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Financing of Subnational Public Investment in India

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As a large federal country, India has a complex system of fund devolution to subnational entities such as states and cities. Since its independence, the country has followed a central planning approach to the allocation of public investment resources at different levels. India's constitution governs the allocation of responsibilities between the central and state governments. Recent constitutional amendments in the 1990s have also served to delineate better the responsibilities of local governments in both urban and rural areas. This complex system of raising and allocating resources between different levels has increasingly come under stress in recent years. Meanwhile, with higher growth in the gross national product and resulting increases in household incomes, the demand for public services has also been rising accordingly. The experience of the last few years suggests that unless appropriate changes are made to the existing system of public investment in India, particularly at the state and local levels, the country will find it difficult to make appropriate investments in both physical and social infrastructure in the future.

This chapter documents briefly the structure of the existing system of fund devolution from the central to state governments and from state governments to local governments. Providing this description is important, because understanding the complexity of the system before making any suggestions for changes in it is essential. The increasing fiscal stress faced by state governments is documented in some detail in this chapter to quantify the serious difficulties they now face.

Similarly, at the city level the current structure of fund devolution is clearly inadequate for meeting the rising infrastructure investment demands created by ever-increasing urbanization. The existing system in which local governments finance investments is described, and its deficiencies are documented. This chapter also makes a case for further decentralization of responsibilities to the local level, which would include corresponding enhancement of incentives and powers to raise resources for investment at the local level.

The existing fiscal system in India was designed to centralize to a great degree financial decisionmaking in the country. Apart from the centralizing imperatives generated in the planning process, a clear intention to enforce appropriate fiscal responsibility through such centralized control also existed. The results have clearly shown that this administrative mechanism for enforcing fiscal responsibility has not been successful. Consequently, the resources available to states and cities for investment in public goods have been decreasing in recent years.

This chapter proposes a new approach to the financing of public investments by advocating greater decentralization of responsibilities. A possible root cause of rising financial irresponsibility is the absence of a direct connection between the investing entities and the ultimate sources of funds: the lending institutions. The central government essentially acts as a giant financial intermediary for raising the funds that other lower-level entities will spend. This system induces irresponsibility at the lower levels because fund allocation is not related to performance. Greater fiscal responsibility may be induced when local and state governments and their agencies are subject to credit ratings and need to generate resources directly from the market, because their ability to raise resources then depends more directly on their own performance. The market, rather than administrative coaxing from the center, is more likely to force them to perform responsibly.

State Government Financing of Investment

The Republic of India is a federation of states and union territories where the constitution governs the revenue powers and expenditure functions of the states and the central government. Until recently, levels of government below the state level, that is, local governments in both urban and rural areas, were not mentioned in the constitution. Thus, state governments created local governments according to specific legislative enactments in each state and at the local government level. Recently, the constitution was amended (73rd and 74th amendments) to explicitly recommend the existence of local governments in both rural and urban areas. Only as a result of these amendments have the functions of local government now become better recognized in the constitution. The constitution has laid down the specific taxing powers and expenditure responsibilities for each level of government (Bagchi, Bajaj, and Byrd 1992; Wallich 1982).

Since independence, almost all infrastructure investment has been made in the public sector. As will be detailed later, the central and state governments have different responsibilities for different sectors within infrastructure. Both central and state governments have devised a variety of means to accomplish these infrastructure investments. At the central level, services such as railways and telecommunications are provided within a government department framework. In the delivery of other services, such as power, the government set up nondepartmental public sector enterprises. In other services, such as ports, yet another form of delivery was designed to go through entities known as port trusts. In the case of departmental activities, the accounts are not separated from government accounts. In addition, no corporate equity structure exists, nor does separate borrowing. Nondepartmental public sector enterprises are usually structured as companies with equity ownership by the government and they maintain separate debt accounts. The accounts of these enterprises are kept in the same way that the accounts of other commercial companies are. They receive equity injections from the government budget and can take loans both from the government and from the open market. Finally, the port trusts are semiautonomous agencies of the government that can receive subventions from the government budget and can take loans from financial institutions or the government. A parallel structure exists at the state government level, where some activities, such as the building and maintenance of roads and irrigation, are carried out within a departmental framework. Other services are delivered by special public sector enterprises. State governments have also created various semiautonomous authorities such as urban development authorities, state electricity boards, and similar bodies that are responsible for other infrastructure services.

In the planning system used in India since 1951, almost all the investment programs of government departments, public sector enterprises, and other public authorities are covered within the five-year plan framework. Budgetary allocations are made for direct investment as budgetary capital expenditures for government departments, as equity and loan injections to public sector enterprises, and as government budgetary subventions and loans to other authorities. All such expenditures are captured in Indian budget documents.

State investment financing is therefore done both through subventions as grants and loans from the central government and through other borrowing methods. Only in the last few years have states moved toward private investment in infrastructure services and greater market exposure of public sector entities. Because of the existence of the documentary system described previously, tracing the financing of state government investments is possible.

For a variety of reasons that relate to the efficiency and ease of tax collection, the constitution assigns a number of important tax resources to the central government and a limited amount of tax resources to the states. In contrast, the states have more expenditure functions than they can finance through their own revenue resources. The relationship between state governments and local authorities also exhibits a similar imbalance between access to revenue resources and expenditure responsibilities. This vertical imbalance between the central government and the states on the one hand and between the states and local governments on the other has given rise to a complex fiscal system in India.

To address these imbalances, the constitution provides for the setting up of a finance commission every five years to administer the system of tax devolution between the center and the states. Successive finance commissions have set the parameters for the system of tax sharing and grants in aid to the states. In addition to the statutory awards the quinquennial finance commissions make, the constitution also empowered the central government to provide additional grants in aid to the states for any public purpose. Under this provision the central government created the Planning Commission through a resolution of Parliament in 1950 to set up a procedure for channeling plan expenditure. Thus two main bodies exist to channel resources from the center to the states:

- The Finance Commission is a statutory body appointed by the central government every five years that essentially makes recommendations for the devolution of resources for nonplan revenue expenditure.
- The Planning Commission is a nonstatutory body that is responsible for making five-year plans that determine the pattern of assistance for state plan expenditures. These may include both revenue and capital expenditures.

Before discussing the details of the patterns of investment financing of subnational governments, understanding the classification of expenditures in India may be useful. Three types of classification are used in Indian public finance accounts. First, all expenditures are divided between revenue expenditure and capital expenditure. Within these categories, expenditure is further divided between nondevelopment expenditure and development expenditure. Finally, all expenditure is divided between plan expenditure and nonplan expenditure. These three classification systems are used for different purposes and overlap in different ways. The revenue and capital accounts are dealt with as might be conventionally expected. Development expenditure covers expenditure on social services such as education, health, water supply and sanitation, housing and urban development, and other welfare services. In addition, development expenditure includes economic services covering expenditure on agriculture and rural development; irrigation; energy, industry, and minerals; transport and communication; science, technology, and environment; area development; and general economic services. Nondevelopment expenditure covers all expenditure on state organizations, fiscal services, interest payments, administrative services, pensions, and the like. Plan expenditures are essentially those generated by the five-year plans. Whereas most plan schemes involve capital expenditure for investment purposes, they also include revenue expenditures involving items such as the wages and salaries required for the administration of these schemes during the five-year plan period. Once the schemes are completed, such recurrent expenditure subsequently becomes nonplan revenue expenditure. Plan expenditure on nondevelopment activities includes, for example, investments in buildings for activities such as administration and police services.

