Nagarlok Vol. XLI No. 4 October - December 2009

Fiscal Decentralization and Financing Urban Public Provisions in the Indian Federal Setup: Needed Municipal Financial Reforms

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INTRODUCTION

THE FISCAL decentralization increases the efficiency of the resources of the government in the provision of urban local services. An increase in decentralization process delegates more powers to lower government authorities and augment their capacity to mobilize resources, accelerating the flow of invisible resources into urban public provisions. In the developing world the widespread interest in fiscal decentralization has emerged with an objective of breaking the grip of Central planning that has failed to bring onto a path of self-sustaining growth and to improve the performance of their public sectors. But the proper goal of restructuring the public sector cannot simply be decentralization.[1]

The traditional theory of fiscal federalism lays out a general normative framework for the assignment of functions for different levels of Government and the appropriate fiscal instruments for carrying out these functions (Richard Musgrave 1959; Oates 1972). Hence, the presumption in favour of decentralized finance is established by simply assuming that centralized provision will entail a uniform level of output across all jurisdictions. Given their strategic position in delivering services in the hierarchy of government set up, more functions, powers and resources have been provided to local governments in many of the developing countries. Constitutionally built-in functions and finances assigned to various levels of government eventually reflect in the high dependency of local bodies on state and the Central Government for funds. However, although, the functions and responsibilities of Local Bodies have increased considerably, enhancement of their resource base has not been made efficient. For providing the finances of urban local governments, though two positive features were provided in the 73rd and 74th Amendments to the Constitution in India like, a) provision for the constitution of State Finance Commission (SFC) every five years and b) amendments of Article 280 of the Indian Constitution by inserting Section 3(C)), the present institutional arrangements for financing and delivering of urban public provisions in India is unlikely to be sustained. In fact, in order to fulfill these requirements, the

Central Finance Commission suggests measures needed to augment the consolidated funds of the states to supplement the resources of municipalities devolved on the basis of the respective SFC recommendations. But due to mounting fiscal pressures on the urban local bodies and the rising demand for different urban service provisions, these suggestions may not be easily met. The rapid growth of demand for public utility services arising out of massive influx of population in the urban areas and limited capacity of state, local level authorities to provide such services, increasing gap between demand and supply, availability of lesser resources with the authorities responsible for providing infrastructure, poor maintenance and upkeep of existing infrastructure, ineffective and inefficient management of infrastructure, obsolete and expensive technology adopted for providing services, substantial wastage during the delivery, highly subsidized urban services, poor recovery and collection of service charges, lack of accountability of public sector leading to inefficiency and low productivity, imperfect market conditions, non-involvement of communities, public sector monopoly in providing services and lack of will on the part of politicians to rationalize the service charges and some other factors make the financing and provisioning of these services more difficult. Hence, financing and management of urban public provisions is becoming more complex, and the time has come to explore appropriate timely policy reform actions.

Though Governments in India have resorted to decentralization through various measures, presently, there is mismatch between functions and finances of Urban Local Bodies (ULBs). Vertical imbalance, fiscal dependency, borrowing constraints and inefficiency in municipal management are affecting the functioning of ULBs. The vertical imbalance is constitutionally in-built and correction to the same needs to be achieved through reforms in the structure of fiscal federalism, including revenue assignment and inter-governmental transfers through the Central and State Finance Commissions. There is also the need for function-finance mapping to ensure that each function to be performed by the ULBs is backed by a corresponding financing source. The revenue instruments assigned to a tier of government should match, as far as possible, the expenditure requirements to induce fiscal responsibility.

Fiscal Decentralization, Investment Climate and Urban Public Provisions

Decentralization can contribute to a sound investment climate in several ways. Decentralization of regulatory responsibilities can help locales adapt approaches to their conditions and preferences and facilitate the involvement of stakeholders. Fiscal decentralization can assure local authorities that taxes raised locally will not be appropriated by the Central government, giving local authorities incentives to develop their local tax base. Decentralization also permits a degree of institutional competition between Centres of authority that can stimulate policy innovation and reduce the risk that governments will expropriate wealth. But there are tradeoffs. Sub-national authorities are not well placed to deal with issues that involve spillovers between jurisdictions. They may also face more severe capacity constraints and be unable to exploit economies of scale associated with particular functions. And sub-national governments are not immune from governance problems—and in some contexts may be more vulnerable to them than national authorities. Reflecting these tradeoffs, the optimal location of particular policy and administrative responsibilities will depend on the country and policy issue concerned. Small countries present fewer opportunities for decentralization than larger ones. But even in large countries, some matters will be best handled centrally, some sub-nationally, and others may require some form of shared responsibility. A clear delineation of responsibility between tiers of governments reduces uncertainty and risk for firms and improves accountability.

A good investment climate fosters productive investment. It supports a sustainable source of tax revenues to fund other important social goals. Improving the investment climate promotes the opportunities and incentives for firms to increase productivity, create jobs, and expand—which is the key to sustainable progress in attacking poverty and improving living standards. A good investment climate also helps to reduce the costs of goods consumed by poor people, and improves the living conditions of poor people directly. It also contributes to an expanding tax base that allows governments to invest in the health, education, and welfare of its people.

In discussing the limited role of ULBs in mobilizing the funds for financing the public utilities in the growing cities, the changing relationship between citizens, local politicians and state-level actors is needed to understand why decentralization does not guarantee improvement of the existing situation. The social, economic, political and cultural context of various units (wards) needs to be considered. In fact, from a functional point of view, lack of financial resources to undertake the new functions provided by the 74th CAA appears to be more apparent. Similarly, most of the responsibility of planning and implementation for public service delivery still lies with the state agencies. When state agencies are not the real decision-makers with regard to network expansion, political interests rather than social needs become relevant and development of public infrastructure by private contractors chosen on the basis of clientelist rather than professional considerations seems to have an impact on the quality of infrastructure, like new roads.

Although local governments have existed in India for long time, only since early 1990s the Government of India and sate governments have introduced decentralization measures that have a direct impact on ULBs. The

Constitutional Amendment has provided constitutional status by recognizing them as the third tier of government and assigning them specific civic functions. It emphasized the demarcations of ULBs by requiring regular elections, curtailing state government powers to suspend them, and enhancing representation of the weaker sections and women. However, although most states have ratified the amendment, it has proved difficult to realize decentralization in practice. The ULBs' increased functions led to their demand for more funds and resources. Unfortunately, the revenues devolved to ULBs did not match the cost of providing these new functions. In fact, ULBs are responsible for the collection of taxes assigned to them, but, still they need the approval of the state government for any major revisions in tax rates or user charges. ULBs also have no power to institute new taxes. While the Constitution specifies how taxes are to be divided between the Union and the states, no such provision regarding the division of a tax revenue between state governments and ULBs exists in State Municipal Acts. This led to the increasing dependence of ULBs on higher levels of state government aid, but no regularity is observed in the flow of funds from state governments to ULBs.

