Local Government Finance and Bond Market Financing: India

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Currency: Indian Rupee US Dollar 1 =Rupees 48.38 as on October 30, 2002 Fiscal Year April 1 through March 31

Abbreviations

ADB	Asian Development Bank
AMC	Asset Management Company
BOT	Build Operate Transfer
CARE	Credit Analysis & Research Ltd (CARE)
CRISIL	Credit Rating and Information Services of India Limited
DEA	Department of Economic Affairs
EXIM Bank	Export Import Bank of India
GIC	General Insurance Corporation
HUDCO	Housing and Urban Development Corporation Limited
ICICI	Industrial Credit and Investment Corporation of India Limited
ICRA	Investment Information and Credit Rating Agency of India Limited
IDBI	Industrial Development bank of India
IDFC	**Infrastructure Development Finance Company**
IFCI	Industrial Finance Corporation of India Limited
IL&FS	Infrastructure Leasing and Financial Services Limited
LIC	Life Insurance Corporation of India
MUD&PA	Ministry of Urban Development and Poverty Alleviation
NIUA	National Institute of Urban Affairs
NSE	National Stock Exchange
RBI	Reserve Bank of India
SEBI	Securities and Exchange Board of India
SIDBI	Small Industry Development Bank of India
SFC	State Finance Commission
TNUDF	Tamil Nadu Urban Development Fund
ULBs	Urban Local Bodies
USAID	United States Agency for International Development
UTI	Unit Trust of India
WB	World Bank

Summary and Conclusions

Objectives

The study analyzes the fiscal and financial situations of the local governments in India, focusing on developing local bond markets facilitating sub-national borrowing, with the necessary regulatory and institutional infrastructure in place. The local governments for the purpose of this study will include states and major urban local bodies such as municipal corporations. The study identifies the areas of policy reforms and technical assistance to support local bond market development and Subnational financing in India.

Background

The New Economic Policy pursued since 1991, and the passing of the *Nagarpalika* (Decentralization) Acts by the Parliament in 1992, have devolved considerable authority to the local (sub-national) governments in India. The socio-political developments in India during the last decade have significant implications on the powers and functions of local government. The states and local bodies in particular play a crucial role in the delivery of social and economic services (public health, education, housing, and urban development), and in the provision of infrastructure (power, irrigation, and transport). They together are responsible for executing Central Government policies and programs, including those for alleviating poverty and providing social security. The fiscal and financial situation of the state and local governments, therefore, assumes importance for the development of the economy in general, and the financial market development at the Subnational level in particular.

State Finances in India

Being the second tier entities in the federation, the financial health of the Indian states assumes importance, as this would determine the sustainability of growth as well as private flow of capital. Fiscal problems encompassing both the Union as well the States were the most important reasons for the 1991 macroeconomic crisis in India. The structural adjustment program pursued during the nineties, which emphasized mostly on the restructuring of the finances of the Union government, left aside the fiscal aspects of the states until very recently. State finances got deteriorated in the mean time, as the demands on basic infrastructure and services increased following the implementation of economic reforms as well as the new responsibilities emerging out of decentralization. Shrinking tax revenues were exacerbated by a surge in current expenditures. Structural imbalances in the form of large revenue deficits, rising debt service burden, very slow growth in non-tax revenue, rising share of non-development expenditures and the increasing financial losses of state enterprises were the major weaknesses of state finances today. The increase in the contingent liabilities of the state governments such as guarantees was also imposing severe fiscal risks on the governments.

The states will have to provide an environment for greater resource mobilization and build the necessary foundation for a higher economic growth, as well as providing resources to improve the social indicators of development. The emerging policy imperatives should focus on the following areas: (i) public expenditure management, (ii) tax policy and administration, (iii) rightsizing the civil service and government, (iv) public enterprise reforms and private sector participation, and (vi) financial management and accountability of the departments.

There is a growing apprehension that the guarantees issued by the state governments to their local bodies and state level enterprises might subsequently devolve on the states, making the state fiscal problems worse. The guarantees also have a macroeconomic dimension; as being guaranteed debts of the public sector enterprises, these could become part of the public sector debt. Credit rating agencies have shown increasing concern about these guarantees, and their rating downgrades are expected to affect the borrowing programs of the states as well their undertakings.

Guarantees extended by the financial institutions without risk assessment have an in-built bias for moral hazard and adverse selection for the financial system. The guarantee system needs to be phased out gradually, by allowing the local bodies to access bond issuance directly without such guarantees, particularly in cases of commercially viable projects.

Finances of Local Government

The Seventh Schedule of the Constitution of India provides the mandates to the states to frame the necessary statutes for the constitution and functioning of the municipal bodies in its jurisdiction. These statutes and acts basically vest the necessary controlling and supervisory powers with the state government on their local bodies. The 74th Constitutional Amendment Act of 1992 made a revolutionary change in the powers and functioning of the local bodies. The local bodies got the status of ‘constitutional authorities’ with this Amendment, contemplating functional and financial autonomy.

Urban local bodies in India vary widely in terms of their level and composition of economic activities, resource potential, services and the efficiency of providers. There are larger urban agglomerations which have the necessary resources for development, and have the capacity to access capital markets. These are the cities that have attracted most of the emerging business and economic activity during India’s liberalization, leaving the smaller towns with extremely limited financial and human resources to lag behind.

There exist wide differences among the local bodies in their tax jurisdiction, the degree of control exercised by the state government in terms of the fixation of tax base, tax rates and tax exemptions, and the level of efficiency with which the taxes are administered and enforced. The functional domain has also been variable, which have mainly depended on the discretion of the state government in power. The functions delegated to the urban local bodies are often concurrent in nature; state governments thereby acting simultaneously in the spheres that have been delegated to the municipal bodies.

The expenditure functions of the urban local bodies cannot be looked at in isolation from the revenue assignment. The endowment of functions has to be linked with the revenue generating capacities of the local bodies in order to maintain a balance between the expenditure and the revenues. It is necessary to ensure that there is uniformity of such functions among the local bodies at least within a state.

Transparency in expenditure assignment and tax devolution is an important prerequisite for decentralization. The mandates given to the State Finance Commissions in terms of devolution of taxes from the state divisible pool to the local bodies needs to be implemented in a rational and time bound manner. The methodologies of resource devolution mechanisms must be evolved appropriately, taking into account the regional features, and should be based on up to date information. In order that the state governments surrender their expenditure responsibilities to their local bodies, and make it commensurate with the devolution with the revenues, necessary central level interventions are needed.

Capital Markets and Local Government Financing

Investment financing for urban infrastructure creation seems to have been more successful once the Subnational governments and the supporting institutions established complementarities. Private sector initiatives in the provision of local economic services have occurred in regions with conducive investment climate, supported by an enabling regulatory and institutional framework. Bond financing is seen to have occurred within the framework of. local credit market growth accompanied with a supportive government intervention and multilateral assistance.

In India the capital market is yet to make a strong impact on financing urban infrastructure, but the trends and initiatives in most instances show a great deal of enthusiasm, potential and dynamism with which the stakeholders such as financial community, city governments and the central government are involved today. What is needed is a right kind of policy framework with appropriate complementarities, supported by an enabling regulatory and institutional framework and multilateral assistance, to make this happen.

Financial sector reforms pursued since early 1990s have changed in many ways the operating environment of the financial intermediaries. There is substantial increase in resource mobilization by the corporate sector and development financial institutions from the capital markets, and most importantly from the bond markets. The banking sector continues to be the primary form of financial intermediary in India. However, the urban local bodies have very little commercial relationship with the banking system; the growth in bank lending to infrastructure, particularly urban infrastructure, has been rather slow . Recently commercial banks are beginning to participate in urban finance through innovative mechanisms such as take-out financings. Development finance institutions and specialized financial institutions promoted specifically for infrastructure development have been able to raise substantial amount of capital through the issuance of tax exempted bonds and lending them for infrastructure projects. Contractual savings institutions such as the Life Insurance Corporation (LIC) and General Insurance Corporation (GIC) are also best suited for financing infrastructure, given the long-term nature of their liabilities.

The concept of urban development fund is of very recent origin in India. These have been set up, often in collaboration with an international counterpart and an Indian financial institution. Union budget of 2002-03 proposed several initiatives that have important implication for bond financing by the ULBs: (i) Infrastructure equity fund, (ii) Urban Reform Incentive Fund(URIF), (iii) City Challenge Fund (CCF), and (iv)Pooled finance development scheme (PFDS).

Commercialization and private sector participation in power, telecom, roads and ports have made significant progress in India, attracting large investments into these sectors. Most of these were essentially national level efforts, which have also attracted foreign direct investments. Though private sector participation and commercialization of urban infrastructure is very recent, but nevertheless very successful in few cases. These sectors have been found suitable for private-public partnerships, and commercialization in various forms such as BOT. Private sector participation and co-financing from financial institutions have occurred in cases where the ULBs have made considerable operationational restructuring.

Support from the state governments in the form of equity, concessions in terms of land or water supply, dedicated revenue streams for loan repayments, and transparent regulatory framework have proved to be very encouraging. The thrust has to be to sustain and enhance cash flows generating capacity, rather than subsidies and guarantees by the higher levels of governments. There is a need for deregulation of state level laws, reduction in process time for clearances, independent regulator for tariff setting, and initial equity participation by state/central bodies, would facilitate such financing.

Fiscal incentives in the form of tax exemption and deduction have in vogue for several years for investments in infrastructure. For this purpose the definition of infrastructure has been expanded to include urban infrastructure making them eligible for tax incentives. Tax exemptions allowed from the income in the form of interest, dividends and capital gains under various sections of the Indian Income Tax Act.

The policy regime in India facilitating financing of urban infrastructure is evolving. The focus has to be fast shifted from the traditional budgetary provision and subsidy based to the one based on private financing from capital markets. The increasing number of urban local bodies getting credit rated, issuance of bonds by a few municipalities, and enabling environment such as private public-participation of urban service delivery are the few enablers towards this. These have to be accompanied by the necessary changes in legal and regulatory environment facilitating private sector participation.

Local Bond Markets Development

The Indian securities markets have witnessed significant growth and change during the last decade, emerging as the major provider of investment capital. The potential for the development of local bond market is large, due to the large urban population and the thrusts given on urban infrastructure development in policy. Indian cities are in need of long-term capital for investment in urban infrastructure. The focus has to be on the creation of the necessary institutional and supporting mechanism so that an active local bond market develops, enhancing the attractiveness of the local securities, by reducing transaction costs and risks for investors.

It needs to be recognized here that market participants need, in addition to the market infrastructure, other economic benefits such as liquidity, legal protection of their investments, protection of return on their investments, and the supportive socio-economic environment at the Subnational level. The investors in Subnational securities benefit as much from a fair and transparent market structure as are the investors in national securities. Securities regulations are not designed in segments, but should be viewed as part of an overall system existing alongside and complemented by established national systems of systems of regulations.

Enabling environment would include broadening of the issuers and investor's base, institutional infrastructure such as credit ratings, and market intermediaries such underwriters, merchant bankers, and trustees, regulations with defined and enforceable debt contracts, protecting the issuers' rights in the event of default and an efficient judiciary overseeing the enforcement of such rights are the necessary preconditions.

There is a need for capacity building efforts in identifying and structuring of credit enhancement mechanisms, within the sustainable borrowing policy framework. Donor assistance in developing more such pilot projects for municipal bonds issuance, in collaboration with rating agencies, merchant bankers and regulatory agencies and stock exchanges is considered important.

Capacity Building

Institutional capability of urban local bodies had weakened considerably due to systemic withdrawal of their functions and powers, and the consequent shrinking of local resource base and fiscal capabilities. The problem stems mainly from the structure and functions of the ULBs under the Indian laws, their poor operational and financial management processes adopted, and improper revenue base and collection efficiency. Significant capacity building efforts are needed to augment the fiscal capability of the local governments in order that they access municipal bond markets.

Areas of Technical Assistance

The analysis in this study brings out the issues that are of significant interest to the Asian Development Bank in furthering her role in effective implementations of her local lending programs in India, in particular, promoting local government financing and bond financing. The areas of assistance for the Bank would cover the following issues:

- To support the implementation of decentralization objectives in India, by improving the efficiency of the Subnational governments such as state and local government in their efforts in the delivery of core services;

- To improving the efficiency of the local fiscal system at the level of state and city governments, such that these entities carry on their economic role efficiently and in sustainable manner;

- To strengthen the role of the private sector in providing basic services such as water supply and sanitation, sewerage, and other urban infrastructure, by bringing in changes in the legal and regulatory frameworks and supporting an enabling environment;

- To deepen the nascent bond market in India and spread its financing involvement into cities of the Indian federation, by providing access to the thousands of urban local bodies who are in need of funds for longer term investments;

- To strengthen the links and building synergies among the Indian stake holders such as state and central governments, private sector service providers, financial institutions, who have hitherto remained isolated from funding the local governments, for floatation of urban finance projects in India; and

- To bring into India the international best practices that have been successful in many decentralized set up and facilitate innovative schemes for urban financing;

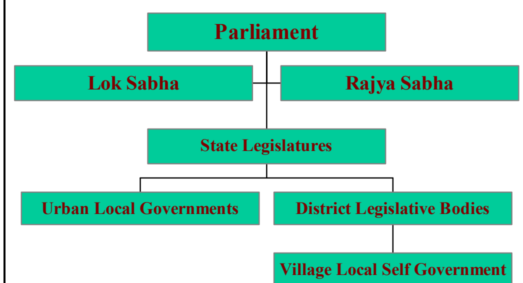
The proposed activities could be spread into both progressive and reform minded states as well as states that have great potential for reforms and decentralization. Although reforming states with a history of successful decentralization are expected to be the main beneficiaries of any new initiative, the later category of states can be brought into dialogue involving central government, state government, financial institutions, regulatory agencies and the donor agencies in order that the benefits of decentralization and capital market access are equitable realized.

I. Introduction

The Republic of India is a federation of twenty-eight states and seven Union Territories[1]. This is a nation of widely contrasting ethnic, linguistic, and cultural diversity. The country's population at 1.027 billion as per 2001 Census is next only to China. With a GDP of $2,200 billion based on purchasing power parity, India is the fourth largest economy in the world, next to USA, China and Japan. The twenty-eight states and seven Union Territories differ vastly in terms of their natural resource endowment, development capacity, and economic performance.

The country's underlying polity is organized on federal principles. The Indian federation comprises a three-tier structure, with the Union at the center, and the State and the Union territories at the second tier and the Local Self-Governments, to include both urban and rural, at the third tier. The states nevertheless remain as important organs of the Indian Union in all matters of polity and economy, to what had been termed by the Sarkaria Commission as 'cooperative federalism'.

Box 1: Political Governance in India



Indeed the 1990s could be considered significant in furthering the policy of local governance and decentralization in India. Several factors have played important role in devolving powers and functions to the Subnational bodies. The passing of the 73^{rd} and 74^{th} Constitutional Amendment Acts by the Parliament in 1992, and the New Economic Policy pursued following the macroeconomic crisis during the early 1990s were the two most significant developments. The Constitutional Amendments (known as the Decentralization Acts) made a revolutionary change in the powers and functioning of the local bodies. These bodies got the necessary status of 'constitutional authorities' with these Amendments, thereby contemplating functional and financial autonomy.

The economic reform in the 1990s had their way for the private sector participation in the provision of urban infrastructure and civic services, thereby to an extent also augmented the capabilities and resource base of the local governments. The fiscal reforms initiated at the center had put considerable pressures on the state finances, by reducing grants, subsidies, loans, and other forms of transfers from the central government. At the same time, an expanding urban population has been creating additional demands on

[1] The three new states Bihar in Jharkhand, Uttaranchad in Uttar Pradesh) and Chattisgarh in Madhya Pradesh, were created in November 2000 by an act of Indian Parliament, essentially due to such socio-economic diversity.

infrastructure and services, requiring both short-term funds for their maintenance as well as long-term funds for creating additional facilities. The capacity to recover the costs of services from user charges has generally been very weak in most of the Indian states.

The reform in the financial sector has been gradually reducing the "directed credit" component of the financial institutions. In this environment, sub-national governments has been required to seek new sources of funding, including exploring the participation of private sector in service delivery. These developments have intensified the need for private capital, including external resources, in economic development of regions. These have also necessitated the need for amending regulations suitable for private sector participations.

On the political front, the emergence of the regional parties forming governments at the states and their presence at the center in successive coalition governments, has led to the shift of power balance towards the states, both political as well as financial. These regional parties no doubt have brought greater autonomy to the states as well, through enhanced financial transfers and development schemes from the center.

Status of Urban Local Bodies

There are 3682 urban local bodies in India, although their size and structure varied significantly across the country. In view of the differences in their structures and economic conditions, these bodies are classified as (i) Municipal Corporations for larger urban areas, (ii) Municipal Councils for smaller urban areas, and (iii) Nagar Panchayats for the rural-urban transition areas. (Details in Annexure-I).

Box 2: India's Urban Local Bodies

Urban Local Bodies	**3,682**
Municipal Corporations	*96*
Municipalities	*1,494*
Others	2,092

Although Local governments are recognized and protected by the national constitution, the states have the *de facto* legislative powers over them. The governments at the states play a crucial role in the delivery of social and economic services (such as public health, education, housing, and urban development), and in the provision of infrastructure (such as power, irrigation, and transport). The states are also responsible for executing Central Government policies and programs, including those for alleviating poverty and providing social security. The mandates to the states are derived from the Constitution to frame the necessary statutes, which basically vest the necessary controlling and supervisory powers with the state governments on their local bodies.

Institutional capability of urban local bodies had weakened considerably due to a systemic withdrawal of their functions and powers, resulting in the shrinking of local resource base and fiscal capabilities. The 74th amendment of the constitution was meant to demarcate the functions and financial powers of the local governments. The XIIth schedule of the Constitution provides for the eighteen functions that are to be undertaken by the urban local bodies, as given below:

1. Urban Planning including town planning.
2. Regulation of land-use and construction of buildings.
3. Planning for economic and social 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 weaker sections of society, including the handicapped and mentally retarded.
10. Slum improvement and up-gradation.
11. Urban poverty alleviation.
12. Provision of Urban amenities and facilities such as parks, gardens, playgrounds.
13. Promotion of cultural, educational and aesthetic aspects.
14. Burials and burial grounds; cremations, cremation grounds and electric crematoriums.

15. Cattle pounds; prevention of cruelty to 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 slaughterhouses and tanneries.

The provisions of the XIIth schedule are not made mandatory, however, and instead it directs the state governments to decide the powers and functions to be devolved on their local bodies. It may be observed that except for the few states like Kerala, West Bengal, Tamil Nadu, and Maharashtra, there have been very few changes in the municipal laws of the other states(See Annexure-II). The functional domain has also been variable, which depends on the discretion of the state government in power. The functions delegated to the urban local bodies are often concurrent in nature, making thereby the state governments to act simultaneously in the spheres that have been delegated to the municipal bodies. For example, functions such as primary education and health have been taken over by the state government departments and functions such as water supply and sewerage, housing and land development have often been returned to state corporations and housing boards. In many cases, the state and their parastatal bodies develop new infrastructure, which is then transferred to municipal bodies for operations and maintenance.

Urbanization

The focus on decentralization and urban governance in India has also been an offshoot of the increasing urban population and concentration of major activities in the cities. According to the Census 2001, India has an urban population of 306.9 million or 30.5 per cent of the total population. Total population of the country increased by about 21.34 per cent during the decade 1991-2001, whereas urban population grew by 46 per cent during the same period. The Technical Group of the Planning Commission on Urban Perspectives and Policies had projected the urban population at 38 per cent of the total population by 2006-07. The increase in urban population over the decades has been due to natural increase of the population, and reclassification of new towns and rural-urban migration.

Table 1: Trends in Urbanization in India

	Urban Population	% of Urban Population to Total Population	Decadal Growth	Contribution Urban Sector to GDP
1981	159.5	23.3	46.1	47
1991	217.6	25.7	36.4	55
2001	306.9	30.5	46.0	60

There are 35 million plus cities in India(Annexure III). These cites have stronger institutional arrangements, better access to resources as well as infrastructure. These larger urban agglomerations have the necessary resources for development, and some of them have the capacity to access capital markets from domestic as well as international sources. These are the cities that have attracted most of the emerging business and economic activity during the last decade of liberalization, leaving the smaller towns with extremely limited financial and human resources to lag behind.

Box 3: Urban Agglomerations/Towns by Category

Class	Population Size	Number
Class I	1,00,000 and above	393
Class II	50,000 - 99,999	401
Class III	20,000 - 49,999	1,151
Class IV	10,000 - 19,999	1,344
Class V	5,000 - 9,999	888
Class VI	Less than 5,000	191
Unclassified		10
All classes		4378

Source: Census 2001

II. State Finances in India

This section presents the trends in fiscal and financial situations of the states in recent years. It provides an overview of the fiscal stance of the states, it's borrowing, and the directions of reforms introduced in their finances. Being the second tier entities in the federation, the financial health of the Indian states assumes importance, as this would determine the sustainability of growth as well as private capital. The role of the state is significant considering its responsibilities in providing the basic economic and social services for the people, and an environment conducive for higher levels of investments. The fiscal and financial situation of the states also assumes importance for the financial market development at the Subnational level.

Resources for the states consist mainly the tax and non-tax revenues, grants-in-aid and loans from the central government as well as state's own market borrowing. Internal resources in the form of taxes consist of land revenue and agricultural income tax, stamp duty and registration taxes, sales tax, state excise tax, road tax or motor vehicle tax, electricity duty and other taxes. Non-tax revenues of the state governments consist of interest receipts, cost recoveries on account of various services provided by the government, and profits and dividends from state public enterprises. The Finance Commission and the Planning Commission make recommendations for transfers to the states by way of grants and loans from the center. In addition to these two channels, various ministries of the central government also make specific purpose transfers to the states, with or without matching requirements.