The Finance Commission helps states allocate funds for their nonplan revenue accounts. These accounts include both development and nondevelopment expenditure. The Planning Commission assists states with all expenditures required for designated plan outlay whether capital or recurrent or development or nondevelopment in nature.

Assignment of Tax and Responsibilities

The constitution uses three classifications to assign expenditure responsibilities between central and state governments. These are known as the union list, the state list, and the concurrent list. Under the union list, the central government is solely responsible for 84 categories of activities such as defense, foreign affairs, international economic relations, atomic energy, aviation, shipping, post and telegraph, communications, national highways, banking and insurance, oil, petroleum and petroleum products, and other activities. The constitution assigns states exclusive responsibility for areas such as public order, police, administration of justice, public health, education, roads and bridges, agriculture, water supply and irrigation, industries other than those assigned to central jurisdiction, trade and commerce within the states, and so on. The concurrent list includes 47 items covering certain areas of criminal law and criminal procedures, economic and social planning, forests, electricity, education, labor, and so on.

The constitution also specifies the respective taxation powers of central and state governments. Among the 13 types of taxes vested with the central government, the most important are taxes on income excluding income from agriculture, corporate income tax, custom duties, and excise duties on most goods. State governments control 19 taxes including direct taxes on land and agriculture income, excise duties on alcohol and other specified goods, taxes on goods, mineral rights, vehicles, the sale of electricity, luxury taxes, and others.

Note that the main taxes, that is, personal and corporate income taxes, and excise taxes, such as customs duties and indirect taxes at the production level, are assigned to the central government. Consequently, state taxation powers are inadequate in relation to their expenditure responsibilities.

Functions of the Finance and Planning Commissions

As stated earlier, the Finance Commission is appointed every five years, and it makes recommendations to the central government on the pattern of tax devolution and grants in aid to state governments. While these recommendations are not formally binding on the central government, the practice has so far been largely accepted. Although the constitution does not limit Finance Commission awards to state needs on the revenue account only, in practice, the Planning Commission has so far largely looked after the capital expenditure of the states. In fact, until the end of the second five-year plan, a good deal of overlap existed between the Finance and Planning commissions. Since then, the terms of reference of the Finance Commission have been confined to the nonplan requirements of the states.

The Finance Commission attempts to estimate the total resources available to the center and to each state government and also the expenditure needs of the two levels of government. It then recommends a pattern of tax sharing, taking into account the resource positions of the center and the states and their respective expenditure patterns. The Finance Commission determines the total share of central taxes to be devolved to the states and then distributes the award among the states. The horizontal award between the states takes into account factors such as states' populations, per capita income, and state-level tax efforts. Until now, customs duties and corporate income tax were not to be shared with the states. As a result, the finance commissions have been restricted mainly to deciding on the proportion of excise duties and personal income tax to share with the states. Only now has the 10th Finance Commission recommended a move to include all central government taxes for the purpose of devolving resources to the states. With the passage of the 74th Amendment to the constitution, the 10th and 11th Finance Commissions have also been asked to account for state devolutions to local bodies.

Until 1969, central assistance to the states was essentially granted on a project-by-project basis, giving the center considerable control over state plans and their implementation. Starting with the 4th plan, plan assistance to the states has been governed on the basis of an accepted formula, which provides for unconditional bloc assistance from the center for state plan expenditures. This is known as the Gadgil formula, named after the then deputy chairman of the Planning Commission. According to this formula, bloc assistance for such plans has been distributed on the following basis:

- 60 percent on the basis of state populations
- 10 percent for states whose per capita income is less than the average of all of India
- 10 percent for states' tax efforts in relation to per capita income
- 10 percent in proportion to the outlook for major irrigation and power projects in the states
- 10 percent in discretionary assistance for special problems.

This overall formula has been amended from time to time at the margin. The assistance given to the states under this arrangement is distributed on a 70 percent loan and 30 percent grant basis.

Certain states, mostly the hilly region states in the north and northeast, have been designated special category states. These receive a lump sum payment fixed by the Planning Commission that is not subject to the Gadgil formula. These states receive these funds 90 percent as grants and only 10 percent as loans.

In addition to the resources provided to the states under the Gadgil formula, the Planning commission also provides resources under various centrally sponsored plan schemes that usually involve matching contributions from state governments. Additional resources are also available to states from foreign sources. Earlier, only 70 percent of these additional resources were used for the specified foreign-aided state projects and the remaining 30 percent was redistributed to all other states under the Gadgil formula. The rationale for this system was that all foreign assistance was taken into account as part of central government resources before working out the states' shares according to the Gadgil formula. This system has been changed so that states now receive 100 percent of the additional resources generated by foreign-aid-funded projects in their states.

Resources for State Plans

The planning process has governed the system for investment activities in India. The Planning Commission undertakes extensive consultation before arriving at the broad contours of a five-year plan. The Planning Commission carries out a parallel technical process that determines which projects and policies to implement and lays out the resulting investment program for the plan. These consultation processes involve discussions with all the central government ministries on the one hand and state governments on the other. For each area of investment, a parallel process of technical discussion takes place. The results of this massive exercise are sectoral investment programs for the central and state governments on the one hand and statewide investment programs on the other. For both the central government and the state governments, the Planning Commission attempts to devise a financing program for the whole plan investment program.

The Indian financial sector has largely been in the central government's hands since the late 1960s. As a result, the financing program for plan investments has included the parallel exercise of allocating a large proportion of financial savings in the country. A variety of sources financing the central government's fiscal deficit includes the following:

- Balance from current revenues
- Contributions of public sector enterprises
- Bonds issued by public sector enterprises
- Market loans
- Small savings (retail savings made in assured return schemes administered by the post office)
- Provident funds
- Capital receipts from previous lending operations.

Market loans include funds from the Life Insurance Corporation of India and SLR bonds mandated for compulsory investments by commercial banks.

Deficit financing also financed a portion of the gross fiscal deficit until recently. Mandating lower than market rates for the SLR bond contributions that commercial banks made once kept the cost of financing of government borrowing low. In recent years, progress has been made in removing such distortions so that most government borrowing is now at market-related rates.

