Financing India's Urban Transformation

Key Findings

- To finance its urban infrastructure, India needs Rs 4 to 4.3 trillion annually – approximately three times the revenue receipts of Urban Local Bodies (ULBs). This significant gap highlights the urgent need to address urban financing shortfalls.
- A deeper examination of ULBs' revenue reveals a pronounced decline in tax-based income. In financial year (FY) 1961, own tax revenue accounted for ₹73 of every ₹100 received, plummeting to just ₹28 in FY2021.
- Despite constitutional amendments to empower ULBs with greater financial autonomy, the devolution of financial powers remains limited. Tax revenue generated by local governments in Canada, Denmark, Finland, Netherlands, Sweden, and the United Kingdom, on average, accounts for 7% of the national Gross Domestic Product (GDP), significantly higher than 0.2% in India.
- Property tax yield is estimated to be between 0.16% and 0.24% of GDP for India compared to 1.9% of GDP in OECD countries.
- ULBs should explore market-based financing options like municipal bonds to bridge the gap. Moreover, there is a favorable perception regarding the liquidity of municipal bonds, which could serve as a catalyst for increased investor participation.

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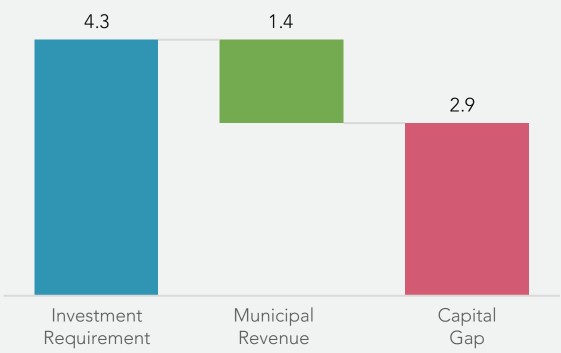
Introduction

Urban development is essential to sustaining economic growth and improving the quality of life for millions, as highlighted in the inaugural edition of this whitepaper series - *The Economic Significance of Urban Areas.* However, the challenge lies in how to fund the infrastructure, housing, and services that cities require to thrive. In this second edition, the focus shifts from understanding the importance of urban areas to addressing the financial strategies needed to support their growth.

With rising populations and increasing demands on public services, financing urban development has become a complex issue. Traditional funding mechanisms alone are insufficient, requiring cities to explore innovative solutions. This whitepaper will examine the sources of financing for local governments, the challenges they encounter in mobilizing capital, and present potential solutions to unlock new capital flows.

The High-Powered Expert Committee (2011), commissioned by the former Ministry of Urban Development, projected that India would need Rs 59.1 trillion to finance its urban infrastructure between financial year (FY) 2013 and FY2032. More recently, the World Bank estimated a similar figure of Rs 60 trillion for the 15-year period from 2022 to 2036. Adjusted for inflation, this translates to an annual investment requirement of Rs 4 to 4.3 trillion-approximately three times the revenue receipts of Urban Local Bodies (ULBs), which stand at around Rs 1.4 trillion. This significant gap highlights the urgent need to address urban financing shortfalls.
A useful starting point to bridge the capital gap is by examining the current financing sources available to ULBs and identifying the inherent challenges they face.

Annual Municipal Revenue and Investment Requirement (Rs trillion)