The Constitution Amendment (CA) did require state governments to constitute State Finance Commissions (SFC) every five years to review the fiscal situation of local governments. As the recommendation of SFCs is in advisory, the state governments have not implemented them adequately. Despite these bottlenecks, many ULBs across the country have been developing innovative ways to meet the growing demand for urban services. It may be noted that, the underlying problem with both finance and infrastructure can be traced to a specific market failure, i.e., it is information asymmetries, and for infrastructure, market power associated with economies of scale. But too often government interventions have made matters worse. Financial markets have been repressed and distorted by state ownership, monopolies, directed or subsidized credit, and other policies appealing to the short term interests of politicians and favoured groups. These measures undermine financial sector development, firm-level productivity, and economic growth. Infrastructure provision has been undermined by governments using state ownership or regulation to pursue objectives unrelated to efficient service delivery—typically favouring some groups over broader interest and introducing new areas of inefficiency. More importantly, the urban financial markets are also affected by political economy. Government policies toward financial markets are influenced by the wishes of powerful groups and the self-interest of politicians. Competition often suffers from that influence.

Role of ULBs in Provision and Financing of Urban Public Utilities

The extent of devolution of powers is at the discretion of the state government and the latter undertakes the functions in the areas of ULBs. There is a considerable difference between what is intended in law and how it is implemented. By all accounts, the states are reluctant to devolve powers to local governments. Most state governments have devolved only a few of the 29 functions listed in the schedule and the powers devolved even in respect of the devolved functions are not significant. In other words, none of the state governments has devolved the function after a proper examination of activities the local governments can effectively implement. Further, the devolution of the functions has not been done in an unencumbered manner. The transferred functions are carried on concurrently with the state government. The major considerations in transferring the functions are: (1) the capacity of the urban governments to carry out these functions, and (2) the strategy to deal with the employees who have been undertaking these tasks at the state level.

Many of the urban services in India are in the nature of "local" public goods and hence urban public provisions remained highly politicized and Governments frequently kept prices below costs. Further, as long as Governments heavily subsidize public infrastructure agencies, the agencies could still operate and expand further. The municipal bodies, which are statutorily responsible for provision of basic services in the urban areas of the country, are experiencing tremendous fiscal stress even to operate and maintain the existing services at satisfactory level. Further, while their responsibility to meet the growing demand to maintain services at satisfactory level is increasing rapidly, there is no commensurate increase in the revenue base, which has in fact been depleting constantly. Faced with such a situation the municipalities are becoming increasingly dependant on higher levels of Government for their operations and maintenance requirements at present. Above all, much of urban infrastructure is intimately linked to decentralization of economic and political powers to sub-national tiers of government.

Traditionally the provision of public utilities has primarily remained within the domain of public sector in India. Governments have traditionally been the provider of services because of the monopolistic nature of these services usually involving high up-front costs and long payback periods besides requiring a huge amount of resources and investment. These services are also characterized by the existence of externalities which make it difficult for agencies to recoup investment costs and operational expenses through the levy of user charges. Hence, bridging this gap and providing resources for creating adequate infrastructure is beyond the capacity of the public sector. Meanwhile, while addressing the financial needs of the public utility services of the cities in India, it should be kept in mind that, the capacity of the state to meet the financial needs of the infrastructure sector remains limited, which in turn resulted in negligible urban development. Due to severe budget and fiscal

problems of the governments at all levels, the possibility of any significant increase in plan outlay for such service provisions is remote. As the gap between total expenditure and current revenue has been predominantly met (74.5 %) through draft on domestic savings, the interest payment burden on the governments is severe and secondly, as cost recovery in a typical Governments sponsored urban services has remained negligible or was never intended, any possibility of increase in resource allocation through receipts on past investments is also not possible. Hence, only if the rate of return on capital on the state sponsored project had been adequate, the sector would have expended considerably. In actual practice due to lack of proper tax policy and adoption of un-remunerative tariff rates, financing of urban infrastructure is a huge liability. In cases where financing of urban utilities is through raising of loan, it has only led to increased indebtedness of the government and the mounting interest burden.

Traditionally as goods/services were produced in India on a small scale, as private enterprise. However, over a period of time the State took over the production as well as distribution of these goods and services. Today as cost of this welfare function has become unaffordable and public service provision deficiencies having become socially unacceptable, the state government now has to evaluate alternative ways to finance these services at least by inviting and encouraging the private sector agencies. Raising funds from the capital market is a recent phenomenon for financing the corporate units in the private as well as the public sector in India. It was in the early 1980s that these funds started to be utilized for financing various industrial activities; however, utilization of these funds for financing long term capital investments in the infrastructure say, urban basic services, continues to remain a rare phenomenon in Indian context. The problem of these funds being utilized for infrastructure is further compounded by certain inherent characteristics of infrastructure in general and of urban basic services, which includes the fact that their financing is different from other industrial financing. The features of non-excludability, externality, natural monopoly, inelastic demand and involvements with long gestation period make the financing of infrastructure different from other industrial financing. The zero or negligible return during the initial years of construction of an infrastructure facility further makes the financing of these services different from other industrial financing. As a consequence, much of infrastructure financing in India in particular has remained within the jurisdiction of public sector.

Though it is often easier to attract foreign capital for power, telecom as well as transport as cost recovery for these services is easier to identify through user charges as beneficiaries could be identified and benefits accruing to them could easily be measured. However, such a concept, even if it was possible was not feasible in Indian urban informal sector. Moreover the problem is created due to the basic factors that act as barriers of such initiative: (a) the absence of a long -term domestic capital market and (b) the absence of a well -developed secondary capital market posing problems for the proper development of the primary capital market bringing about lack of funds for such non-remunerative services. Moreover, the absence of the financial intermediaries particularly in this sector has made the market full of risks. The existence of financial intermediaries helps in mitigating the different types of risks involved in the process of accessing the capital market. Further problems have also been faced in this regard due to the very nature of the urban basic services—the ways they are hitherto provided where recovery against these services cost are never considered an important issue. Thus, in outlining the role of ULBs in delivering urban utility services in the context of severe financial constraints, the fiscal decentralization has been the subject of intense debate as it emerged as public policy measure for the problem cities. The international experience indicates that in a large number of countries, the powers of the local governments are drawn from the upper tiers of the government (such as in Australia, Korea and Canada). In some countries (such as Germany and Brazil), their role and functions are specified by law.