The five-year plan program is not a budget program. It can essentially be described as an indicative plan investment program. The applicable budgetary program is formulated on an annual basis and is coordinated with the nonplan budget. Policymakers naturally make an attempt to guide the annual budgetary allocations so that they remain consistent with the five-year plan program. As might be expected, at the end of any five-year plan, substantial differences are observed between the original five-year plan and the results of the annual allocation exercise.

The following resources are available for financing state plans:

- Balance of current revenues
- Contribution of state public enterprises
- Domestic borrowings by the states, for example, market borrowing including that by public sector enterprises, proceeds from small savings and provident funds, and term loans from financial institutions
- Central assistance for state plans.

Thus, apart from the balance of current revenues and the contributions of public sector enterprises, different kinds of loans finance a substantial portion of state plans because the majority of central assistance comes as loans from the central government. In fact, the central government has consistently accounted for about 70 percent of total outstanding state government debt over the last 20 years or more.

State governments are allowed to borrow from the central government under Article 293 of the Constitution. This article empowers the central government to provide loan assistance to the states subject to the following guidelines:

- State governments can borrow internally within India using the consolidated funds of the state as security and within the limits fixed by the state legislature.
- The government of India can make loans to any state and can provide guarantees with respect to loans raised by any state, within the limits or guidelines devised by Parliament.
- A state may not raise any loan without the consent of the government of India if any repayments are still outstanding on loans or guarantees that the government of India has previously given.

The planning system, which has resulted in the central government lending substantial funds to states for financing state plans, has meant that states are not likely to be able to fully repay their debt to the central government. Consequently, the central government has effectively controlled the ability of states to borrow. In the current system, this situation is likely to continue for the foreseeable future. In this system, the central government allocates the amounts that different state governments may borrow from the market annually. These market-borrowing limits are set by a working committee composed of the Planning Commission, the Ministry of Finance, and the Reserve Bank of India. The Reserve Bank of India functions as banker to the states and conducts all public borrowing on their behalf. In this system, all state governments receive the same rate of interest regardless of the credit quality of any state. Some attempts are now being made to inject some flexibility into this system by allowing state governments to raise a portion of their borrowing directly (Reddy 1998).

Deteriorating Situation of State Finances

State finances have significantly deteriorated since the early 1980s. This has resulted in slowed growth in state plan expenditures relative to the center's expenditure. This is illustrated in table 13.1, which shows the share of states in total plan outlays. From the mid-1950s to the late 1970s, the share of states stayed relatively stable at around half of total expenditures. This has since deteriorated to about 40 percent or less in the late 1990s. The consequence is that the ability of state governments to invest in both social and physical infrastructure has declined considerably, because unlike the central government, subnational governments, such as states, cannot indulge in deficit financing. As a result, the states suffered reduced public investment in the 1980s, while the central government was able to accelerate central plan expenditures that were financed by rising fiscal deficits, including deficit financing, right through the late 1980s. This process culminated in the fiscal crisis of 1991.

Table 13.1. Share of States in Plan Outlays, 1951–2002
(percent)

Plan	*Center*	*States*
First five-year plan (1951–56)	36	64
Second five-year plan (1956–61)	54	46
Third five-year plan (1961–66)	49	51
Annual five-year plan (1966–69)	51	49
Fourth five-year plan (1969–74)	50	50
Fifth five-year plan (1974–79)	48	52
Annual five-year plan (1979–80)	46	54
Sixth five-year plan (1980–85)	53	47
Seventh five-year plan (1985–90)	59	41
Eighth five-year plan (1992–97)[a]	62	38
Ninth five-year plan (1997–2002)[b]	58	42

a. Estimated.
b. Projected.
Source: Bagchi and others (1992b); Planning Commission (1998).

The existing planning system has essentially resulted in the central government acting as a giant financial intermediary, borrowing from the public in different ways to finance plan expenditures at both the central and state levels. In this system no connection exists between the viability of projects and their financing costs. Since the introduction of the Gadgil formula for bloc plan assistance to the states, which results in loans being given to states up to 70 percent of total transferred resources regardless of the end use of expenditures, the nexus between resources for financing and end uses has been completely broken. Different finance commissions have remarked on the untenability of this system, which does not distinguish between financing of public goods and private goods by state governments. The consequence has been that returns from these investments have been consistently low. In principle, investments in public goods should result in higher tax revenues, and investment in private goods should result in higher tax revenues through the imposition of user charges for public services. The majority of public expenditures at the state level have gone into financing power generation, transmission, and distribution through state electricity boards; state road transport corporations; urban development authorities for investing in urban infrastructure services; irrigation; housing; and the like. Public sector enterprises of different varieties carry out most of these activities (except irrigation). If these enterprises were able to impose appropriate economic pricing of their services they could have provided returns to state governments as dividends and could have been able to service their debt fully. In reality, these enterprises have not been able to provide appropriate dividends to state governments' budgets, nor have they been able to meet their own debt service payments. In addition, they have not been able to generate net positive internal resources to invest in expanding their services.

Table 13.2 illustrates this situation with the financing pattern of state plans for the sixth, seventh, and eighth five-year plans. The contribution of the balance of current revenue to the financing of state plans, which was as high as 40 percent of the total in the sixth five-year plan, declined to less than zero in the eighth five-year plan. Similarly, the contribution of public sector enterprises has been consistently negative throughout the whole period. Consequently, the share of borrowing by state governments has been increasing consistently from about 35 percent of total resources for the state plan during the sixth plan to more than 50 percent in the eighth plan. Correspondingly, the share of central assistance also increased from 37 percent in the sixth plan to more than 50 percent in the eighth plan. Thus, in the current situation nearly all plan expenditure is now being financed by borrowing of one kind or another. Within the pattern of borrowing, the share of market borrowing has also increased consistently.

Table 13.2. Financing Pattern of State Plans

Sources of finances	Sixth plan, 1980–85 (1979–80 prices) R$ crore	Percentage of total	Seventh Plan, 1985–90 (1984–85 prices) R$ crore	Percentage of total	Eighth plan, 1992–97 (1991–92 prices) R$ crore	Percentage of total
1. Balance of current revenue	14,826	41	17,368	23	–2,009	–1.4
2. Contribution of public sector enterprises	–4,620	–13	–3,757	–5	–2,723	–1.9
3. Total borrowing	12,679	35	27,644	37	75,750	52
a) Net borrowing	3406	9	9242	12		
b) Small savings	5901	16	19070	26		—
c) Term loans from foreign investors	1,887	5	4,445	6		
d) Miscellaneous capital receipts	–2,012	–6	–5,113	–7		
e) Budget deficit	3,497	10	–			
Total state resources	22,885	63	41,255	55	70,335	48
Central assistance	13,690	37	33,264	45	75,750	52
Total resources	36,575	100	74,519	100	146,085	100

— Not available.
a. Actuals.
b. Estimated.
Source: Bagchi and Sen (1992); Planning Commission (1998).