Table 2 presents on the evolution of fiscal indicators of the states in recent periods. State-wise data are presented in Annexure IV. It can be observed that the fiscal situations of the states have got aggravated considerably in recent years. Imbalances have emerged in the form of large revenue deficits, rising debt service burden, very slow growth in non-tax revenue, rising share of non-development expenditures and the increasing financial losses of state enterprises were the major weaknesses of state finances.

The gross fiscal deficit of the states has remained consistently at high levels since the 1990s, although a slight improvement has taken place during the last two years (which declined from 4.6 per cent of GDP in 1999-2000 to 3.8 per cent of GDP in 2001-02). Both primary and revenue deficits have deteriorated. Revenue deficits accounted for over 50 per cent of gross fiscal deficit of all states. There exists a considerable inter-state variation in the fiscal performance, as seen from the Annexure-III.

Fiscal problems encompassing both the Union as well the States were the most important reasons for the 1991 macroeconomic crisis in India. The structural adjustment program pursued since then emphasized mostly on the restructuring of the finances of the Union government, leaving aside the fiscal aspects of the states until recently. State finances got deteriorated in the mean time, as the demands on basic infrastructure and services increased following the implementation of economic reforms as well as the new responsibilities emerging out of decentralization.

Table 2: Select Fiscal Indicators of State Governments (in per cent)

Item	1990-00 (Average)	1999-00@	2000-01@	2001-02@
Gross Fiscal Deficit/GDP	3.1	4.6	4.3	3.8
Primary Deficit/GDP	1.25	2.3	1.9	1.2
Revenue Deficit/GDP	1.17	2.7	2.4	2.0
GFD / Total Expenditure (excluding recoveries)	21.4	30.7	27.7	25.2
Revenue Deficit / Revenue Expenditure	9.3	20.8	17.2	14.8
Conventional Deficit / Aggregate Disbursements	-0.1	0.9	0.7	0.2
Revenue Deficit / GFD	34.8	59.2	54.3	51.5
Non-Developmental Revenue Exp/ Revenue Receipts	39.6	50.9	48.7	50.4
Interest Payments/Revenue Receipts	16.5	21.9	21.7	22.8
Developmental Expenditure / GDP	10.2	9.5	10.2	9.3
Social Sector Expenditure / GDP	5.7	5.9	6.2	5.8
Non-Developmental Expenditure / GDP	4.6	5.6	5.6	5.8
States' Tax Revenue/GDP	5.3	5.2	5.5	5.8
States' Non Tax Revenue / GDP	1.7	1.5	1.4	1.3

@ Data covers 26 State Governments & the National Capital Territory of Delhi.
Source: Reserve Bank of India

The market borrowings by states consist of the issuance of bonds through the Reserve Bank of India, loans from the central government, loans drawn from the small savings schemes, and other financial institutions. The Reserve Bank of India extends short-term accommodation as the Ways and Means Advances (WMA) to meet any temporary mismatch between receipts and payments of the state governments. The market borrowings constitute a very small proportion of the total deficit financing. The major part being accounted for by loans from the central government, and, most importantly, small savings schemes, and loans from financial institutions such as insurance companies. Over 80 percent of net small savings collections are available for investments in state government securities and the state governments also borrow from the state provident funds.

The growing deficits over the year resulted in a significant amount of debt, leading to a very high debt services. Interest payments account for about a quarter of the revenue receipts for all-states.

Table 3: Financing of State Governments' Gross Fiscal Deficits
(Rs Crores)

Year	Loans from the Central Government (net)	Market Borrow-ings(net)	others#	Gross Fiscal Deficit (2+3+4)	States' Outstanding Liabilities		Total Liabilities as% to GDP
					Total+	Market Loans	
1990-91	9,978	2,556	6,253	18,787	1,10,289	15,618	19.4
	(53.1)	(13.6)	(33.3)	(100.0)			
1991-92	9,373	3,305	6,222	18,900	1,26,338	18,923	19.3
	(49.6)	(17.5)	(32.9)	(100.0)			
1992-93	8,921	3,500	8,471	20,892	1,42,178	22,426	19.0
	(42.7)	(16.8)	(40.5)	(100.0)			
1993-94	9,533	3,620	7,443	20,596	1,60,077	26,058	18.6
	(46.3)	(17.6)	(36.1)	(100.0)			
1994-95	14,760	4,075	8,862	27,697	1,84,527	30,133	18.2
	(53.3)	(14.7)	(32.0)	(100.0)			
1995-96	14,801	5,888	10,737	31,426	2,12,225	36,021	17.9
	(47.1)	(18.7)	(34.2)	(100.0)			
1996-97	17,547	6,515	13,189	37,251	2,43,525	42,536	17.8
	(47.1)	(17.5)	(35.4)	(100.0)			
1997-98	23,676	7,280	13,244	44,200	2,81,207	49,816	18.5
	(53.6)	(16.5)	(30.0)	(100.0)			
1998-99	31,057	10,467	32,730	74,254	3,41,978	60,283	19.4
	(41.8)	(14.1)	(44.1)	(100.0)			
1999-2000P	32,656	12,636	45,474	90,765	4,19,821	72,919	21.5
	(36.0)	(13.9)	(50.1)	(100.0)			
2000-2001 (RE)*	32,033	12,567	50,221	94,821	5,03,613	85,486	23.1
	(33.8)	(13.3)	(53.0)	(100.0)			
2001-2002 (BE)*	33,633	10,666	49,730	94,028	5,91,509	96,151	23.9
	(35.8)	(11.3)	(52.9)	(100.0)			

Notes: Figures for 2000-01 and 2001-02 are, respectively, Revised Estimates and Budget Estimates and Provisional data relate to the budgets of 26 State Governments; # Include loans from financial institutions, provident funds, reserve funds, deposits and advances, *etc*.; + Includes internal debt, loans and advances from the Central Government and Provident Funds, *etc*
Source: Reserve Bank of India

Guarantees

In addition to its direct borrowing, the state governments also provide guaranties for the Subnational borrowings. The outstanding guarantees extended by the State governments amounted to Rs. 1,68,712 crore as at end March 2001, comprising 8.2 per cent GDP. A recent study on guarantees revealed that five large states-Gujarat, Maharashtra, Karnataka, Andhra Pradesh and Tamil Nadu account for over 50% of the total state level guarantees, with sectors such as irrigation and power projects accounting for the largest proportion[1].

[1] See CRISIL, Monitoring State Guarantees: Fiscally Unsustainable, July 2002.

Table 4: Outstanding Government Guarantees

(Amount Rs Crores)

Year	Centre		States		Total	
	Amount	% to GDP	Amount	% to GDP	Amount	% to GDP
1	2	3	4	5	6	7
1993	58,088	7.8	42,515	5.7	1,00,603	13.4
1994	62,834	7.3	48,866	5.7	1,11,700	13.0
1995	62,468	6.2	48,479	4.8	1,10,947	11.0
1996	65,573	5.5	52,631	4.4	1,18,204	9.6
1997	69,748	5.1	63,409	4.6	1,33,157	9.7
1998	73,877	4.9	73,751	4.8	1,47,628	9.7
1999	74,606	4.3	97,454	5.6	1,72,060	9.9
2000	83,954	4.4	1,32,029	6.8	2,15,983	11.2
2001	86,862	4.2	1,68,712	8.1	2,55,574	12.2

Source: Reserve Bank of India

Entities such as the state housing boards, urban development authorities, municipalities, electricity boards, and state road transport corporations have hitherto mobilized substantial amount of resources through state government guarantees, and various other forms of credit enhancements such as escrow accounts, pledging grants of the higher levels of governments, etc. Although such guaranteed borrowings have financed investments in the states, they also have created significant fiscal risk for them.

Box 5: CRISIL Downgrades Maharashtra Government Rating

The Credit Rating and Information Services of India (CRISIL) has downgraded the Government of Maharashtra from `BB plus (so)' to `D (so)' on October 16, 2002. The move follows delay in meeting interest and principal obligations on bonds issued by special purpose vehicle (SPV) of the Government for irrigation. Maharashtra has become the first State in the country to be downgraded to `D (so)',(signifying a default grade). The annual interest payment of the Government has risen to over Rs7,286 crore in 2001-02 from Rs2,904 crore in 1997-98. The fiscal deficit and stock of debt of the Government has increased to Rs10,800 crore and Rs70,228 crore, respectively, in 2001-02.

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Financial Institutions Move To Attach Govt Assets In Maharashtra

The Industrial Development Bank of India (IDBI) and the Industrial Finance Corporation of India (IFCI) have obtained a decree from the debt recovery tribunal (DRT) to attach the property of the Government of Maharashtra. The move follows failure of nineteen sugar co-operatives and spinning mills to repay their loans. The Government of Maharashtra had provided guarantee for the repayment of these loans. The dues from these co-operatives amount to Rs550 crore. As the government failed to honor its commitment, the financial institutions approached the DRT and obtained a decree.

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The guarantees can have macroeconomic dimension; as being guaranteed debts of the public sector enterprises, these could become a part of the public sector debt. Credit rating agencies have shown increasing concern about these guarantees, and their rating downgrades are affecting the borrowing programs of the states as well their undertakings. Guarantees extended by the financial institutions without risk assessment have an in-built bias for moral hazard and adverse selection for the financial system. There is a growing apprehension that such guarantees might subsequently devolve on the states, making the state fiscal problems worse. Management of the debt levels of the state governments as well as their guarantees remains crucial in maintaining even the financial and banking sector stability.

Table 5: Ceilings on Guarantees as promulgated by Different State Governments

State/Year	Ceiling and other features
Assam (2000)	Administrative ceiling on government guarantee against loan principals fixed at Rs.1500 crore.
Gujarat (1963)	Statutory ceiling originally fixed at Rs.60 crore in 1963, revised to Rs.20,000 crore in March 2001.
Karnataka (1999)	Total outstanding Government guarantees as on the first day of April of any year shall not exceed eighty per cent of revenue receipts of the second preceding year(excluding the additional borrowing for implementation of the Upper Krishna Project.). The Government will charge a minimum of one per cent as guarantee commission.
Rajasthan (1999)	The total of loans and guarantees of the state government on the last day of any financial year shall not exceed double the amount of estimated receipts in the consolidated fund of the State for that financial year and also that the outstanding guarantees issued by the State Government shall not exceed the amount of receipts in the consolidated fund of the State.
Sikkim (2000)	The total outstanding Government guarantees as on the first day of April of any year shall not exceed thrice the State's tax revenue receipts of the second preceding year.
West Bengal (2001)	The total outstanding Government guarantees as on the first day of April of any year shall not exceed ninety per cent of revenue receipts of the second preceding year(which shall not apply for any loan raised by the West Bengal Infrastructure Development Finance Corporation Limited for funding different infrastructure projects). The Government will charge a minimum of one per cent guarantee commission.

Source: Reserve Bank of India(1999)

The Reserve Bank's Technical Committee on State Guarantees (1999) recommended eschewing such practices and, providing for credit enhancement only within an overall limit. Some states in India have introduced statutory and administrative ceilings on guarantees, some of who also charge the guarantee commission on outstanding guaranteed amount (see Table 5). It is interesting to note that most of the public sector banks who had extended loans and subscribed to the bonds issued by such state level entities are not willing to invoke the state Government guarantees, even when payments are overdue. This is because, once invoked the assets get classified as sub-standard or doubtful, depending on the period of the overdue, thus requiring significant provisioning on the part of banks.

The guarantee system needs to be phased out gradually, by allowing the local bodies to access bond issuance directly without such guarantees, particularly in cases of commercially viable projects. The Fiscal Responsibility and Budget Management Bill 2000 prescribed that the Central Government shall not give guarantees for any amount exceeding one-half percent of GDP during any financial year. This provision is yet to be seen as being implemented. In addition to the explicit guarantees in the form of credit guarantee, there are implicit guarantees extended by the state governments such as letters of comfort, structured payment obligations, which also carry significant fiscal risks[1].

Fiscal Reforms in Recent Years

In recent years, a number of states have begun introducing medium term structural reforms in their finances, some of which can be summarized as follows:

- Some states have begun introducing expenditure management systems by setting up expenditure reforms committees and identifying performance indicators to assess the quality of expenditure restructuring.
- Some states have prepared a medium term expenditure plan and placed the annual budget within the context of such a medium term plan(Karnataka and Andhra Pradesh). For investments in infrastructure and social developments, such medium term expenditure plan has been seen to yield better results and ensure greater autonomy to the state departments within the defined limits. The Reserve Bank of India has been organizing conferences of the State finance secretaries, thereby providing a forum for dialogues and sensitization of various issues relating to state finances.

- Focus on decentralization would indicate that the state will face a significant financing requirement due to the increased spending on infrastructure, social sectors, non-wage operation and maintenance services, as these will have to be provided before the costs can be recovered through increased user charges. Keeping this in view, some states have undertaken comprehensive review of the functioning of the state PSUs and their restructuring and policy discussion on restructuring of public sector enterprises (in Karnataka).

- Recognizing the need to place an appropriate incentive structure to engage the private sector and the financial institutions, some states have established specialized funds for infrastructure development(Gujrat and Karnataka).

[1] see Reserve Bank of India, Annual Report 2000-2001,) Government of India, (2000). *Fiscal Responsibility and Budget Management Bill* Reserve Bank of India, (2001), *Report of the Core Group on Voluntary Disclosure Norms for State Governments.* Report of the Advisory Group on Fiscal Transparency(Chairman: Montek Singh Ahluwalia), June 2001.

- Considering the enormous losses of the State Electricity Boards and their impact on state finances, some states have signed Memorandum of Understanding (MoU) with the Central Government for bringing reforms in their power sector and setting up of State Electricity Regulatory Commissions (SERCs) for determining electricity tariff(in about fifteen states).

- Following the recommendations of the Core Group on Voluntary Disclosure Norms for State Budgets (2001), several states have begun disseminating comprehensive information on their finances, including information on guarantees, performance of state-owned enterprises, etc. The financial markets have started reacting to such financial disclosures and credit information.

- The recommendations of the Reserve Bank's Technical Committee on State Government Guarantees (1999) such as selectivity in the provision of guarantees, institution of ceiling, setting up of guarantee redemption funds, etc are being implemented at various stages. As a follow up of the decisions taken in the Conference of State Finance Secretaries held in May 2001, the Reserve Bank of India has constituted a Group to examine the issue of fiscal risk under different types of guarantees issued by the States.

- Following the recommendations of the of the Eleventh Finance Commission (EFC), the Center has set up an Incentive Fund, to encourage fiscal reforms at the state level. The Fund would comprise two parts: first part would comprise 15 per cent of the withheld portion of the Grants recommended to cover the deficit of the states on non-plan revenue account, and the second part created by contribution from the Central Government equivalent to 15 per cent of the revenue deficit grants recommended by the EFC. . The release from the Incentive Fund is based on a monitorable fiscal objective, thereby providing incentive to the state governments to implement fiscal reforms.

The states have to provide an environment for greater resource mobilization and build the necessary foundation for a higher economic growth, as well as providing resources to improve the social indicators of development. The emerging policy imperatives should focus on the following areas: (i) public expenditure management, (ii) tax policy and administration, (iii) rightsizing the civil service and government, (iv) public enterprise reforms and private sector participation, (vi) financial management and accountability of the departments, and (vii) fiscal transparency, dealing with fiscal information at the state level as well as transparent intergovernmental fiscal relations.

There exits much greater scope for the government to enhance resource mobilization through better efficiency in tax administration and compliance, increasing user charges from public utilities, revenues from public sector divestiture programs and from small savings. State's own revenue generation from taxes has to be complemented by the transfers through the policy recommendations of the Planning Commission as well as the

Finance Commission and transfers from the center to the states for specified purposes and sponsored schemes. States should aim at measuring a consolidated debt position of the states, by taking into account the level of guarantees offered by the state governments.

III. Sate of Local Governments Finances

The resource base of the urban local bodies consists of their own tax and non-tax revenues, grants as defined by the Finance Commission, grants and loans from the higher level of governments, and market borrowings.

Revenues of ULBs

Own Tax	**Own Non-Tax**	**Shared Tax**	**Grants**
Octroi	Water Sewerage	Stamp Duty	State Government
Property Tax	Building License	Electricity Tax	Other Agencies
Other Taxes	Vehicles / Animals	Motor Vehicle Tax	
	Investment Income		
	Fines		

Indian constitution specifies about the taxes that are to be divided between the union government and the state governments (Chapter I of part XII). Although the 74th Amendment is not very specific about the type of taxes the ULBs should have, the respective state governments provide for the sources of their tax revenue, the methods of their mobilization in the statutes of their urban local bodies, and the functions and devolution mechanisms as defined by the State Finance Commissions (SFCs). It may be observed that there exist wide differences among the local bodies in their tax jurisdiction, the degree of control exercised by the state government in terms of the fixation of tax base, and tax rates and tax exemptions (see Table 6). Also the efficiency with which the taxes are administered and enforced vary from states to states.

Table 7 presents the share of revenue, expenditure and the revenue-expenditure ratio for all levels of urban local bodies during 1990-91 and 1997-98(Annexure VI and VII provide some state-wise figures). This period provides fairly a good comparison of pre- and post-74th Amendment on local finances. Table 8 through 10 presents the data of selected ULBs drawn from different states, expected to provide further the situation on a representative basis.

In 1997-98 the aggregate revenue of urban local bodies in India was Rs 8090.5 crores. Tax revenue accounted for over 50 per cent of total revenue raised by the municipal corporations. Most important sources of taxes are property tax and Octroi- a levy on goods brought into the city. Revenues as proportion of the expenditures are higher for smaller urban areas such as Nagar Panchayats and for Municipalities that are higher than Municipal corporations. This is basically due to the inability of the smaller urban areas to expand their expenditure far beyond the revenue, capacity rather than any sign of self-sufficiency.

Table 6: Revenue Raising Powers of the Corporations as per their Acts

Corporation	Own Taxes	Shared Taxes	Grants in Lieu of Tax
Hyderabad	Property Tax, Lighting tax, Advertisement tax	Tax on transfer of immovable property, Profession or trade Tax, Entertainment tax	Octroi, Vehicle / Animal tax
Maharashtra and Gujarat(as per BPMC Act)	Property Tax, Octroi, Vehicle / Animal tax, Theatre tax, Entry toll on vehicles / Animals, Water tax	Profession or trade Tax, Entertainment tax	
Karnataka	Property Tax, Entry toll on vehicles / Animals, Advertisement tax, Lighting tax	Tax on transfer of immovable property, Entertainment tax	Octroi, Vehicle / Animal tax
Ludhaina	Property Tax, Octroi, Vehicle /Animal tax, Advertisement tax	Tax on Profession or trade Tax, Theatre tax, Entertainment Tax	Tax on transfer of immovable property
Calcutta	Property Tax, Entry toll on vehicles /Animals, Advertisement Tax	Profession of trade Tax	

Source: CRISIL , Contrasting Profile of Urban Local Bodies.

An important source urban revenue is the property tax. But the complicated valuation procedures, legal disputes, ceilings imposed on rents of the properties under the Rent Control Act etc have made the revenues from properties near stagnant. The near stagnancy in revenues from properties have occurred when the actual value of the properties have gone up multifold. Despite its significance, only the Finance Commissions of Tamil Nadu and Uttar Pradesh have rationalized the property tax procedures. This requires the repeal of the Rent Control Act and the Urban Land Ceiling Act (UCLA).

It can be seen from Table 7 that the user charges (as given as own non-tax revenues) are the lowest for all urban areas. States, which have started commercialization and private sector participation in the areas basic services with necessary regulatory reforms, have benefited from higher revenue generation. Some municipalities have even leased out roads and bridges to private players under special schemes such as Build-Operate and Transfer by modifying the state toll acts. States such as Andhra Pradesh have gained in revenues by successfully introducing user charges such as betterment levy, impact fees, valorization charges.

There is no detailed breakdown of the aggregate expenditure of local government in India. A broad indication is that about two-third was spent on core services (water supply, sanitation, street lighting, roads, burials and burial grounds) and the balance non-core services, including general administration. On the aggregate it can be seen that per capita expenditure of the municipalities are increasing at a time when the per capita revenue receipts are not increasing as much as, thus widening the resource gap of the local bodies.

Table 7: Revenue and Expenditure of local Bodies (All India)

Category	Item	1990-91	1992-93	1994-95	1995-96	1996-97	1997-98
All Urban Local Bodies							
Revenue	Own Tax	49.22	51.12	50.74	51.01	49.40	48.38
	Own Non-Tax	20.38	18.55	17.13	17.00	16.92	17.47
	Other Revenue	30.40	30.34	26.83	26.84	28.86	29.63
Expenditure	Exp. On Core Services	40.94	31.55	29.57	33.45	54.77	66.90
	Other Expenditure	59.06	68.45	70.43	66.55	45.23	33.10
Revenue/Expenditure		16.11	20.59	18.81	18.52	13.03	8.05
Municipal Corporations							
Revenue	Tax Revenue	53.67	55.46	53.93	54.08	53.13	52.50
	Non-Tax Revenue	22.05	20.05	17.76	17.95	17.87	18.82
	Other Revenue	24.29	24.48	20.52	20.16	21.75	21.86
Expenditure	Core Services	47.23	32.49	29.81	36.00	60.59	74.49
	Other Services	52.77	67.51	70.19	64.00	39.41	25.51
Revenue/Expenditure		14.16	19.66	16.09	16.18	10.44	6.20
Municipalities							
Revenue	Own Tax	42.66	44.30	44.96	48.06	40.18	43.83
	Own Non-Tax	17.26	15.81	15.97	15.00	13.38	15.02
	Other Revenue	40.09	39.88	39.08	36.94	36.29	41.15
Expenditure	Exp. On Core Services	22.00	28.59	27.67	24.36	24.95	17.75
	Other Exp.	78.00	71.41	72.33	75.64	75.05	82.25
Revenue/Expenditure		18.70	19.71	26.17	22.30	22.42	16.44
Nagar Panchayats							
Revenue	Own Tax	32.43	33.51	38.49	30.77	29.13	25.73
	Own Non-Tax	17.41	14.30	14.71	15.77	15.59	13.85
	Other Revenue	50.16	52.19	46.80	53.46	55.28	60.42
Expenditure	Exp. On Core Services	48.28	48.50	48.04	49.45	49.83	51.62
	Other Exp.	51.72	51.50	51.96	50.55	50.17	48.38
Revenue/Expenditure		101.36	94.79	95.09	98.58	86.98	96.56

Source: Government of India, Report of the Eleventh Finance Commission, 2000.