The responsibilities of the local bodies are generally uniform across countries and mainly include provision of education, health and sanitation, welfare and water supply, although the priority attached to each of these sectors has varied across countries. Local governments in many countries are unable to meet their expenditure from their own resources and depend largely on transfers and borrowings, wherever possible. The 73rd and 74th Constitutional Amendments in 1992 accorded statutory recognition to these local bodies as institutions of self-government. These Amendments assigned the task of preparing plans for economic development and social justice, to the local bodies apart from their traditional functions. Notwithstanding the Constitutional requirement on the part of the State Legislatures, the SFC observed that 'the pace of empowerment of these (local) bodies to function as institutions of self-government has, however, generally been slow. Most of the state governments have also constituted State Finance Commissions (SFCs), as required by the statute, to review the financial position of the local bodies and recommend the devolution of financial resources. It has, however, been observed that the principal recommendations of the SFCs are not accepted by the state governments and even the accepted recommendations are not always implemented on the grounds of resource constraint. Furthermore, funds transferred for the implementation of development schemes remain unspent either on account of institutional/procedural constraints or are diverted to meet other committed expenditure.

The significance of local bodies has greatly enhanced over the years and the asymmetry in revenue and expenditure decentralization starts at the local

government level. In recent years, a number of ULB's in India have accessed the capital market. It is noted that a number of countries (notably, Argentina) have placed prudential controls on local government borrowing, given their implications for general government finances. The Government of India had, in February 2001, specified guidelines for the issue of Municipal Bonds and it had permitted the issue of tax-free bonds to finance the development of urban infrastructure subject to, *inter alia*, compulsory credit rating of the debt instrument and creation of an escrow account for debt servicing with earmarked revenue. The magnitude of funds raised *via* municipal bonds, however, remains small. The factors that are reported to have been impeding the development of the municipal debt market include: (*i*) weak financial position of local bodies, (*ii*) cash-based (instead of accrual-based) accounting systems which do not capture information about the asset-liability profile, (*iii*) relatively short tenure of bonds in relation to the gestation period of infrastructure projects that are being financed and (*iv*) absence of bond banks (as in the US) that access capital market and then on-lend to smaller local bodies.

The existing functions and sources of finance of ULBs have come to be identified as 'local' in nature not on the basis of any economic logic or theoretical foundation but on the recommendations of successive committees and commissions starting from the Royal Commission on Decentralization (1906), which examined the financial problems of local self-governments in India. Subsequently, the Municipal Acts which were passed first in 1924 with reference to Bengal and again in 1934 with reference to all British Provinces identified certain functions as being local in nature. These have come to be confirmed by the subsequent Rural Urban Relationship Committee, (1966), and a host of other committees and commissions in India. For instance, the Rural-Urban Relationship Committee observed the goals of the local government in the context of the changed scenario, viz.; (a) to function as local units of self-government; (b) to provide local public services and conveniences for healthy living, work and play; (c) to ensure planned and regulated development of urban areas; (d) to mobilize local resources and utilize them to the maximum good of the community; and (e) to promote social, economic and cultural development in an integrated manner. Even before Independence, it had become a convention to create municipal bodies and to assign the functions by the British in India. However, after Independence, new functions have been assigned to ULBs, which included environmental protection, town planning, urban poverty alleviation, welfare of weaker sections, etc. Accordingly, functions of ULBs in India include supply of safe drinking water, construction and maintenance of municipal roads, public street lighting, and preventive health care like immunization against epidemics as well as curative primary health facilities, garbage removal, construction of storm water drains, market stands, public parks, gardens and public halls. In recent years, a few more functions like pollution control, solid waste recycling, and public education about civic responsibility have also been added.

Urban Municipal Finances and the 74th CA Act

Finance is one of the core concerns in any planning and governance issue related to infrastructure provisions. The Constitution has given a clear mandate to the local bodies to evolve institutions of self-governance through widening their operation base. The growing pressure of urbanization has made this task difficult and compelled the ULBs to have a fresh look into their resource base. It is only natural that urbanization pushes up expenditure level and local government budgets are expected to increase with urbanization. It brings the question of how far the expenditure response exceeds the revenue response. In fact, the pressure on expenditure is usually greater and increased urbanization is synonymous with increased fiscal gap. Hence, the problems of funding the urban infrastructural finance have to be carefully managed as the pattern of financing primarily depends on the user charges. Further, though it is possible for urban institutions to access resources from the capital markets to finance a large portion of urban capital expenditure, the solution of massive increase in the user charges approach, in no way permits the urban local authorities. Even if this approach is followed, the urban fiscal situation may not improve at all as the revenue sources at the disposal is limited.

The total revenue available to finance the growing expenditure requirements of the cities can be classified into tax revenues, non-tax revenue and external funding. These are referred to as traditional revenue sources, which are reported to be grossly inadequate in relation to needs. Tax revenue of an urban local body is determined by: (a) the size of the economy and population base represented the per-capita income level, (b) the relationship between various tax bases and the economic base, and (c) the statutory tax rate for each tax, and the collection efficiency defined as the ratio of actual tax collection to statutory tax liability. Financial managements need to look into all these factors in order to create a vibrant revenue base for the ULBs. Instead, the ULBs are increasingly focusing attention to only one factor, i.e. mopping up money from the market with long-term debt liabilities. As urban planning now falls under the purview of the ULBs and it is also the task of the planners to suggest financial resource mobilization as a prerequisite to plan implementation process, the local bodies are deeply embroiled in the dilemma of indebtedness. Meager finances are forcing them to go in for loans and trying up buoyant resources into the payment trap. But what impact it is having on provision of services? How far the new financial instrument is helping the local bodies in achieving its objective of providing adequate infrastructure? These issues have to be addressed properly by considering the significance of urban governance in managing these financial commitments.

India's long history of urban municipal governance was characterized by some structural infirmities which affected its performance. Municipal bodies were delegated limited powers. Their autonomy was restricted. The allocation of poor financial resources made them totally dependent on the state government. Inadequacy in the services provided by municipalities raised doubts in the public mind about their ability to efficiently discharge their civic responsibilities. State governments were prone to taking the drastic step of superseding municipalities on grounds of malfunctioning, and not following it up with election at an early date. Political considerations often dominated the decisions.