Table 13.3 shows the difference between what was projected and what actually happened in the financing of state plans in the sixth, seventh, and eighth five-year plans. First, a consistent shortfall has occurred between what was projected and what was actually accomplished in terms of plan expenditures and resources. The balance from current revenues during the sixth and seventh five-year plan turned out to be about 60 percent of what was expected initially. In the eighth five-year plan, even though the contribution from the balance of current revenues had been scaled down considerably, plan resources actually went to marginally finance current revenue expenditure rather than to finance plans. Similarly, the contributions of public sector enterprises have been consistently negative and higher than had been projected in each case. Whereas borrowing compensated for the shortfalls in the sixth and seventh five-year plans, this could not be done in the eighth five-year plan. Generally, central assistance has been greater than the projected levels in each of the plans. This record suggests that the borrowing abilities of state governments have declined in recent years and their difficulties in financing investment expenditures will now increase. This is a cumulative result of low returns to proposed investments, which have made states' credit quality worse and worse. The fact that interest payments have been rising consistently since the early 1980s from about 10 percent of revenue expenditures to more than 16 percent illustrates this declining credit-worthiness. The lack of return from state enterprises has also reduced the buoyancy of nontax revenues.

That the overall worsening fiscal situation of state governments is relevant to the financing of investment expenditures is illustrated in table 13.4. Capital outlays as a proportion of gross fiscal deficits fell from about 62 percent in the late 1980s to less than 50 percent in 1998. In contrast, revenue deficit has risen as a proportion of the gross fiscal deficit from about 8 percent in the late 1980s to more than 35 percent in 1998. Consequently, borrowing by state governments is now increasingly devoted to financing revenue expenditures rather than capital expenditures. This can only lead to a further deterioration of the fiscal situation in coming years. The resources available for investment will decrease continually in the foreseeable future unless a change in the system takes place.

Table 13.3. Shortfalls in Projected Financing of State Plans, 1980–97

Sources of finances	Sixth plan (1980–85)[a] (1979–80 Prices)			Seventh plan (1985–90)[a] (1984–85 prices)			Eighth plan (1992–97)[b] (1991–92 prices)		
	Projected (R$ crore)	Actual (R$ crore)	Actual/ projected (percent)	Projected (R$ crore)	Actual (R$ crore)	Actual/ projected (percent)	Projected (R$ crore)	Actual (R$ crore)	Actual/ projected (percent)
Balance from current revenue	22,312	14,826	66	28,974	17,368	60	12,985	–2,009	
Contribution of public sector enterprises	–516	–4,620		–1,969	–3,757		4,000	–2,723	
Borrowing	11,454	12,679	111	23,956	27,644	115	84,500	75,060	89
Total state resources	33,250	22,885	69	50,961	41,255	81	179,985	146,085	81
Central assistance	15,350	13,690	89	29,737	33,264	112	78,500	75,750	96
Total resources for state plans	48,600	36,575	75	80,698	74,519	92	179,985	146,085	81

a. Actuals.
b. Estimated.
Source: Bagchi and Sen (1992); Planning Commission (1998).

Table 13.4. Selected Fiscal Ratios for State Governments, 1985–98
(percent)

Year	*Capital outlay gross fiscal deficit*	*Interest payments revenue expenditure*	*Revenue deficit gross fiscal deficit*
1985–90	62.4	10.8	7.7
1990–95	55.3	13.6	24.6
1996–98	47.5	15.8	35.8

Source: Reserve Bank of India (1998).

Key Issues

The current system for the financing of investments by subnational governments clearly cannot be sustained. The problem has essentially arisen as a result of the lack of a nexus between borrowing and the end use of expenditures in capital investment. This is ironic because the existing system was designed to preserve the fiscal health of the state governments through appropriate central government control. Because state governments are not allowed to run deficit-financing activities, they should therefore be constrained from fiscal excess. However, the opposite has occurred.

In view of the limits placed on state governments' borrowings and because of recent demands for expenditures, state governments have increasingly resorted to public borrowing through public sector enterprises. The issue of state government guarantees for their pubic sector entities has increased, which enables them to borrow directly from the market. However, the capital market institutions are now beginning to question the quality of these guarantees. Thus, a movement now exists to collate information on the volume of existing guarantees so that the existing liabilities of state governments can be made more transparent.

The problem of state financing of investments suggests that action must be taken on both ends of the system. Spending on investments to provide private goods must be related more directly to the generation of returns through the levy of appropriate user charges. The current problem is based on the lack of nexus between borrowing ability and returns to the activity; because of this the levy of user charges is essentially done politically. However, once the ability to raise resources depends on the financial health of state entities, this will effect political thinking on the appropriate levy of user charges.

To raise resources to invest in the provision of public goods, subjecting state governments to credit ratings may be desirable so that their ability to borrow depends on their fiscal health. A system that provides appropriate signals to policymakers might be more successful in ensuring the fiscal health of state governments in the future. Clearly, the existing system has failed in this objective.

Financing of Investment by Local Governments

The 1991 census showed that 53 cities in India had populations of more than half a million each, and 300 cities had populations of more than 100,000 each. Even with modest rates of urban population growth, these numbers will continue to increase in the foreseeable future. Therefore, investments in urban infrastructure, such as drainage, sewerage, water supply, roads, electricity, and transportation, are increasingly needed. The implications for both financial and physical resources, though not well quantified, are likely to be serious. The essential problem is that such infrastructure yields benefits in the long term, but investments have to be made now (Datta 1992; Edadan and Mathur 1998).

So far, local governments have not had the financial or human resources to make adequate urban infrastructure investments. As discussed earlier, local governments in India are essentially state government creations that are subject to the provision of state legislation. Consequently, local governments are not integrated with national planning efforts, and no direct plan allocations for investment by local authorities exist. Whatever plan allocations are made for urban development have to be routed through state governments. This system has resulted in a severe lack of information on investment expenditures made by local governments. As a result, no consolidated data are available on local-level investment expenditures.

Over a long period stretching from the 1960s to the 1980s, the functioning of local bodies has tended increasingly to erode. For various reasons, the majority of city municipal corporations had been suspended by state governments and were being administered by them. The same also occurred with many municipalities. In cities where major development programs were undertaken (for example, Calcutta, Delhi, Kanpur, and Madras), separate urban development authorities were established that had few connections with the existing municipal corporations. These investment programs were largely externally funded with international, national, and state resources, and bore little relation to their local fiscal viability. This was partially unavoidable because long neglect of such investments in these cities had made investment vitally necessary. Remarkably, the major investments in sewerage in some of India's biggest cities were made almost 100 years ago, and little has been done since then. A result of the relatively large investments that were made in the last two or three decades is these cities' lack of financial resources to maintain these new assets. This has occurred because adequate attention was not paid to the institutional reforms that should have accompanied these investments.