Source: World Bank, RBI

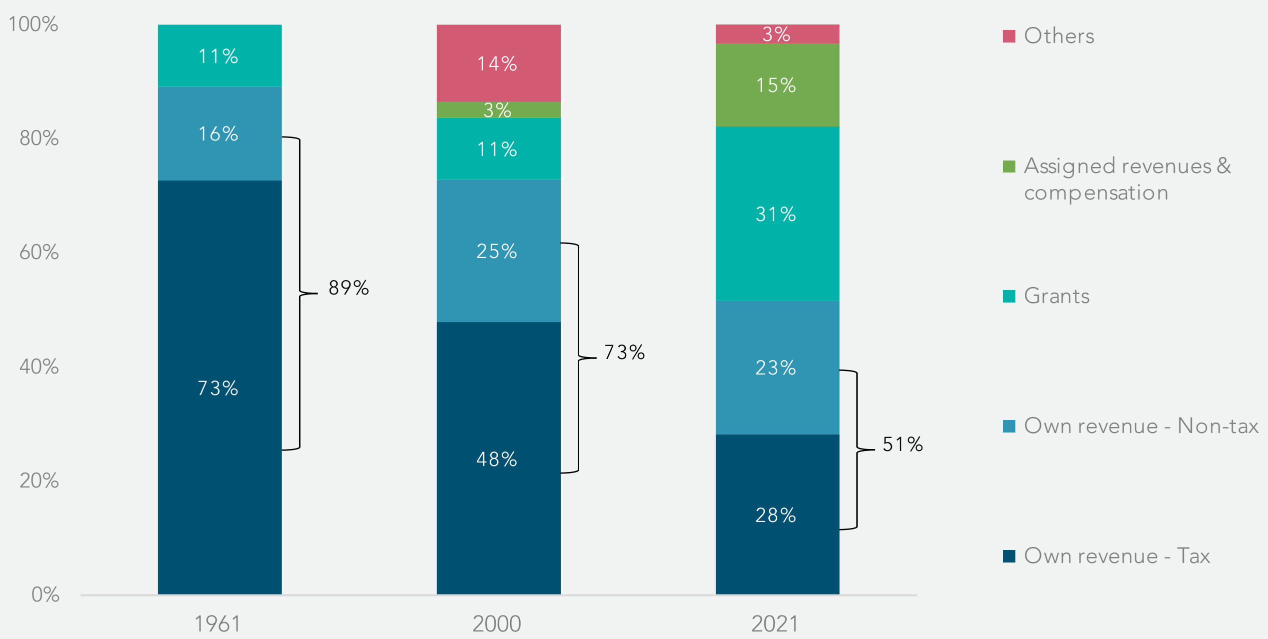
Overview of ULB Finances

ULBs derive their finances from a range of sources, primarily comprising of their own revenue, grants-in-aid, assigned revenues and compensation such as entertainment tax and stamp duty collected by higher levels of government and assigned to ULBs, and other miscellaneous sources. According to FY2021 data from the Reserve Bank of India (RBI) and the Ministry of Housing and Urban Affairs (MHUA), for every ₹100 in total revenue, ULBs generated ₹51 from their own sources, received ₹31 from grants, ₹15 from assigned revenues, and the remaining portion from other sources. However, this composition of revenue streams has evolved significantly over time.

Twenty years ago, ULBs relied more heavily on their own revenue, with ₹73 coming from self-generated sources. Looking back 60 years, this figure was as high as ₹89. Conversely, the reliance on grants has sharply increased; while grants accounted for just ₹11 in revenue six decades ago, they now contribute ₹31.

A deeper examination of ULBs' revenue reveals a more pronounced decline in tax-based income. In FY1961, own tax revenue made up ₹73 of every ₹100 received, dropping to ₹48 in FY2000 and plunging further to just ₹28 in FY2021. Non-tax revenue, on the other hand, has seen a modest increase, rising from ₹16 in FY1961 to ₹23 in FY2021, indicating a shift in how ULBs fund their operations. This changing financial structure highlights the increasing dependency on external support, particularly through grants, and the diminishing role of local tax collections in urban governance.