The Municipal bodies have come to depend on higher levels of government for their operations and maintenance requirements. In this regard the 74th Coustitution Amendment has assigned the responsibility of operations and maintenance of such service provisions be progressively decentralized to municipal bodies and wherever feasible may also be to private sector. In other words, It has brought about a radical departure from the past structure of local governance. Among other things, it:

- Makes the constitution of municipalities mandatory;
- Recognizes a third tier of elected representatives below the Centre and the states;
- Requires direct elections to a municipality (exceptions have been specified);
- Reserves one-third seats for women ar.d also reserves seats for the Scheduled Castes and Tribes;
- Lays down a fixed tenure of five years for municipalities;
- Severely restricts the power of the state government to dissolve a municipality;
- Requires the State Finance Commission to review the financial position of the municipalities and make recommendations to the Governor in regard to the taxation powers of the municipality, revenue sharing and grants -in-aid;
- Requires the State Election Commission to conduct elections of municipalities; and
- Makes the setting up of District Planning Committees, Metropolitan Committees mandatory.
- The 74th Constitutional Amendment thus ensures that the urban local governments are not at the mercy of the state governments.

According to 74th Constitution Amendment Act the functions of municipalities would go beyond the traditional civic functions and are expected to play an important role in the formulation of plans for local development and the implementation of development projects and the programmes, including those specially designed for urban poverty alleviation. The list of functions laid down in the twelfth schedule is as follows:

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 purpose.

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 the society, including the handicapped and the mentally retarded.

10 Slum improvement and their 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, cremation grounds and electric crematoriums.

15 Cattle ponds, 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 Regulations of slaughter houses and tanneries. etc.

Thus, the 74th Constitutional Amendment has given a new functional base for the ULBs in India.

Reforms Initiatives for Urban Public Provisions and Financing

The 74th Amendment Act of the year 1992 has brought a sea change in the perception of ULB's and now it gives Constitutional identity to them and also empowers them with wider powers to undertake various civic functions. The Act also provides for a clear hierarchy of ULB's and makes provisions for devolution of funds from the Centre and state governments. It also clearly mandates a participatory approach by the creation of district planning committees, metropolitan committees and ward committees. The Act further provides for several features which now make ULB's more powerful. In the wake of this development recently, several ULBs have embarked on a variety of reform initiatives in order to secure good urban governance, like; Property Tax Reforms, Accounting Reforms, Emphasis on Private Sector Participation and NGOs in infrastructure provisions, Municipal Bonds, Incentive Funds, Pooled Financing etc.

Property Tax Reforms

In India, the Annual Ratable Value (ARV) system of property tax is popular at the urban level. However due to several problems in the ARV system, this was abandoned as the base of the tax in some states and switched over to a new system based on unit values. Broadly, it envisages a zonal rate for different homogenous zones into which the city is divided. Zonal rate constitutes the basic tax to be paid by all lands and buildings and elements of progression are brought into the system on the basis of location, quality of construction, age of buildings and land use. These are graded and different values are imputed to different grades and the unit values are then determined in the form of a ready reckoner. These values are applied in determining the base by multiplying the carpet area with the unit values per sq. feet, as exists in Patna. Thus, now the system seems to be objective, simple to administer and easier for the taxpayers to comprehend. Besides the merit of adopting a Unit Value system of Property Tax, the State Government like Uttar Pradesh has amended municipal laws for de-linking the standard rent concept of the Rent Control Law from valuation of Property Tax base.

Accounting Reforms

The Office of the Comptroller and Auditor General (C & AG) has recommended that accrual basis of accounting needs to be followed in ULB's and it has evolved accounting and budget formats for them. The C & AG has developed a detailed set of formats for keeping the accounts. Further, if ULBs follow the guidelines of the Task Force, accounting would be streamlined to a better presentation of the financial picture and consequently, more clarity in the situation to enable decision making. The advantage in this method also helps Audit Party to understand the financial picture more correctly and enable them to perform their role as a watchdog better. Thus, as improved accounting is crucial to support better planning and ensure accountability to citizens through improved public reporting, several states and larger cities have started introducing accounting reforms recently.

Private Sector Participation and NGOs

Recently several ULBs, State Housing Boards and Development Authorities have started involving the private sector in service delivery to meet the growing demand for these service provisions. For instance, in the sphere of solid waste management, the case of the city of Bangalore stands out as a classic case. Several parts of the city have been contracted out to private profit making contractors and this system of governance with the local body playing the role of a monitor and the private sector doing the actual service delivery, with the citizens acting as a watch dog appears to be working well. Similarly, in the city of Visakahapatnam, water supply provision and street lighting maintenance are both privatized through contracts. The benefits of this type of a system have been experienced in many municipalities, and thus large number of municipalities have shown interest in contracting out works to the private sector in many of the cities. The Non-Governmental organizations (NGOs) which are functioning across the country without any profit goal, and showing voluntary interest in social services and development thus playing a major role in delivering good urban governance. While in some instances, the local beneficiary community itself is involved in many cases. Many parts of Delhi are being looked after by ACCORD, an NGO, working in the field of solid waste management. There are also thousands of NGOs who are engaged in various sectors such as health, women, child, water and sanitation, education, etc.

In fact, the most of ULBs have not yet seriously thought on private sector participation in the provision of urban services as there are no "enabling" legal provisions that facilitate the use of non-government sector. While the Municipal Acts do not use precisely the word "private sector", a serious reading of the legal provision suggests that the Acts do permit the use of any person for delivering specific services. Hyderabad Municipal Corporation Act, 1955 (No. 11 of 1956), for example, clearly states: "The Commissioner when authorized by the Corporation can enter into an arrangements with any person for supply of water" (Section 342). This could include construction and maintenance of water works, purchasing or taking on lease any water works, storage and transportation of water etc. More or less similar clauses are found in the other Municipal Acts. With the passing of Constitution (74th) Amendment Act, all the states are expected to make amendments to their respective municipal acts, incorporating the necessary changes. This has already been done in a majority of states; quite a few examples may be cited

here; like, Amended Municipal legislation in Maharashtra contains a provision to the effect that where any duty has been imposed or any function has been assigned to a municipality by law, the municipality may either itself discharge such duty or outsource to any agency. Government of Gujarat and Tamil Nadu have issued Guidelines on Public-Private Partnerships in urban infrastructure and services. Issuing the guidelines and inserting specific clauses in the state municipal acts enabling the involvement of the private sector will go a long way in improving the quality of services in the urban areas. Importantly, Reports of First Generation Finance Commission of some of the states such as Kerala, Madhya Pradesh, Punjab and Tamil Nadu have suggested for contracting out certain municipal services to the private agencies. Of course, Tamil Nadu State Finance Commission, for example, has also suggested for contracting out of garbage, maintenance of commercial assets, etc to private agency in order to reduce the financial burden on municipal bodies and improve the delivery of the services. In Punjab, ULBs have been given full powers to get the civic amenities done through the private agencies. Similarly, Madhya Pradesh Finance Commission suggested that the collection and disposal of garbage should be given to private agencies. Even in Karnataka, the solid waste management service is carried out with the participation of private sector as well.

