IIMB-WP N0. 493

Working Paper No. 493

Financing of Urban Local Bodies in India

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Year of Publication – June 2015

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Abstract:

The rising level of urbanisation in India draws attention to inadequate infrastructure levels in urban areas. While many factors play a role in infrastructure development, this paper examines the financial requirements for such growth. The paper examines the broad fiscal position of urban local bodies in India and the arrangement under different five year plans and various Commissions – central and state. Considering India's growth prospects on the horizon, and the ensuing financing requirements, this paper eventually makes some suggestions in an attempt to enhance the municipal bond financing market and contribute towards infrastructural development.

Keywords: Urban Local Bodies, Municipalities, Panchayats, Finances, Municipal Bonds

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Introduction

Indian economy has witnessed rapid growth in recent years. Productivity of the cities and towns is one of the important determinants of national economic growth, job creation and social development. Provision of basic services in these towns and cities is just one of the fundamental necessities and therefore development of the urban and rural areas is vital for the progress of a nation.

The government at the centre has dismissed the planning commission and replaced it with NITI Aayog, a body for strategic thinking. The closure of planning commission signifies that planning would no more be top-down but a bottoms–up approach. Therefore the role of local bodies becomes prominent in future. Municipal or Urban Local Bodies (ULBs) and the Panchayati Raj Institutions (PRI) are the main providers of key services at the grass-root level to the citizens. These local bodies directly deal with the local population, and accordingly are best informed about the ground reality. Accordingly, their inputs and suggestions deserve due consideration in planning and implementation processes and their concerns require suitable attention by the state governments. Focus needs to be laid on strengthening of the organisational as well as financial position of the local bodies. With changing times technological up-gradation of functions and services provided by these local bodies would become essential and therefore, there is need for enhancing their infrastructure.

India is undergoing manifold phases of infrastructural development. Efficient expansion of national growth needs a strong and developed infrastructure system. However, this would entail substantial amount of financial resources. Over and above their own revenue, which is generally meagre, most local bodies significantly depend upon the devolution of resources and grants from the State governments. To meet the rising financial requirements, new sources of funding would also need to be explored.

India is urbanising rapidly. In India, in 2011, 31 per cent of population was in urban areas and the trend shows that number of people living in urban areas is growing at a faster rate than

[1] Authors wish to thank Keerti Mallela and Sharada Shimpi for research assistance.

population in rural areas. The number of urban areas or towns have increased from 1827 in 1901 to 7935 in 2011 (Government of India, 2013a). The share of persons living in urban areas rose by 3.35 per cent in the decade 2001 to 2011 from 2.10 per cent in the decade 1991 to 2001 (Government of India, 2013a). The urban population is concentrated in large cities. There were 53 million plus cities accounting for about 43 per cent of India's urban population in 2011. Class-I cities having population over 3 lakh accounted for about 56 per cent of urban population while those with 1 lakh to 3 lakh accounted for 14 per cent. This pattern of population concentration has implications on employment opportunities (Government of India, 2013a). The government has been initiating measures for addressing the issue of urbanisation for nearly two decades. The urban population increased from 78.9 million in 1961 to 377 million in 2011, and is estimated to reach 470 million in 2021 and 700 million in 2041 (Government of India, 2013a). One of the areas that require attention, as pointed out by the Twelfth Five Year Plan (FYP), is the issue of urban poverty, which can be related to employment opportunities (Government of India, 2013b).

Growth of urbanization leads to need for higher communication, migration, floating population and mushrooming of slums. Thus, there is need to provide for housing, health, water supply, sanitation and education. Urbanisation is a job-creating process and contributes to economic and overall growth. The urban share of GDP was estimated at 62-63 per cent in 2009-10 by the 12th Five Year Plan. Also, increased demand for urban infrastructure is related to growing urbanization. The country has a clear deficiency of world class infrastructure. Such infrastructure shortages can act as obstacles in the growth process. Accordingly, infrastructure development is crucial to sustain India's economic growth. And the current levels of infrastructure, both urban and rural, are not enough to meet demands of the growing population.

The gradual increase in urban population is certain to put strain on urban infrastructure. In addition, the union government has discussed about developing of '100 smart cities' as satellite towns of larger cities or modernizing the existing mid-size cities. The development of such cities would entail substantial expenditure for creation of urban infrastructure such as water supply, sanitation, public health, roads, transport arrangements like metro, etc. These developments require substantial amount of financial resources. According to the High Powered Expert Committee, which was set up by the Ministry of Urban Development (Government of India, 2011), Rs. 39.2 lakh crore (at 2009-10 prices) is the estimated requirement of investment for urban infrastructure over the period from 2012 to 2031. As per the Twelfth Five Year Plan (Government of India, 2013b), investment in the infrastructure sector in the Twelfth Plan has been estimated at Rs. 60 lakh crore approximately. The Indian investor has yet not explored the municipal bonds market, which needs to be examined. The debt market in India for municipal bond has grown considerably since the first issuance in 1998. The government, over a period of time has been examining the issue and allowed the municipalities to issue tax-free bonds in 2001.

A fundamental component of infrastructure development is the financing aspect. Also, the revenues of states from their own sources are typically insufficient. Considering the pace of urbanisation and the infrastructure necessities, financing requirements appear to be enormous in the coming years and accordingly an important focus area is how to meet the financial requirements of the urban areas.

The focus of this paper is on municipal finances. The remaining paper is organised in five sections. The next section discusses about the 73rd and 74th amendments in the Constitution of India, with respect to local bodies. Section 3 presents a discussion on financial resources of urban local bodies. The focus of Section 4 is municipal bond market as a resource to meet the growing necessities of the local bodies. Section 5 suggests the requirement of a National Pooling Scheme and provides some suggestions to boost the municipal bond financing market in the country. Finally, conclusions are presented in Section 6.