Sources of Municipal Revenue



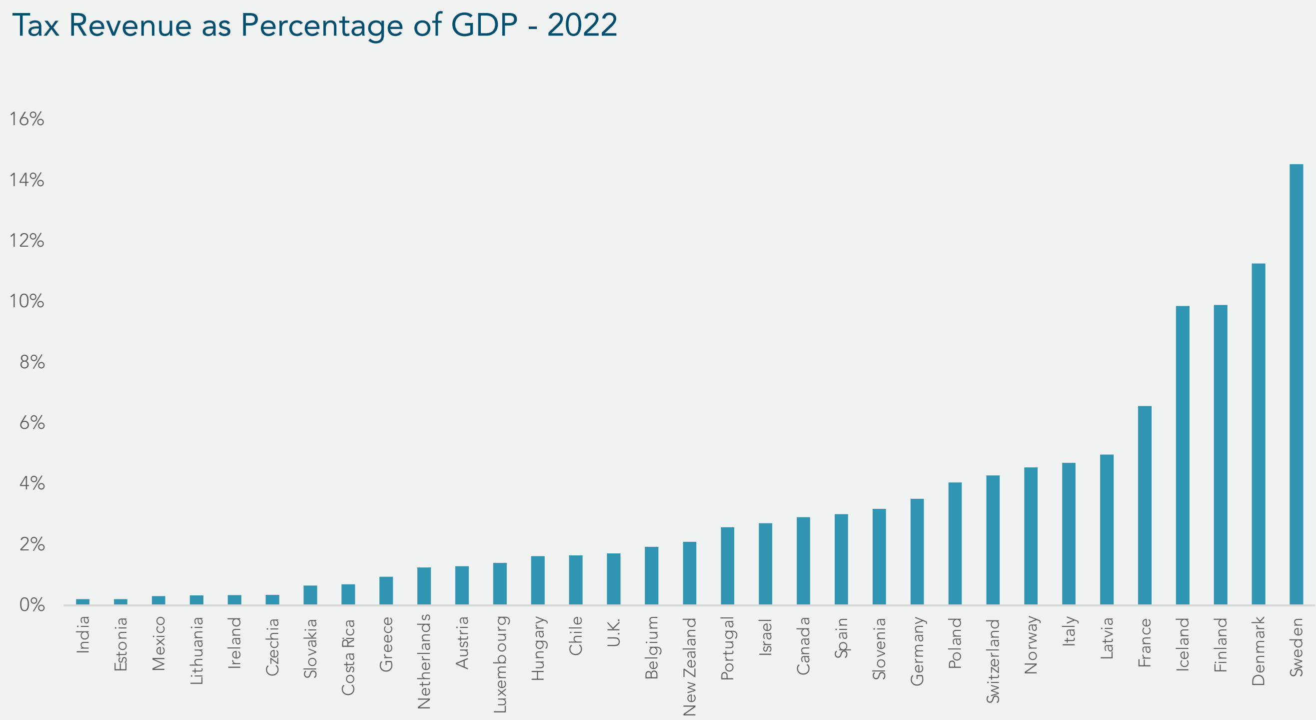
Note: Figures may not add up to 100 percent due to rounding

Source: RBI, MHUA

Challenges in Mobilizing Capital

Limited Fiscal Decentralization

ULBs in India are increasingly struggling in improving their own revenue sources largely due to the incomplete nature of fiscal decentralization. Despite constitutional amendments to empower ULBs with greater financial autonomy, the devolution of financial powers remains limited. As significant authority remains vested with state governments, ULBs are left with limited control over their key revenue streams. The Annual Survey of India's City-Systems 2023 report reveals that only one state in India – Assam – has empowered its ULBs over all key taxes, including property, profession, advertisement, and entertainment taxes. In other states, ULBs either do not have the authority to levy key taxes, or where they do, their powers are significantly constrained. On the other hand, several member countries of the Organisation for Economic Co-operation and Development (OECD) have empowered their ULBs. Local governments in Canada, Denmark, Finland, Netherlands, Sweden, and the United Kingdom (U.K.) have full discretion over tax rates for 89% of their revenue pool, providing significant fiscal autonomy and flexibility.
As a result, tax revenue generated by local governments in these countries, on average, accounts for 7% of the national Gross Domestic Product (GDP), significantly higher than 0.2% in India.