Municipal Bonds

Besides municipal accounting reforms, in order to give boost to development of the municipal bond market in order to generate additional revenue, the Central government amended the Income Tax Act for issuance, of tax-free municipal bonds and permitted Rs.2, 000 million in 2001-02 and Rs. 5,000 million in 2001-03 to be raised through tax-free municipal bonds. Besides this, the Central government introduced two incentive funds to motivate the state governments to introduce reforms for attracting investments in urban settlements. But some of the factors that inhibit development of municipal bond market have been observed, like: (*i*) lack of credit worthiness overlarge number of city governments and municipalities, (*ii*) problem of credit enhancement, (*iii*) need for technical assistance, (*iv*) lack of robustness, in revenue generation from own source of revenue, and (*v*) lack of professional skills for structuring and development of commercially viable or bankable projects, (*vi*) lack of confidence amongst the lenders about the ability of local governments to service the debt.

Incentive Funds

In order to create revenue base for the local governments, during 2002-03 the Government has introduced the incentives, viz.: (*i*) Urban Reform Incentive Fund, and (*ii*) City Challenge Fund. Urban Reform Incentive Fund

(URIF) with an initial outlay of Rs.500 crore has been set up to provide reform linked assistance to the states. Detailed guidelines have also been formulated to give financial assistance to states for introducing reforms that have been identified in the Guidelines. On the other hand, the City Challenge Fund is an incentive based grant facility that will support cities to fund transition costs of moving towards sustainable and credit worthy institutional systems of municipal management and delivery, and sector level reforms (e.g. in the urban water and sanitation sector), is really an innovative development.

Pooled Financing

Pooled financing structures are state sponsored intermediaries, a measure to meet inadequate resource and to support borrowings by smaller municipalities. Under this system, state sponsored intermediaries borrow on its own financial strength for a number of smaller municipalities that are individually not in a position to access the capital market on their own strength. Pooled finance mechanism indeed serves as debt fund for small and medium size municipal entities. A spin-off of this structure is that it can be used to leverage urban reforms in small and medium towns.

The Government of India has formulated guidelines that will help create pooled finance structures in various states which, help to identify small and medium towns with a population of upto a million. They envisage: (*i*) facilitating development of bankable urban infrastructure projects, (*ii*) reducing the cost of borrowing with appropriate credit enhancement measures, (*iii*) raising funds from the market for bankable projects through Bonds, (*iv*) support municipal bodies in project development for urban infrastructure, and (*v*) restructuring of existing costly debts.

Whatever may be the reform process that is being adopted for the Indian ULBs, the principles for reforms in infrastructure management laid down by the World Bank need due consideration as these called for: manage infrastructure like a business, not a bureaucracy; introduce competition-directly if feasible; indirectly if not; give users and the stakeholders a strong voice and real responsibility; public-private partnerships in financing have promise; governments have a continuing, if changed role infrastructure (Nand Dhameja 2003).

Needed Municipal Financial Reforms

To enable fiscal decentralization which can play an important role in providing public services at local level, a number of reforms at the local government level are proposed. These are:

1. Clear activity mapping based on comparative advantage in implementing expenditures and devolution of functions to the urban local bodies based thereon;

2. Providing appropriate revenue opportunities to local bodies;
3. Guiding the local governments to undertake reforms in their tax systems, particularly taxes on land and property;
4. Capacity building of local governments to enable them to raise resources and provide public services efficiently;
5. Unbundling the state sector schemes and consolidating central sector schemes to enable greater flexibility and autonomy to ULBs in the implementation;
6. Professionalisation of SFCs and reforms in the state transfers to make them adequate, rule based, equitable and incentive compatible; and
7. All these are possible only when there is an up-to-date information system comprising of fiscal, demographic, geographical and economic data for the ULBs jurisdictions.

Activity Mapping

The most necessary reform is to identify the functions that need to be undertaken by the ULBs and devolve these functions to them. Activity mapping in the wards of ULBs is the first step and this should be followed by identifying assignment of revenue resources and designing and implementing the transfer system to meet the requirements of the ULBs to carry out the functions devolved to them in an equitable and efficient manner. Activity mapping, identification of independent source of revenues and reforming the transfer system and building capacity of ULBs to efficiently implement their tax and expenditure policies has to constitute the core of local government reform in India.

Once the functions are transferred, it should be the local governments who should have unbridled authority in implementing them. If they so desire the ULBs should have the authority to discontinue such schemes, as they think, are not important. The employees transferred to implement the expenditures in ULBs should be accountable entirely to the ULBs. For instance, it may be useful to initiate actions to create a district cadre of teachers, health workers and other functionaries providing local public services and the ULBs should have full authority for appointments, promotions and transfers(within the district). The general purpose transfers recommended by the SFCs should take into account the expenditure requirements to undertake these functions.

Augmenting Own Revenues

It is doubtful whether in the short and medium term, it is possible to enhance the own revenue resources of ULBs at the district level. However, at the city level, it should be possible to improve fiscal autonomy and improve the standards of services by raising greater volumes of own revenues. Enhancing fiscal independence of ULBs through augmenting own resources involves: (*i*) assignment of expandable revenue sources and (*ii*) development of the capacity in the ULBs to raise more revenues by improving their capacity to enforce and administer the taxes and non-tax revenues assigned to them.