In effect, state governments meet a significant proportion of the financial needs of local bodies via shared tax revenues, capital grants, and loans. In general, local governments have not been able to raise loans themselves for investment purposes. Under the current system, just as state governments cannot borrow from the market without central government approval, local governments are not able to borrow without state government approval. Moreover, lending institutions usually require local governments to obtain state government guarantees. Whatever funds local governments have been able to borrow in recent years have come from the Housing and Urban Development Corporation or from the Life Insurance Corporation. Allocations of credit from the latter depend on the investment according to guidelines laid down by the central government.

The 74th amendment to the Constitution now provides constitutional recognition of the existence of local governments. Under this amendment, local governments will now be provided with greater fiscal authority to both raise revenues and manage their expenditures. The changes envisaged by this amendment will take some time to be implemented because a number of institutional changes will have to take place to strengthen local governments. Just as the fiscal relations between central and state governments are governed by the awards of the statutory Finance Commission, the states are now supposed to set up state finance commissions on a regular basis to provide transparency and regularity in the fiscal devolution systems between state and local governments. As these state finance commissions become a regular feature of the fiscal scene, local governments are likely to be strengthened and to start exercising the powers designated to them. (See the annex for the provisions made under the 74th constitutional amendment in 1992.)

The current state of urban development management covers a wide variety of experiences. Some large cities still have no organized management worthy of note, while others might well be excessively managed. Generally, municipal corporations or municipal boards govern most cities, but, as already mentioned, many of these bodies were, until recently, suspended for varying lengths of time. As a result, state-appointed officers administered the cities. Because the 74th amendment requires new elections within six months of any suspension, most municipal corporations are now being resurrected. In cities where major urban investment programs exist, urban development authorities usually operate directly under the state government rather than under the local authority. Essentially, two reasons explain this. First, local authorities have long been regarded as inefficient, ineffective, corrupt, and too susceptible to local pressures. Second, the financing of urban development has been such that the funds have come from the central or state levels, hence, entrusting the execution of works to an agency under direct state control was considered prudent. The idea was to make the urban development authority responsible for capital investment works, while the municipal corporation was relegated to maintenance tasks. In some cases, the demarcation of responsibilities between the corporation and the urban development authorities is not entirely clear, leading to avoidable disputes. This often causes difficulties, because no connection has typically existed between investments and local financing capabilities. Hence, local authorities are often unable to raise resources adequate to the task of maintaining the new infrastructure.

Over the last two or three decades, the functions, powers, and prestige of local governments have tended to erode. As a result, the prognosis for their regeneration was not optimistic until the 74th constitutional amendment for devolution of powers to local bodies was passed. However, few choices appear to be available. Indeed, the rehabilitation of local authorities from the present state of neglect would need major shifts in the national and international techniques of financing urban development. Local authorities need not be seen as unnecessary stumbling blocks in program formulation and execution. Urban development authorities could be subsidiaries of local authorities, rather than of state governments. With appropriate checks and balances, the local authorities can indeed be held responsible, the funds placed at their disposal, and the execution of programs planned. The resources would be related to the availability of financial resources whether they are borrowed from the state, the center, or raised locally or nationally in the capital market. Such a procedure would improve financial discipline, as would the formulation of investments that are more in line with a city's paying capacity. Infrastructure investments would be made within the corporation's fiscal resources and tax capabilities.

Local Financial Resources

The main revenue sources of urban areas are property taxes and octroi duties (taxes levied on the entry of goods into a city). General agreement appears to exist that urban local finances have not been as buoyant as might have been expected or as is desirable. However, according to a study conducted by the National Council of Applied Economic Research (1980), the situation has not always been as bad as is sometimes suggested. While state and national taxes increased an average of 17 percent per year in 1970–71 and 1977–78 (in current prices), local taxes increased about 15 percent per year. In principle, local taxes should increase faster than national and state taxes because of increasing urbanization and industrialization. Property taxes and octroi are the main revenue sources for local bodies; both these sources should be buoyant. When more housing is constructed and existing properties are constantly appreciating in value, property taxes should be expected to lead the growth in revenues. Similarly, with increased urban activity, octroi can be expected to increase faster than other state and national revenues.

Octroi duties have generally been found to be more buoyant than property taxes. However, general agreement exists that from the national point of view, eliminating octroi duties is desirable to facilitate movement of goods across the country so that a truly common market can form. While few rational economic arguments are made against the abolition of octroi, another local revenue source must replace octroi that reflects the level of economic activity in the city. Ad hoc arrangements or revenue sharing from state taxes have not been appropriate substitutes because they are unpredictable. The devolution of state revenues must take place according to a set formula as the devolution of central taxes to states does. Because the demand for local services is likely to depend on the level of economic activity, the principle of local taxation reflecting that activity should be recognized. The campaign against octroi has met with some success, and many states have indeed abolished it. However, an adequately buoyant replacement has not been implemented, leading to further impoverishment and weakening of local bodies in the 1980s. Octroi have generally been replaced with some means of devolution of state-level taxes, but the fiscal pressures on state governments have meant that these arrangements have been largely unsatisfactory.

The other main source of local revenue is the property tax. In principle, the assessment of property taxes should respond to the increasing value of properties. In a situation of rapid urban growth, the tax base and property values should increase continually. In fact, the property tax collections have been relatively inelastic. This has been partly due to inefficient assessments and administration, but also to legal impediments, which may be related to the former. The key legal impediment is the operation of outmoded rent control laws. While ensuring the protection of tenants from capricious eviction and from unreasonable rent increases is essential, the rent control laws as they currently operate are essentially counterproductive. They have a twofold effect on property taxes. First, because housing investment is inhibited as a result of rent control laws, the quantity of housing investment is lower than it would be otherwise. Therefore, the total value of properties does not increase as much as it otherwise might do. Second, because properties can only be assessed at standard rents, assessments are bound by law to be lower than existing actual rents. Lifting all rent control laws suddenly would be difficult and undesirable. A phased approach could be adopted that exempts new properties from rent controls, while older properties are subject to continual annual increases in value linked to a determinate price index. This would ensure tenant protection while encouraging future housing investment and establishing a built-in measure to inject buoyancy into property tax revenues.

Wide-ranging discussions have taken place concerning amendments in recent control legislation at political, bureaucratic, and academic levels. Much of this discussion has been motivated by the desire to improve property tax collection, rather than using it as a measure for removing distortions in the housing market. Over the last decade, the weight of opinion—political, bureaucratic, and academic—has clearly shifted toward substantial amendment or abolition of rent control legislation. As a pacesetter, Delhi's Rent Control Law has already been amended substantially, although perhaps not adequately. However, owing to strong political pressure by vested interests, such as rich, commercial tenants who expect rent hikes, the amended law has yet to be implemented by the government.

If rent control laws were suitably amended to enable regular property regulation, increases in property values resulting from investments in public infrastructure would then be captured in the tax net. The resulting revenues would help with maintenance expenditures and with servicing of the capital expenditure debt incurred. At the same time, the provision of services such as water supply, garbage collection, transportation, and the like, whose consumption can be identified by household, should be based on the levy of user charges as far as possible. To help the poor, such charges could subsume a system of cross-subsidies.