There exist wide differences among the local bodies in their tax jurisdiction, the degree of control exercised by the state government in terms of the fixation of tax base, tax rates and tax exemptions, and the level of efficiency with which the taxes are administered and enforced. The expenditure functions of the urban local bodies cannot be looked at in isolation from the revenue assignment. The endowment of functions has to be linked with the revenue generating capacities of the local bodies in order to maintain a balance between the expenditure and the revenues. It is necessary to ensure that there is uniformity of such functions among the local bodies at least within a state.

Table 8: Tax Revenues of Muncipal Corporations

State/Local Body	1990-91	1995-96	1999-00
Gujarat-Ahmedabad			
Property	27.6	27.3	26.1
Octroi	71.4	69.1	69.2
Miscellaneous	0.9	3.6	4.7
Karnataka-Hubli-Dharwad			
Property	57.9	66.7	40.0
Service	33.1	20.7	18.6
Trades & Callings	4.1	2.4	1.3
Miscellaneous	4.9	10.2	40.0
Kerala-Kozhicode (Calicut)			
Property	46.1	28.3	32.2
Service	22.5	18.7	27.8
Trades & Callings	2.4	2.4	3.9
Toll	11.6	8.4	7.0
Miscellaneous	17.4	42.1	29.1
Madhya Pradesh-Indore			
Property		17.4	20.2
Service		10.2	8.5
Octroi		62.0	62.7
Terminal		2.8	2.6
Trades & Callings		6.9	5.5
Animal & Vehicles		0.0	0.0
Maharashtra-Nashik			
Property	9.2	7.7	6.8
Octroi	70.6	70.8	54.2
Miscellaneous	20.2	21.5	39.1
Meghalaya-Shillong			
Property	30.7	52.5	41.4
Service	5.5	4.7	6.6
Animal & Vehicles	0.0	0.2	0.1
Toll	54.9	36.9	43.1
Miscellaneous	8.8	5.7	8.8
Punjab-Ludhaina			
Property	14.3	17.4	16.4
Octroi	79.8	73.6	78.2
Miscellaneous	5.8	9.0	5.4
Pondicherry			
Property	21.3	17.9	15.8
Service	0.5	0.4	1.3
Octroi	16.4	28.0	15.5
Trades & Callings	0.7	0.3	1.3
Toll	0.1	0.1	0.1
Miscellaneous	60.9	53.3	66.1
Rajasthan-Jodhpur			
Tax Revenue	98.9	99.6	
Octroi	1.1	0.4	
Tamil Nadu-Chennai			
Property	43.4	38.9	40.8
Miscellaneous	56.6	61.1	59.2
General Administration	2.9	5.0	4.1
Miscellaneous	100.0	100.0	100.0

Source: Statistical Abstract of India, 2000

Table 9: Expenditure of Corporations

State/Local Body	1990-91	1995-96	1999-00
Gujarat-Ahmedabad			
General Administration	13.1	14.7	16.5
Public Health	2.8	2.2	2.5
Safety & convenience	3.7	4.1	3.5
Education	23.5	22.2	21.7
Public Works	1.4	3.7	3.5
Miscellaneous	55.5	52.9	52.3
Karnataka-Hubli-Dharwad			
General Administration	6.2	15.6	24.5
Public Health, Safety & convenience	32.7	36.9	28.5
Education	0.0	0.0	0.0
Public Works	32.4	28.0	40.7
Miscellaneous	28.6	19.4	6.3
Kerala-Kozhicode (Calicut)			
General Administration	15.1	14.6	11.6
Public Health	4.9	12.7	10.0
Public Works	59.6	55.4	84.9
Miscellaneous	20.4	17.3	5.1
Madhya Pradesh-Indore			
General Administration		69.5	77.3
Public Health		13.2	8.4
Safety & convenience		6.3	6.6
Education			0.1
Public Works		11.0	7.6
Maharashtra-Nashik			
General Administration	1.4	17.6	9.8
Public Health	9.8	23.9	28.9
Safety & convenience	2.9	6.6	7.4
Education	6.2	0.1	1.2
Public Works	5.4	8.6	5.1
Miscellaneous	74.2	43.2	47.6
Meghalaya-Shillong			
General Administration	19.7	19.0	17.7
Public Health	57.9	55.6	39.2
Safety & convenience	1.4	10.0	5.5
Public Works	13.4	9.6	33.4
Miscellaneous	7.7	5.8	4.2
Punjab-Ludhaina			
General Administration	9.4	5.3	5.9
Public Works	14.2	34.5	36.9
Miscellaneous	76.4	60.2	57.2
Pondicherry			
General Administration	10.6	9.7	10.5
Public Health	1.3	1.4	1.2
Public Works	16.6	7.8	7.4
Miscellaneous	71.5	81.1	91.3
Rajasthan-Jodhpur			
General Administration	19.1	4.9	
Public Health	30.2	14.3	
Safety & convenience	0.3	0.2	
Public Works	25.2	48.5	
Miscellaneous	25.1	32.1	
Tamil Nadu-Chennai			
General Administration	2.9	5.0	4.1
Miscellaneous	100.0	100.0	100.0

Source: Statistical Abstract of India, 2000

Table 10: Loan Repayments and wages and salaries as % of Revenue Expenditure

State/Local Body	1990-91	1995-96	1999-00
Gujarat-Ahmedabad			
Repayment of loan	13.6	12.0	14.7
Wages and Salaries	4.6	4.5	4.3
Karnataka-Hubli-Dharwad			
Repayment of loan	9.2	1.0	5.3
Wages and Salaries	52.8	70.4	52.2
Kerala-Kozhicode (Calicut)			
Repayment of loan	18.0	31.1	14.9
Wages and Salaries	207.1	209.4	234.2
Madhya Pradesh-Indore			
Repayment of loan		1.0	0.6
Wages and Salaries		56.2	57.6
Maharashtra-Nashik			
Repayment of loan	12.9	0.4	0.2
Wages and Salaries	27.9	53.9	43.9
Meghalaya-Shillong			
Repayment of loan	5.1		
Wages and Salaries	54.1	59.2	52.8
Punjab-Ludhaina			
Repayment of loan	6.6	1.2	1.3
Wages and Salaries	62.1	35.1	32.8
Pondicherry			
Repayment of loan	2.6	1.1	1.1
Wages and Salaries	28.2	30.0	48.0
Rajasthan-Jodhpur			
Repayment of loan	4.2	0.2	
Wages and Salaries	406.9	125.3	

Source: Statistical Abstract of India, 2000

Transparency in expenditure assignment and tax devolution is an important prerequisite for decentralization. The mandates given to the State Finance Commissions in terms of devolution of taxes from the state divisible pool to the local bodies needs to be implemented in a rational and time bound manner. The methodologies of resource devolution mechanisms must be evolved appropriately, taking into account the regional features, and should be based on up to date information. In order that the state governments surrender their expenditure responsibilities to their local bodies, and make it commensurate with the devolution with the revenues, necessary central level interventions are needed.

Financial Devolution

Devolution of resources from the central government to the states is an important feature of the system of Federal finance in India. Article 280 of the Constitution calls for the setting up of a Finance Commission every five years at the level of states. This commission is entrusted with the task of reviewing the financial position of local bodies, and recommend for the devolution of taxes, user charges, shared revenues and other inter-governmental transfers. The Central Finance Commission and the State Finance Commissions are the bodies responsible for assessing and advising the respective levels of government on the financial needs of local government. General and specific grants are made to local government by the states. Following the recommendations of the Eleventh Finance Commission central government will provide financial assistance for local authorities to strengthen their capacity to maintain their accounts and conduct audits.

Table 11: Transfer of Resources from the Centre to the States

(Rs. Crore)

	Resources transferred to the States					
Year	**Share of States in Central Taxes**	**Grants from the Centre to States & UTs**	**Loans (gross) from the centre to States & UTs**	**Repayment of loans by States**	**Gross transfers to States (2+3+4)**	**Net transfers to States (2+3+4-5)**
1	**2**	**3**	**4**	**5**	**6**	**7**
1970-71	755	612	1028	658	2395	1737
1980-81	3792	2796	3146	917	9734	8817
1990-91	14535	13293	14522	4653	42350	37697
1991-92	17197	15805	13199	3781	46201	42420
1992-93	20522	17943	13335	4639	51800	47161
1993-94	22240	20956	15263	5192	58459	53267
1994-95	24843	20297	18807	4494	63947	59453
1995-96	29298	21577	19627	4790	70502	65712
1996-97	35061	23545	24031	6459	82637	76178
1997-98	43548	30452	14729	7125	88729	81604
1998-99	39145	25844	15935	9475	80924	71449
1999-00 (R.E.)	43510	30240	21912	11923	95662	83739
2000-01 (R.E.)	54079	41424	21534	12687	117037	104350

Source: Reserve Bank of India

Most of the states have already set up SFCs and have made their recommendations. It is hoped that the functioning of the SFCc would ensure sufficient transfer of funds to local bodies based on objective criteria and strengthen the spirit fiscal federalism. There is a need to standardize the divisible pool of taxes to bring in uniformity across the states. The SFCs need to focus on the emerging revenue raising capabilities of the local bodies. Suggestions have been made to synchronize the formation of the central and state Finance Commissions in order that their recommendations are implemented in expected time frame.

In this context it is worth noting the suggestions made by the National commission to review the working of the Constitution:

- Distinct and separate tax domain for municipalities should be recognized. List of taxes that come under municipal jurisdiction should be prepared and it should form part of the common schedule of functions and responsibilities for local bodies. In the event it is decided to continue with the 11th and 12th schedules as separate, the tax domain should figure in the relevant schedule.

- Articles 268 to 274 of the Indian constitution clearly specify the distribution of tax revenues between the union and the state governments. Similar to that the concept of a divisible pool of taxes, which can be shared between the Union, the states and the municipalities, should also be recognized. Categories of taxes and levies that form part of the divisible pool, the tax collection responsibility and the share of the three tiers of governments should be categorically specified.

- In case of taxes and levies, the proceeds of which are to be shared with municipalities, prior consultation will be required before any modification is made in the scope of tax or its rates.

- Article 276 on taxes and professions, trade and employment should be amended as suggested by the 11th finance commission. The ceiling should be specified by Parliament from time to time rather than requiring amendments to the constitution.

- State laws should provide for composition of the State Finance Commission and the criteria for its membership similar to the provisions in the case of the finance commission set up by the president under article 280.

- State laws should provide for the establishment of the SFCs in a periodical manner and determine a time schedule for the same so that the work and output of the SFCs are synchronized suitably with the Central finance commission.

Articles 243-I and 243Y should be amended to ensure that the Action Taken Report by the government is laid before the state legislature within six months of the submission of the SFC recommendations.

IV. Local Government Financing and Capital Markets

The resource requirements for investments in Indian urban sector are massive, as various estimates presented from time to time (see Table 12). The scale and size of investment requirements for infrastructure creation as well as their operations and maintenance (O&M) require multiple sources of financing, including external resources. Given the revenue surplus of urban local bodies and the fiscal constraint of central and state governments, the major chunk of resources would have to come from two main segments.

Table 12: Estimate of Resource Requirement for Urban Infrastructure

Source	Services/Infrastructure Covered by the Report	Period of Recommendation	Resource requirements (Rs Crores)
Ninth Plan Document	Urban Water Supply and Sanitation	1997-2002	50,000
India Infrastructure Report(Rakesh Mohan Committee)	Various Urban Infrastructure such as capital costs as well as O&M needs	2000-2005	1,25,000
Zakaria Committee Norms(1963) updated to 1997-98	Water supply, sewerage/sewerage disposal, storm water drainage, construction of roads and paths, street lighting and electricity distribution-O&M	2000-2005	72,099
Ministry of Urban development, Government of India	Revenue gap of O&M requirements relating to civic services	2000-2005	18,500

Source: Government of India, The Eleventh Finance Commission Report, August 2000, Page 72.

Domestic financial institutions would remain as provider of capital with appropriate risk mitigation mechanism in place and financial sector reforms. Most of it has to come from the long-term bond markets requiring suitable policy measures for its growth. It would be worth mentioning here the suggestions of the Ninth Five Year Plan(1997-2002) as follows:

Financing of urban infrastructure is bound to pose new challenges to the different constituents of the financing system. Innovative mechanisms and practices will have to be encouraged and supported to stimulate the flow of finances such as the municipal bond system, municipal financial reforms, fiscal and monetary incentives for the creation of environment-friendly environment, participation of cooperatives, community groups and NGOs etc.

Access to capital markets, and most importantly, to bond markets by the local governments should be seen in the context of the following: (i) It would enable

Subnational bodies leverage the internal resources to access long term capital for infrastructure investments; (ii) It would shift the focus from the hither to distorted financial resource allocation based on a cash subsidy program; (iii) It would enable the present generation to make lumpy investments through bond issuance rather than limited pay-as-you-go financing of such investments; (iv) It would make feasible one of the vital objective of the 74^{th} Constitution Amendment in terms of investing and resource raising; and finally (vi) It would ensure a market based credit discipline on the city governments, by promoting fair discloser and accounting, and better management practices.

Contribution of capital markets, and the bond market in particular, towards financing infrastructure projects has been very impressive, and the trends and initiatives in specially in the urban sector show a great potential. What is needed is a right kind of policy framework with appropriate complementarities, supported by an enabling regulatory and institutional framework and multilateral assistance, to make this happen.

Framework for Urban infrastructure financing

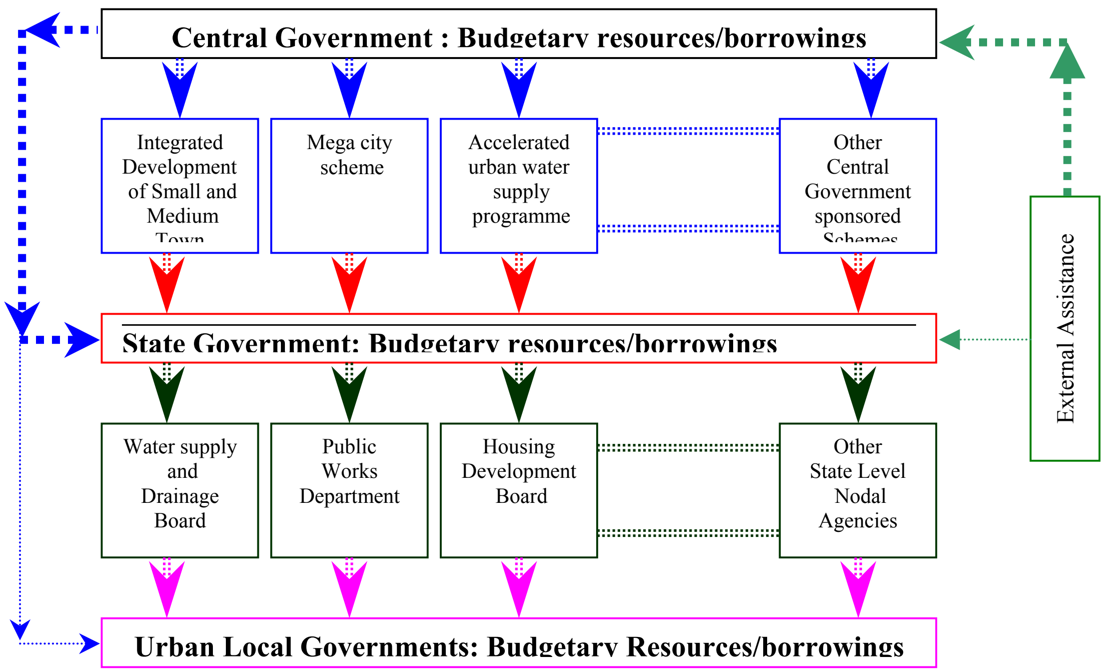
Urban planning and development is basically a state subject. The state governments and their local bodies are required to make provision for the basic urban infrastructure and civic services such as water supply, sewerage and drainage facilities, solid waste management, street lighting, and road transport facilities.

The involvement of states and local bodies in service delivery and infrastructure development depends to a great extent on the organizational and policy regimes confronting the states. In majority of states, the state governments themselves undertake the provision of urban infrastructure through their public health and engineering departments. In few states the governments undertake capital investments through their statutory boards, leaving the local governments to do only the operation and maintenance functions. The examples are Chennai Metropolitan Water Supply and Sewerage Board in Tamilnadu (CWSSB), Bangalore Water Supply and Sewerage Board in Karnataka (BWSSB), Delhi Jal Board in New Delhi, etc. In states like Haryana and Rajasthan, the state public health and engineering departments undertake both capital investments and O&M activities. In recent years, the municipal corporations of Ahmedabad, Pune, Nasik and Mumbai who themselves undertake the both capital investments and O&M activities.

The central government also makes direct investments in urban infrastructure as well as provides project specific grants to state and local governments, under plan and non-plan plan schemes. These projects may come under central government sponsored schemes or schemes of state governments. Some of the schemes under central governments include (i) Integrated development of small and medium towns scheme, (ii) Mega city scheme, (iii) schemes for the National Capital Region Planning Board (NCRPB), (iv) The Accelerated Urban Water Supply Programme, (v) The Low Cost Sanitation scheme and (vi)Urban transport.

In general most of the provision of infrastructure and civic services have been done by pooling multiple sources; revenues from the state and local governments would augmented by the funds transferred from the central ministries, including external sources(see figure below). Typically such pooled financing arrangements have their inherent flaws; transfer of funds from the higher-level of governments often depends resources of the local bodies, making the amount of transfers highly unreliable. This also affected planning and implementations of projects, resulting in inordinate delays.

Figure 1: Framework of Financing Urban Infrastructure in India



External Assistance

Multilateral agencies such as World Bank, Japan Exim Bank, Overseas Development Administration of the Government of UK (ODA-UK) have been involved in the funding of urban infrastructure projects. The funding of the multilateral agencies is by offering line of credit to Indian financial institutions like IDFC, IL&FS and HUDCO who are involved in funding urban infrastructure projects. The funds are released to these financial institutions with condition such that equal amount is also contributed by these financial institutions.

Table 13: Sector-wise Utilization of External Aid During 1998-2000

	Rs. Crore	US $ Million
Energy	7809	1904.63
Social Sector	6228	1519.02
Agriculture	4429	1080.24
Infrastructure	2906	708.78
Environment	1927	470.00
Industry & Finance	1197	291.95
Urban Sector	859	209.51
Others	1694	413.17
Total	**27049**	**6597.32**

Source: Government of India

Financial Markets and Local Government Finance

The Indian financial system is characterized by a large network of commercial banks, development financial institutions(DFIs), investment institutions like LIC and GIC, state-level financial institutions, national level refinance institutions, and specialized financial institutions created for financing infrastructure and urban services such as housing. There are around 12,500 non-banking financial companies in the private sector catering to the financing needs of the corporate sector. Financial sector reforms pursued since early 1990s have changed in many ways the operating environment of the financial intermediaries. There is substantial increase in resource mobilization by the corporate sector and development financial institutions from the capital markets, and most importantly from the bond markets.

Table 14: Institutional Structure in Indian Financial Markets

Operations	Name	Activity
All India FIs	ICICI IDBI IFCI	Lending to corporate sector
	SIDBI	Small scale industries
	IIBI	Companies referred to BIFR
	Banks	Lending to households and Corporate Sector
Specialized FIs	EXIM Bank	Export-Import financing
	IL&FS	Infrastructure, financial services
	HUDCO	Housing and Urban Infrastructure
	IDFC	Infrastructure development and financing
Refinance FIs	NABARD	Agriculture Sector
	NHB	Housing sector
Investment FIs	UTI	Mutual funds
	LIC	Insurance
	GIC	Non-life insurance
State Level FIs	SFCs	Lending to medium and small scale companies
	SIDC	Industrial and infrastructure development

Commercial Banks: The banking sector continues to be the primary form of financial intermediary in India, with 19 nationalized banks along with State Bank of India (SBI) and its seven subsidiaries, 34 Indian private sector banks and 45 foreign private sector banks as of March 31, 2001. Banking sector as such is the largest conduit for the mobilization of domestic savings, the main source of external credit to the households and firms.

Traditionally the urban local bodies have very little commercial relationship with the banking system; their monetary operations exclusively being carried out by the government treasury. Bank lending to infrastructure is very low, and their involvement in financing of urban infrastructure has been rather negligible.

In recent years, banks are beginning to participate in urban finance. One of the innovations has been in the form of 'take-out' financing arrangement or financing with "mezzanine" structure. Typically a specialized financial intermediary involves the commercial banks in financing urban infrastructure, whereby the banks can take up the earlier maturities while the intermediary takes up the later ones(discussion on this initiative follows). These way commercial banks are able to use their short maturity deposits by pulling out their investments after the end of a specified period. This shows a definite scope for involvements of banks in infrastructure with co-financing arrangement.

Table 15: Commercial bank lendings to infrastructure sector(Rs Million)

Total Credit	Outstanding as on March 26, 1999	Outstanding as on March 24, 2000	Outstanding as on March 23, 2001
1. Power	21090	32890	52460
2. Telecommunications	22730	19920	36440
3. Roads and Ports	15630	19620	24590
4. Total for Infrastructure	59450	72430	113490
5. Total for all sectors	1789990	2001330	2188390
6. Share of (4) in (5)	3.32 %	3.62 %	5.18 %

Source: IDBI Developing banking report (2000-2001)

Development financial Institutions (DFIs): Of the six development finance institutions, IDBI and ICICI are the two important players in infrastructure finance in India. These institutions have been able to raise substantial amount of capital through the issuance of tax-exempted bonds and investing in various projects. With the increase in the exempted salary limit for investments in infrastructure bonds and the fall in returns on tax relieved small saving certificates, the infrastructure bonds have become quite popular among the tax saving individuals.