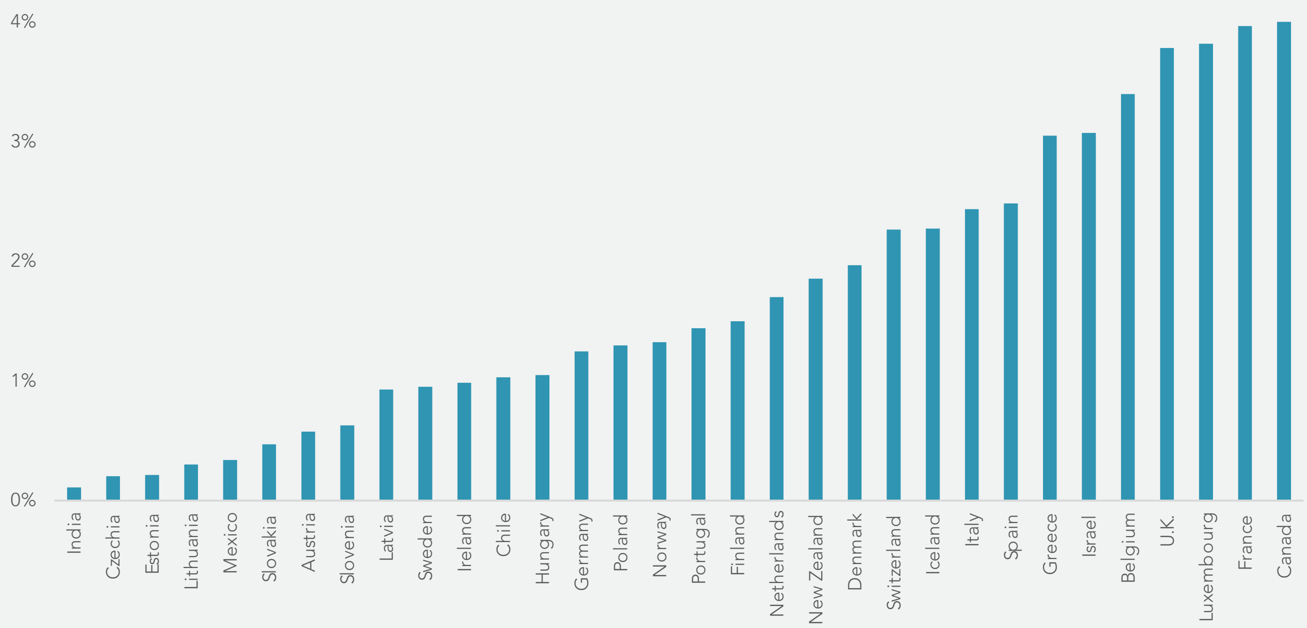
Note: Data for India is for FY2021

Source: OECD, RBI

Poor Tax Collection Efficiency

While local governments in India lack substantial authority to levy many key taxes, it is also important to highlight that, even when they do have this power, there are significant inefficiencies in tax collection. The 13th Finance Commission, constituted by the President of India, estimated the tax efficiency for 36 largest cities in India to be just 37%. Collection efficiency is assessed by comparing actual tax revenue with potential revenue based on the existing tax base and rates. At the national level, the property tax yield was estimated to be between 0.16% and 0.24% of GDP. Unfortunately, little has changed since the report's release in 2009; in fact, the situation appears to have worsened, with property revenues estimated to account for only 0.11% of GDP in FY2020. Countries elsewhere appear to collect property taxes five to twenty times that of India. Property tax revenues average 0.6% of GDP in the economies of Rapid Reformers -Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia-and 1.9% of GDP in OECD countries. Issues such as inadequate administrative capacity, a narrow tax base, and widespread tax evasion contribute to substantial revenue leakages in India.

Property Tax as Percentage of GDP - 2020



Source: OECD, RBI

Unlocking New Capital – Municipal Bonds

Although advancing fiscal decentralization and improving tax collection efficiency will boost revenue streams, these efforts alone may not be sufficient to meet the growing investment needs of cities. Therefore, ULBs should explore market-based financing options like municipal bonds to bridge the gap. Municipal bonds are a critical financing tool for local governments, offering numerous advantages. They provide access to a broader pool of capital from both domestic and international investors, often securing lower financing rates due to reduced premiums. Additionally, municipal bonds allow for larger sums of financing, better suited to the demands of major infrastructure investments. Moreover, issuing these bonds fosters financial discipline within local governments by introducing stringent compliance, reporting, and audit requirements. This approach also helps reduce the reliance on higher levels of government for grants, a situation which has historically proven to make ULBs vulnerable and inefficient.