The critical issue in urban fiscal decentralization is both of designing proper tax system and of building local capacity to enforce taxes and raise significantly higher revenues is that whether the local government will be able to provide the services according to the needs of their citizens. Fiscal decentralization is meaningful only when the local governments have the power and the capacity to raise the revenues to finance substantial proportion of the public services. Thus, improving own revenues of municipal corporations is at the core of improving urban fiscal decentralization in India. It is important to note that when decentralization was mandated in 73rd amendment, no attempt was made to augment the consolidated fund of the state. It was believed that the finances devolved to them would take care of the functions that were de-concentrated. Indeed, the increased administrative and co-ordination cost of decentralization was recognized, but the fond hope was that the local governments will automatically use the tax powers more intensively and will provide better standards of public services assigned to them.

Reforms in the Transfer System

If the assignment system has not helped to improve the decision making power of decentralized units, the transfer system has not helped to enhance their fiscal autonomy either. The system of transfers to local governments should comprise of a combination of general purpose unconditional transfers to enable them to provide public services according to the activities assigned to them and specific purpose transfers to ensure prescribed minimum standards in services considered being extremely important (meritorious). The prevailing system of transfers in regard to both general purpose and scheme based is in urgent need of reform.

The SFCs should be required to work out the general purpose unconditional transfers to ULBs. An ideal system of transfers would require the SFCS to estimate expenditure needs and revenue capacity of all local body units at the city level. A clear activity mapping of general functions should help them to estimate the costs of delivering these services. Similarly estimation of revenue capacity of each local body unit would require significant information and effort. While the actual modalities of the transfer should be left to the SFCs in different states, it is important that the state governments should take necessary initiatives to compile basic information relating to fiscal,

demographic and economic variables at the district city levels. There is a need for significant strengthening of the local fiscal management unit in each of the states to compile and update information regularly and help the ULBs in their reforms of expenditure and tax systems. Above all, the most important reform needed is to professionalize the SFCs. The State Governments should ensure that the persons appointed for the purpose are well qualified.

Urban Public Provisions and Needed Financial Reforms: Emerging Policy Issues

Due to inadequate finance and inability of the ULBs to generate such huge resources, the urban bodies are unable to deliver their obligatory functions. Though the state government exercises legislative, administrative, financial and judicial control over ULB's, this has become more of a curse than a boon. Due to higher financial dependence on state, the ULB's have become mere agents of state. The financial control over the urban bodies has also been rigid that they have virtually no autonomy left and when there is rigid control the relationship between the state and urban bodies would be strained.

Intensive outreach to citizens and CBOs is a critical element in the urban reform process and in increasing municipal revenues. ULB leaders need to convince the beneficiary citizens of project to obtain their support and participation and to help generate additional municipal revenues. Simplification of procedures, rules of eligibility, approval process, and funds release facilities, better community awareness and active participation of CBO. In order to develop community and private sector interests in investing in urban infrastructure, it is necessary to share information with them. A communication strategy to facilitate better community awareness and education should be integral to all development programmes.

In terms of institutional structures as it is evident, now, municipal functions are fragmented between different corporations, agencies and local government bodies across state and local levels with conflicting lines of accountability. Further, the existing agencies for municipal services delivery are structured along line function systems with limited accountability, limited incentive for innovation in delivery of services and limited use of private sector capacity to manage and finance services. In short, there is a limited interface and accountability between political and administrative systems and communities. In particular, poor communities have a limited voice over city policies.

In terms of fiscal problems too, there is persistent under performance on revenue effort with unattainable tariff structures and non-transparent subsidy schemes. The general property tax systems require restructuring and modernization for many reasons. Low income households are often at the regressive end of fiscal system adopted by the urban administration. At the same time, improvements in tax revenues and user charges are likely to be most acceptable in the context of concurrent improvements in the institutions of service delivery. This is perhaps analogous to the political acceptance of tolling of highways after high quality highways came about.

In terms of financial aspects, of course, urban bodies have limited credit worthiness, with opaque financial and accounting systems and limited treasury management systems. Cities depend on fiscal transfers from other tiers of government or Central government intermediation, e.g. through HUDCO. The limited access to private finance in turn limits the targeting of public funds for broader social programmes and safety nets for the poor. However, access to capital markets is dependent on the institutional and fiscal reforms.

There is a need of independent regulatory capacity to overset operations of private participation in infrastructure, enforce social obligations of governments in particular with regards to the poor and ensure application of environmental standards. Urban infrastructure reforms therefore have dimensions of institutional, fiscal, financial and regulatory reforms with economic efficiency and poverty reduction as the core objectives of the programme. The sector focused reforms in service delivery e.g., a programme which focuses only on water and sanitation and solid waste need to incorporate such institutional fiscal and regulatory reforms at least in future.

In terms of financing patterns, however, the foundation of urban public services has to be user charges; it is possible for urban institutions to access resources from the capital markets to finance a large portion of urban capital expenditure to be serviced by user charges in the future. This approach hence makes it possible to have a massive increase in capital expenditure on urban infrastructure without worsening the fiscal problem. In addition, the tariff restructuring process allows for more efficient and targeted impact on the poor. Thus, the emerging challenges in meeting the urban infrastructural financing are indeed difficult to list here. These would be efficiently met, if the initial urban governance efforts be expedited through a more forwarded and most needed urban local level reforms process.

The Indian Constitution has slotted urban development as a state rather than Central function. Urban Local Bodies during these years are under the administrative and financial control of state governments. A whole range of parastatals have gradually usurped the power of local bodies. High-powered commission in Karnataka is explicit in the need to devolve power of parastatals especially the powers of Development Authorities to Municipal Bodies. Despite this, and in direct contravention to the spirit of the 74th Constitutional Amendments, parastatals not only remain but also flourish. In Karnataka, new and more powerful forms emerge. In the case of Bangalore, a significant

issue is that of emergence of various types of special purpose agencies almost one for each new mega-development project. Therefore, the issue is when parastatals are empowered to plan and implement development projects; the ULB's and citizens have to bear the cost for projects. The other important issue relates to parastatals forming instruments to enforce political control along party lines by higher levels of governments. The impacts of political interventions in the governance of ULB's are of great concern for the citizens.