Table 16: Disbursements of DFIs on infrastructure sector(Rs Million)

Institution	1996-97	1997-98	1998-99	1999-00	2000-01	Upto Mar 2001
IDBI	13927.5	24277.1	23906.9	25704.7	32402.2	202071.0
ICICI	12103.1	31543.0	19845.5	29103.6	43778.2	157757.9
IFCI	6435.3	9005.6	12910.0	8036.2	6255.9	54422.10
IIBI	69.3	591.4	1444.0	1016.0	2784.7	6751.5
LIC						36455.8
GIC						3217.3
UTI						22611.3
IDFC	-	-	3750.0	6420.0	7620.0	17790.0
SIDBI	3053.8	3197.8	3820.6	5308.1	3416.2	34553.1

Source: IDBI, India development banking report 2000-01

Specialized Institutions: Three specialized financial institutions promoted specifically for infrastructure development are the Housing and Urban Development Corporation

Limited(HUDCO), Infrastructure Development Finance Company(IDFC), and the Infrastructure Leasing and Financial Services Limited (IL&FS).

Housing and Urban Development Corporation Limited (HUDCO): HUDCO is a central government institution mandated to provide long term finance for housing and urban infrastructure. By leveraging upon the central government funds, and by raising resources directly from the capital markets, it has increased its financing of environmental infrastructure projects.

It operates mainly through the State Housing and Urban Development Board, Development authorities, and municipal corporations for financing operations. It also subscribes to the bonds/debentures issued by these entities. Multilateral institutions such as the World Bank, ADB, USAID, KfW (Germany), JBIC (Japan) have extended financial assistance to HUDCO for funding housing and urban infrastructure. The number of urban infrastructure projects and the amount sanctioned during 2001-2002 are given in Table 17.

Table 17: HUDCO: Funding Urban Infrastructure

Type Of Scheme	No	Loan(Rs Crores)
Water Supply	341	6866
Sewerage & Drainage	80	1343
Transport/Roads	127	4696
Area Development	100	1313
Social Infrastructure	106	1381
Commercial Infrastructure	121	3352
TOTAL	875	18,952

Source: HUDCO

Infrastructure Leasing and Financial Services Limited (IL&FS): IL&FS was set up in 1987 as a private entity, which promotes commercialization of infrastructure projects in conjunction with public and private sector sponsors. The company has floated Special purpose vehicles (SPVs) with State Governments and private sector as co-sponsors. These SPVs created enter into concession agreement with the respective state and local governments for building and operating the infrastructure projects in commercial format through collecting user charges. With line of credit from multilateral lenders and raising resources through bond issuance, IL&FS has been very successful in promoting urban infrastructure projects in India.

Infrastructure Development Finance Company (IDFC): IDFC was formed as an exclusive funding agency for infrastructure projects, to bring in private sector initiatives. The infrastructure sectors that are financed by IDFC include energy, telecommunications & information technology, integrated transportation, food & agri-business infrastructure, and to a limited extent urban infrastructure. The institution is expected to provide the essential link between the public infrastructure projects and the capital markets, using credit enhancement, technical assistance, creating partnerships among a variety of financial institutions, and by subscription to shares and debentures of infrastructure companies.

One of its recent innovations has been to facilitate financing involvement of banks and investment institutions through "take-out" arrangements. The take out finance structure offered by IDFC enabled New Tirupur Area Development Corporation to access capital market for its water project. IDFC and the Government of Karnataka have recently created the Infrastructure Development Corporation of Karnataka(iDeCK), one of the first public-private partnerships of its kind, to promote and develop infrastructure projects in Karnataka state. Institution such as IDFC has the potential to expand and deepen India's municipal debt market by increasing its participation in their projects as well providing appropriate risk-sharing avenues to the financiers.

Contractual Savings: Contractual savings institutions such as the Life Insurance Corporation (LIC) and General Insurance Corporation (GIC) have found financing infrastructure projects feasible, given the long-term nature of their liabilities. These institutions would extend term loans to urban infrastructure projects being executed by the state governments and parastatal agencies, often with a state government guarantee. These institutions also directly subscribe to the bonds/debentures issued by the infrastructure companies. Public provident funds have so far restrictions for their investments and they are allowed to invest only in government securities.

Commercialization and Private Sector Participation

Commercialization and private sector participation in power, telecom, roads and ports have made significant progress in India, attracting large investments into these sectors. These were essentially national level efforts to improve the basic infrastructure facilities and to attract foreign direct investments. These sectors have also offered very attractive returns as against investments in urban infrastructure. Power sector attracted large number of domestic as well as international energy companies. The independent power producers (IPPs) entered into agreements with the concerned State Electricity Boards (SEBs) for selling power to them. The power purchase agreement (PPA) prescribed the minimum off-take by the SEBs and the price per unit of power. The off-take agreement, allowing 100 per cent FDI and the counter guarantee from the union government for several fast track projects made in this sector very attractive for the lenders. The domestic financial institutions like IDBI, ICICI and IFCI have considerable exposure to the power sector. Similarly in the telecom sector, the huge potential and willingness to pay for value added services in urban areas made privatization initiative in this sector a success. Roads and bridges were offered to private players on long-term lease to build, operate and maintain by collecting user charges in the form of toll from the users. The concession agreement with the government also prescribed the minimum guaranteed traffic.

In the case of power and telecom sectors the union government came with policy reforms to accommodate private players and commercialization. Independent regulatory agencies such as Telecom regulatory authority of India (TRAI) and Central Electricity Authority (CEA) were setup and empowered for telecom and power sector, respectively. The governments' comfort to the lenders and the promoters in the form of guarantee for minimum demand, repayment by state government agencies, number of competitors etc. has proved to be fruitful in these sectors.

The Noida Toll Bridge Company Limited (NTB) is a SPV promoted by IL&FS for the Noida-Delhi toll bridge project. The project include constructing a bridge across the river Yamuna on a BOOT scheme,with details as follows:

Starting of operations: February 7, 2001

Estimated cost	: Rs 4082 million
Concession period	: 30 years
Assured returns	: 20 percent
Debt equity ratio	: 2.33:1

Sources of Funds

Equity	: Rs 1016 million
FCDs	: Rs 208 million
IL&FS (World Bank)	: Rs 600 million
Term loans	: Rs 1075 million
Deep discount bonds	: Rs 500 million

Fully convertible debentures(FCD)
Coupon rate: 14%
Conversion period: 36 months from the date of allotment
Credit rating: AAA (SO) by CARE
Credit enhancement mechanism: Irrevocable and unconditional guarantee offered by IL&FS for interest payment on FCDs
Deep Discount Bonds issued
Tenure of the bond - 16 years
Credit rating - AAA (SO) by CARE
Put option - Investors have the put option to sell the bonds to IL&FS and/or IDFC at a predetermined price at the end of 5th year and 9th year from the date of allotment.

Credit enhancement mechanism: Irrevocable repurchase guarantee in the proportion of 60:40 of the repurchase amount IDFC & ILFS

New Tirupur Area Development Corporation Limited (NTADCL): Set up in August 1994, NTADCL was India's first commercially structured water supply and Swerage project developed on a private-public participation basis. The equity participation and grant came from the Union Government, IL&FS, the Tamil Nadu Corporation for Industrial Infrastructure Development, the Tirupur Exporters Association, and the private consortiums consisting EPC contractors such as Bechtel, Mahindras and United utilities.
Type of contract
Concession model - BOOT scheme
Concession Period - Minimum 28 years and Maximum 38 years
Concession granter - Government of Tamilnadu and Tirupur municipality
Total Project cost: Rs 11, 630 million

Sources of fund

Equity	:Rs 3,900 million
Subordinate Debt:	Rs 750 million
Debt:	Rs 6980 million
IDBI, IDFC, and SIDBI:	Rs 2500 million
Commercial Banks:	Rs 1680 million
World Bank and USAID:	Rs 2300 MN
Debt (proposed):	Rs 500 million

Allocation of risk : Between Government of Tamilnadu & **NTADCL** - commercial, construction, operations and insurable force majeure

Credit enhancement mechanisms
Risk of water supply - Setting up of lean period fund by Government of Tamilnadu
Municipality - Letter of credit for one month and escrow for 3 months water revenues from the municipality
Debt servicing - Sinking fund method of depreciation

Though private sector participation and commercialization of urban infrastructure is very recent and have been very successful in few cases. These sectors have been found very much suitable for private-public partnerships, commercialization in various forms such as management contract, a lease contract, contracts such as Build-Own-Operate (BOO), Build-Operate-Transfer (BOT), and Build-operate-lease-transfer (BOLT). Support from the state governments in the form of equity participation, concessions in terms of land or water supply, dedicated revenue streams for loan repayments, transparent regulatory framework have proved to be very encouraging.

Many state governments have been successful in urban infrastructure development through the project finance routes, by creating special purpose vehicles(SPVs). These entities have been successful in issuing bonds/debentures of 3-7 years maturity. SPVs are formed as a company under the Companies Act 1956, with the equity contribution from the state governments or sponsors as the seed capital. The liabilities of the promoters are restricted only to the specific project and would not have adverse impact on the promoter's (here in most cases one of the promoter is a government entity) original business. Lending for the project is done without any recourse to the promoters. The advantages of SPVs are not restricted only to the financing but also in the ability in executing the projects. One of the promoters generally takes the responsibility of executing the day-to-day functions by bringing their expertise.

Private sector participation and co financing from financial institutions have occurred in cases where the ULBs have made considerable operationational restructuring. It also required supportive political environment, and regulatory changes in terms of user charges. Sate governments support by way of equity financing has made significant difference, as promoters are one of the primary concerns of lenders. Co-financing from a financial institution with management support is the vital. The entire thrust of the reforms has to be to sustain and enhance cash flows generating capacity, rather than subsidies and guarantees by the higher levels of governments. There is a need for deregulation of state level laws, reduction in process time for clearances, independent regulator for tariff setting, and initial equity participation by state/central bodies, would facilitate such financing.

The policy regime in India facilitating financing of urban infrastructure is evolving. The focus has to be fast shifted from the traditional budgetary provision and subsidy based to the one based on private financing from capital markets. The increasing number of urban local bodies getting credit rated, issuance of bonds by a few municipalities, enabling environment such as private public-participation of urban service delivery are the few enablers towards this. This has to be accompanied by the necessary changes in legal and regulatory environment facilitating private sector participation. The following are the some of the recent initiatives as a follow up of the Union Budget 2002-03 proposals:

- **Infrastructure equity fund:** Infrastructure equity fund, to be managed by IDFC with an initial corpus of Rs 1000 crores, is proposed to be set up to provide equity investment in infrastructure projects. The initial contribution would come from the public sector insurance companies, financial institutions and commercial banks. Also an institutional mechanism will be set up to coordinate debt financing in infrastructure projects larger than Rs 250 crores. IDFC would act as coordinating agency with the primary responsibility for various sectors with IDBI and ICICI.

- **Urban Reform Incentive Fund(URIF)**: URIF with an initial contribution of Rs 500 crore would provide reform-linked assistance to the states. The assistance shall be extended for the state governments to implement reforms on Rent Control Act (RCA), repeal of Urban Land ceiling Act(ULCRA), rationalizing stamp duties, enabling laws for speedy approval of contracts, levy of reasonable user charges, revision of municipal laws in line with the model laws prepared by the ministry of urban development and poverty alleviation.

- **City challenge fund (CCF):** City challenge fund would assist the municipal corporations by means of partial financing for the reforms measures undertaken.

IV. Bond Markets and Local Government Financing

The Indian bond market has witnessed significant growth and sophistication in recent years, in terms of investors and issuers, instruments, trading volumes and market awareness. Table 18 gives the structure of issuers and instruments in Indian bond markets, distinguishing between national and Subnational components. The issues by the central government comprising treasury bills and dated securities issued are the most important segment. The other active issuers at the national level are corporate, all India financial institutions and commercial banks, and central public sector undertakings. The development financial institutions have progressively used bond markets to raise the necessary resources for their lending to infrastructure, and which also have been found attractive for the primary investors due to the beneficial fiscal regimes. During 2001-02 the central government and the central public sector enterprises raised Rs 34,834 crores, comprising about 55 per cent of the total bond issues. Bonds and debentures issued by the private corporate sector was another 26.5 percent during the same period(Table 19).

Table 18: Structure of Indian Bond Markets: Issuers and Instruments

	Issuer	Instruments
National	Central Government Securities	Treasury Bills, Dated Securities, Zero Coupon Bonds, Floating Rate Bonds, Inflation Index Bonds
	DFIs, Commercial Banks	Bank Bonds, Infrastructure Bonds, Zero Coupon Bonds, CDs, CPs
	Public Sector Companies	PSU Bonds, Taxable and Tax free bonds, CPs
	Private Sector Companies	Bonds and Debentures, Zero Coupon Bonds, Floating Rate, CPs
Subnational	State Governments	State Government loans
	Sate Level PSUs and FIs	Government guaranteed PSU Bonds
	State Level Special Purpose Vehicles(SPVs) & Statutory Boards	Bonds, often with revenue dedication, with or without government guarantee
	Municipal Corporations	Municipal Bonds, with revenue dedication, with or without government guarantee

Infrastructure sector such as power, telecom, roads and urban infrastructure have been possible through the issuance of domestic bonds, both at the national as well as state level. Konkan Railway Corporations, National Highway Authority of India, Power Finance Corporation, etc are some of the best-known cases in this field.

The local bond markets would comprise issues made by the state governments, state financial institutions, state level public sector undertakings and urban local bodies such as municipal corporations. Bonds issued by the state level undertakings often carry the guarantee by the respective governments. During 1997-2002, eight municipal corporations raised through issuance of bonds, securitized in some form or other by the revenue receivables and/or grants (more on this later).

Table 19: Indian Debt Markets(Rs Crores)

	1995-96		1999-00		2000-01		2001-02	
	No.of Issues	Amount	No.of Issues	Amount	No.of Issues	Amount	No.of Issues	Amount
Government	59	14280	159	44000	146	58020	158	34834
Central Government	53	13483	95	29570	89	46643	110	26514
Commercial Enterprises	52	13383	90	28010	86	45576	103	22337
Statutory Bodies	1	100	5	1560	3	1067	7	4177
Private Sector	1869	19235	457	25937	428	19363	247	12586
Indian Private Sector	1839	18471	403	21818	383	14673	204	11042
Foreign Private Sector	30	764	54	4119	45	4689	43	1543
State Government	6	797	63	14330	55	11127	48	8320
Commercial Enterprises	3	296	24	6365	29	5561	23	4362
Statutory Bodies	3	500	35	7215	25	5416	23	3837
Total	1928	33515	616	69937	574	77383	405	47419

Source: Reserve Bank of India, National Stock exchange

Table 20: Private Placements(Rs Crores)

	1998-99		1999-2000		2000-01	
	No	Value	No	Value	No	Value
All India FIs & Banks	28	18603	44	14359	43	21672
Central PSUs	17	3110	18	8435	19	7839
Private Corporates	127	7425	117	12594	100	9169
State FIs	2	313	6	2605	4	2286
State Level Undertakings	30	9479	48	16526	48	11426

Source: Prime Database

Table 21: Market Borrowings of States(Auction Results)

State	Date of issue	Amount Rs Crore	Cut-off Yield	Gol 10-Yr Yield
West Bengal	08.08.2000	250	11.80	11.43
Maharashtra	08.08.2000	280	11.70	11.43
Andhra Pradesh	08.08.2000	400	11.80	11.43
Tamil Nadu	08.08.2000	290	11.70	11.43
Kerala	29.08.2000	200	11.75	11.42
Karnataka	05.12.2000	250	11.57	11.32
Kerala	17.04.2001	200	10.53	10.25
Gujarat	20.07.2001	190	9.50	9.35
Gujarat	06.08.2001	250	9.40	9.10
Andhra Pradesh	13.08.2001	475	9.53	9.25
Madhya Pradesh	13.08.2001	105	9.55	9.25
West Bengal	13.08.2001	250	9.72	9.25

Source: Reserve Bank of India

State Government Bonds

The bond issuance by the state government depends on the extent of deficit financing by the state and are issued by the Reserve bank of India. These securities would effectively serve as the benchmark for other state-level bodies. As of June 2002 there were 662 State Government bonds outstanding, maturing in next 10-years. Until 1998-99 the states issued securities at pre-announced coupon rates and prices and were issued by the Reserve Bank through common tranches. This implied that the better off and the more creditworthy states could raise their loans at the same rates as not-so-creditworthy states. Since 1999, an option has been given to the states to raise 5 to 35 per cent of their borrowings by way of competitive auctions. The states with better fiscal and financial management situations have benefited from such auctions when used, by way of lower borrowing costs.

Table 23: Weighted Avg. Yield of State Government Securities

Year	Range	Weighted Average
1995-96	14.00	14.00
1996-97	13.75-13.85	13.83
1997-98	12.30-13.05	12.82
1998-99	12.15-12.50	12.35
1999-00	11.00-12.25	11.89
2000-01	10.50-12.00	10.99
2001-02*	9.40-10.53	10.20

*Up to August 2002

Source: reserve Bank of India

State Sponsored Institutions

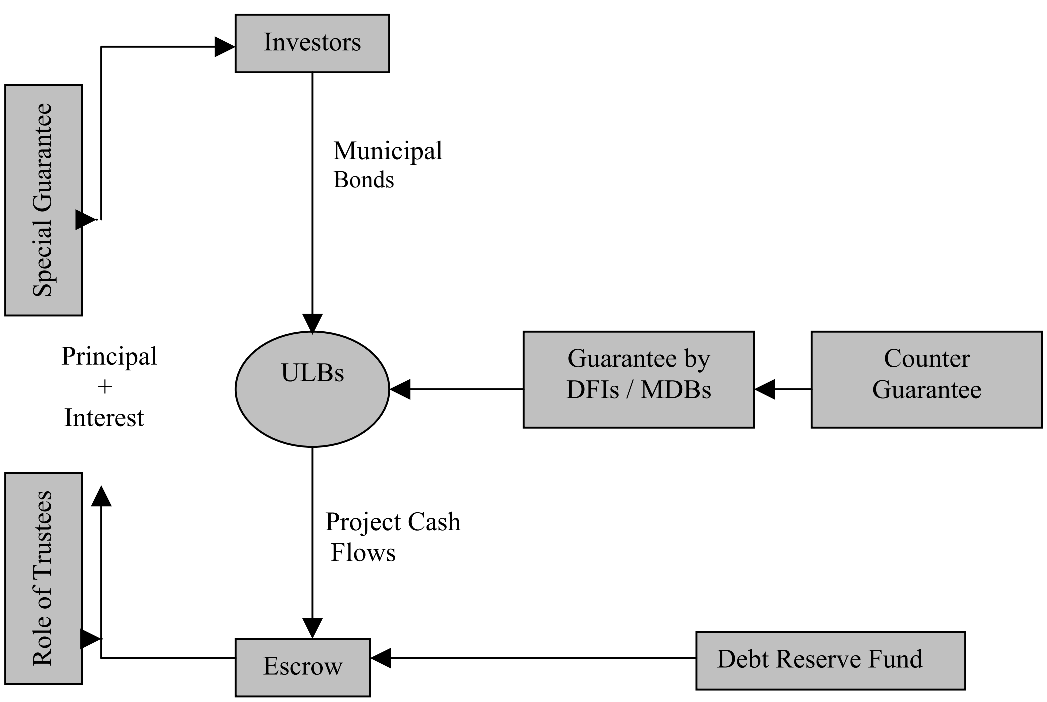
State sponsored institutions include state level financial institutions, state sponsored special purpose vehicles (SPVs), and statutory boards such as Water Supply and Sewerage Boards. Most of these state level entities make bond issuance through private placements, which are often guaranteed by the respective state governments. These can be taxable or tax-free, often in the form of structured issues or carrying credit enhancement features such as revenue dedication. The instruments are usually known in India as "structured obligations(SO)", because these securities are structured to enhance credit rating. In recent years these bond issuance have increased significantly, and as we have mentioned before, are carrying significant fiscal risks for the state governments.

Municipal Bonds

Municipal bond issuance in India is of recent origin, beginning with the first issuance by the Bangalore Mahanagarapalika in 1997 of Rs 100 crore, with a coupon rate of 13 per cent. Ahmedabad Municipal Corporation was the first municipal corporation to make a public offering in January 1998 raising Rs 1 billion at 14 percent coupon. So far eight municipal corporations have issued bonds worth Rs 5.3 billion(see Table 24 for details). The emerging view is that more such bodies will soon be entering the bond markets. Over 30 major cities have obtained credit rating from the agencies such as CRISIL, ICRA and CARE with an intention to enter bond markets.

The municipal bonds generally are securitized instruments, providing future revenue flows as collateral(see figure 2). The ULB making the bond offerings would surrender THE rights of its future revenues, in order to service the bond issued. This revenue flows would comprise octroi, user charges collected from water supply and sewerage, state government grants and property tax, toll collected from the vehicles, even the grants received from higher levels of governments. In cases the future revenues are considered insufficient to meet the service obligations, third party guarantee from the state government as well as debt service reserve funds are also created. The motivation therefore is to obtain an investment grade rating for the issuer that has no track record in capital markets.

Figure 2: Bond Issuance Structure by ULBs



The MUD&PA guidelines stipulates the issuers will undertake to maintain the Debt Service Coverage Ratio (DSCR) of at least 1.25 throughout the tenor of the bond. This over-collateralization and the provision of debt service reserve account serve as additional credit enhancement that reduces the risk to the investors.