While ULBs have been accessing capital markets since 1997, the municipal bond market in India remains in its early stages. From 1997 to 2021, municipal corporations in India issued bonds totaling approximately USD 800 million, compared to an estimated USD 1.5 billion issued in South Africa. On a positive note, there has been a resurgence of interest in municipal bond issuance in India, with nearly two-thirds of the total funds raised occurring between 2017 and 2021.

While numerous studies provide extensive recommendations to boost the supply of municipal bonds, there is a lack of research focusing on investor sentiment. To fill this gap, Dun & Bradstreet conducted a survey in June 2024 involving more than 3,200 large businesses across 32 economies to gauge their perspective. Two key insights emerged for India:

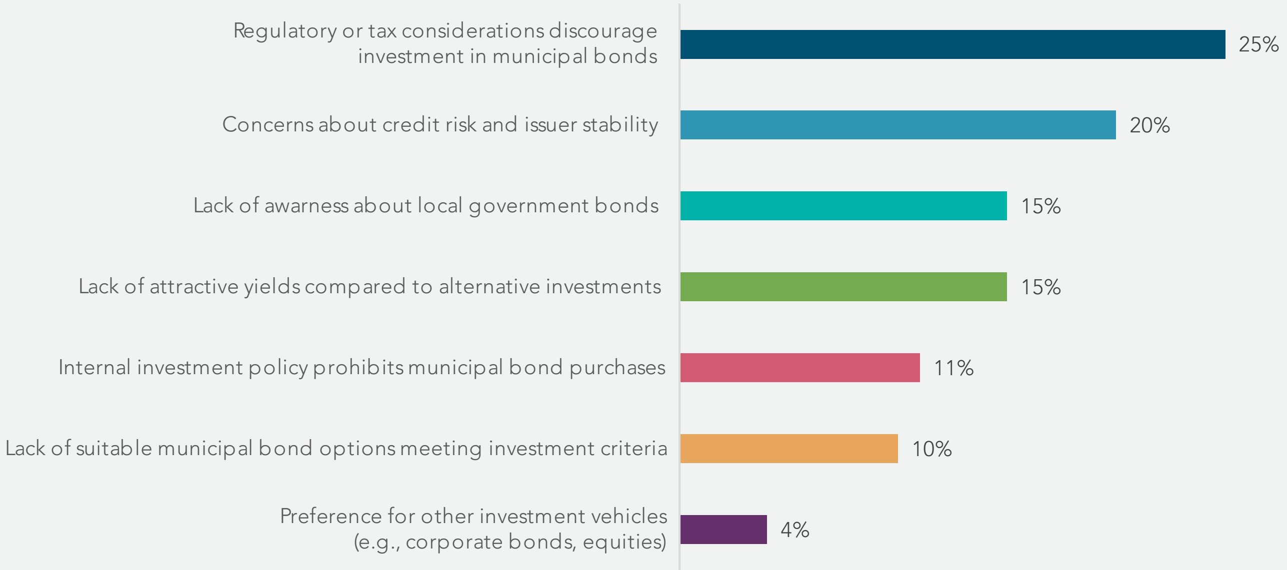
1. Half of the concerns raised by non-investors could be alleviated by enhancing financial transparency and increasing awareness of municipal finances.
2. There is a favorable perception regarding the liquidity of municipal bonds, which could serve as a catalyst for increased investor participation.

Of the businesses that do not currently invest in municipal bonds, 20% are primarily concerned about credit risk and issuer stability. Additionally, 15% cited a lack of attractive yields compared to alternative investments, and another 15% pointed to limited awareness of local government bonds. These concerns can be alleviated by enhancing financial transparency and increasing awareness of municipal finances.

Concerns regarding credit risk and issuer stability primarily arise from the absence of timely, audited, and standardized financial statements for ULBs. Although the City Finance Portal developed by the MHUA represents a positive step forward, data availability remains inadequate; only 41% of ULBs reported their financials for FY2022, and no data is available for subsequent years. To enhance investor confidence, both the coverage and timeliness of financial reporting must be significantly improved by mandating ULBs to submit the financials.