However, there are a few issues which deserve attention here; the first and most serious is the scarcity of finance. There is an imbalance in terms of their functions and revenue. Though they can impose certain taxes, the elected members of the ULB's hesitate in doing so for the fear of displeasing their electorate. Therefore, the taxes collected by urban bodies are not sufficient to cover the expenses of the services provided. The administrative machinery at the disposal of local bodies is insufficient and ineffective. The staff, which is often underpaid, also indulges in corrupt practices, which leads to loss of income. Quite often failure in collecting taxes leads to accumulation of arrears running into crore of rupees. Many civic bodies are even unable to provide basic civic amenities. With their low capacity and lack of willingness because of the high political cost involved to generate their own resources through taxation, the municipal bodies' dependence on higher authorities is substantial. Several studies have highlighted the significant disparity that exists in the income of local bodies and its various components across size class of urban centres. A study by the National Institute of Public Finance and Policy (NIPFP 1995) reveals that the per capita (own) revenue for D class cities, with a population above five lakh was more than three and half times that of A class towns, with a population below one lakh, in the early 1990s. The tax and non -tax revenue together constituted 90 per cent of the total revenue in the case of the former while the figure for the latter was 70 per cent only. Correspondingly, the share of grants in total revenue for D class cities was only five per cent while that for the lower class towns was as high as 18 per cent. The high dependence on external grants for the smaller towns is a major handicap in undertaking the development responsibility on their own. In other words, the larger cities are financially stronger and can take up public works and social infrastructure projects on their own. But this is not the case for smaller towns. At the lower level there is a personnel system but, at the higher level, there are 'deputationist" integrated and unified personnel systems as well as a separate system of staff of various gradations appointed by authorities at different levels. The basic issue is not the type of personnel system but its quality. For too long, municipal services have been treated as inferior and have not attracted 'superior' talent. Therefore, the need is to improve pay scales, allowances, leave conditions, career prospects, scope of self-improvement and incentives. The need of the hour is to train the personnel periodically to improve their effectiveness and efficiency.

The manner in which governments regulate and tax firms and transactions, domestically and at the border, play a big role in shaping the investment climate. Sound regulation addresses market failures that inhibit productive investment and reconciles the interests of firms with wider social goals. Sound taxation generates the revenues to financé the delivery of public services that improve the investment climate and meet other social objectives. The challenge all governments struggle with is how to meet these objectives without undermining the opportunities and incentives for firms to invest productively, create jobs, and expand. While there can be tensions between firms' preferences and social goals in this area, there is huge scope for improving approaches in most developing countries without compromising broader social interests. Too often, governments pursue regulatory approaches that fail to achieve the intended social objectives because of widespread informality, yet harm the investment climate by imposing unnecessary cost and delays, inviting corruption, increasing uncertainty and risk, and creating unjustified barriers to competition. The key is to strike a better balance between market failures and government failures, ensuring that approaches are adapted to local conditions and by enhancing transparency. Successful reforms remove unjustified burdens and streamline procedures. They reduce regulatory uncertainty and risk by curbing discretion and expanding consultation. And they remove unjustified barriers to competition by reducing regulatory barriers to entry and exit and by tackling anticompetitive behaviour by firms. For instance, tax rates in developing countries are similar to those in developed countries. But a high level of informality, coupled with poor administration, places a disproportionate burden on those who do comply, and distorts competition. Keeping the size of government in check and spending public money efficiently help ease the pressure on revenue collection. Beyond this, broadening the tax base and simplifying tax structures can help. Increasing the autonomy of tax agencies has also improved performance in Peru and many other countries.

Need for Coordinated Decentralized Fiscal Approach

In view of increasing demand for the urban utility services (public provisions), the ULB's have to ensure the regularity and efficiency in delivering the urban public goods and services. But, most of the ULBs find it difficult to ensure regularity and financial soundness to meet the services demand. Thus, though, multiple agencies are bound to exist in large metropolitan cities, the main issue is one of the planning and coordination. Coordination among the various agencies responsible for providing infrastructure and services in the urban areas which requires consideration on priority. Generally it has been observed those infrastructures created by one agency are often damaged by another agency operating in the urban area. Roads are generally laid first and when water supply and sewer pipes are laid then the roads already laid are

dug and are damaged requiring re-laying of road at huge cost. Similarly while laying down telephone lines, installing electric lines, making improvement in road network, road infrastructure are damaged. Thus, it would be important that such services should be done in a planned and coordinated manner and all services should be laid as per a pre-drawn programme so that no damage is done to the infrastructure which is already laid. Plan of infrastructure should be available with local authority and before lying of services prior permission of local authority should be made mandatory. Damage, if any, done to any infrastructure should be rectified on the risk and cost of the department doing such damage. Obviously, the underlying problems that prevail with both finance and infrastructure can be traced to a specific market failure—for finance, it is information asymmetries, and for infrastructure, market force associated with economies of scale. But too often government interventions have made matters worse. Financial markets have been repressed and distorted by state ownership, monopolies, directed or subsidized credit, and other policies appealing to the short term interests of politicians and favored groups. Those measures undermine financial sector development, firm-level productivity, and economic growth. Infrastructure provision has been undermined by governments using state ownership or regulation to pursue objectives unrelated to efficient service delivery—typically favouring some groups over broader interest and introducing new sources of inefficiency. Governments are confronting these issues, but progress is slow and uneven. They are pursuing new approaches that recognize that finance and infrastructure are not only part of the investment climate for other firms, but are also profoundly shaped by the investment climate for providers of financial and infrastructure services. That is why many governments are taking steps to increase competition among providers of finance and infrastructure, secure their property rights, and regulate them in ways that recognize the trade-off between market failures and government failures. Governments are also working to improve management of public resources—to get more for their money when they finance or subsidize infrastructure services. As financial markets are affected by political economy of the country in question, Government policies toward financial markets, in fact, are influenced by the wishes of powerful groups and the self-interest of politicians. Competition often suffers from that influence.

The 74th Constitutional Amendment is a step taken to decentralize the process to plan and identify the development priorities that strengthen urban local body planning process. This Amendment has also given an opportunity to identify the local issues as per the citizen's needs, and financial power to execute such projects. But, urban infrastructure will be the key issue in organizing the urban structure irrespective of locational qualities. Indian cities are structured around organic development or citizen centred decision in planning process than planned formally. The visual quality of spaces is inherent with such process. The recent trend of providing quality infrastructure is bringing pressure on ULB's, which are not organic in sense but are imposed at local and regional level. This is raising the questions of sustenance of the development and lack of human resource in managing at urban local body level. It is important to gear up ULB's, so that they will be in a better position to accept and plan according to the speedy changes. In addition the interest and debt burden of investments made in the past and ineffective cost recovery have also become combersome. So there is a need to look beyond the inter-governmental transfers or tax or government debt as source of urban infrastructure finance, it is difficult to mobilize the required resources. Thus, it becomes urgent and inevitable to advocate alternative options that could be thought of to meet the resource requirements of the urban sectors.