Table 24: Features of Municipal Bond Issuance in India during 1997-2002

December 1997	**Bangalore Mahanagar Palika** of Karnataka state issued the first municipal bonds in India for Rs 100 Crore, with 7 years maturity and a coupon of 13 per cent per annum. The purpose of bond floatation was to raise resources for the development of roads, side drains and street lighting in Bangalore City. The bond issuance was made through private placement mode, and was guaranteed by the Government of Karnataka. CRISIL provided the rating of A(SO), indicating adequate safety. The principal as well as interest payments were secured by way of structured payments mechanisms i.e. collection and deposit of property tax and government grants to a designated Escrow account, which were used for payments to the bond holders, and this being supervised by a Trustee: The Karnataka State Financial Corporation. The issue was managed by the State Bank of India Capital Markets Limited.
January 1998	**Ahmedabad Municipal Corporation** of Gujrat state issued Rs. 100 crores at 14 per cent payable semi annually. The bond was secured on a Charge/Mortgage on AMC's properties. Redemption was in 3 tranches of Rs. 333, 333 & 334 per Rs 1000 at the end of 5th, 6th and 7th year. Designed as a Structured obligation, the issue had a credit rating of AA(SO) from CRISIL. Octroi collection from 10 designated collection points were specifically earmarked for servicing the bond and kept in an Escrow account. 75%(Rs. 750 Millions) were in the form of private placement(firm allotment basis), organized by IL & FS, with co-lead managers such as Kotak Mahindra, SBI Caps, ANZ Grindlays bank and another 25%(Rs. 250 Millions) were in the form of public issue, fully underwritten by the Lead Managers.
May 1999	Nashik Municipal Corporation of Maharastra raised Rs. 100 crores at 14.75 per cent, to part finance ITS projects such as Water Supply, Underground Sewerage and for construction of flyovers, bridges, truck terminus etc. The Bonds were assigned a rating of "AA(SO)" CRISIL. Lazard Credit Capital Ltd. Served as the arranger of the issue and Bank of Maharashtra acted as the Agent and Trustees. Octroi collection from four designated collection points were earmarked in an escrow account for servicing the bonds, which were to be done in 3 tranches after year 5, 6, & 7.
September 1999	Ludhaina Municipal Corporation of Punjab state issued the Rs 10 Crore at 13.5-14 per cent. With a credit rating by ICRA of LAA-(SO), the bond issuance were made in the form of private placements without the state government guarantee. The escrow of the revenue streams from Water and sewerage charges formed the basis for enhancing the rating. Property worth 1.25 times the size of the issue was pledged as security. Repayment arrangement was made in four equal installments payable from the end of 7th years onwards.
November 2000	Nagpur Municipal Corporation of Maharastra state issued bonds worth Rs 50 crores at 13 per cent coupon payable semi-annually, through a private placement of secured non-convertible debentures. Arranged by the SBI Capital Markets Limited, the maturity of the issue was 7 years, with a put and call option at the end of five years, and a redemption option at the end of fifth, sixth and seventh years. The issue carried a rating of LAA-(SO) by ICRA. The proceeds of the bond issue were to be used to fund water supply projects in the corporation.
April 2001	Madurai Municipal Corporation of Tamil Nadu state issued a Rs.30 crores by way of private placement at 12.25 per cent without a government guarantee. The Bonds were in the form of secured, redeemable and non-convertible debentures and were taxable. Credit rating of LA+(SO) was assigned by ICRA and was without a government guarantee. The issue was made to part-finance the requirement for the two-lane Inner Ring Road between Kanyakumari Road and Melur road and also to refinance the then high cost loan from the TNUDF. The Agent and Trustees was Canara Bank, Bangalore. Securitized through a

	dedicated escrow account into which the toll collections from the inner city ring road are deposited on a daily basis. With a maturity of 15 years, the bond had a put and call option after 8 years.
July 2001	Indore Municipal Corporation of Madhya Pradesh state issued a non convertible redeemable bonds of Rs 10 crore at 11.50 per cent payable annually. Private placement with guarantee from the state government, the proceeds were to be utilized for the improvement of the City Roads. Redeemable in 3 installments of 30 per cent, 30 per cent and 40 per cent, payable at the end of the 5^{th}, 6^{th} and 7^{th} year
March 2002	**Ahmedabad Municipal Corporation** of Gujrat state issued for the second time tax free Bonds of Rs. 100 on a private placement basis. With a rating of AA(SO) from CRISIL, the coupon was 9.00% p.a payable semi-annually, for first five year and the rate beginning the sixth year at the prevailing Bank Rate + 2.50% payable semi annually until maturity. With a maturity of 10 years, the bonds have the put and call option at the end of 5th year from deemed date of allotment. Lead arranger to the issue was GSFS Capital and Securities Ltd. and other arrangers included IL & FS Merchant Banking Services Ltd., ICICI Securities and Finance Company Limited and Centrum Finance Limited. The Trustees was the Central Bank of India. Credit enhancement for the bond issuance was made through an Escrow account of property tax revenues.
2002	Hyderabad Municipal Corporation of Andhra Pradesh state issued tax free bonds of Rs 82.50 crore at 8.5 per cent payable semi annually and a maturity of 7 years. The floating of bonds were backed by an escrow mechanism. The purpose was to part-fund the corporation's plans to invest Rs 247.51 crore on various developmental projects. Credit rating of AA+ (SO) was given to the corporation by CRISIL. The State Bank of Hyderabad has acted as the Trustees. Escrow account of non-residential property tax, professional tax, advertisement tax, entertainment tax, stamp duty and town planning charges are payable semiannually towards the debt servicing.

Urban Development Funds

The initiative to set up an urban development fund can be traced to the third Calcutta Urban Development Project launched by the World Bank in the early 1980s. This was in the form of a loan fund to finance investment in the urban areas of the Calcutta metropolitan region. The West Bengal government was the sole manager of the fund, thereby preventing any private sector participation and the repayment performance of the fund was also poor (Peterson 1996). The most successful fund of recent origin is the Tamil Nadu Urban Development Fund (TNUDF) promoted by the government of Tamil Nadu with a line of credit from the World Bank(see below), and there is now proposal to create an Urban Environmental Infrastructure Fund by the ADB in the state of Karnataka.

The UDFs are created often in collaboration with an international counterpart and an Indian financial institution along with the state government equity participation, to attract private capital into urban infrastructure projects. These funds extend long-term loans for tenure of 12 - 15 years depending on the type of projects. The funds use various security arrangements, which include escrow accounts of property taxes, water charges and hypothecation of movables.

There is also an initiative to set up a pooled financing mechanism in the State of Tamil Nadu, build on the successful experience of the TNUDF. Fist of its kind in India, the $ 3.2 million "Water and Sanitation Polled Fund" is being promoted by the USAID-FIRE project, with the collaboration from the TNUDF, to cater to the financing needs of the 14-smaller municipalities in the state of Tamil Nadu, and providing guarantees in order that the tenor of the municipal bonds are lengthened and pricing factor improved.

Tamilnadu Urban Development Fund (TNUDF)

TNUDF was established under the Indian trusts act, by Government of Tamil Nadu in 1996 with the participation of financial institutions such ICICI, HDFC and IL&FS, with a line of credit from the World Bank. The share holding pattern of TNUDF is GoTN (49%), ICICI (21%), HDFC and IL&FS (15% each). Created as a Trust Fund and managed by an asset management company Tamil Nadu Urban Infrastructure Financial Services Limited(TNUIFSL), the Fund is engaged in the development of urban infrastructure in the State of Tamil Nadu. ULBs, statutory boards, public sector undertakings, private corporate, joint sector projects are the eligible borrowers. The tenure of the loans offered vary from 12 - 15 years depending on the type of project for which it is funded. Special recovery mechanisms such as escrow accounts of property tax, water charges and hypothecation of movables are generally used. Various Projects have been approved and loans disbursed by TNUDF. Some of the projects include 'Karur bridge' built on BOT basis by Karur municipality, Madurai ring road in public-private partnership etc. In certain cases, the debts are blended with the grants to reduce the interest cost for ULBs. Apart from providing loans, TNUDF is also into 'capacity building' activities such as computerization of accounts and training development of municipal administration in order to improve the management performance of ULBs.

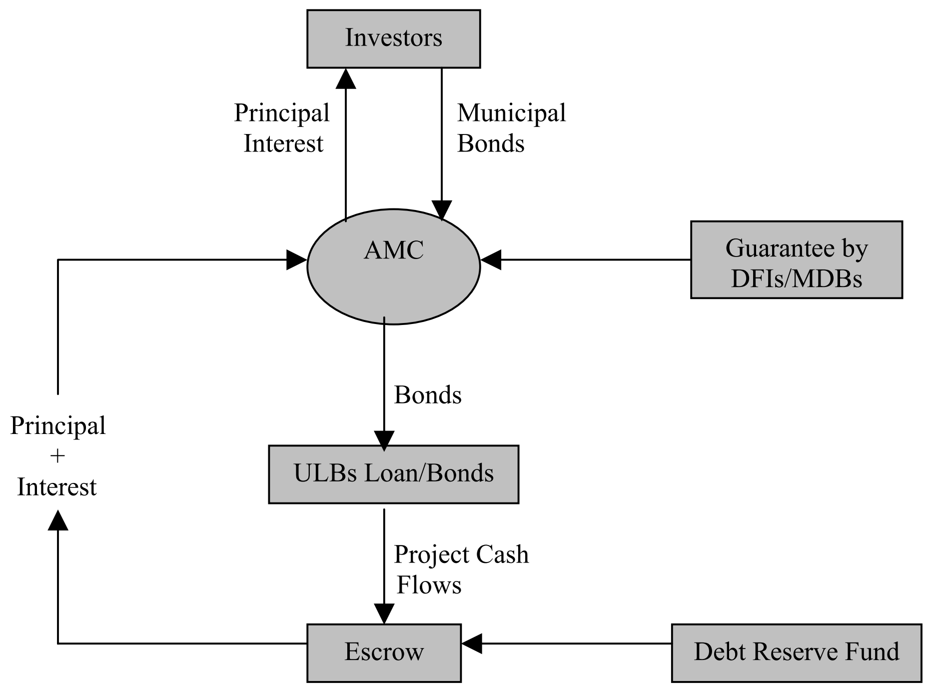
The concept is very much similar to that of state-level bond banks in the United States, something like a state-sponsored financial intermediary which would raise finances through bond issuance and then on-lending to the local bodies by buying their bonds. There are two types of such financing pool: a "blind pool" wherein a bond bank raises sufficient funds based on its own credit rating and then on-lends to the local governments; or project specific pool whereby several projects are pooled and lumped together in a bond issuance, thereby reducing significant transaction costs of the issuance and improved pricing.

The Tamil Nadu initiative is of the later type whereby several smaller municipalities are being pooled in the bond offers to finance municipal environmental infrastructure projects involving underground water and sewerage[1]. The proposed structure envisages the USAID to provide a partial credit guarantee that would enable to lengthen the maturity of bonds from 7 to 15 years, with possible put/call options after 7 years, or alternatively, an annuity repayment mechanisms. The Tamil Nadu Urban Infrastructure

[1] Based on the preliminary proposal on "Further Development of the Municiapl Bond Market in India: Proposal for Using development Credit Agency, April 28, 2001". Also see Urban Finance September 2002, published by the National Institute of Urban Affairs.

Financial Services Limited(TNUIFSL), which is the asset management company(AMC) for the TNUDF, will purchase the bonds of the municipalities and fund these by issuing its own bonds, with the regular credit enhancement structures(see Figure 3).

Figure 3: AMC as an Intermediary



There is also a proposal in the Union Budget 2002 to create a **Pooled Finance Development Scheme** (PFDS), to assist the smaller urban local bodies that can access capital markets through issue of bonds with the credit enhancement facilities. Typically the TNUDF or the proposed pooled financing mechanisms are not just debt funds that run on commercial principles, but they also bundle together both grants as well as loans. The Funds also provide technical assistance in capacity building of ULBs in project preparation and financial management. This experience reveals the great potential for financing numerous local governments in India.

Enabling environment for Subnational Bond Market Development

The experience of municipal bonds and funds presented in the last section provide good pointers for the spread of such mechanisms for local financing. The major issue is how to create the necessary institutional and supporting mechanism so that an active local bond market develops, enhancing the attractiveness of the municipal securities, by reducing their transaction costs and risks for potential investors. Enabling environment would include broadening of the issuers and investor's base, institutional characteristics such as secondary market trading, promoting distribution process among underwriters, merchant bankers, and trustees, introducing innovations such as credit enhancement and guarantees. International experience suggest that given appropriate

(a) Vibrant National Bond Market

India has established a relatively sophisticated capital market with debt security trading, clearing and settlement operations in place. Market infrastructure for effective bond pricing has been established, with the setting up of an electronic dealing systems(such as the Real Time Gross Settlement System), which lends transparency and efficiency to the market operations, as against the traditional OTC deals negotiated over telephone. Significant institutional and regulatory changes are also underway resulting in efficiency and price discovery.

The recent introduction of the Negotiated Dealing System(NDS) which became operational on February 15, 2002, provides an on-line electronic bidding facility in auctions, screen-based electronic dealing and reporting and dissemination of real time trade information. The NDS also facilitates "paperless" settlement of transactions in government securities with connectivity to Clearing Corporation of India Ltd, set up in June 2001, and the existing Delivery Vs Payment (DVP) system at the Public Debt Office of the Reserve Bank of India. The bond market is dematerialized with the NSDL and a total of 2100 securities are already available in this form as of December 2001. All outstanding stocks of bonds and debentures were to be dematerialized by June 30, 2002.

A system of primary dealers, as specialized bond dealers from among the financial institutions, play a critical role in promoting market liquidity, participate in auction of both central and state government securities, and provide two-way trade quotes. The Discount and Finance House of India (DFHI) set up in 1988 and the Securities Trading Corporation of India (STCI) set up in 1994, which have been transformed into Primary Dealers, for developing an efficient secondary market in government securities. Transaction taxes such as stamp duties on bond transfers that acted as market deterrent for secondary market trading has been eliminated on the dematerialized segment.

The auction system for selling securities of 91-day and 364-day Treasury Bills as well as dated government securities facilitate the transparency in government borrowing program and establish market determined yield(the auctions of 14-day and 182-day Treasury Bills were discontinued since May 14, 2001). A benchmark yield curve exists in government securities, stretching up to 20 years maturity, and providing reasonable amount of liquidity of securities across maturity range. Short-term money market instruments such as repurchase agreements(Repo) provide short-term pricing benchmarks; establish strong linkages with other money market segments. Debt market has also been opened up to foreign institutional investors (FII).

(b) Investors

Most of the central and state government securities are held by the institutional investors, which include commercial banks, development financial institutions, insurance companies, provident funds, and non-bank finance companies. Commercial banks accounts for about 60 per cent of the securities issued by the state governments, followed by the Life Insurance Corporation of India another 10 per and provident funds account for another 3-4 per cent (Table 25).Commercial banks are required to hold 25 per cent of their net demand and time liabilities in eligible securities for the purpose of their statutory liquidity requirement (SLR).

The insurance companies such as LIC are required to invest not less than 50 per cent of their total investments in central and state Government securities. Almost the entire resources raised by way of employees provident fund and pension funds go into fixed income securities markets, with over 40 per cent invested in central government and other government guaranteed securities. The mutual fund industry, particularly the gilt funds, has grown significantly in recent years, making sizeable investments in debt securities.

Table 25: Ownership of State Government Securities
(As atEnd March, Rs Crore)

Category of Holders	1995	1996	1997	1998	1999	2000	2001
RBI	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial Banks	22796.8	25661.3	28892.0	32922.7	38412.8	45713.0	.
LIC	3680.8	4616.9	5867.7	7395.0	9947.0	11932.0	14381.0
Unit Trust of India	1.0	1.0	0.0	0.0	1.0	16.0	15.0
Provident Fund	617.2	833.6	1282.7	1738.0	2419.2	3235.9	4028.0
Other PF Scheme	258.1	669.8	659.1	826.6	.	.	.
Others	3854.3	6148.9	6880.0	7945.7	.	.	.
Total	31208.2	37931.4	43581.6	50828.0	61531.0	73884.6	86765.0

Investment of banks in securities of Subnational and authorities are given in Table 26 and state-wise figures are given in Annexure VII. Government guaranteed municipal bonds are also considered SLR eligible securities. Local authority loans and securities carry additional risk weighting over loans and securities issued by the central and state governments. RBI guidelines require banks to assign a risk-weight of 20 per cent in State Government guaranteed securities. In case of default, such investments are to be treated as NPAs and 100 per cent risk weight is to be attached with adequate provisioning.

Anther factor which limits the preference of institutional investors for Subnational securities is the central bank's guideline making it mandatory for banks, financial institutions and primary dealers to hold debt securities only in dematerialized form, whether publicly issued or privately placed.

Table 26: Classification of Investments in Local Securities by Banks in India Year End-March, Rs Lakhs

	Securities / Shares / Bonds / Debentures Issued by	Bank Group				
		State Bank of India and Associates	Nationalised Banks	Other Indian Scheduled Commercial Banks	Foreign Banks	All Scheduled Commercial Banks
1	Local Authorities*	5,993	91,124	10,546	10	1,07,673
		(0.7)	(5.3)	(5.3)	(-)	(3.8)
2	State Financial Corporations	92,386	2,08,923	29,131	23,041	3,53,481
		(11.4)	(12.2)	(14.6)	(28.5)	(12.6)
3	State Industrial Development Corporations	4,164	33,331	10,894	-	48,389
		(0.5)	(1.9)	(5.5)		(1.7)
4	State Electricity Boards	2,48,207	2,60,484	26,006	3,830	5,38,527
		(30.6)	(15.2)	(13.0)	(4.7)	(19.2)
5	Co-op. Institutions	18,138	9,793	682	62	28,675
		(2.2)	(0.6)	(0.3)	(0.1)	(1.0)
6	Industrial Finance Corporation of India	82,463	1,42,983	13,601	1,351	2,40,398
		(10.2)	(8.3)	(6.8)	(1.7)	(8.6)
7	National Bank for Agriculture and Rural Development	6,386	21,705	5,160	20,205	53,456
		(0.8)	(1.3)	(2.6)	(25.0)	(1.9)
8	Industrial Development Bank of India	1,51,243	3,71,364	30,161	10,547	5,63,315
		(18.6)	(21.6)	(15.1)	(13.1)	(20.0)
9	Industrial Credit & Investment corporation of India	50,016	1,33,446	4,899	1,562	1,89,923
		(6.2)	(7.8)	(2.5)	(1.9)	(6.8)
10	Rural Electrification Corporation	9,171	35,161	2,435	-	46,767
		(1.1)	(2.0)	(1.2)		(1.7)
11	Export-Import Bank of India	9,014	30,868	5,005	1,328	46,215
		(1.1)	(1.8)	(2.5)	(1.6)	(1.6)
12	National Co-operative Dev. Corporation of India	5,775	50,006	-	-	55,781
		(0.7)	(2.9)			(2.0)
13	Housing and Urban Dev. Corporation of India	11,424	40,274	7,412	1,646	60,756
		(1.4)	(2.3)	(3.7)	(2.0)	(2.2)
14	Unit Trust of India	17,658	19,877	4,831	158	42,524
		(2.2)	(1.2)	(2.4)	(0.2)	(1.5)
15	Industrial Reconstruction Bank of India	13,281	52,319	7,740	70	73,410
		(1.6)	(3.0)	(3.9)	(0.1)	(2.6)
16	Housing Boards	2,563	15,834	1,382	48	19,827
		(0.3)	(0.9)	(0.7)	(0.1)	(0.7)
17	Others	84,252	2,00,498	39,822	16,858	3,41,430
		(10.4)	(11.7)	(19.9)	(20.9)	(12.1)
		8,12,134	**17,17,990**	**1,99,707**	**80,716**	**28,10,547**
		(100.0)	**(100.0)**	**(100.0)**	**(100.0)**	**(100.0)**

Notes : Figures in brackets indicate percentages to total. * Includes Municipalities and Port Trusts.
Source: Reserve Bank of India

The household sector remains the most significant source of savings in the economy, with over 80 per cent of their savings held in fixed income investments. Much of the households savings are essentially in the form of bank deposits, however (see Table 27 and 28). According to an all-India survey of households conducted by the National Council of Applied Economic Research, the urban population predominantly uses banking system for their savings(Table 28). The potential for widening the retail investor base in Subnational securities is high. This requires increasing their awareness about securities issued by such bodies. The existence of secondary markets would positively influence the decision to buy long-term securities. Promoting issuer-investor relationship at the local level remains an important issue. Local issuers are not very much familiar with the municipal securities as an investment option. With an improved environment of disclosure and secondary market trading, local investors would consider the local securities as more advantageous.

Table 27: Savings of Households by Instruments
(In per cent)

Instruments	All India	Urban	Rural
UTI Schemes	8.45	19.52	4.05
Other MFs	5.45	12.02	2.84
Fixed Deposits	76.23	83.89	73.18
Bonds	6.21	11.56	4.08
Provident Fund	20.92	40.24	13.24
Life Insurance	39.21	57.31	32.01
Chit Funds	5.94	9.51	4.52
Post Office RDs	44.73	40.77	46.3
Small Savings	27.46	35.98	24.07
Preference Shares	2.63	6.59	1.06
Others	8.75	11.85	7.52

Source: NCAER, Survey of Indian Investors, 2000.

Table 28: Savings of Household Sector in Financial Assets
(in percent)

Financial Assets	1990-91	1995-96	1996-97	1997-98	1998-99	1999-00
Currency	10.6	13.4	8.6	7.4	10.0	8.9
Fixed income investments	74.9	78.9	84.4	88.5	86.1	83.6
Deposits	33.3	42.1	48.2	47.5	41.9	37.1
Insurance / PF/Pension Funds	28.4	29.4	29.2	29.8	31.9	35.2
Small Savings	13.2	7.4	7.0	11.2	12.3	11.3
Securities Markets	14.4	7.8	6.9	4.5	4.1	7.5
Mutual Funds	9.1	0.5	2.7	1.4	1.9	5.2
Government Securities	0.2	0.4	0.4	1.6	0.6	0.9
Other Securities	5.1	6.9	3.8	1.5	1.6	1.4
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Reserve Bank of India

Secondary Markets

Secondary market in Subnational securities needs to be created, as the demand for securities in the primary issuance would be greater for the securities having secondary markets. Secondary market trading of bonds takes place mostly through the over-the-counter(OTC) basis, although the wholesale debt market (WDM) segment of the National Stock Exchange(NSE) set up in 1994, and on the Mumbai Stock Exchange, permitted since November 2000, are emerging as trading platform for debt securities. The WDM(wholesale debt market) segment of NSE is a fully automated screen-based trading system, which enables members across the country to trade simultaneously with enormous ease and efficiency.