The concern regarding the lack of attractive yields appears to be tied to limited awareness about municipal finances. In reality, municipal bonds often offer higher returns than sovereign bonds. Yields on AA-rated municipal bonds typically range between 8.5% and 10% for tenures of 3-5 years, compared to the 7.1% yield on 10-year Government Securities. While it could be argued that the risk of municipal bonds is higher than G-Securities, 55% of businesses in India indicated a preference for bonds that offer medium yields with medium credit quality, compared to just 29% who favor lower yields with higher credit quality. This suggests that many businesses may be overlooking the relatively attractive returns of municipal bonds due to limited awareness.

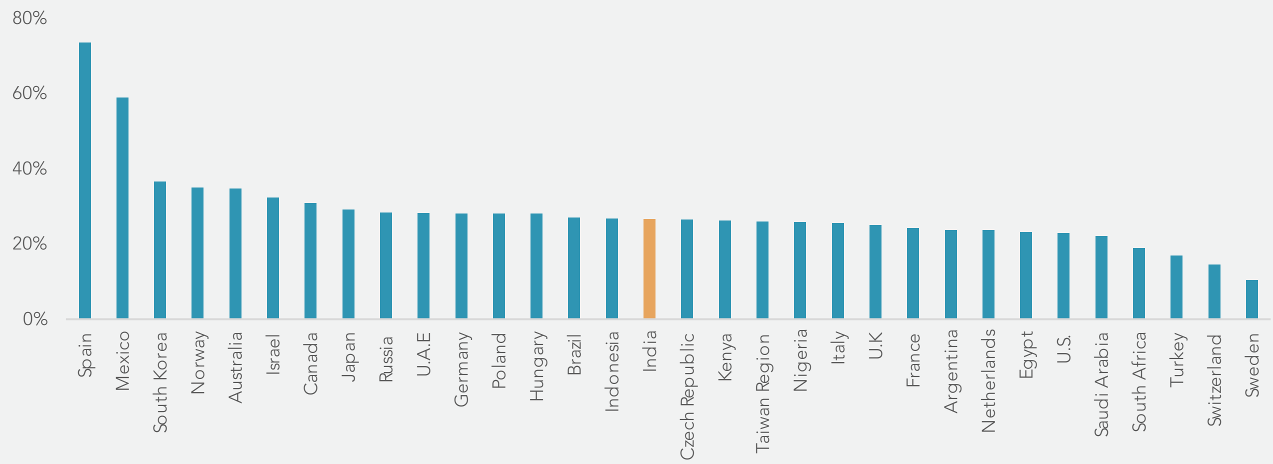
Primary Reasons for Non-Participation in Municipal Bond Market (% of Businesses)



Source: Dun & Bradstreet

Moreover, there is a favorable perception regarding the liquidity of municipal bonds, which could serve as a catalyst for increased investor participation. In India, 27% of businesses view the municipal bond market as highly liquid, surpassing perceptions in the U.K. (25%), the U.S. (23%), and South Africa (19%). To translate this favorable perception into tangible capital flows, four critical steps must be undertaken to strengthen the municipal bond market and unlock its full potential.

Percentage of Businesses That Perceive the Municipal Bond Market to Be Highly Liquid



Source: Dun & Bradstreet

Strengthening fiscal decentralization can empower local governments to manage their finances more effectively, thereby enhancing their creditworthiness and ability to issue bonds.

Improving collection efficiency through robust tax administration will ensure that municipalities have a stable cash flow, making them more attractive to investors.

Enhancing financial transparency by mandating timely and comprehensive reporting will help boost investor confidence by enabling them to assess risks in a more informed and accurate manner.

Establishing specialized agencies, similar to Denmark's KommuneKredit and Finland's MuniFin, can provide targeted support for municipal financing, offering expertise in local government funding while facilitating access to international capital markets. Such agencies can play a pivotal role in underwriting municipal bonds, lowering financing costs, and ensuring the sustainability of local public investments, thereby contributing significantly to the overall development of the municipal bond market in India.

These measures will not only enhance the creditworthiness of municipalities but also drive sustainable urban development. Ultimately, a thriving municipal bond market will become a cornerstone of India’s urban transformation, enabling the financing of critical infrastructure, fostering economic growth, and ensuring long-term prosperity for future generations.

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