Financing of Urban Development

The essential problem of urban infrastructure investment is that such infrastructure yields benefits in the long term, but investments have to be made in the present. Given national priorities and the serious fiscal constraints in the foreseeable future, seeing a radical increase in the allocation of budgetary resources for urban infrastructure investment is difficult. Yet demand for these investments will be difficult to resist, and therefore they will have to be made. Making urban infrastructure largely self-financing is important. Systems must be designed in such a way that their long-term viability is ensured. This would involve appropriate pricing of the facilities and services offered and reforms in the local tax structures, because not all urban public services can be based on user charges. A number of related fiscal, administrative, and legal measures are needed in connection with the financing of urban development.

Urban infrastructure investments are characteristically long-term investments in the sense that benefits accrue over many years. Thus sewerage, drainage, water supply systems, and roads constructed today are expected to yield benefits for at least 50 years. Because of this characteristic the finance needed for such investments should be long-term finance. However, the lack of long-term sources of funds has been a key constraint in the financing of urban development. As a result, these investments have been neglected until absolutely unavoidable, and then policymakers have resorted to central funds supported by external financing, often from the World Bank. This is not a new problem, nor is it specific to India. Rapidly urbanizing countries have often had to resort to large magnitudes of external financing for urban infrastructure investments (Lewis 1978). The problem arises because urbanization is accompanied by or caused by increasing levels of industrialization. The demand for using savings to finance what are usually termed productive investments with quicker pay-off periods is also high. Therefore, finding the long-term finances necessary for the financing of urban infrastructure investment is usually difficult.

The 74th amendment to the constitution provides for devolving greater fiscal authority to local governments to raise revenue and manage expenditure. In this context, the issue of municipal debt is likely to assume greater importance at the local level. So far most capital investment at the local level has been made directly or indirectly through state government funding. Just as subventions from the central government to state governments have been made through both grants and loans, investments at the local level have been financed by combination of grants and loans from state governments. In instances of large capital investment, states have given approval for market borrowing by municipal corporations.

The existing legislative enactment governing borrowing by local authorities is the Local Authorities Loan Act 1914. Under this act, municipal authorities are allowed to raise loans up to Rs 500,000 from the open market. Loans greater than Rs 2.5 million or with maturity of more than 30 years require central government approval.

Compared with municipalities, municipal corporations in India have greater freedom to borrow from the market, but are usually limited by the state governments. The limits to borrowing powers set by the states are guided by

- Total annual ratable value of property tax within municipal corporations
- The value of the municipal corporations' own property and assets
- The corporations' own domestic revenue
- Savings made by the municipal corporation over a period of time.

Municipal corporations are permitted to borrow from the market through instruments such as debentures and bonds. However, the requirement for state government approvals or government guarantee conditions make it difficult for local bodies to borrow directly from the market. In principle, market borrowing by states covers the loan requirements of municipal corporations and urban development authorities. Therefore, the level of independent market borrowing made by municipalities has not been significant. The Reserve Bank of India appears to regard municipal borrowing as private borrowing and is therefore not inclined to regulate it. It is, however, concerned with the guarantee liability of state governments should they issue guarantees for municipal corporations' borrowing. In practice, the central government limits state government borrowing and local government borrowing through credit limits.

When municipal corporations do get permission from state governments to borrow, they usually borrow from institutions such as the Life Insurance Corporation of India, commercial banks, the Housing and Urban Development Corporation, and similar bodies. In many cases, these agencies require state government guarantees before they lend to the municipal corporations, thus their borrowing is once again subject to central government and Reserve Bank control of state government borrowing and guarantees.

In conclusion, the borrowing powers of municipal corporations, even when not limited by local provisions in state governments' legislative enactments or their own statutes, are effectively restricted by the demands of lending agencies. In view of this situation, considerable work is now going on in India to promote new methods of financing for municipal government investments.

Different countries have solved the problem of urban infrastructure financing in different ways. In the United States, the standard method of financing is through municipal bonds. The resource cost of raising funds through municipal bonds is reduced for local bodies by making the interest on them free of income tax. Interest paid on them can therefore be lower than on other bonds. This is effectively a subsidy from the federal government to city governments. The well-developed financial market in the United States does the rest. Ratings of bonds floated by different authorities account for the different degrees of risk associated with bonds for different cities. Conversely, city authorities have an incentive to keep their fiscal house in order to get and retain favorable ratings.

In principle, developing a similar system in India is feasible. The first steps have already been taken, and the first Indian municipal bond was issued recently by the Ahmedabad Municipal Corporation. Another municipal corporation bond is in the process of being issued by the Pune Municipal Corporation. A few other municipal corporations are also preparing to move in the same direction. However, many problems remain, and municipal corporations that issue bonds will remain exceptions to the rule for some time to come.

In this context, discussion of the strengthening of local bodies, both organizationally and financially, assumes great importance. Only if local bodies can be held financially viable and responsible can a system of long-term finance be instituted for proving resources to local authorities. As an intermediate measure, higher-level institutions with better credit quality should be able to raise long-term funds by issuing long-term bonds. These could then be marketable just like any other public sector bond. Similarly, if these bonds were made tax free, the interest rate given could be lower, and hence the cost of funds kept within prudent limits. Such funds can be passed down directly to local bodies or through state-level financing bodies in some of the larger states. An important function of such institutions would be to provide technical assistance in the design of urban infrastructure programs, to help local bodies become fiscally responsible, and so on. Project evaluation would help ensure that funds are lent to only those local bodies that have viable investment programs. Moreover, such a system should promote the recovery of costs through appropriate user charges.

Once such a system has been in place for some time, it will have helped to induce autonomous fiscal responsibility in local bodies. At that point, permitting some of the larger municipal authorities to raise their own public resources by directly floating municipal bonds will be possible. The ability of local bodies to raise funds—directly and indirectly through financial institutions—depends on their fiscal position and their capability to invest these funds in resource-raising investments. Municipal bodies must be held accountable for the investments they make. For this reason, separating investment responsibilities from maintenance responsibilities, as has been done in many cities by founding urban development authorities, is a bad idea. Completed investments are typically transferred to municipal bodies for maintenance, while little is done to raise the resources needed to undertake maintenance responsibilities. If, however, such a system enforces better fiscal discipline, and local authorities do pay back the borrowed funds according to schedule, the efficient utilization of resources would increase overall.

Clearly, integrating local management and financial responsibilities in India in the interest of healthy urban development is urgently needed. Some of the problems of urban growth that were encountered in the 1970s, 1980s, and 1990s have undoubtedly arisen from the lack of accountability in the system. No one is really responsible for urban development. The central government is too remote from the concerns of specific cities and, moreover, lacks viable instruments. State governments are also beset with state-level problems. Local governments do not really exist or are weak. As a result, India is encountering problems in healthy urban growth and has even witnessed a deceleration in the 1980s.