Eligibility criteria for listing on the NSE include a minimum paid-up capital of Rs. 10 crore or market capitalization of Rs. 25 crore (net worth of Rs. 25 crore in the case of unlisted companies). Public issues are directly eligible and a credit rating required for listing of private placements. Municipal bonds and bonds issued by the statutory bodies are eligible for trading in the permitted category of NSE. Only few bonds of the Municipal Corporation of Ahmedabad and Nasik and the National Capital Region Board(NCRB) are listed on NSE, although their trading is very thin.

Presently the secondary market trading comprises mostly the central and state government securities. Investors in Municipal Bonds effectively held to maturity. Municipal issuers will benefit from listing and trading in secondary market, as this will greatly enhance trading and visibility. The National Stock Exchange would be the preferred exchange for listing of private placement issues made by the Subnational bodies. The Exchange has terminal in most of the Indian cities, allowing nationwide access for investors. Listing and trading requires continuing disclosure requirements for the local bond issuers. The monitoring of the outstanding bonds by the local rating agencies will also facilitate the information disclosure and development of a secondary market.

Table 29: Secondary Market Distribution in Turnover in WDM Segment(Rs Crore)

Securites	1999-00	2000-01
Government Securities	282,880	390,952
T-Bills	11,007	23,143
PSU Bonds	1,528	3,617
Instituional Bonds	3,345	4,270
Bank Bonds & CD	805	2,027
Corporate Bonds & CD	4,615	4,516
Others	36	57
Total	304,216	428,582

Source: National Stock Exchange.

Regulatory Design for Local Debt Markets

The capital market infrastructure in the national system provides the necessary impetus to the development of local bond markets. It needs to be recognized here that market participants need, in addition to the market infrastructure, other economic benefits such as liquidity, legal protection of their investments, protection of return on their investments, and the supportive socio-economic environment at the Subnational level. The investors in Subnational securities benefit as much from a fair and transparent market structure as are the investors in national securities. Securities regulations are not designed in segments, but should be viewed as part of an overall system existing alongside and complemented by established national systems of systems of regulations. Regulations with defined and enforceable debt contracts, protecting the issuers' rights in the event of default and an efficient judiciary overseeing the enforcement of such rights are the necessary preconditions. The securities markets in India come under the following major regulatory structures:

- The Public Debt Act 1944 which empowers the Reserve Bank of India to regulate the primary issuance for debt securities by the central and state governments.

- The Securities and Exchange Board of India(SEBI), established in 1992, regulate the primary issuances in capital and debt markets, other than government securities, and ensure sound trading practices in the secondary market through stock exchanges. SEBI has introduced a number of measures in the areas of investor protection, listing, and disclosure norms.

- The securities of the local bodies, as an organ of the government, come under the The Local Authorities Loan Act 1914. The issuance, disclosure in the offer document, listing and trading norms of debt instruments are documented in the SEBI guidelines.

- The Companies Act 1956, which sets out the code of conduct for, the corporate sector in relation to issue, allotment and transfer of securities and disclosures to be made in public issues. The issues made by the SPVs come under this category.

- The Securities Contracts (Regulation) Act 1956, which provides for regulation of transactions in securities through control over stock exchanges.

- The Depositories Act 1996 provides for electronic maintenance and transfer of ownership of dematerialized securities.

- The Fixed Income and Money Market Dealers' Association (FIMDA) is a self regulatory organization for fixed income and money market instruments, which also prescribes norms to promote operational flexibility and smooth functioning of these markets.

It may be argued here that even if debt instruments issued by the local bodies are "government securities" for the purposes of the Public Debt Act, 1944. When such instruments are offered to the general public, the SEBI would have the necessary authority in respect of issuance of instruments, because the definition of the term "securities" as per the SEBI Act, which is as defined in section 2(h) of the Securities Contracts (Regulation) Act, 1956. The responsibility for regulating the securities market is shared by the Department of Economic Affairs (DEA), Department of Company Affairs (DCA), the Reserve Bank of India (RBI) and SEBI. A High Level Committee on Capital Markets coordinates the activities of these agencies. The orders of SEBI under the securities laws are appellable before a Securities Appellate Tribunal (SAT). In a notification issued by the Government of India on March 2, 2000,

The MUD&PA provides the guidelines for the issue of tax free municipal bonds as follows:

- The eligible issuers of Tax Free Municipal Bonds shall be local-self Governments, other local authorities or public sector companies duly constituted under an Act of Parliament or State Legislature, or have been constituted under relevant state government statues like Water Supply and Sewerage Boards/Authorities, or constituted through a financial intermediary.
- The funds raised shall be used only for capital investments in urban infrastructure, setting up of new project(s) and expansion, augmentation or improvements of the existing system, for providing potable water supply, sewerage or sanitation, drainage, solid waste management, roads, bridges and flyovers; and urban transport;
- The financing plan of the project should be approved by the local authority or the Board of the Agency before the bond issue, with benchmarks for commencement and completion, milestone dates for all the proposed components, with land acquisition and other statutory clearances.
- The issuer shall create an Escrow account for debt servicing with earmarked revenue, and all state grants or transfers to the issuer should be deposited into the escrow account. The bond issue must clearly set forth the order of priority according to which the revenue generated by the enterprise will be allocated for various purposes. An independent Trustee will monitor earmarking of revenue through Escrow mechanism.
- Within six months of the close of every financial year, the escrow account and the project account will be audited by a firm of Chartered Accountants appointed by the concerned State Urban Development Departments from a panel of Chartered Accountants approved by the C & AG and the fully compiled audit report submitted to the MOUD&PA.
- The issuers will undertake to maintain the Debt Service Coverage Ratio (DSCR) of at least 1.25 throughout the tenor of bond(DSCR is a ratio of net income(of the entire utility/ corporation, as against the specific project) after meeting all the obligations and liabilities of the issuer except the long term debt obligations (principal and interest) to long term debt servicing obligations).
- The Tax Free Bonds should have a minimum maturity of 5 years, and can have option to offer deep discount bonds or other financial innovations such as buy-back, after a lock-in period of three years, to enhance the tenor of the bond.
- The issuer can have the choice of raising the amount as a public issue or by private placement or a combination of both. Where a public issue is made the issuer shall abide by the guidelines issued by the Securities and Exchange Board of India (SEBI).
- Income by way of interest rate upto 10.50 per cent will be entitled to exemption from Income Tax under the Income Tax Act, 1961 without limits.
- The maximum amount of Tax Free Municipal Bonds as a percentage of the total project costs (excluding interest during construction) will be 33.3 percent or Rs.50 crore whichever is lower(which have been increased to Rs 200 crore).
- The debt equality ratio for the project shall not exceed 3:1. In case of municipal authorities, the issuers shall at least contribute 20 percent of the project costs either from internal resources or other grants or a mix of the two.
- The issuer shall obtain an investment grade rating from an RBI approved credit rating agency before the issuance, and the agency shall carry out appropriate due diligence process at the time of rating award and monitor the same as part of its surveillance during the tenor of the bonds.
- The MOUD&PA, GOI shall be the nodal agency for processing the proposal for bond issuance, will seek approval by a committee having representatives of the DEA and the CBDT, and notify the bonds issuance in the Official Gazette with the approval of the Finance Minister.
- The Tax-Free bonds may be listed on the Stock Exchange.

the areas of responsibility between RBI and SEBI have been clearly delineated. In terms of this notification, the contracts for sale and purchase of government securities, gold related securities, money market securities and securities derived from these securities and ready forward contracts in debt securities shall be regulated by the RBI. Such contracts if executed on stock exchanges shall however be regulated by SEBI, in a manner that is consistent with the guidelines issued by the RBI.

Therefore, it may be said that the manner of issuance of debt instruments by local bodies are governed by multiple legislations and there appears to be a case to have a single law governing such issues by local bodies. State Finance Commissions (SFCs) is expected to deal with assignment of powers relating to taxes, transfers, and borrowing. However, their role has been rather extremely limited in so far as borrowing powers are concerned.

Private Placements

Private placement of issues are the most preferred method in Indian debt market, even by the AAA credit rated borrowers, due the disclosure norms followed in the case of public issues. Most of the Subnational issues are made through private placement, the state level undertakings are the most dominant issuers in the private placement sectors, next to the all India financial institutions and banks(Table 20). Being private placement, the disclosure requirements are also relaxed.

It can be very well said that the Indian regulators, including SEBI, have very little experience as regards the local debt issuance. All Subnational bond issues should be made against a prospectus, regardless of whether they were being presented as a public or private placement. There is need for specific listing and disclosure rules, making them more suitable for municipal securities. SEBI should standardize and enforce such disclosure requirements which would typically include the particulars of the issue, project cost, sources of financing, listing proposed, auditors, lead managers, trustee, credit rating, and other issues such as local government borrowing powers and clearances from the Ministries. Present documents applied more or less in line with the private placements issues of the corporate sector is less applicable. It is necessary to produce a model issue document for issue of Subnational bond, and making differentiation as regard to various categories of issuers. It is also necessary to recognize that the document should not be bureaucratic, bringing in more complexity, rather aiming at improving better market discpline.

Credit Rating

Credit rating is mandatory for debt instruments (if public issue) having a maturity exceeding 18 months. There are three major credit rating agencies in India: the Credit Research and Information Systems of India Ltd (CRISIL), the Indian Credit Rating Agency (ICRA), and Credit Analysis and Research (CARE). The three agencies have partnership with international credit majors: CRISIL with S&P, ICCRA with Moody's and CARE with Fitch Ratings. They together these agencies account for the whole of the domestic bond issuance. These agencies rate bonds and debentures, fixed deposits and short-term instruments such as CPs.

Most of the Subnational issues in India are in the form of revenue bonds, often with explicit government guarantee. The issues include a credit enhancement features in their bond offerings, which determine to a large extent the issuer's credit rating. Short term ratings are very few. Agencies use "SO" implying a structured obligations. In rating such structured debt obligations, the criteria used by the rating agencies generally cover the following factors: (1) economic base, diversity and growth; (2) state government finances; (3) economic management, (4) operations of the local bodies(see the Box below). Criteria used by the Indian rating agencies for Subnational bond issuance are evolving, as the city governments are bringing in more financial disclosure and accountability. The ULBs in India differ considerably with respect to their revenue raising powers, coverage of service delivery, legal and administrative framework, and economic base.

Private placement issues made by a number of state enterprises and state level enterprises generally don't obtain credit ratings. Nor are there any legal provision for them to provide financial and accounting information to regulators and higher levels of government. The Ministry of Urban Development Circular makes indicated in their circular of February 2001 to obtain an investment grade rating for the issuance of tax free municipal bonds.

Credit rating is definitely not just a regulatory issue as much as a measure of market discipline. The state government guarantee is not a substitute for important disclosure through credit ratings. The Reserve Bank of India as part of the standardization of private placement issues proposes ratings for all issuer, private as well as public, which should include bond issuance by the Subnational entities as well. State Government guarantees should not be treated as a substitute because they only increase a local body's dependence on safety nets.

Credit ratings reveal important information for the investor as well as issuer, thereby serve as a reliable guide to investors in determining the default risk associated bond issuances. Mandatory rating which along with a statutory limitation on borrowing powers of Subnational bodies would bring in considerable market discipline. Indian rating agencies should publicize periodically the ratings of state governments, by providing independent assessment of their credit risks. This would facilitate the functioning of capital markets at the Subnational level, as more and more such bodies are accessing markets. Socio-political changes at the local level need to be captured by rating agencies and information dissemination. The rating agency is also expected to monitor the same as part of its surveillance during the tenor of the bonds. State governments could take important initiatives in making available the credit ratings of their local bodies, something like pre-screening of the potential issuers.

CRISIL Rating Indicators: State and Municipal Governments

State Government Ratings	Municipal Ratings
Economic Structure • NSDP Composition and growth rate • Per Capita NSDP and growth rate • Demographic Profile • Per Capita Availability of Power, Roads, Railways, etc. • Per Capita Availability of education and health facilities • Industry growth rate • Per Capita sanctions & disbursements by Financial Institutions • Mineral reserves **State Government Finances** ❑ Revenue receipts and expenditure ❑ State's Own Revenues/Total Revenues ❑ Grants from Centre/Revenues ❑ Revenues Deficit ❑ Fiscal Deficit and its Composition ❑ GFD/NSDP ❑ Debt/NSDP ❑ Debt/Revenue Receipts ❑ Capital Expenditure/Fiscal Deficit ❑ Revenue Receipts/Interest **Economic Management** ❑ SG Guarantees ❑ Utilization of W&M Advances and overdraft facility ❑ Performance of State Level PSUs ❑ Plan Performance	**Economic Base of the Service Area** ❑ Population & its growth rate ❑ Sanctions & disbursements made by financial institutions ❑ Non-domestic power consumption ❑ Industrial water connections in the service area. ❑ Sales tax collections ❑ Stamp duty collections on property transfers ❑ Per capita income ❑ No. of vehicle registered with the Regional Transport Office ❑ Demand for telephone connections with DoT ❑ Growth in bank deposits raised by major public sector bank **Current Financial Position** ❑ Tax receipts/Total revenues ❑ Non-tax receipts/Total revenues ❑ Grants from SG/Total revenues ❑ Revenue deficit ❑ Overall deficit ❑ Collection efficiency of property tax ❑ Collection efficiency of water tariff ❑ Debt service coverage ratio **Operations of the Municipal Body** ❑ Expenditure on core services/Total expenditure ❑ Expenditure on wages & salaries/Total expenditure ❑ Water supplied per capita ❑ Per capita expenditure on primary education ❑ Per capita expenditure on health services

Source: CRISIL

Borrowing Powers:

The powers of state governments to borrow are subject to Article 293 (3) of the Constitution in terms of which the approval of central government is required. Article 293 (4) further provides, that while giving consent under article 293(3), the Central Government may impose such conditions restricting the borrowing. This is a standard requirement of a lender, though a transparent framework laying down the factors governing such consent is not presently in place. The government borrowings are considered as borrowing against the security of the consolidated funds of India or of the respective states. In addition the state government provides guarantees on borrowings by the state enterprises and statutory boards, which can be treated as debt having the potential of ultimately falling on it. While a few States have passed laws on guarantees, none has passed a law on borrowings. There seems to be a case to review provisions relating to borrowings and guarantees by states.

The policy environment and legal framework governing borrowing powers of local bodies such as municipalities are given in the Local Authorities Loans Act of 1914. Subject to the boundaries laid down under the said Act, the relevant State governments are free to lay down the framework within which their local authorities raise loans. The salient provisions of this Act include, among other things, the following:

- A local authority may, subject to the prescribed conditions, borrow on the security of its funds or any portion thereof for any of the purposes specifically mentioned therein. These purposes include public welfare activities like giving of relief and the establishment and maintenance of relief works, prevention of outbreak or spread of dangerous diseases etc.

- The relevant state Government may make rules consistent with the said Act, in respect of, inter alia, (i) the nature of the funds on the security of which money may be borrowed; (ii) the works for which money may be borrowed; and (iii) the manner of making applications for permission to borrow money; (iv) the manner and time of making or raising loans; (v) the sum to be charged against the funds which are to form the security for the loan, as costs in effecting the loan; (vi) the attachment of such funds, and the manner of disposing of or collecting them; and (vii) the accounts to be kept in respect of loans

The acts governing local authorities borrowing powers are out of date and needs to be amended. The state of Maharastra had amended this act in the Bombay Provincial Municipal Corporation Act (BPMC) of 1949.

Municipal Bankruptcy

An important requirement for greater participation by private lenders is the comfort of enforceable security during times of financial stress. Presently, there appears to be very little to protect the interest of a private lender in the case of a constitutional body like a municipal corporation or a statutary board, insofar as enforcing secured assets of or bringing about insolvency proceedings against such bodies are concerned. The existing framework of insolvency can be applied to the Special Purpose Vehicles (SPVs) set up by the State governments as shareholders. As these being registered under the Companies Act, 1956, the rules of insolvency as laid down in the Insolvency Laws would be applicable.

The Provincial Insolvency Act, 1920 and The Presidency Towns Insolvency Act, 1909 (the "Insolvency Laws") provide the necessary legal and administrative structures for recovery . Recent initiatives include (i) the setting up a Committee by the Government of India under the chairmanship of the retired judge of the Supreme Court of India, Mr. V Balakrishna Eradi, to review laws pertaining to corporate insolvency in India, and (ii) the setting up of an Advisory Group on "Bankruptcy Laws" under the Chairmanship of Dr. LN Mitra, by the Reserve Bank of India. These committees have been directed towards identifying and addressing the problems pertaining to insolvency of 'corporate' entities. The recent one is the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002 that was promulgated by the President on the 21st June, 2002 which has been tabled before the Lok Sabha for its approval subsequently. The consensus seems to be towards the formation of a National Company Law Tribunal (the "Tribunal") by consolidating the powers and jurisdiction currently being exercised by different structures.

The above initiatives seek to create separate substantive as well as procedural laws to govern by and large the issues relating to corporate insolvency, and does not apply to local bodies. Further, there is no judicial precedence whereby a local body being a defendant in a suit for insolvency, had been declared to be "insolvent" for the purposes of the Insolvency Laws i.e. no local body has been adjudicated to be "insolvent". In the circumstances, it may be said that there are no specific statutes in India, which contemplate insolvency of local bodies, leave alone govern the procedures of their insolvency. If a local body defaults, the only legal remedy available to an investor would be to seek relief by way of a writ in the relevant High Court as provided under Article 226 of the Constitution**.** However, the process of seeking remedy against local bodies would be more complicated, as the Courts would be reluctant to enforce any security offered by a local body as these are protected by the principle of sovereign immunity. Moreover, in case there are more than one bodies involved, for example, in a project involving water supply or purification passing through more than one State and local body.

In order to permit local bodies to function as independent entity for accessing capital markets and to ensure that investors could enforce security provisions by bringing about insolvency proceedings against, the following are recommended:

1. Promulgation of a law to lay down a separate insolvency process (in the nature of a fast-track recovery process) for local bodies.

2. Constitution of separate insolvency courts to try matters pertaining to borrowings by and insolvency of, local bodies.

3. Promulgation of a separate statute setting out the revised manner of constitution of local bodies, in order to facilitate greater transparency and responsibility in fiscal dealings

Fiscal Incentives for Bond Issuance

Post tax Return on Selected Fixed Rate Financial Instruments(June 2002)	
Instrument	**(% p.a.)**
Tax Free Municipal Bond	8.5
Public Provident Fund(Tax free)	9.00
RBI Tax Relief Bonds	8.00
Debt Funds	7.00-8.00
Bank Deposits(5-Year)	5.50-6.50
Post Office	6.25-7.25

*Rates vary as per income slabs

Fiscal incentives in the form of tax exemption and deduction have in vogue for several years for investments in infrastructure. For this purpose the definition of infrastructure has been expanded to include urban infrastructure such as water supply, solid waste management systems, etc which are made eligible for tax incentives. Tax exemptions allowed from the income in the form of interest, dividends and capital gains under various sections of the Indian Income Tax Act. Various participants that benefit from these incentives are the financial institutions and commercial banks that raise bonds for the investments in infrastructure sectors, the companies or funds that are involved in infrastructure projects, and finally, the investors who supply the funds. The benefits for these participants are in the form of exemptions from tax, deductions in respect of profits and gains and tax rebate, respectively. Various sections of Income Tax Act under which the benefits can be availed are presented in the box given below.

Section 10(15) (vii): Under this section of the Income Tax Act, 1961, the income earned through the interest on notified bonds issued by a local authority (municipal bonds) is exempted from tax. This exemption is applicable from the assessment year 2001-02. Under this section all the bonds issued by the local authorities such as Municipal Corporation and statutary corporations are exempted from tax.

Section 10(23 G): Income from the investments by the companies/funds on infrastructure companies that are solely engaged in (a) developing or (b) maintaining and operating or (c) developing, maintaining and operating infrastructure facilities is exempted from tax under section 10 (23 G) of the Income tax act. The definition of infrastructure projects includes urban infrastructure projects such as toll road projects, water supply projects, water treatment system and irritation projects, sanitation and sewerage system or solid waste management. The income earned would include interest, dividends received and long-term capital gains. Fee or commission received for giving any guarantee to enhance credit and approved by the central government is also exempted. This exemption shall be approved by the central government based on the application through rule 2 E in the prescribed form No. 56 E.

Tax rebate under the head salaries: Amount invested by individuals in equity, debentures, bonds of a public company engaged in infrastructure or units of a mutual fund proceeds of which are utilized for the infrastructure can seek tax rebate under section 88 of the Income Act. Income up to 20 percent of the amount invested in bonds for qualified infrastructure projects is exempt from an individual's tax liability. Starting from 2001-2002, the maximum investment limit to claim rebate under Section 88 has been enhanced to Rs 80,000, subject to a minimum investment of Rs 20,000 in infrastructure bonds issued by financial institutions like IDBI & ICICI. This exemption will be approved by the central government under rule 20 of the prescribed form No 59.

Deductions in respect of profits and gains: Section 80-IA: Under this section of the Income Tax Act, deductions in respect of profit and gains for enterprises engaged in infrastructure development. 100 percent of the profit is deductible for 10 consecutive years from the initial assessment year within twenty years of the setting up of the enterprise. To claim deduction under this section, the enterprise should have entered into a concession agreement with the central government, state government or local authority for developing, maintaining and operating a new infrastructure facility. BOT, BOOT and BOLT schemes used for urban infrastructure development are entitled to claim exemption under this section. Housing and other development activities, which are integral to the infrastructure project, will also qualify for the benefits under this section.

Section 80L: Deduction under section 80L is available for amount invested in debentures of, and equity shares in a public company engaged in infrastructure.