Section 2: 73rd and 74th Constitutional Amendments

The 73rd and 74th Constitutional Amendment Acts of 1992 have been the most noteworthy milestones in strengthening of local governance in rural and urban areas in India. These Amendments, aimed at strengthening municipal bodies and Panchayati Raj institutions, are recognised as key steps in providing essential services to citizens. Until the amendments, local governments were under the State Governments' direct control in an 'ultra vires' fashion, without legislative provisions. To improve performance, accountability, and credibility of local bodies, an attempt was made by these amendments to include important functions like devolution of financial and administrative responsibilities, to the third tier of governance, therefore, making path for fiscal 'federalism'.

Until 1991, panchayats suffered from some serious issues like no regular elections, extended supersessions, inadequate representation of the weaker sections like scheduled castes and tribes, lack of devolution of powers, and insufficient financial resources. In light of these concerns, Article 40 of the Constitution brought in the aspect of State government taking steps to provide powers and authority to village panchayats, so as to enable them to function as units of self-governance. Over the years, it was observed that Panchayats deserved constitutional status, so that they could function as local agents of economic and social development.

Following this, the 73rd amendment of the Constitution of India was passed in 1992. It put forth important points directed towards self-governance of Panchayats and granting them a dignified position in rural local governance. Some features of the amendment included elections every five years, with supersessions not exceeding six months; reservation of seats for scheduled castes, tribes, and women; and providing adequate finance to the Panchayats through securing authorization from State legislature; amongst others. Thus, decentralization of rural local governments, giving rise to 'institutions of self-government' delved on two significant aspects: an exclusive jurisdiction for each Panchayat, with autonomy and power to govern respective area, therefore giving Panchayats a distinct status; and reinforcing allocation of financial and administrative powers from States to local governing bodies, therefore making way for 'federalism'.

While rural local governments received attention through the 73rd amendment, it was recognized that Urban Local Bodies (ULBs) too had been neglected for the past many years. ULBs also faced similar issues like PRIs. The 74th Amendment Act enacted in 1992, addressed these issues by creation of local governments, devolution of financial and administrative powers, and their effective and efficient functioning. It was sought that these local governments would bridge the gap between citizens and the higher tiers of government, by taking into account immediate as well as long term needs of their respective jurisdiction. The objectives and responsibilities of these municipalities were outlined in the 12th schedule and included urban planning, slum improvement, sanitation conservancy and public amenities.

Section 3: Finances of Urban Local Bodies

Municipalities in India have a long history. According to Rao (1986), "The British introduced some kind of municipal management much earlier than their consolidation of sovereignty over the country". According to the World Bank (2011b), "The creation and spread of municipal corporation structure across India is directly related to the taking over of the Indian possessions of the East India Company by the British Crown after the Indian Uprising of 1857".

"The word 'municipality' denotes a town, city or district that has its local government and 'corporation' refers to a group of people elected to govern a large town or city and provide public services".[2]

The Oldest Municipal Institution in India is the Corporation of Chennai (earlier Madras), established on September 29, 1688.[3] This was followed by Municipal Corporations in erstwhile Bombay (now Mumbai) and Calcutta (now Kolkata).[4] Some of the historical developments over the last few centuries, with respect to municipalities are presented in Annex 1:

Till 1992 India functioned as a two tier structure (centre and states). The third tier (local bodies) came into recognition after the 73rd and the 74th amendments in 1992. The 74th Amendment added a new component pertaining to the ULBs to provide for; and among other items, this included constitution of the following municipalities:

a) **Nagar Panchayats**: Areas in transition from rural area to urban area
b) **Municipal Councils**: Smaller urban areas
c) **Municipal Corporations**: Larger urban areas

Municipal Corporation is divided into zones. Each zone has its Municipal Commissioner (Chief Executive Officer and head of the executive arm of the Municipal Corporation), followed by the Municipal Corporation Inspectors.[5]

In India, in 2011, 4041 towns had urban local bodies (Government of India, 2013a). In the country, there are three different types of urban local bodies – as discussed in the previous section. The municipal corporations for major cities in the country, like Ahmedabad, Bengaluru, Delhi, Chennai, Hyderabad, Kolkata and Mumbai, are able to raise and generate resources by some techniques but in case of smaller towns, dependence on the government is significantly

[2] Government of India (2006b)
[3] http://www.chennaicorporation.gov.in/about-chennai-corporation/aboutCOC.htm
[4] Government of India (2007)
[5] http://www.archive.india.gov.in/citizen/nagarpalika/nagarpalika.php?id=2

large. In general, financial resources of urban local bodies are scarce, and unable to meet the expenditure requirements, and therefore the dependence on other two upper tiers of government is substantial. The constitution of India specifies the taxes to be divided between the centre and state governments but does not specify the revenue base for urban and local bodies. Even the 74th amendment is not specific about the type of taxes that urban local bodies should have. The resource base of ULBs typically consists of their own sources, state revenue, government grant, loans from state governments, and market borrowings. The urban local bodies are sometimes not even aware of the opportunities and avenues of generating revenues through taxes and non-tax charges. Even if they are aware they do not have the skill to optimize tax collection. The urban bodies, specially the smaller ones, find it difficult to demonstrate their credit worthiness and therefore would require help and assistance in designing financial instruments for mobilizing resources from the market.

The existing pattern of municipal finances has not been able to meet the required expenditure on infrastructure development in urban areas. Municipal finance involves planning of revenue and expenditure decisions of the municipalities. Their budgets comprise plans with details regarding proposed expenditure and sources of financing during a financial year. Revenues of municipalities come from different sources but are limited in amount. Rao (1986) classified municipal revenue sources as follows: a) municipal own revenue comprising tax and non-tax revenue; (b) shared taxes with the state government; (c) grants-in-aid from the state and central government; and (d) borrowings from financial institutions.

RBI (2007) also broadly categorized the revenue base of municipal corporations. Following are some important revenue sources of select municipal corporations in India.