A New Approach to Financing Public Investment

India successfully ascended to a higher growth path in the 1980s—to an average gross domestic product (GDP) growth of 5 to 5.5 percent per year from the average of 3 to 3.5 percent in the previous 30 years. Evidence already exists that an average of 6.5 percent per year is now being achieved despite the recent slowdown. A growth rate of 7 to 7.5 percent per year should be considered within reach over the next 10 years.

However, this will require accelerated investment in infrastructure at different levels by both the public and private sectors. As has been shown, past fiscal devolution practices have resulted in considerable erosion of public finances, which leads to a reduction in public investments at all levels. To reverse this trend, a change must take place in the whole system of public investment and financing practices. If radical changes are not made in the current system, stepping up both public and private sector investments in infrastructure at all levels will not be possible.

Roles of Planning and the Planning Commission

The share of public investment in total investment is falling—from almost 50 percent in the past to a projected 30 to 33 percent by 2002, which is the end of the current five-year plan period. This implies that available public resources must be used more selectively in the areas that supply public goods, or as promotional or seed capital in other areas with the objective of crowding in investment.

Similarly, with the increasing importance of state governments and the consequences of the 73rd and 74th amendments to the Constitution, which empower both urban and rural local governments, decisionmaking and expenditure allocated for different sectors and schemes should become much more decentralized.

Accordingly, India should restructure the Planning Commission so that it functions productively in alignment with the needs of the 21st century. The Planning Commission should

- Set national goals as signposts for all to follow, including states, private sector, local bodies, and so on
- Act as a policy coordinator between different wings of the central government and state governments, particularly to attain stated goals in the infrastructure and social sectors
- Promote and coordinate social and infrastructure investment in both the public and private sectors through
    - Facilitation
    - Monitoring
    - Resource raising
    - Project identification
    - Project programming
- Act continually as a conveyor of future-oriented thinking in different sectors as different needs arise and not just at the time of plan preparation.

These functions require considerable changes in the current structure and functioning of the Planning Commission, which has become excessively bureaucratic and devoid of technical expertise. As the country has developed, expertise has become much more widespread than before. Bringing this expertise together from different sources such as public and private companies, research and other domestic institutions, and from abroad, will require much more openness and expertise on the part of the Planning Commission.

New Approach to Public Investment

In the absence of a positive balance of current revenue, the fact that public investments are funded with resources the government borrows from the market must guide all public investment activity. These resources are not freely available and must be allocated in such a way that they generate appropriate returns. Whereas obtaining clear returns that are identifiable from investments in public goods is not possible, obtaining returns from other investments through user charges is. In such cases, as far as possible, investment should be made through accountable entities that can see the connection between investments and economic returns and act accordingly. So far, the government, particularly the central government, has acted as a giant financial intermediary, borrowing funds from the market and then onlending them to other entities, such as state governments, development authorities, public sector enterprises, and the like. However, in this system little accountability exists. In effect, no sanctions are levied against lower-level entities that do not pay back their loans. In addition, poor performance in the past does not endanger the possibility of obtaining new resources. In fact, new loans effectively help service the older loans.

Reducing the role of the government as a financial intermediary would therefore be preferable. For those activities related to the provision of public goods, providing outright grants would be better. For other activities, particularly in the area of infrastructure, budgetary funds should be used to provide equity to enterprises, which would then help such entities to crowd in other resources, either as additional equity or as debt.

State governments, state government corporations, urban development authorities, municipal bodies, and so on should all be allowed to borrow freely in the market. Such a change in the system would naturally take some time to implement, and a great amount of technical assistance would be required to make most of these entities creditworthy. These bodies would then be expected to float state bonds, municipal bonds, and so on. These bonds could take the form of revenue bonds connected to the revenue-raising ability of these entities, or they could be related to specific projects and programs. These organizations' ability to borrow would be governed by their credit rating, which would encourage both state governments and local bodies to maintain viable fiscal conditions. For smaller local authorities unable to access the market directly, setting up bond banks or financial intermediaries that borrow on their behalf and then on-lend on the basis of adequate credit and project assessments is possible. However, this is a major change and its implementation would require a constitutional amendment.

In view of the severe constraint on public resources, the available resources must be used to help in raising other resources as far as possible. In principle, this can be done by using public resources as equity-like resources. Different sectors exhibit different degrees of commercial viability. For example, sectors such as power and telecommunications can be fully viable on a commercial basis, and they should be able to service both debt and equity resources. However, other sectors such as urban water supply and sewerage may not exhibit commercial rates of return for some time. In such sectors, the government can provide equity like resources on a concessional basis with stipulations on rates of return expected being lower than would be expected commercially. Such arrangements would enable project entities to raise other equity and debt resources on a fully commercial basis, thus enabling greater investment than would otherwise be possible. To illustrate, if the government provides equity resources for a water project with no dividend expectation for 15 years based on a 2:1 debt-equity ratio, and if debt can be raised commercially at, for example, 15 percent, the project is then considered commercially viable and credit rated as such, at a 10 percent overall rate of return. User charges can then be set at affordable rates. Such a procedure can be used in many sectors and projects to effectively use public resources to leverage other resources to invest in preferred investment activities for social and physical infrastructure.

This procedure can also be effective in providing much greater autonomy to public sector entities. Public scrutiny of resource allocation would then apply only to the equity allocations and not to the debt raised by these entities. Within the stipulated dividend expectations, public sector entities would then be much freer to make their own decisions.

To further decentralize decisionmaking and to introduce greater accountability, resources for equity investments could be placed in separate, perhaps sectoral, equity funds, which would then allocate the funds on the basis of project viability and any other guidelines. Fund allocation could then become much more demand oriented and subject to greater accountability. National priority setting can be reflected in allocation of these equity funds between sectors and, perhaps, between regions. Through such a procedure, subsidies can coexist with commercial viability and accountability in public investment.

Generation of Savings or Resources for Investment

Gross domestic savings have already reached 24 to 26 percent, depending on whether measurement is based on current or constant prices. The aim should now be to reach a gross domestic investment level of about 30 percent of GDP by 2002 and an associated gross domestic savings rate of about 27.5 percent, implying the use of external savings (current account deficit) of about 2.5 percent. How can the rate of gross domestic savings be raised by about 2.5 to 3.0 percent?

PUBLIC SECTOR SAVINGS. The key requirement is to restore the rate of public sector savings to the levels existing in the early 1980s, when they were in excess of 3.5 percent of GDP. Subsidies, both explicit and implicit, greatly erode public sector savings in the provision of services, such as power, water, public transport, irrigation, and the like. Consensus must be achieved on the use of user charges in the delivery of these services. An explicit program or policy to raise user charges to economically viable levels on a phased basis in five years must be implemented.