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The urban bodies have limited credit worthiness in terms of its financial soundness, along with adequate financial, accounting and limited treasury management systems. The limited access to private finance in turn limits the targeting of public funds for broader social programs and safety nets for the poor. Moreover, access to capital markets is dependent on the institutional and fiscal reforms. Hence, there is a need of independent regulatory capacity to overset the operations of private participation in infrastructure. Urban financial reforms therefore have dimensions of institutional, fiscal, financial and regulatory reforms, with economic efficiency and poverty -reduction as the core objectives of the programme. In terms of financing patterns, the foundation of urban institutions for urban infrastructure is to be user charges. But it is not possible to access resources from the capital markets to finance a large portion of urban capital expenditure to be serviced by user charges. This approach hence makes it possible to have a massive increase in capital expenditure on urban infrastructure without worsening the fiscal problem. In addition, the tariff restructuring process allows for more efficient and targeted impact on the poor.

Many municipalities have accumulated huge debts and are facing serious problems in servicing their debt which has serious repercussions on the availability and quality of urban basic services in the urban areas. This in turn affects the urban productivity and human efficiency. Abolition of octroi, loss of elasticity and buoyancy of property taxes, poor cost recovery and resources as also the not-so-effective administration of taxes put a further dent on the already sick municipal institutions. It was also experienced that in many states the functions like provision of water supply and sewerage has either been taken over by the state governments or transferred to parastatal agencies. It is also a shared responsibility in some states. In Bangalore for example, entire water supply and sewerage system is the responsibility of a metropolitan parastatal agency, namely, Bangalore Water Supply and Sewerage Board. In Mangalore, the source development and bulk water supply is undertaken by the state level agency, Karnataka Urban Water Supply and Sewerage Board, while the city corporation does the distribution functions, finance and institutional capabilities, thus has had its own toll on the level and quality of even the most basic services and quality of urban life.

The assignment of appropriate function to the municipalities through

12th Schedule of the Constitution and mandatory provision for Constitution of Finance Commission by every state, once in five years to review the financial health of the municipalities in the state and make recommendations to strengthen the finances of the municipalities are some of salient features of the Act. Considering the present institutional arrangements for services like water supply and sanitation, the state level agencies, and parastatal organizations may continue to plan and implement capital works, the responsibility of operations and maintenance may have to be progressively decentralized to municipal bodies and where feasible to private sector.

Conclusion

Recently, local bodies face the challenge of increasing revenue in India. But, progress has also been made in developing the policy and legal framework for local governments to access outside resources to finance urban public provisions. However, to access more capital markets, ULBs must develop commercially viable projects and strengthen their own financial position at present which may depend on establishing a healthy revenue base at the local level. Hence, to increase their creditworthiness, municipalities will have to improve collection of property taxes and water tariffs which would be viable for the people. This requires political commitment and obtaining stakeholder support, introducing new cost recovery and pricing practices, and creating a comprehensive information base. Moreover, state governments can enable all these changes at the local level through policy and regulatory changes. But, a serious handicap is the absence of "Public Hearing System" in respect of monitoring and evaluation of the public programmes or policies at all levels of local governments in many of the states in India. Effective partnerships of Central, state and local governments, community-based and civil society organizations, the private sector, and academic institutions will not only increase investment by the private sector and communities for improving urban infrastructure but also strengthen ULBs in achieving the objectives of decentralization envisioned in the 74th Constitutional Amendment in recent days.

Past experiences have revealed that Government alone cannot undertake the enormous task of infrastructure development for meeting public utilities. It is observed that service provided by public agency is usually at a higher cost of production whereas when private organization is given a monopoly, regulation by the government is essential to prevent cost escalations. The Public-Private Partnership (PPP) can improve efficiency by combining advantages of public and private sector and Government can retain control over the organization to ensure that public interest is served. But, if PPPs have to deliver high-quality and cost-effective services to consumers and the government, there must be adequate risk transfer from the government to the private sector, which may further boost investment climate at the urban level.

Equally important, the quality of services has to be negotiated so that payments to service providers can be linked to performance and the risk of costly contract renegotiations can be minimized. There has to be either competition or incentive based regulation in order to ensure quality delivery. An appropriate institutional framework characterized by political commitment, good governance, and clear supporting legislation is hence needed and the government will have to refine its project appraisal and prioritization skills so as to enable it to manage a complex PPP programme. The lack of accounting standard for reporting PPPs and standards practiced so far arises concerns about transparency, especially regarding the longer- term fiscal implications of such schemes when executed by urban agencies. The decentralization of autonomy will increase the efficiency of ULBs and they must be prepared to introduce viable local reforms so as to improve their financial efficiency. However, the ability of municipalities to take advantage of the urban reforms opportunities depends on their presenting themselves as viable financial entities. In this regard, the ULBs must demonstrate creditworthiness and obtain an investment grade credit rating and this forces them to improve their revenue base by introducing reforms, including improved cost recovery and financial management, and better management of urban services. There should also be clear demarcation of powers between the parastatals and ULBs and the ULBs need to be empowered through decentralization strategies, restructured governance, technology upgradation and induction of specialized and skilled personnel. The rationale of fiscal decentralization has to be the top agenda of financing the urban public provisions (utilities) in the larger urban cities of India.

To conclude, the case for establishing adequate and effective tax systems at decentralized levels of government is one of the critical issues of fiscal federalism in the developing world. And it is a truly challenging problem (Bahl and Linn 1992). Fiscal reform efforts in the developing world must focus on: (*i*), Restructuring systems of intergovernmental grants, in some instances to reduce the extent of financing that they provide to decentralized levels of government, and, more generally, to remove the perverse incentives that they often embody fiscal behaviour on the part of recipients, (*ii*) Redesigning revenue systems so as to provide decentralized levels of government a much expanded access to own-revenues to finance their budgets and thereby reduce their dependence on transfers from above and (*iii*) Reviewing the use and restrictions on debt finances to ensure that debt issues are not a ready way to finance deficits on the current account. All three of these avenues of reform contribute in important ways to the establishment of a hard budget constraint, but one that permits decentralized levels of government to do their jobs. Nevertheless, a comprehensive process of fiscal dencetralisation is underway in developing countries, including India, and it involves the issue of defining the fiscal responsibilities at the different levels of government and introducing fiscal instruments and procedures needed both to support emerging private markets and to deliver needed public services (Bird, Ebel, and Wallich 1995).

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