- Tax revenue: property tax, vacant land tax, octroi, tax on animals, taxes on carriages and carts, advertisement tax.
- Non-tax revenue: municipal fees, sale and hire charges, user charges, lease amounts.
- Other receipts: sundry receipts, lapsed deposits, fees, fines and forfeitures, Law charges costs recovered, rent on tools and plants, miscellaneous sales.
- Assigned (shared) revenue: profession tax, surcharge on stamp duty, entertainment tax, motor vehicles tax.
- Grants-in-aid:

- Plan grants made available by way of planned transfers from the upper tier of Government under various projects, programmes and schemes, and
  - Non-plan grants made available so as to compensate against the loss of income and some specific transfers.
- Borrowings: Loans undertaken by the local authorities for capital works etc., mainly from – Life Insurance Corporation of India, State and Central Governments, banks and municipal bonds in select cases.

Government of India (2003) lists the following taxes, tolls and fees which are relevant to the ULBs and for which State Legislatures are competent to frame laws:

- Taxes on: Lands and buildings; Entry of goods into a local area for consumption, use or sale therein; Consumption or sale of electricity; Advertisements other than advertisements published in the newspapers and advertisements broadcast by radio or television; Goods and passengers carried by road or inland waterways; Animals and boats; Professions, trades, callings and employments; Luxuries, including taxes on entertainments, amusements, betting and gambling.
- Tolls.
- Fees in respect of any of the matters in this List, but not including fees taken in any court.

Five Year Plans and Finance Commissions

The Government of India as per the Constitution has been making allocations to local bodies through five year plans and finance commissions. This section provides a brief overview of such allocations.

Five Year Plans (FYPs) and Local Bodies

Five-Year Plans in India are centralized national economic agendas for a span of five years. The first FYP was introduced in 1951. First Five Year Plan made a lump-sum provision of Rs. 15 crore for local development works, so as to draw local initiative and resources. This was done with an expectation that the municipalities, district and taluka boards and other local bodies would prepare schemes, for which financial assistance would be allocated from this lump-sum provision. Some of the plans and attempts in the FYPs, concerning local bodies are listed in Table 1.

Table 1: Select Measures for Local Bodies in India

FYP	Year	Proposed Allocations or Recommendations for Local Bodies
First	1951-56	Rs. 15 crore: Lump-sum provision for local development works
Second	1956-61	Clear distribution of functions, responsibilities and jurisdictions, Recognized that Local Bodies had inadequate finances
Third	1961-66	Financial assistance for housing for low income groups, improvements in habitable areas, improvements in structure and organization of financial resources for local bodies
Fourth	1969-74	Rs. 45 crore planned to be raised by local bodies for urban planning and development
Fifth	1974-79	Rs. 10.27 crore allocated to local bodies for improving urban sanitation and water supply; Market Borrowings of INR 3030 crore was also encouraged
Sixth	1980-85	Managerial efficiency of local bodies; financial assistance to local bodies; tax incentives; Rs. 1.60 crore allotted for policy formulation and research on urban development, to financially strengthen local bodies
Seventh	1985-90	Horizontal coordination at local governance level; Taxes recognized as main source of own revenues; recognition of physical and financial targets
Eighth	1992-97	73rd and 74th Amendments were passed; Decentralization; Recognized that Local Bodies needed regulatory as well as financial legislation and resources
Ninth	1997-02	Increase tax revenues; Autonomy and Power to Local Bodies; Financial Planning at Local level integrated with reports of State Finance Commissions; Concept of cooperative federalism
Tenth	2002-07	Centre to State transfers were recognized as main sources of finance; gap in managerial skills and expertise in Municipalities; Transparency of systems, levying of user charges, increasing non-tax revenues and cost control; improving credibility of municipalities to attract institutional finance and debt funding
Eleventh	2007-12	Municipalities sought to be made financially sustainable through Municipal Finance Improvement Program; recognized that there was a gap between revenues and financial requirements of Rs. 76,896 crore; Recognized that revenues of local bodies must be improved in terms of revenues from land, revenues from civic facilities like parking, hoarding fees, and the like (pooled financing), and from capital and secondary markets, municipal development funds and municipal bonds
Twelfth	2012-17	Proposal to set up an urban regulator at State level; Increase implementation of information technology at ULB Level

Source: Government of India, Various Reports

Finance Commissions and Local Bodies

a. Central Finance Commissions

The Finance Commission is constituted by the President, under article 280 of the Constitution and the First Finance Commission was constituted on April 6, 1952. The purpose of Finance Commission is primarily to make recommendations on the distribution of tax revenues between the Union and the States, and also amongst the States.[6]

The Tenth Finance Commission was the first to have recommended grants for rural and urban local bodies. The Tenth Finance Commission gave some concrete recommendations regarding municipal finances, that Rs. 1,000 crore for urban local bodies may be used for developmental purposes, in the five year term of the Commission. This was under the condition that local bodies would raise resources and match requirements during the time, and that the grants by the Centre would not be used for operational purposes.

The Eleventh Commission's recommendations were directed towards local bodies' financial assistance to a greater extent. Supplementing State funds for further financial assistance on the basis of state finance commissions' reports, and recommendations on the usage of funds for functions like audits, maintenance of civic facilities and operations of the local bodies were also part of its recommendations. The annual grant during this period was Rs. 400 crore for the ULBs (Table 2).[7]

Table 2: Grants recommended under Finance Commissions

Finance Commission	Municipalities
Tenth	Rs. 1,000 crore
Eleventh	Rs. 2,000 crore
Twelfth	Rs. 5,000 crore
Thirteenth*	Rs. 23,111 crore

*The Thirteenth Finance Commission recommended 1.93 per cent of the divisible pool of 2010-15, for local bodies after converting it into grant-in-aid, estimated at Rs. 87,519 crore.
Source: Government of India (2014)

[6] http://fincomindia.nic.in/ShowContentOne.aspx?id=8&Section=1
[7] http://fincomindia.nic.in/writereaddata/html_en_files/oldcommission_html/memorandum/eleventhemod.htm

Fourteenth Finance Commission

The Fourteenth Finance Commission recognised that one of the major difficulties local bodies need to deal with is insufficiency of finances.[8] The Fourteenth Finance Commission (FFC)[9] commissioned a study on finances of municipalities through the Administrative Staff College of India (ASCI). The FFC report mentions, that the ASCI study emphasized that governing cities is becoming a challenge due to issues of insufficient finances, weak institutional framework and lack of capacity for service delivery.