Capital gains tax: Section 54E-a and 54E-b: Under section 54E-a and 54E-b of the IT Act, capital gains income earned by companies may be sheltered from taxation by income earned from infrastructure bonds

AMC bond issuance: A Case

The Box in the following presents the case of the most publicized municipal bond issuance by the Ahmedabad Municipal Corporation in 1998. The AMC bond issuance was possible with significant financial market assistance and capacity building efforts which was coordinated by the USAID under its FIRE-D project.

The AMC strategy leading up to the bond issuance involved the restructuring of the operations of AMC relating to fiscal and financial management, user charges, human resource development, and implementation of capital planning process. Development of municipal bond markets require existence of viable infrastructure projects, with definite cash flows, regulatory framework enabling private sector participation in local projects, and cash flow generating capability of projects through defined user charges and fiscal and financial capability of the city government. These and other capacity building issues are discussed in the next section.

Indian cities are in need of long-term capital for investment in urban infrastructure, and given the present resource constraint faced by the ULBs, the time is ripe to develop municipal bond markets in India. AMC along with other experience as presented in Table 24 show that India has the potential for the development of local bond market. The growth of institutional investors such as pension funds, provident funds, insurance companies spreading towards Subnational level would imply an increasing demand for local debt securities.

Case of Ahmedabad Municipal Bond Issuance

Objective:

Issue Size: Rs. 1000 Millions
Face Value: Rs. 1000 at par.
Redemption: In 3 trances of Rs. 333, 333 & 334 at the end of 5th, 6th and 7th year.
Interest: 14% per annum payable semi annually on the outstanding principal.
Security: Charge/Mortgage on AMC's properties

> Structured Obligations: Octroi collection from 10 designated octroi-points(Aslali, Odhav, Hathijan, Sarkhej, Narol-Sarkhej, Keshavnagar, Kalol - Koba, Hansol Bridge, Angadia) were to be specifically specifically earmarked and kept in an Escrow account for servicing the Bond.

Issue Opened On:	16th January 1998
Issue Closed On :	27th January 1998
Deemed Date of Allotment:	February 01, 1998

Rating: CRISIL provided the the rating of "AA(SO)", based on the financial performance of AMC in 1996-97, indicating a high degree of certainty as regard the timely payment of interest and principal. AMC became the first urban local body in India to obtain a formal credit rating.

The private and public issue components were as follows:

> 75%(Rs. 750 Millions) were in the form of private placement(firm allotment basis), organized by IL & FS with co-lead managers such as Kotak Mahindra, SBI caps, ANZ grindlays bank.
>
> 25%(Rs. 250 Millions) were in the form of public issue, fully underwritten by the Lead Managers.

Applications for listing made to the National Stock Exchange and Ahmedabab Stock Exchange on the 3rd week of December, 1997.

The draft prospectus were approved by SEBI for public placement, as per the guidelines

The total cost of bond issuance was 3.5% of the total value(which typically includes

The application received from the investors included the following categories:

Investors	**No. Of Applications**
Govt. Sponsored Financial Institutions (UTI, LTC etc.)	2
Nationalized Bank	6
Govt. Companies & Corporations	4
M.F. Promoted by Institutions/Bank	2
Pvt. & Co-operative Banks, Pvt.M.F.	9
Corporate Bodies	10
Trusts & Foundations	112
Co-op. Societies, Provident funds	38
H.U.F.	62
Individuals (95.1%)	4861
Total number of investors	5106
Amount received :	Rs.1040.67 Millions

Local Bond market Developments: A Roadmap

For the debt markets to cater to the needs of the local government financing, particularly financing urban infrastructure, additional efforts are needed. The efforts may cover simultaneously addressing issues at the levels of central, state and local governments, relating to the legal, administrative and capacity building aspects. The AMC case shows that municipal bond issuance requires significant capacity building efforts and capital planning process by the issuers. It also requires building capital market relationship, making investors aware of the issuer profile, familiarity with market intermediaries and regulatory environment. It is to be recognized that developing municipal bond markets can be more complicated. Donor assistance in developing more pilot projects for municipal bonds issuance, in collaboration with rating agencies, merchant bankers and regulatory agencies and stock exchanges would facilitate and expedite the process.

We chart out the following issues that would provide an enabling environment for the local bond markets to develop. The exact duration and sequencing of these measures would depend to a large extent on the level of involvement of the local government as well as the framework within which they work.

- Wider Acceptance of the 74th Amendment of the Constitution
- Achieving Stability and Transparency in Intergovernmental Fiscal Relations
- Correcting Fiscal Imbalances of the States
- Addressing Fiscal and Financial Management at the Local level
- Urban Management Issues (User Charges, taxes)
- National and state level Regulatory Design Issues
- Privatization of essential urban infrastructure
- Developing Local Bond Markets
- Regulatory Design and Dissemination
- Capacity Building of Urban Local Bodies
- Policy dialogue at the center, State and Local level

We provide in the following the essential roadmap for local bond market development in India at different levels of government covering interventions in the following broad areas: (i) Policy Objective, (ii) Key Performance Indicator, and (iii) Areas of Intervention.

Local Bond market Developments: A Roadmap

Policy Objective	Key Performance Indicator	Areas of Intervention
		Level of Center
Objectives of the 74th Amendment of the Indian Constitution	The process of decentralization and the financial devolution and capital market access.	Identification through appropriate case study of selected states, taking both reform minded as well as non-reforming states, as regard the decentralization objectives, and study of their evolution of financial resources and fiscal management practices, constraints identified, and lessons drawn for future interventions. Facilitating the implementation of the XIIth schedule of the 74th amendment as mandatory on the state governments, so that it will restore the 18 approved functions to given to ULBs Evolving role of the State Finance Commissions (SFCs) as an empowering body for the design of the local governance.
Regulatory Issues	Determination of the Borrowing Powers of local bodies	The design of the Local Authority Loans Act 1914, for its suitable amendment, for respective states to be incorporated in their own statutes, specifying their borrowing powers, security, and other provisions of local borrowing.
	Capital Market Regulations affecting private placement of bonds	The study of the suitability of the guidelines of the Securites and Exchange Board of India Act 1992 as regards the private placements of issues made by the urban local bodies, the disclosure formats, model prospectus.
	Secondary market trading of municipal bonds	Working with the stock exchanges for listing and trading of municipal bonds and other private placements by the state level bodies, drafting of the regulatory mechanisms
	Municipal Bankruptcy issues	Creation of a separate statute for the municipal bankruptcy.
Performance Indicators for ULBs	Building data base	Development of urban indicators for all the urban local bodies in India, can be taken up with the Ministry of Urban Development and Poverty Alleviation.
Policy dialogue	Dissemination and common understanding	Conduct national and state level workshops to bring stakeholders together to develop a common understanding of options and action plans Towards an efficient and corruption free local bodies, transparency in governance, and system
		Level of State
Fiscal and Financial Management	Strengthening of the state finances	Training and financing of improvements in tax administration, medium term expenditure management framework, managing public debt and guarantees, including reforms of the civil services and bureaucracy.

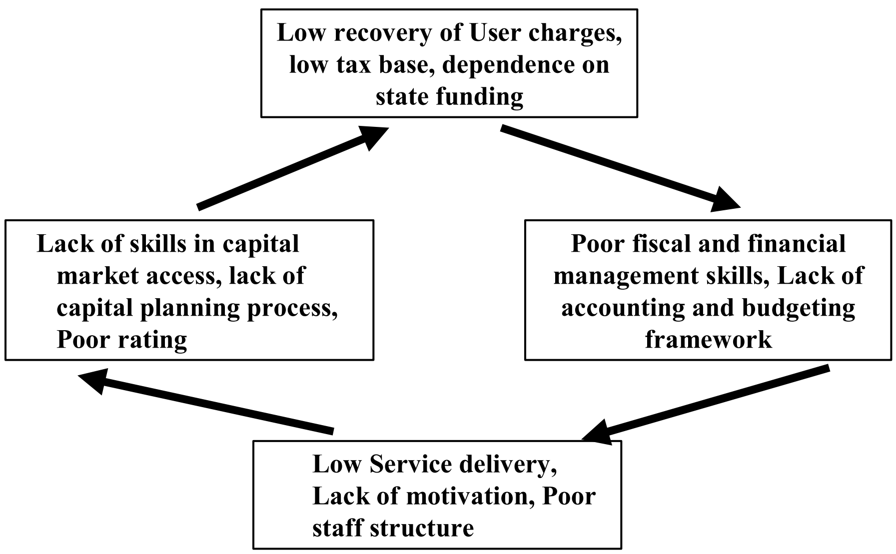
Privatization	Privatization of essential urban infrastructure services such as water and sewerage systems	Strengthening and reforming of the existing regulatory agencies and contractual framework for private sector participation in service delivery, and creating new regulatory infrastructure wherever it does not exist.
Debt Management	Debt management policy for fiscal stability	Proper debt management policy to be put in place Borrowings to be restricted only for the capital expenditure Debt service indicators to be prescribed for ULB and their structuring Risk management system to be in place for mitigating various risks
	Contingent liabilities of the state governments	For a national policy on contingent liabilities and guarantees of the states
Level of Urban Local Bodies		
Organization of Municipal structure	Strong Municipal Commissioner system in the ULBs, avoiding Fragmentation of executive authority Inappropriate staff structure	Restructuring of the recruitment policy for the ULBs so that executives with appropriate competence occupy these organizations. Recruitment of professional by the apex parastatal for every sector. Staff transfer rules to be made the same as the state government employees
Financial Accounting		Technical assistance in the preparations of operating manuals for reforms in fiscal and financial management of municipal corporations, operating manuals for an accrual based accounting system for such corporations. Implementation of the double entry accrual based accounting system Following generally accepted accounting principles (GAAP) to be implemented in phases
Financial Control and Audit	Audit to be made mandatory	Adequate training need to be provided for auditing staff Implementation of double entry accrual based accounting system and identification of performance indicators that would enable performance based audit or efficiency / cost audit

		Private sector participation to be explored for the activities
Human Resource Management	Training and capacity building activities	Training programs for the city managers (key officials) in the areas of (i) fiscal and financial management, accounting and audit, (ii) preparations of budgets, (iii) capital planning process, (iv) capital raising from the financial markets, (v) legal and regulatory environment of capital market, including credit rating, (vi) determination of user chargers for core services and other taxes such as property taxes and innovative sources of revenues, (vii) municipal bond issuance, documentation, negotiation, (viii) application of information technology in municipal governance, and (ix) corporate governance.
Urban Management	User Charges	The ULB needs to have power to raise the tariffs under certain conditions - Example KWSSB has power to raise the tariff under certain conditions, differentiation in user charges reduced, Introduction of meters to all the connection, Energy audit to be mandatory and performance parameter to be specified
	Property Tax	RCA is redundant and need to be modified suitably for present conditions ULBs to have power to revise the ARV periodically Indexing the base cost to factors like inflation or the real value of property would make the revenue source buoyant Following the Mirzapur experiment, Geographic information system (GIS) could be used to generate the property records Private sector or community participation for tax collection services Land can be used as a source of revenue - Example Navi Mumbai and Delhi and other land based tax sources could be introduced
	Other tax revenues	The ULB needs to have power to raise the tariffs under certain specified conditions
Local Government Finances	Municipal Bond Issuance	Capacity building of selected cities, preparing for municipal bond issuance
	Credit Rating	Capacity building of selected cities, from reform minded as well as not so better off, and preparing them toward credit rating, in collaboration with the Indian credit rating agencies.
	Inter governmental Transfers	Strengthening the role of the SFCs in formulating appropriate transfer rationale and mechanisms of the specific grants to be allotted to ULBs, on the merit of the commercial viability of the projects and other reforms undertaken.
Skilled Technical staff and Manpower	Develop competency in preparing master plan, technical drawings, contractual documents bidding procedures and project design skills.	Combing technical and financial consultancies - Example **Nagpur Municipal Corporation** hiring Tata Consulting Engineers and Tata Consultancy services

V. Capacity building for Urban Local Bodies

The ULBs in India are confronting the situation of a vicious circle. The problem stems mainly from their structure and functions under the Indian laws, their poor operational and financial management processes adopted, and improper revenue base and collection efficiency. Significant capacity building efforts are suggested to augment the fiscal capability of the local governments in order that they access municipal bond markets.

ULBs: Vicious Circle



I. Functional Autonomy: The vision behind the 74th amendment was to empower the local bodies functionally and financially so that they can look after the social and economic development without depending on higher-level governments. Since the functions that are delegated to these bodies are concurrent in nature, state governments have the liberty of acting simultaneously in spheres that have been delegated to the municipal bodies. Second, there are wide differences observed between the local bodies in terms of population, revenue-generating capacity and many of the local bodies are not be in a position to take over the responsibilities bestowed on them by the constitutional amendment. Finally, the fear of dilution of power or mere unwillingness of the state government in case of rival political parties having strong representation in municipal bodies could also be a reason.

- It is imperative that all the state governments should assign the functions to their local bodies through law and once assigned the functions should not be withdrawn or uncertainty created due to state intervention.
- There should be clear demarcation of functions among states, state government departments and para-statals and local bodies, who have hitherto been involved in providing various urban infrastructure and civic activities.

II. Human Resource management: There is a need to develop appropriate human resource policy assigning the developmental responsibilities. The recruitment and transfer for urban local bodies are fully controlled by the state governments. The executives are generally deputed from the state governments departments and the frequent changes in the executive cadre give instability to the local governance. Also the present manpower is woefully inadequate to undertake the new responsibilities.

- For executive level, separate municipal cadre need to be prepared and the transfer policies should be made the same as the state government employees to ensure stability.
- Various aspects of project management skills need to be imparted through training programmes.

III. Project Management Skills: Functional autonomy means that the urban local bodies apart from their regular operation and maintenance of infrastructure facilities should look after the developmental works. This would need development of skills and expertise in various areas project developments such as technical sanctions for the projects, costing for various works, development of contractual documents, bidding procedures, commercial assessment of urban infrastructure projects, project management skills, etc. The options for the ULBs are to continue using the services provided by the state department or parastatal agencies or involving specialized external project management consultants.

- ULBs can also use professional project management teams for implementation of large or fast track projects. This has been successfully used by CIDCO to implement large number of urban infrastructure projects in New Mumbai and also followed by the Ahmedabad and Chennai Municipal Corporations.

IV: Financial Management: Lack of prudent financial management practices of urban local bodies are the main hindrances for them to reach capital market. This would include the usage of double entry accrual based accounting system, proper budgeting techniques, capital planning process for raising funds through various resources, proper management of debts, and proper financial control through external and internal audits.

Budgeting: Proper budgeting gives the management relevant information on the expenditure plans and commitment of their revenues. Urban local bodies prepare three different budgets viz., revenue income and expenditure budget, loan budget and the suspense accounts budget. Line item based budgeting system is followed for the revenue income and expenditure budget. Under this all the expenditures are classified using objective classification method and the higher level of governments ensure financial compliance by keeping cap, often decided arbitrarily, for various types of expenditures. Though this system has the merit of checking the misappropriation of funds by the local governments, it leaves very less flexibility for the functioning of the local governments.

In the revenue side, forecasts for revenue realization is obtained by incrementing the past revenues. Quite often the increments the past revenues and expenditure to balance the revenue forecasts with the expenditures.

- The improvements in technology have changed the process of offering various urban services drastically and the historical cost does not reflect the true cost. Zero-based budgeting is needed in state level to identify the relevant costs.

- The increments used in revenue and expenditure forecasting should be linked to factors such as inflation in order to make them realistic.

- Many municipalities do not have their own account/cost codes and follow the codes of the respective state government. Standardization of account codes within states atleast would facilitate compilation of local information properly, enable the state finance commissions' function simpler and become the corner stone for the comparative performance indicators system for the municipalities discussed in the later section.

- The utility of the loan budget and the suspense accounts budget can be fully realized only on the usage of accrual based accounting system. Cash based accounting do not take into account the time of the expenditure incurred and often results in past expenditure preempting the future revenues rendering the budgeting exercise futile. Improved budgeting techniques such as performance based system can be used only with the accrual based accounting system.

- Management of short-term receivables and payables often land the urban local bodies in liquidity crisis. Inordinate delays and irregularity of transfers from higher level governments and lack of proper mechanism for contractors' payment are responsible for the same. Preparation of monthly cash budgets would aid in planning the short-term finance better.

- The historical costs used by the municipalities are obsolete and do not offer the real picture of the marginal cost of offering the services. Implementation of Activity Based Costing system (ABC) would help not only in identifying the services in which private sector participation would be beneficial but also in making decisions on fixing tariffs/taxes for the services to be provided by the municipalities on commercial lines.

IV. Capital planning process: Historically, the funding of capital projects of the local bodies were done solely by the transfers from central and state governments. With the possibility of rescheduling of the loans and adjusting the local repayments in the transfer amounts the need for capital planning process was never felt. But when the local bodies raise capital through issuance of bonds or debts they have to pre commit some of their future revenues for the repayment and the capital planning process assumes significance.

Municipal Bond Issuance Process

- Project Feasibility study
- Capital planning process
- Prepare for Disclosure
- Decision to Issue
- Credit Rating
- Formation of Bond Parties (underwriter, trustee, State government guarantee)
- Information Memorandum
- Audit and Standing Committee Approval
- GOI and SEBI approval
- Issuance of bonds
- Listing
- Use of Funds and Follow Up

V. Accrual based double entry accounting:

The single entry cash based accounting system followed by the urban local bodies do not convey any useful information on the financial health of the local governments.

Though the movement to double entry accrual based system has started in many states pioneered by the state of Tamilnadu, lack of knowledge of the municipal staff, huge investment involved in computerization and training of personnel, pending annual accounts for several years are the stumbling blocks that hinder the pace of the transition. The success of the transformation to double entry accural based system needs full commitment apart from significant external support in the form of finance, training of personnel and deputation of qualified accountants for assistance during the transition period.

VI. Financial control and Audit

The financial control in local governments is ensured through two processes viz., by directly controlling the expenditure by keeping sanction limits or/and through the appointment of internal and external auditors. The former procedure is one of the reasons for the extraordinary delays in sanctions.

The 74th amendment provides for the state legislatures to enact provisions for the external and internal audit of municipal accounts. External audit is carried out by the State Director or Controller of local fund for both municipalities and municipal corporations. Though annual external audit is statutory it is seldom followed partly owing to the insufficient manpower and the internal audits conducted by the municipal staff are ineffective. Annual external audits need to be made compulsory.

- Relevant statutes need to be modified to engage external professional accounting firm as external audits as an alternative to the audit by Controller of local fund.
- Scope of the internal audits to be widened to include the audit on the compliance of various statutory audits, operational indicators apart from the financial indicators.

These changes shall be viewed positively by the credit rating agencies and help in getting better rating for their bond issues.

VIII. Improving sources of revenue

The 74th amendment has widened the functional domain of the urban local bodies with increased responsibilities. These increased responsibilities need to be matched with increased revenue raising powers and the existing revenue sources to be made buoyant. In this section, we have discussed on how to make the tax /non-tax revenues of the local bodies buoyant apart from the new forms of revenues to be explored.

Tax revenues: Property tax is one of the important sources of tax revenues for the local government. However, it does not contribute significantly to the revenues of the local bodies due to improper system of maintaining records, legal hassles arising out of the Rent Control Act (RCA) and the complicated valuation procedures in vogue.

- The ambiguity in the statutory provisions regarding the reasonable or fair rent have resulted in lot of ligitation cases in the court of law depriving the local governments from the revenue. Since the notorious RCA has outlived its purpose it should be repealed and the local governments be given authority to settle the disputes arising out of the same.
- Valuation procedures are very complex and leave room for the manipulation. Adopting "Area based valuation system" followed in Patna Municipal Corporation or a simple "Mass Appraisal technique" taking into account few important characteristics of the properties would reduce the complexities and increase collection efficiency.
- Map based system of maintaining records using Geographic Information system (GIS) as in Mirzapur municipality would improve the coverage of information on the properties and widen the tax net.

Reforms on municipal accounting in Tamilnadu

- State government of Tamilnadu took the initiative to implement double entry accounting system in all the municipalities
- A committee headed by retired director of local audit worked with FIRE-D to develop the accounting manuals
- After discussions with the municipal administration and state finance department final shape was given to the manual
- FIRE-D simultaneously worked with Institute of chartered accountants of India (ICAI) and developed a technical guide for accounting and financial systems for ULBs in India
- With World Bank funding, Tamilnadu urban development fund (TNUDF) contracted 25 professional chartered accountant firms to work with municipalities for implementation of the accounting system
- Technical assistance were offered for eighteen months to smoothen the transition

Alternative land based tax revenues: Various state finance commissions have observed that Property tax alone could not fully capture the increase in the value of the land and alternative land based non-property taxes should be used by the urban local bodies to widen their revenue base.

- Options such as Vacant Land Tax, tax on land value increment and betterment levy are to be considered.
- Land could be used as an important source of revenue where the land valuation is very high. This has been successfully demonstrated by CIDCO in New Mumbai and the Delhi Municipal Corporation.

Non-tax revenues or user charges: In this section, we focus our discussion on improving the revenue from the water charges for two reasons: One, water charges are the only user-charge collected by all the local bodies. Two, providing safe potable water to all the citizens remain one of the important goals of the Union Government of India with an annual burden to the government exchequer in the tune of Rs 9,000 - 10,000 million. Two important reasons for the commercial non-viability of water supply projects are huge amount of unaccounted for water (UFW) and very complex pricing structure.

- Unaccounted for water mainly arises due to lack of metered connections. Even in economically advanced state like Maharashtra only 10% of the connections are metered. This is also because in many places water is supplied using stand posts for an entire area or community. Even in such cases water charges in the form of community charges could be considered.

- The pricing structure of water connection prevalent in India is very complex. The panel given below gives various pricing structure being in vogue in different states. Industrial users are generally charged high prices to cross subsidize the domestic users. High disparity in domestic and non-domestic users have motivated misrepresentation of the purpose of the use and hence the level of disparity should be brought down. Also the water charges need to be linked to the consumption to make this source of revenue buoyant.