Apart from raising the level of public sector savings, the levy of user charges is essential if private investment is to flow into infrastructure. Levying user charges will also be effective for crowding in private infrastructure investment. The power sector provides the best illustration of this point. Private investors will find it difficult to invest in the sector unless the state electricity boards become financially viable, which can only happen if average power tariffs are raised. Thus the levy of economic user charges not only enables higher public savings, and therefore investment, but also crowds in private investment.

However, policymakers must take care to build equity concerns into the levy of user charges. One approach involves lowering the economic level of user charges through budgetary allocation of equity to service providers without expectation of return. Another approach is to look for self-administering means tests. For example, in the case of water, the policy could be to levy a full user charge on households with independent taps within the house, while providing free water to all those who obtain their water from community facilities such as public stand posts. Many innovative variations will have to be tried to ensure equitable user charges. If most borrowed resources of investing agencies either come directly from the market or from financial institutions, this discipline will emerge automatically.

PRIVATE SAVINGS. Among the many significant effects of economic reforms has been the consistent increase in private corporate sector savings. Of equal significance is the fact that household financial savings have been on the rise, despite some hiccups in total household savings in the post-reform period. This indicates that households could mobilize more financial savings if safe savings investments and savings institutions were more widely available. According to the 1991 census, more than 300 cities now have more than 100,000 people and more than 50 cities have more than half a million people. Yet only in the largest cities are savings mobilized for intermediation in the capital market. More savings could be mobilized if investment were easier in insurance funds, pension funds, provident funds, and the like. Similarly, households could invest directly in capital market instruments such as stocks and bonds, if a safer network of retail brokers with good corporate backing was available.

Opening the insurance, pension, and provident funds market so that people get much better access to these savings instruments is of the utmost importance. Policymakers have taken the first steps to open the insurance sector to new players. Similar steps should now be taken to allow people to invest in private pension and provident funds. Unorganized sector workers do not at present have access to pensions. With increasing urbanization and breaking up of joint families, old-age pensions are becoming a social necessity. Thus, opening of the pension fund market is essential, but it must take place on a fully-funded basis. The areas of insurance and pension funds require strong regulatory authorities that maintain strict prudential control so that people's hard-earned savings remain safe.

The largest and most widespread network of savings is that of the post office savings system. This system needs to be put on a more commercial footing so that some of the services mentioned can be provided through this network, as has been the practice in Japan.

Public-Private Partnerships in Infrastructure

The public sector has made most infrastructure investment in the country. However, given constraints on the availability of public resources and the increased requirement for infrastructure investment, the tendency to give up responsibility for infrastructure investment is high. Thus, the current trend is to hope for private sector investment from areas where it has not previously been forthcoming. The fact of the matter is that, because of the lumpy nature of investment, including high risks, low pay-back possibilities, projects with long gestation periods, and so on, private investors will find it difficult to invest in many infrastructure sectors without additional comfort levels. The method of "free" government equity has already been suggested as a means of crowding in private sector investment. However, other methods of public-private partnerships must be explored. The objective must be to use scarce public resources to leverage greater private resources. Many possibilities for joint sector projects exist, for example, through providing government guarantees, securing past government debt, privatizing initial government equity after initial risks are overcome, and so on.

A specific example of this kind of joint investment involves government guarantees, which can be backed up by setting up a contingent valuation fund. Thus, through such funds, government guarantees can be valued and insured. This would reduce the potential risk to the government of issuing these guarantees and would also provide credible backing to investors. In addition, this would obviate the need for the central government or the Reserve Bank of India to administer controls on subnational borrowing.

Annex A.13.1. Extracts from the 74th Constitutional Amendment, 1992[1]

A. Twelfth Schedule (Article 243)

1. Urban Planning including town planning.
2. Regulation of land-use and construction of building
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 interest of weaker sections of society, including the handicapped and mentally retarded.
10. Slum improvement and upgradation
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.

243Y. (1) The State Finance Commission constituted under Article 243-I shall also review the financial position of the municipalities and make recommendations to the Governor as to:

(a) the principles which should govern

[1] Taken from Edadan and Mathur (1998).

(i) the distribution between the state and the municipalities of the net proceeds of the taxes, duties tolls and fees leviable by the State, which may be divided between them under the Part and the allocation between the municipalities at all levels of their respective shares of such proceeds;
(ii) the determination of the taxes, duties, tolls and fees which may be assigned to or appropriated by, the municipalities;
(iii) the grants-in-aid to the municipalities from the Consolidated fund of the state;

(b) the measures needed to improve the financial position of the municipalities;

(c) any other matter referred to the Finance Commission by the governor in the interest of sound finance of the municipalities

2. The Governor shall cause every recommendation made by the commission under this article together with an explanatory memorandum as to the action taken thereon to be laid before the legislature of the State.

243Z. The legislature of a state may by law make provisions with respect to the maintenance of accounts by the municipalities and the audit of such accounts.

243ZE. (1) There shall be constituted in every metropolitan area a Metropolitan Planning Committee to prepare a draft development plan for the metropolitan area as a whole

(2) The legislature of a state may, by law, make provision with respect to-

(a) The composition of the Metropolitan Planning Commission
(b) The manner in which the seats in such Committee shall be filled;

Provided that not less than two-thirds of the members of such Committee shall be elected by and from amongst, the elected members of the municipalities and chairpersons of the panchayats in the metropolitan area in proportion to the ratio between the population of the municipalities and of the panchayats in that area;

(c) the representation in such committees of the Government of India and the Government of State and of such organisations and institutions as may be deemed necessary for carrying out of functions assigned to such committees;
(d) the functions relating to planning and co-ordination for the metropolitan area which may be assigned to such committees;
(e) the manner in which the chairpersons of such committees shall be chosen

3. Every Metropolitan Planning Committee shall, in preparing the draft development plan-

(a) have regard to-

(i) the plans prepared by the municipalities and the panchayats in the Metropolitan area;
(ii) matters of common interest between the municipalities and the panchayats, including co-ordinated spatial planning of the area, sharing of water and other

physical and natural resources, the integrated development of infrastructure and environmental conservation;

(ii) the overall objectives and priorities set by the Government of India and the Government of the State;

(iii) the extent and nature of investments likely to be made in metropolitan areas by agencies of the Government of India and of the Government of the State and other available resources whether financial or otherwise;

(b) consult such institutions and organisations as the Governor may, by order, specify

(4) The chairperson of every Metropolitan Planning Committee shall forward the development plan, as recommended by such committee, to the Government of the State.

243ZF. Notwithstanding anything in this Part, any provision of any law relating to municipalities in force in a state immediately before the commencement of the Constitution (Seventy-fourth Amendment) Act, 1992, which is inconsistent with the provisions of this Part, shall continue to be in force until amended or repealed by a competent legislature or other competent authority or until the expiration of one year from such commencement, whichever is earlier:

Provided that all the municipalities existing immediately such commencement shall continue till the expiration of duration, unless sooner dissolved by a resolution passed to that effect by the Legislative Assembly of that state or in the case of a state having a Legislative Council by each House of the legislative of that state.

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