FFC recommended higher grants for local governments. The amount of grant for local government has increased to 53.5 per cent from 27.5 per cent as recommended by the 13th Finance commission and 17.5 per cent as recommended by the 12th Finance Commission. Consequent to the 74th amendments to the Constitution, the Tenth Finance Commission introduced exclusive grants for urban local bodies.

The four Finance Commissions, prior to the FFC, used population and area (except for the Tenth FC) as the criteria to reflect need for resources. The FFC has recommended distribution of grants to states using population data (Census 2011) with a weight of 90 per cent and area with a weight of 10 per cent. Based on the urban and rural population (Census 2011) of the respective state, the grant to each state will be divided into a grant to the duly constituted gram panchayats and a grant to the duly constituted municipalities.[10]

The FFC has recommended grants in two parts: basic grants and performance grants. The ratio of basic to performance grant is 80:20 with reference to duly constituted municipalities.

The FFC observes that by taking steps as per recommendations of the State Finance Commissions (SFCs) and the Central Finance Commissions, there is considerable scope for the local bodies to improve revenues from own sources. To further add to the resources at the level of state and local bodies, the FFC has suggested some measures in the following areas:

- **Tax measures**: property tax, use of land-based instruments, advertisement tax, entertainment tax, and tax on professions, trades, callings and employments.

[8] Reddy (2015)

[9] Government of India (2014)

[10] Oommen (2015) however mentions that, population being given such undue weightage is iniquitous. Also, that omission of other relevant criteria can just assist in temporary deferral of democratic decentralisation.

- **Non-Tax Measures**: Income from cess or royalty on minor minerals, service charges on government property and issue of municipal bonds

The FFC has recommended a grant of Rs.87,144 crore to the municipalities. The FFC suggested that part of land conversion charges can be shared by the state government with municipalities. The municipalities can also levy betterment tax on the residents in the urban areas. FFC also recommended that the states could consider empowering local bodies to impose advertisement tax on buses, cars, compound walls, etc. to raise resources. Further, FFC suggests that tax should also be imposed on new types of entertainments like boat ride, cable television and internet café, which should benefit urban local bodies in raising resources.

The FFC observed that the market for municipal bonds is insignificant in India and these bonds have played a limited role as a source of finance for funding urban infrastructure projects. FFC recommended that local bodies and states should explore the issuance of municipal bonds as a source of finance with suitable support from the Union Government. Regarding the larger municipal corporations, the FFC mentions that the states may allow such corporations to directly approach the markets. In case of medium and small municipalities which may lack the capacity to access markets directly, the FFC states that an intermediary could be established to assist such municipalities.

b. State Finance Commissions (SFCs)

Status of different State Finance Commissions is as follows, as per the Fourteenth Finance Commission (Government of India, 2014):

- Fifth SFC: Constituted by two states
- Fourth SFC: Constituted by eleven states.
- Third SFC: Constituted by six states
- Second SFC: Set up by six states; one is yet to do so.

Analysis of the SFCs reveals that only a few states like Karnataka have devised a formula for devolvement of resources to ULBs.

Details about the SFC III reports of different states as per the Thirteenth Finance Commission (Government of India, 2009) are listed in Annex 2.

Section 4: Municipal Bonds

Apart from the traditional revenue sources of ULBs discussed in the last two sections, one of the modern sources of financing infrastructure projects is through the capital markets. The concept of municipal bonds is in its nascent stage in India, compared to other advanced countries where this is an important source of financing urban infrastructure. An instance is the USA, where the municipal securities market plays a vital role in infrastructure development. Aguilar (2015) mentions, the total amount of municipal bonds outstanding was $3.6 trillion, as of the end of the third quarter of 2014. As per the U.S. Securities and Exchange Commission (2012), the municipal securities market is a diverse market, with a total face amount of $3.7 trillion (as of December 31, 2011). Also, within the total aggregate principal amount of over $3.7 trillion, different municipal bonds outstanding were more than one million. The USAID (2004) states that, the prevalence of revenue bonds in the US, increased to over 70 percent in the past twenty years. This USAID document also mentioned, "the revenue bond structure in the US is backed by strong and credible covenants related to the revision of user charges, debt service coverage ratio and additional debt mobilization". In India, 28 municipal bond issues have been made since 1997, mobilizing funds amounting to approximately Rs. 30 billion (Khan, 2013).

According to Financial Institutions Reform and Expansion – Debt Market (FIRE-D) Project (USAID, 2004), municipal bonds are of two general types - General obligation (GO) bonds which carry full faith and credit of the issuing authority, and are appropriate for general services like, roads or street lighting wherein it's difficult to levy user charges. And revenue bonds, which are tied to specified sources of revenue from the facilities or services which they finance.

According to Sheikh and Asher (2012), in India, bond releases by the ULBs cannot be classified as either revenue bonds or as general obligation bonds. Instead, these are referred as structured debt obligations with a distinguishing feature that they are issued conditional on the borrower pledging or 'escrowing' certain sources of revenue for the debt servicing.