- Considerable portion of the operational expenditure in water supply is towards the cost of energy. Hence efforts to improve the operational efficiency of supplying water should be undertaken on the lines of Maharashtra where periodic leak detection surveys, water audits and energy audits have been made mandatory and the transfer of grants to the local bodies are contingent on conducting these audits satisfactorily.

Alternative sources of non-tax revenues: Some of the options such as special assessment district, valorization charges that are used internationally should be explored by the urban local bodies to supplement the revenues from water charges

IX. Urban Indicators for Performance Measurement

There are no formal performance measurement tools available to measure the absolute as well as comparative performance of urban local bodies. Lack of pertinent information on the past performance of the urban local bodies remains a hindrance for raising capital through capital markets. Also there should be comparative indicators to compare the performance of the local bodies and evaluate them.

The city level indicators would extensively cover on the performance indicators of the city and the local government can use this information to set performance targets, monitor their own performance over time and to make more rational financial and planning decisions. And the Comparative performance indicators enable comparison of two ULBs. This would be useful for the higher level governments for policy analysis and programmatic planning and also provides the individual ULBs with performance benchmarks against which they can assess their performance.

Statewide performance indicators system in Tamilnadu

Tamilnadu Urban Development Fund (TNUDF) with the assistance from USAID AND Kirloskar Consultants Limited (KCL) established the statewide performance indicators system in Tamilnadu. The indicators were developed in three categories: service levels and coverage, service efficiency and financial management. These factors are applicable for municipalities as well as municipal corporations. But ranking is done separately for municipalities and municipal corporations because of the variations in population, geographic size and complexity of legal authority and responsibilities. The indicators would help the TNUDF and the Directorate of Municipal Administration to target local bodies for development financing and/or to identify policy, project and capacity building interventions.

VI. Areas of Technical Assistance

The analysis in the previous sections clearly brings out the issues that are of significant interest to the Asian Development Bank in furthering her role in effective implementations of her local lending programs in India, in particular, promoting local government financing and bond financing. The Bank has significantly increased her lending in India since the first operations which began in 1986. In the urban sector, presently seven loans with a total value of about $1 billion have been approved for supporting improvement of basic urban services. These projects include water supply, wastewater management, drainage, transportation, solid waste management, slum rehabilitation and capacity building. The following are the specific projects currently underway in India:

- Karnataka Urban Infrastructure Development ($115 million)
- Karnataka Urban Development and Coastal Environmental Management Project($145 million)
- Rajasthan Urban Infrastructure Development Project ($250 million)
- Kolkata Environmental Improvement Project ($220 million)
- Urban Environmental Infrastructure Fund through ICICI-($80 million)
- Urban infrastructure component under the Gujarat Earthquake Rehabilitation and Reconstruction Project($200 million)

The areas of assistance for the Bank would cover the following issues:

- To support the implementation of decentralization objectives in India, by improving the efficiency of the Subnational governments such as state and local government in their efforts in the delivery of core services;

- To improving the efficiency of the local fiscal system at the level of state and city governments, such that these entities carry on their economic role efficiently and in sustainable manner;

- To strengthen the role of the private sector in providing basic services such as water supply and sanitation, sewerage, and other urban infrastructure, by bringing in changes in the legal and regulatory frameworks and supporting an enabling environment;

- To deepen the nascent bond market in India and spread its financing involvement into cities of the Indian federation, by providing access to the thousands of urban local bodies who are in need of funds for longer term investments;

- To strengthen the links and building synergies among the Indian stake holders such as state and central governments, private sector service providers, financial institutions, who have hitherto remained isolated from funding the local governments, for floatation of urban finance projects in India; and

- To bring into India the international best practices that have been successful in many decentralized set up and facilitate innovative schemes for urban financing;

The proposed activities could be spread into both progressive and reform minded states as well as states that have great potential for reforms and decentralization. Although reforming states with a history of successful decentralization are expected to be the main beneficiaries of any new initiatives, the later category of states can be brought into dialogue involving central government, state government, financial institutions, regulatory agencies and the donor agencies in order that the benefits of decentralization and capital market access is fully realized.

The implementation of fiscal and financial management at the state as well as city governments level require financial and technical resources that many government agencies presently do not have. The areas needing attention are numerous such as fiscal reform, expenditure management, tax reforms and user charges implementations, reform of state public enterprise, reforming urban sector and city governance, design of regulatory framework such as municipal borrowing powers and bankruptcy. The implementation of objectives in the above areas requires significant training and capacity building activities.

Recent experience show that multilateral assistance have acted as an important catalyst in successfully reforming and modernizing fiscal management in some of the Indian states such as Uttar Pradesh and Andhra Pradesh, medium-term expenditure framework in Tamil Nadu; public enterprise reform in Orissa; urban property tax reform and urban finance reform in Gujrat, reforming Panchayat Raj institutions in Madhya Pradesh, urban management of environment in Karnataka, municipal development funds in Tamil Nadu and Rajasthan, private-public provision of core service delivery in Tamil Nadu and the National Capital Region, civil service reform and reforms in municipalities, manuals for municipal accounting systems and training programs for municipal managers in the state of Gujrat.

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Annexure

A-I: Structure Urban Bodies in India

States	Municipal Corporations	Municipalities	Others*	Total
Andhra Pradesh	7	94	15	116
Arunachal Pradesh				
Assam	1	28	50	79
Bihar	6	70	94	170
Goa		14		14
Gujarat	6	85	58	149
Haryana	1	81		82
Himachal Pradesh	1	19	28	48
Jammu & Kashmir		2	67	69
Karnataka	6	121	88	215
Kerala	3	55		58
Madhya Pradesh	18	103	283	404
Maharashtra	15	229		244
Manipur	7		21	28
Meghalaya		6	-	6
Mizoram	2	4	-	6
Nagaland			9	9
Orissa	2	30	70	102
Punjab	4	96	37	137
Rajasthan	3	11	169	183
Sikkim				
Tamil Nadu	6	102	636	744
Tripura		1	12	13
Uttar Pradesh	11	226	447	684
West Bengal	6	112	4	122
All India Total	96	1494	2092	3682

These include smaller urban local bodies such as Nagar Panchayats, Town Panchayats, Notified Area Committees, Municipal Councils, Town Area Committees, City and Town Municipal Councils, Town Committees, Notified Area Councils, Municipal Boar, Notified Area Authorities

Source: Government of India, Eleventh Finance Commission Report, August 2000.

Annexure II: Million Plus Cities in India

Rank	Cities	Population 2001
1	Greater Mumbai	16,368,084
2	Kolkata	13,216,546
3	Delhi	12,791,458
4	Chennai	6,424,624
5	Bangalore	5,686,844
6	Hyderabad	5,533,640
7	Ahmedabad	4,519,278
8	Pune	3,755,525
9	Surat	2,811,466
10	Kanpur	2,690,486
11	Jaipur	2,324,319
12	Lucknow	2,266,933
13	Nagpur	2,122,965
14	Patna	1,707,429
15	Indore	1,639,044
16	Vadodara	1,492,398
17	Bhopal	1,454,830
18	Coimbatore	1,446,034
19	Ludhaina	1,395,053
20	Kochi	1,355,406
21	Visakhapatnam	1,329,472
22	Agra	1,321,410
23	Varanasi	1,211,749
24	Madurai	1,194,665
25	Meerut	1,167,399
26	Nashik	1,152,048
27	Jabalpur	1,117,200
28	Jamshedpur	1,101,804
29	Asansol	1,090,171
30	Dhanbad	1,064,357
31	Faridabad	1,054,981
32	Allahabad	1,049,579
33	Amritsar	1,011,327
34	Vijayawada	1,011,152
35	Rajkot	1,002,160
Total		**107,881,836**

Source: Census of India, 2001

A-III: Status Functions as Per 74th Amendment

Items	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	9	10	11	12	13	14	15	16	17	18
Andhra Pradesh	N	N	N	Y	N	Y	N	Y	Y	N	N	Y	N	Y	N	Y	N	Y
Gujarat	N	N	N	Y	Y	Y	Y	Y	Y	N	N	Y	Y	Y	Y	Y	Y	Y
Haryana	N	N	N	Y	Y	Y	Y	N	N	Y	N	Y	N	Y	Y	Y	Y	Y
Himachal Pradesh	N	N	N	Y	Y	Y	Y	N	N	N	N	Y	N	Y	Y	N	Y	N
Karnataka	Y	Y	N	Y	Y	Y	N	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Kerala	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Madhya Pradesh	Y	Y	Y	Y	Y	Y	Y	Y	Y	N	Y	Y	N	Y	Y	Y	Y	Y
Maharashtra	N	N	N	Y	Y	Y	Y	N	N	N	Y	N	Y	Y	Y	Y	Y	Y
Rajasthan	N	N	N	Y	Y	Y	Y	N	N	N	Y	N	Y	Y	Y	Y	Y	Y
Tamil Nadu	Y	Y	Y	Y	Y	Y	Y	Y	N	N	N	N	N	Y	Y	Y	Y	Y
Uttar Pradesh	Y	N	N	N	Y	Y	N	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
West Bengal	Y	Y	N	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Delhi	N	N	Y	N	N	Y	N	N	N	N	N	Y	N	Y	Y	Y	Y	Y

This Annexure gives the status of 18 functions as assigned to the municipalities in the 12 schedule of the Constitution defined in Page 12. Y here implies for Yes: function assigned to municipalities by the state government, & N here implies for No: function not assigned to municipalities by the state government. Thus a state like Kerala has all the Y implying that all the 18 fucntions have been assigned to the local bodies by the state government.

Source: National commission to review the working of the constitution: Decentralization and Municipalities.

A-IV: Selected Indicators of Fiscal positions of States

	GFD/GFD Exp.		Revenue Deficit/GFD		Capital Outlay/GFD		Int. Pay./Rev. Exp.		State's Tax Revenue/Rev. Exp.		States Non-Tax Rev./Rev. Exp.		Gross Transfers/Agg. Dis. E		Debt Servicing/ Gross Transfers	
States	1990-95	2001-02	1990-95	2001-02	1990-95	2001-02	1990-95	2001-02	1990-95	2001-02	1990-95	2001-02	1990-95	2001-02	1990-95	2001-02
					Avg	(B.E.)	Avg	(B.E.)	Avg	(B.E.)	Avg	(B.E.)	Avg	(B.E.)	Avg	(B.E.)
Andhra Pradesh	17.6	28.4	11.5	43.7	58.5	42.9	11.8	19.3	47.0	44.7	15.5	10.7	40.4	36.3	19.9	24.7
Assam	12.0	27.6	442.1	66.4	-218.5	25.2	13.9	15.5	21.5	19.3	13.5	6.3	65.0	49.4	26.1	23.1
Bihar	20.7	22.7	51.3	39.9	31.2	43.4	18.1	21.2	23.5	19.7	12.3	3.5	58.5	62.8	20.6	23.0
Gujarat	20.2	32.8	11.3	83.6	70.3	35.4	14.5	14.2	57.9	36.9	18.0	14.3	26.1	29.3	42.1	26.2
Haryana	13.4	22.6	14.1	37.3	48.1	55.4	12.3	19.9	50.0	58.5	32.9	18.1	21.7	15.1	34.6	55.9
Himachal Pradesh	21.7	39.4	6.9	71.8	85.6	28.8	14.4	24.6	18.9	16.5	7.4	4.1	60.2	42.6	14.4	21.4
Jammu and Kashmir	14.0	10.7	468.4	-68.7	-363.7	169.0	20.7	16.5	11.7	14.0	6.8	5.2	75.9	72.8	18.7	14.6
Karnataka	16.7	22.8	11.2	51.2	85.9	42.5	11.1	14.3	58.6	54.4	12.7	6.5	30.9	31.2	24.3	24.9
Kerala	20.7	23.4	44.0	73.1	36.9	21.0	14.8	18.6	52.2	56.9	7.5	6.1	37.4	22.1	26.6	22.2
Madhya Pradesh	14.7	23.1	10.1	59.9	77.5	36.1	11.9	16.7	37.3	35.8	19.9	9.7	42.0	42.4	20.1	21.6
Maharashtra	16.0	16.2	8.8	37.4	75.7	57.1	11.3	17.5	59.4	67.0	18.6	13.0	26.3	14.8	34.3	82.4
Orissa	23.2	27.6	22.4	54.2	71.9	30.8	18.4	29.3	25.7	27.6	11.9	7.9	56.2	51.4	21.5	30.9
Punjab	30.0	28.0	45.9	60.4	27.3	33.0	16.0	20.2	47.1	42.1	20.5	25.3	37.7	17.1	38.9	71.9
Rajasthan	18.2	28.5	3.4	56.3	83.4	36.3	14.9	24.5	35.0	38.4	20.2	10.3	43.4	32.5	22.2	40.0
Tamil Nadu	16.5	23.3	72.3	56.9	29.1	37.1	9.0	13.5	52.5	58.7	8.6	5.6	33.8	22.3	20.2	34.3
Tripura	12.1	26.5	-56.2	23.0	155.6	75.6	9.8	10.9	5.7	6.7	3.7	4.6	83.1	67.5	8.1	5.6
Uttar Pradesh	24.1	23.6	34.2	39.5	30.3	47.5	16.4	27.2	32.0	38.2	11.0	5.2	50.8	45.5	17.7	31.6
West Bengal	21.7	39.3	52.0	59.9	27.8	25.7	15.8	28.7	45.0	34.5	4.4	4.3	48.6	32.9	27.8	43.0
All India	**19**	**25.1**	**24.6**	**49.8**	**55.3**	**42.2**	**13.6**	**19.5**	**42.2**	**43**	**15.8**	**9.9**	**40.1**	**34.2**	**24**	**31.1**

A-V: Composition of State Government Debt State Wise (Amount Outstanding as on March 31, 2000, Rs. In Lakhs)

State	Central Loans	Market Loans & Bonds	Loans From Banks, etc	W & M Adv. From RBI	Provident Funds, Etc.	Reserve Funds & Deposits	Total Debt	Total Debt*
Andhra Pradesh	1605641	703706	172113	21984	285750	458740	3247934	2767210
Arunachal Pradesh	40919	5792	21968	0	19347	1614	89640	88026
Assam	459044	188848	22076	8458	108183	68852	855461	778151
Bihar	1601754	618450	16865	0	790275	178241	3205585	3027344
Goa	124174	25315	11877	0	33920	18700	213986	195286
Gujarat	1641025	300705	85319	0	240379	612944	2880372	2267428
Haryana	613022	146188	56112	1841	328791	73839	1219793	1144113
Himachal Pradesh	314157	61348	52967	85263	179280	76814	769829	607752
Jammu & Kashmir	362996	66519	32743	110823	132907	3035	709023	595165
Karnataka	1075114	364054	83212	0	364414	319805	2206599	1886794
Kerala	655614	392922	122078	12381	658380	177793	2019168	1828994
Madhya Pradesh	1098965	401686	77439	19254	642334	259100	2498778	2220424
Maharashtra	2733340	444185	115340	0	456070	1406692	5155627	3748935
Manipur	40579	22444	15746	41093	28016	16037	163915	106785
Meghalaya	35859	30876	10761	0	14798	20811	113105	92294
Mizoram	35460	12416	16390	8298	26923	10176	109663	91189
Nagaland	35241	46402	18503	16883	37987	583	155599	138133
Orissa	822411	418923	54866	30433	472131	150390	1949154	1768331
Punjab	1448800	204924	168224	100591	457426	80120	2460085	2279374
Rajasthan	1222210	501901	177646	88499	651689	313927	2955872	2553446
Sikkim	22129	18581	6946	0	15460	949	64065	63116
Tamil Nadu	1237732	477735	118896	0	426709	371773	2632845	2261072
Tripura	65717	33043	17953	0	54061	5106	175880	170774
Uttar Pradesh	3522543	1187165	120521	57063	863594	1442287	7193173	5693823
West Bengal	2855202	497871	132836	0	297171	539456	4322536	3783080
Total	23669648	7171999	1729397	602864	7585995	6607784	47367687	40157039

Note: * Excluding W & M Advance From RBI(Total debt minus reserve funds and deposits minus W & M advance from RBI).

A-VI: Composition of Municipal Revenues (%) for the year 1997/98

State	Own Resources	Tax Receipts	Non-Tax Receipts	Shared Revenue	Grants
Andhra Pradesh	51.17	36.37	14.80	33.56	13.03
Assam	59.08	23.24	35.84	0.00	23.37
Bihar	52.77	36.86	15.91	2.99	40.31
Gujarat	87.45	79.74	7.71	0.18	11.10
Haryana	80.51	42.80	37.71	13.44	3.95
Karnataka	43.18	18.12	25.06	5.67	43.62
Kerala	70.32	44.69	25.63	20.65	4.74
Madhya Pradesh	47.34	22.61	24.73	11.88	39.90
Maharashtra	95.40	65.44	29.96	0.53	3.84
Orissa	67.12	46.92	20.20	0.93	28.59
Punjab	89.02	69.60	19.42	6.14	3.81
Rajasthan	89.80	62.90	26.90	0.17	9.30
Tamil Nadu	44.34	21.21	23.13	21.93	29.49
Uttar Pradesh	19.44	13.50	5.95	0.36	79.14
West Bengal	59.33	36.51	22.82	5.05	30.53
Himachal Pradesh	25.86	15.27	10.59	0.00	72.04
Manipur	98.29	90.42	7.87	0.20	0.15
Meghalaya	46.27	37.66	8.62	0.00	40.09
Tripura	42.92	27.31	15.61	0.00	33.74
Total	82.78	56.40	26.38	4.05	11.99

Source: NIPFP(2000).

A-VII: Per-capita Expenditure, revenue receipts and the revenue gap: State Wise

States	Per-capita Expenditure		Per-capita revenue receipts		Revenue gap		
	1992/93	1997/98	1992/93	1997/98	1992/93	1997/98	AGR
Andhra Pradesh	146.96	318.38	246.52	410.47	44.06	108.34	19.72
Assam	49.75	81.77	46.10	79.78	19.34	34.63	12.36
Bihar	80.73	104.29	42.70	113.11	53.19	44.61	-3.46
Gujarat	328.12	438.21	381.99	707.45	-11.59	-180.49	
Haryana	364.96	598.22	378.90	531.21	18.80	170.55	55.42
Karnataka	203.90	321.05	199.69	381.61	109.62	156.28	7.35
Kerala	152.50	228.38	154.40	275.46	31.56	34.67	1.90
Madhya Pradesh	169.62	322.74	179.89	300.88	85.44	180.31	16.11
Maharashtra	889.98	1750.50	960.51	1917.20	-14.17	-78.53	
Orissa	205.22	248.29	193.08	231.51	78.90	92.90	3.32
Punjab	269.09	542.81	258.63	499.03	50.74	98.58	14.21
Rajasthan	248.77	497.24	273.96	479.35	10.64	66.78	44.39
Tamilnadu	172.84	331.46	215.86	424.37	42.72	143.28	27.38
Uttar Pradesh	169.22	223.23	169.33	225.02	132.42	179.47	6.27
West Bengal	440.88	522.83	396.83	568.40	258.45	185.61	-6.41

Source: NIPFP(2000). AGR is the annual growth rate in percentage.

A-VII: State-Wise Distribution of Investments of Banks in State Government Securities and Shares / Debentures / Bonds of State Associated Bodies: March 31, 2000 (Amount in Rs. Crore)

State/Union Territory	State Govt. Securities	Regional Rural Banks	Co-operative Institutions	State Electricity Boards	ULBs	State Financial Corporations	Housing Boards	State Industrial development Corporations	Road Transport Corporations	Other Govt. and Quasi Govt. Bodies	Total
1. Andhra Pradesh	4983	24	43	345	0	352	13	19	49	178	**6006**
2. Arunachal Pradesh	34	0	0	0	0	0	0	0	0	0	**34**
3. Assam	1108	1	0	400	0	40	0	0	0	0	**1549**
4. Bihar	3515	62	0	430	0	130	7	0	5	0	**4149**
5. Goa	175	0	0	0	0	0	0	0	0	4	**179**
6. Gujarat	1583	29	37	393	166	276	8	109	77	182	**2859**
7. Haryana	1018	16	33	245	0	163	3	0	0	105	**1583**
8. Himachal Pradesh	426	4	6	143	0	64	0	0	40	144	**826**
9. Jammu & Kashmir	451	4	1	88	0	58	0	0	0	30	**632**
10. Karnataka	2125	33	65	85	17	432	3	25	0	257	**3043**
11. Kerala	2596	3	43	310	3	183	22	20	11	216	**3406**
12. Madhya Pradesh	2749	65	18	1001	0	196	26	31	0	3	**4089**
13. Maharashtra	2171	22	42	891	247	213	5	143	160	1429	**5323**
14. Manipur	126	0	0	0	0	0	0	0	0	0	**126**
15. Meghalaya	168	0	0	72	0	0	0	0	0	0	**240**
16. Mizoram	67	0	0	0	0	0	0	0	0	0	**67**
17. Nagaland	230	0	0	0	0	0	0	0	0	0	**230**
18. Orissa	2793	37	0	75	0	285	0	41	0	123	**3354**
19. Punjab	1416	9	20	515	4	163	0	64	12	93	**2297**
20. Rajasthan	3640	52	8	371	0	190	20	57	25	71	**4435**
21. Sikkim	86	0	0	0	0	0	0	0	0	5	**91**
22. Tamil Nadu	2738	5	14	589	15	180	39	154	0	150	**3885**
23. Tripura	172	0	0	0	0	0	0	0	0	0	**172**
24. Uttar Pradesh	8071	120	2	474	0	445	2	37	0	108	**9259**
25.West Bengal	3271	14	3	452	118	148	10	98	0	562	**4677**
28. Delhi	0	0	0	0	0	9	47	0	0	73	**129**
Total	**45713**	**501**	**337**	**6879**	**571**	**3527**	**205**	**798**	**380**	**3732**	**62642**

Notes: Figures are inclusive of non-guaranteed bonds and unsecured debentures. Urban Local Bodies include Municipalities, Municipal Corporations & Port Trusts.
Source : Reserve Bank of India Bulletin, April 2001.