needed public policy interventions; it was claimed that only the public sector had the wherewithal to bridge the gap between the demand for and supply of urban services of communities that could not afford them. Such interventions proved to be limited in impact and inadequate to deal with the scale of the problem. The project-based approach ignored the importance of sustainable delivery of services.

Following the country's transition toward a market-based economy and the spirit of decentralization embodied in the Constitution (74th) Amendment Act, 1992, the urban sector in India has begun to change. There is a growing recognition that statutes concerned with urban development need to be reviewed and changed because they do not permit expansion of the land and housing markets. It is evident that the Urban Land (Ceilings and Regulation) Act, 1976, and rent control laws are major impediments to the development of land and property markets, and constitute a deterrent to economic growth. Similarly, the pricing system of urban services requires major overhauling because services, when sold below cost, cannot be sustained. The premise that subsidies are essential for the poor to access services has proved to be wrong, with a greater part of the subsidies leaking out to the better-off households, and the poor having to rely on poor quality, high-cost services.

NURM has grown out of the above factors and a serious examination and appraisal of experiences of past efforts for improving service delivery and management. The objective of NURM is to encourage city governments to initiate measures to improve the existing service levels in a financially sustainable manner. The Mission believes that to make cities work as well as contribute substantially to India's economic growth, it is essential to create incentives and support for urban reforms both at the state and city levels, develop appropriate enabling and regulatory frameworks, enhance the creditworthiness of urban local bodies, and incorporate the poor in the service delivery systems.

The Mission encourages states/cities to undertake fiscal, financial, and institutional changes required to create efficient and equitable urban centers. It intends to free land and housing markets from the constraints of age-old statutes, adjust infrastructure tariffs and prices to the cost of service provision in conjunction with local tax reform to meet the cost of joint services, and introduce accountability and responsiveness in municipal governments. NURM seeks to make fuller use of the energy and initiative of the private sector in implementing its reform agenda. It rests on the premise that sustainable improvements can take place only when investments are accompanied by wide-ranging statutory, institutional, and pricing reforms. The Mission entitles 63 cities to receive financial aid from the central Government for infrastructure projects and to simultaneously initiate the process of reforms.

KEY LESSONS

The first two case studies—the issuance of bonds by AMC and property tax reform in Andhra Pradesh—provide the following interesting propositions and insights into the connections between fiscal innovations and governance.

(i) A simple and transparent tax system has a greater possibility of securing citizens' acceptance and of being sustained, even if it entails a higher tax burden. The Andhra Pradesh initiative with respect to property tax reform suggests that, notwithstanding the general reluctance on the part of municipal councils to increase the tax burden on their constituencies, a system that is (a) simple and comprehensible; (b) standardized and designed to eliminate discretion in estimating ARVs or the property tax burden; and (c) transparent in that the tax rate ranges are known to the taxpayers, will be widely acceptable.

(ii) Efficient administration and enforcement of tax systems are crucial for securing public support on issues, such as raising resources in the market and pledging revenue streams for redemption of loans. 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 subject to tax levies, and taking steps to prevent leakages and corruption are necessary to restore the confidence of the citizens and tax-payers in the functioning of a local body. Public cooperation and good governance cannot be expected to follow in the absence of an efficient and equitable tax administration.

(iii) Public sharing of credit-rating information is important for building alliances and partnerships with the nongovernment sector and other interest groups. The credit rating of a corporate body like AMC 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 potential is currently being tapped or not tapped, and the financial strengths and weaknesses of the local body.

(iv) Commitment and leadership are critical for 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 discriminatory and constraining in terms of its revenue-generating capacity. He opted for a system that was simple, open, and nondiscriminatory.

NURM is a testimony to the fact that sustainable urban development is a complex activity and a function of several factors related to statutory, institutional, fiscal, and pricing spheres. For India—currently in the throes of an urban transition in which its urban population base is poised to add more than 250 million persons during 2005–2030—the impediments to sustainable growth should be identified and adequately addressed, not by taking up isolated projects but by effecting structural and systemic improvements.

SUSTAINING URBAN DEVELOPMENT

India faces an enormous challenge in having to meet the requirements of a large and growing urban population base. The two initiatives discussed in this chapter— the issuance of municipal bonds and reform of property taxation—demonstrate how city governments can improve their revenue base and utilize the nascent but growing capital market for infrastructure financing. NURM aims to eliminate the numerous impediments that have blocked investments in cities and city-based infrastructure. The long-term task, however, lies in coming to grips with the urban phenomenon as it is likely to develop in the face of open borders and external influences. How to absorb them, ensuring that their gains are spread equitably among the different civil society groups, is the challenge that needs to be recognized.