Though the municipal bond markets are yet to get predominance in India, there appears to be some consensus that municipal bonds could prove as a promising alternative. The system of municipal bonds was extensively discussed at a national workshop on the potential and relevance of a municipal bond system for India, conducted in 1995.[11] In 1996, Rakesh Mohan Committee on Commercialization of Infrastructure Projects, recommended development of the municipal bond market in the country.[12]

A noteworthy step in the history of municipal bonds in India was by the Ahmedabad Municipal Corporation, in 1998. Ahmedabad Municipal Corporation made the first municipal bond issue in India, without a state government guarantee (USAID, 2011). This involved raising Rs. 100 crore from the capital market and comprised 25 per cent public placement and 75 per cent private placement (Sadhu and Bharatwaj, 2003). Prior to this, in 1997, the Bangalore Municipal Corporation had issued bonds guaranteed by the State government (NIPFP, 2011).

According to USAID (2004), in India, urban sector suffers from a number of constraints, including low tax base, lack of credible credit history, and low cost recovery, especially for water and sewerage, and market rigor. And that the investors are unlikely to accept even the GO structure of bonds, bearing in mind the lack of a track record and market image of municipal bodies. Further, the USAID (2004) mentions that, the FIRE-D Project, in association with CRISIL and IL&FS, worked to introduce Structured Debt Obligations (SDO) for municipal authorities. SDO helps to raise the credit quality of the proposed instrument by earmarking reliable and predictable streams of revenue from specific revenue sources of the municipal body. These cash flows, which are used for debt servicing, are monitored by an independent trustee.

Tax free municipal bonds

The Government of India added a new clause in 2000-01, to the Income Tax Act, exempting interest income from bonds issued by the local authorities. Herein, the funds raised by way of such tax free municipal bonds are to be used only for capital investments in urban infrastructure to provide one or more of: potable water supply; sewerage or sanitation; drainage; solid waste management; roads, bridges and flyovers; and urban transport (if this is a municipal function under respective state legislation).[13]

Again, the first launch of tax-free municipal bonds was made by the Ahmedabad Municipal Corporation in 2002, for Rs. 500 million (NIUA, 2002).

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[11] USAID (2004)
[12] USAID (2004)
[13] Government of India: http://moud.gov.in/tfmb; http://moud.gov.in/sites/upload_files/moud/files/pdf/tax_muni.pdf

Trend in Bond Issuances

As per the report of the Sub-Committee on financing urban infrastructure in the 12th plan, around Rs. 4,450 million have been mobilised by India's city governments, from the domestic capital market via taxable municipal bonds (Government of India, 2012). Table 3 provides details about borrowings through bonds in the primary markets. Tenor of the bonds ranges between 5 years and 15 years. As can be noted, data is scanty but the trend is clear that bond issuances are not very popular in India.

Referring to the trend in the value of municipal bond issues since 1997, Khan (2013) mentions that till 2005, the value of municipal bond issuances was on a rise, but it dropped sharply since then. Khan further mentions that since 2007,[14] very few issuances have taken place, and after 2010 practically no issuance has happened. As per SEBI (2014), the last municipal bond issue in India was in 2010 by the Greater Vishakhapatnam Municipal Corporation for Rs. 30 crore. Chakrabarti (2014) points out that the municipal bond market in India has difficulties due to reluctant investors, unclear regulation and low ratings.

A sound credit rating of the local body contributes to the confidence of the potential investors. The systems and processes of the organisation play a determining role, in the rating process. Also, lack of availability of orderly information about the ULBs could delay processes of determining and assigning rating by the rating agencies, which could in turn affect the ULBs approach to capital markets. According to CARE Ratings (2012), feasibility of a project (for which fund is being raised) is the key factor in a credit rating besides other parameters and factors like financial, economic, administrative and legal.

The USAID (2004) states that India's first municipal credit rating was in February 1996, when Ahmedabad received a municipal credit rating, conducted by CRISIL. According to USAID, Ahmedabad Municipal Corporation's (AMC) financial and liquidity position was strained during 1992-93. Accordingly, AMC initiated an endeavour in 1994, for improvements in collections of octroi and property taxes; Also, AMC worked on professionalization of its workforce. Such

[14] As per World Bank (2011a): "Strong growth in bond issues was evident between 2000 and 2005, with no new issues in 2006, 2008 and 2009, and only one small issue in 2007".

efforts resulted in a financial revival and AMC reached a revenue surplus of Rs. 49 crore by 1994-95.[15]

Table 3: Municipal Bonds in India

Sl. No	ULB/Utility	Amount (Rs. Cr.)	Bond Type	Rate of interest	No. of years	Date of issue
1.	Ahmedabad Municipal Corporation (AMC)	100	Regular Return-Fixed Rate	14		1.16.1998*
2.	Nashik Municipal Corporation	100	Regular Return-Fixed Rate	14.75	7	09.11.1999
3.	Ludhiana Municipal Corporation	18	Regular Return-Fixed Rate	14	10	06.16.2000
4.	Ludhiana Municipal Corporation	2	Regular Return-Fixed Rate	13.5	10	08.24.2000
5.	Tamil Nadu Urban Development Firm	106	Regular Return-Fixed Rate	11.85	5	08.25.2000
6.	Bangalore Water Supply & Sewerage Board	10	Regular Return-Fixed Rate	12.9	7	11.30.2000
7.	Nagpur Municipal Corporation	31	Regular Return-Fixed Rate	13	7	12.20.2000
8.	Kanpur Development Authority	50	Regular Return-Fixed Rate	13.5	5	03.05.2001
9.	Corporation of Madurai	50	Regular Return-Fixed Rate	12.25	15	03.07.2001
10.	AMC	100	Step Up Liquid-Floating Rate-Tax Free	1st 5yrs: 9 Bank Rate + 250 Basic Points	10	03.07.2002
11.	Municipal Corporation of Hyderabad	83	Tax Free-Regular Return	8.5	7	03.21.2002
12.	Tamil Nadu Water & Sanitation pooled Fund (WSPF)	30	Taxable	9.2	15	Dec 2002
13.	Nashik Municipal Corporation	50	Tax Free-Regular Return	7.5	5	05.06.2003
14.	Visakhapatnam Municipal Corporation	65	Regular Return-Fixed Rate	7.25	7	03.24.2004
15.	AMC	58	Tax Free-Regular Return	6.4	10	03.25.2004

[15] USAID (2004)

Sl. No	ULB/Utility	Amount (Rs. Cr.)	Bond Type	Rate of interest	No. of years	Date of issue
16.	Hyderabad Metro Water Supply & Sewerage Board	50	Tax Free-Regular Return	7.0	6	29.03.2004
17.	Chennai Metro Water Supply & Sewerage Board	42	Tax Free-Regular Return	5.2	7	29.03.2004
18.	Nashik Municipal Corporation	50	Tax Free-Regular Return	7.5	5	25.03.2005
19.	AMC	100	Tax Free-Regular Return	7.5	10	08.02.2005
20.	Thane Municipal Corporation	50	Regular Return-Fixed Rate	8	8	24.02.2005
21.	Thane Municipal Corporation	50	Regular Return-Fixed Rate	6.5	8	24.02.2005
22.	Chennai Metro Water Supply & Sewerage Board	50	Regular Return-Fixed Rate	-	7	24.02.2005
23.	Corporation of Chennai	45	-	Not placed	–	23.12.2004
24.	Kolkata Municipal Corporation	100	-	Not placed	–	05.10.1999
25.	AMC	100	Tax Free-Fixed Rate	6.0	10	
26.	KUIDFC (for 8 cities around Bengaluru)	100	Tax Free-Fixed Rate	5.9	15	29.03.2005
27.	Tamil Nadu WSPF	6.7	Tax-free	7.25	10	Feb-Apr 2008
28.	Greater Vishakhapatnam Municipal Corporation	30	-	-	-	2010
29.	Tamil Nadu WSPF	83	Tax-free	7.5	10	Sept 2010
30.	Tamil Nadu WSPF	51	Taxable	10.6	10	Aug 2012
31.	Tamil Nadu WSPF	51	Taxable	8.7	10	May 2013

* As per ADB (2003), Appendix 2, Pg. 164: Issue opened on 16 January 1998; As per World Bank (2011b), Date of issue: 05.10.1999

Sources: Authors' own computation based on various sources -

1) World Bank (2011b), Pg. 265;

2) Tamil Nadu Urban Infrastructure Financial Services Limited - http://tnuifsl.com/wspf.asp

3) http://www.kuidfc.com/WEBSITE/WebPage.nsf/lookupAllCat/Projects-Trust

Apart from the role of the rating agencies, some of the important considerations for existence of an effective and vibrant municipal bond market would be finances of the respective municipal body itself, volumes of instruments offered to the market, the number of investors, and prevalence of a dispute resolution mechanism. For the municipal bond market to pick up pace in India, one of the areas which requires focus is how the municipal bodies manage their finances.

While the larger municipal corporations are in a relatively better position to get into the capital markets, most of the smaller and medium-sized ULBs do not have the financial resources to opt for this mode (NIUA, 2002). The system of pooled financing introduced recently brought about a change, as the smaller and medium-sized ULBs could now approach the capital markets for financing requirements of infrastructure projects. Referring to the Water and Sanitation Pooled Fund in Tamil Nadu and its objective of helping the smaller ULBs in getting access to the debt capital markets, Sahasranaman (2012) states "Pooled financing allows such entities to pool together their projects and access the market with one single bond issue backed by the cash flows from all the underlying projects".

The Central Government approved the Pooled Finance Development Fund Scheme in 2006. This was done mainly to benefit the ULBs, by providing credit enhancement to them, so as to access market borrowings on the basis of their credit worthiness through the State-Level-Pooled Finance Mechanism. Implementation of the Pooled Finance mechanism requires setting up of a 'State Pooled Finance Entity' in every state. One of the objectives of this scheme was to facilitate development of the municipal bond market in the country.[16] The states which have established their 'State Pooled Finance Entity' are Andhra Pradesh, Assam, Karnataka, Kerala, Nagaland, Orissa, Rajasthan and Tamil Nadu (World Bank, 2011b).

The initial mobilization of resources in the pooled financing framework in India was by the Tamil Nadu Water and Sanitation Pooled Fund (WSPF). The Government of Tamil Nadu designated Tamil Nadu WSPF as the 'State Pooled Finance Entity'. The WSPF is managed by the Trust Manager, Tamil Nadu Urban Infrastructure Financial Services Limited. During 2002

[16] Government of India - http://moud.gov.in/sites/upload_files/moud/files/POOLED%20FINANCE%20DEVELOPMENT%20FUND.pdf

and 2013 this fund raised a sum of over Rs. 222 crore by issuing bonds under the pooled bond framework.[17]

The Karnataka Water and Sanitation Pooled Fund (KWSPF) was created in 2003. KWSPF was approved by the Government of Karnataka to function as the 'State Pooled Finance Entity'. The Fund Manager/ Asset Management Company for the issue of these Bonds is the Karnataka Urban Infrastructure Development and Finance Corporation Limited (KUIDFC). KWSPF raised Rs. 100 crore in 2005 for the Greater Bangalore Water Supply and Sewerage Project. [18]

There are constraints on the supply and demand side that limit the municipal bond market. The supply side constraints include small number of credit-worthy issuers, lack of financially viable projects and numerous administrative problems. Municipal credit-worthiness depends on the quality of accounting and financial management, availability of reliable financial data, human resources available at the local government level, and political security of leadership of local government. The demand side constraints include lack of demand from main investors like banks, insurance companies and provident funds because municipal bonds are relatively illiquid investment and therefore exit is difficult in times of need. Finally, municipal bonds are not gilt-edged and therefore risk-weight is high.

Section 5: Need for a National Pooling Scheme and Other Recommendations

In the above discussion it has emerged that financial resources available with the urban and rural bodies are not sufficient to meet the expenditure requirements which are expected to increase in future. The pressure of urbanisation and the need to provide infrastructure support to 100 smart cities and more would imply increasing need for raising additional financial resources. To address this issue of additional financial resources one alternative could be to tap larger resources from the households and private sector. The private sector and households would only contribute and participate in financial growth when urban local bodies are strengthened with standardised accounting and administrative procedures. The third tier of governance involves 3,842 highly diversified urban local bodies which need to be strengthened.

[17] http://www.tnudf.com/wspf.asp; http://tnuifsl.com/wspf.asp
[18] http://www.kuidfc.com/WEBSITE/WebPage.nsf/lookupAllCat/Projects-Trust

On the financial resource front, municipal bonds can be a potential source of financing infrastructure and can contribute immensely to improve the dismal financial position of the local bodies in the country. It would also assist in channelizing stagnant household savings available in the country, into the market. The urban local bodies should tap these financial resources through bonds, probably floated and managed by a national level body.

However, to make this model a common practice in India, the related challenges would need to be tackled. The key factors responsible for underdevelopment of municipal bond markets are lack of institutions, participants and instruments. The institutions consist of the security market regulator, credit rating agencies, clearing houses, stock exchange and the regulations and governance norms prescribed by these institutions. The participants comprise the market players – investors on the demand side and issuers on the supply side. The term 'instruments', is used to indicate the form and features of securities issued in the bond market. Appropriate reforms, regulatory and institutional improvements may need to be implemented. For the existence of an effective and vibrant local body bond market, important considerations are regulatory institutions, transparency in the finances of local bodies, large volume of instruments offered, large number of investors, rating agencies and a robust dispute resolution mechanism.

Concept of National and State level Bodies

To instil confidence in the local bodies, increase volume of bonds, and lend credibility to attract investors, India could consider a National Local Body Financing Authority (NLBFA) at the national level and a State Local Body Financing Authority (SLBFA) to meet the requirements of urban local bodies. These entities would function in close coordination with the central and the state governments. First and foremost, NLBFA and SLBFA could focus on standardization of budget making processes by the urban bodies, assess the financial requirements of feasible projects, train the relevant personnel in budget accounting and policy preparation, and tap the capital markets, akin to the joint-family approach followed by the RBI for state government borrowings under market loans for more than six decades since independence. This will assist in tackling some of the constraining issues pertaining to municipal bonds, as it would raise the level of confidence of the investors, and ensure consistency and volumes in supply of local body bonds in the market.

Project-specific bonds

Projects chosen for development through such bond flotations should be such that they appeal to local sensibilities. Therefore, project-specific bonds should be conceived, along with features highlighting direct and indirect benefit to the local populace. The local population could be the potential investors and bearing in mind the local affiliation and commitment, the investors would probably show preference and inclination towards such local bonds. The local authorities, who sponsor the project, being closer to the local population, would be accountable and responsible for delivery of projects.

Modern practices and systems

For the local body bond market to pick up pace in India, necessary improvements need to be made, such as adopting modern accounting practices and systems for recording transactions, maintaining regular accounts in the financial accounting of urban local bodies, proper audit of accounts and annual budget-making. A formal and standardised system of data maintenance and dissemination of information could be explored. Further, a regular system of monitoring, auditing and evaluation may also be required.

Consolidated analysis of local body budgets

Deliberation on a consolidated analysis of local body budgets is required. This could be made available by the central and the state governments, as is annually prepared by the RBI in the case of state budgets. This would prove to be a useful tool in undertaking reliable and extensive analysis of the local bodies, as also the states, and apart from providing greater transparency in fiscal transfers, could lead to higher growth in the economy.

Section 6: Conclusion

The Indian economy is poised for high economic growth in the next few years for various reasons, important being demographic dividends and urbanisation. The infrastructure in the country is lacking to support such potential high growth. The purchasing power with the people, however, is significantly large and can be tapped for the purpose of investment. The 73rd and 74th amendments to the Constitution, more than two decades ago have not been implemented as is clearly apparent from the discussions in various Finance Commission reports of the Government of India. The urban local bodies continue to depend on financial resources transferred from the state and the centre to meet their regular expenditure.

The paper examines alternative source of financial resources in terms of municipal bonds which have been floated by select urban local bodies since 1997. However, the market for such bonds has not developed. The paper examines some of the reasons for the non-development of the municipal bond markets – number of instruments offered annually as well as outstanding; rating of such instruments; institutions that offer municipal bonds; and the regularity and supervisory institutions monitoring the floatation of such bonds. Finally, the paper suggests that pooling of needs for floatation of municipal bonds can be consolidated at the national level and bonds can be floated by the national body, in a joint family system, and proceeds distributed to the respective urban local bodies.

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Annexure 1: Municipal Governance – Historical Developments

1688*	Establishment of the Corporation of Chennai (earlier Madras)
1726	Aforementioned corporation substituted by a Mayor's Court
1773	With the passing of the Regulation Act of 1773, semblance of the commencement of municipal administration started
1793	The Governor General-in-Council empowered to appoint justices of peace in leading towns, by way of the Charter Act of 1793
1842	First Municipal Act passed – applied to Bengal only (But the Bengal Act failed)
1845	Elective element introduced in the Corporation town of Bombay
1847	Elective element introduced in the Corporation town of Calcutta
1850	Government of India extended local self-government to the entire country, by passing the Improvements in Towns Act; the Act also authorised a system of administration by Councillors in matters such as repairs, lighting, construction, etc.
1861	Indian Councils Act, 1861 passed; The development of Corporations and other local bodies in the provinces could be influenced by the provincial government
1863	• The Royal Army Sanitation Commission appointed by Government of India – Immediate measures proposed, for improvement of sanitation and hygiene conditions of towns • Based on the Royal Army Sanitary Commission Report, a series of Acts were passed; this resulted in establishment of city municipalities by way of Lord Mayo's resolution of 1870
1863-1867	Presidency corporation towns reconstituted – Calcutta in 1863; Bombay in 1865; and Madras in 1867
1870	Lord Mayo's Resolution – Lord Mayo, Governor General of India, recognised the need for popular association in civic functions; Therefore, called for the introduction of an elected President in municipalities
1882	Lord Ripon's Resolution of 18 May 1882 on Local Self-Government – This was the next historic step; Handled constitution of local bodies, their functions, finances and powers; Set the foundation of local self-government; Present form and structure of municipal bodies is based on this resolution. After reviewing results of the 1870 Resolution and the popular opinion, Government of India considered that an increase in the scope of local governments was desirable. Following were the key objectives of the reform: • Decentralise more functions to the local management • Make the local government an instrument of political and popular education Among other points: According to the Resolution, in addition to the cities and municipalities, *taluka* or *tehsil* must be the least local administrative unit. Also, local bodies were to be assigned sufficient financial sources to frame their own budget
1906	The Royal Commission on decentralisation was appointed, to suggest ways and means of decentralization of powers and functions
1915	Government of India resolution; However, no radical reforms in the local government space, by way of this resolution, or even due to the Decentralization Report of 1909
1919	Reforms of 1919; Beginning of real growth of municipal institutions and their involvement in local development may be said to have started with the introduction of the reforms.

	Government of India Act, 1919: Local government became a provincial head; The Act gave a distinct specification of the taxes leviable by the local bodies
1935	Government of India Act, 1935 - Envisaged a federal constitution; Implementation of new reforms were to be in two successive phases – Provincial autonomy and Federal structure; Local self-government got a relative (in comparison with earlier legislation) setback in the Constitutional Act of 1935
1937	Introduction of provincial autonomy
1946	Bhore Committee on sanitation and public health (1946): Highlighted to the government, about the depressing conditions in the moffusil areas
1954	Central Council of Local Self-Government constituted under Article 263; Emphasis on co-ordination between Union and the States in urban development
1959	All-India Mayors Conference convened periodically since then

* The Year of setting up of the Madras Corporation has been mentioned as 1687 in Rao (1986) and Government of Tamil Nadu, 1996 (http://www.tnrd.gov.in/reports/firstsfc/english/1-2.pdf)
Source: Rao (1986), Government of India (2007) and Government of Tamil Nadu (1996).[19]

[19] http://www.tnrd.gov.in/reports/firstsfc/english/1-2.pdf

Annexure 2: Details of SFC III Reports*

S. No	State	Date of Constitution of SFC	Period Covered by SFC	Devolution Recommendation
1.	Andhra Pradesh	29.12.04	2005-06 to 2009-10	Data not available
2.	Assam	06.02.2006	2006-07 to 2010-11	1. No devolution for the year 2006-07 2. 10% of non loan gross own tax revenue receipts after deducting actual collection charges for 2007-08 3. 25% of non loan gross own tax revenue receipts after deducting actual collection charges for 2008-11
3.	Bihar	20.07.2004	July 2004 - 24.06.2007	3% of net proceeds from state
4.	Haryana	22.12.2005 22.12.2005	2006-2009 2006-2011	4% of the net tax revenue to Local Bodies (LBs)
5.	Himachal Pradesh	26.05.2005	2007-08 to 2011-12	Cess on liquor to be transferred to LBs; incentive fund at the rate of Rs. 10 crore to LBs; Gap filling grant of Rs. 228.28 crore. Grant-in-aid to LSGIs; and maintenance expenditure for roads
6.	Karnataka	28.08.2006	2010-11 to 2014-15	1. 33% of state's own revenue receipt to be devolved to PRIs and ULBs in the ratio of 70:30 2. Salary component of officials working in PRIs should be delinked while working out the total share of PRIs and ULBs
7.	Kerala	20.09.2004	2006-07 to 2010-11	25% of the total state tax revenue of the year 2003-04 be transferred to LBs during the year 2006-07. For subsequent years, annual growth rate of 10% may be applied for transfer of funds to the LBs
8.	Madhya Pradesh	19.7.2005	2006-07 to 2010-11	Data not available
9.	Maharashtra	15.01.2005	2006-07 to 2010-11	Data not available
10.	Orissa	10.09.2008	2010-11 to 2014-15	15% of average gross tax revenue of state for 2005-06 to 2007-08 @Rs. 896.17 cr p.a. be devolved to LBs
11.	Punjab	17.09.2004	2006-07 to 2010-11	4% share of net proceeds of all state taxes be devolved to the LBs
12.	Rajasthan	15.09.2005	2005-06 to 2009-10	3.50% of net own tax proceeds of the state; entertainment tax 100%; royalty on minerals 1%
13.	Sikkim	04-03-2009	2010-11 to 2014-15	Report yet to be submitted
14.	Tamil Nadu	14.12.2004	2007-08 to 2011-12	10% of state's own tax revenue be devolved to LBs; Specific purpose grant shall be at 0.5% to 1% of state's own tax revenue
15.	Tripura	28.03.2008		
16.	Uttar	23.12.2004	2006-07 to	6% of net tax proceeds to PRIs and 9% to ULBs

S. No	State	Date of Constitution of SFC	Period Covered by SFC	Devolution Recommendation
	Pradesh		2010-11	which is under consideration
17.	West Bengal	22.02.2006	2008-09 to 2012-13	Untied fund of Rs. 850 crore from 2009-10 with annual increase of 12% on a cumulative basis for subsequent years

***Other states -- SFC III not constituted:** Arunachal Pradesh, Chhattisgarh, Gujarat, Uttarakhand; **Data not available:** Goa, Jammu & Kashmir, Jharkhand; **Exempt under Article 243M:** Meghalaya, Mizoram, Nagaland; **Under process of being constituted**: Manipur

Source: Government of India (2009)