

Roadmap to Financial Viability

ULB reforms is the key

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Nearly 30 per cent of India's population is urban. Yet, most urban local bodies (ULBs) are financially weak and are unable to satisfactorily meet their obligatory functions such as providing good roads, adequate lighting, sufficient drinking water and proper waste disposal systems. ULBs can, however, quickly transform themselves into creditworthy entities offering acceptable service delivery levels if they step on the reform path. Even better, they can get their reform costs funded under various initiatives announced by the Government of India (GoI). The need of the hour, then, is strong leadership that wants to make the transformation, something that numerous mayors and municipal commissioners have already documented as eminently possible.

The core objective of reforming local bodies has to be focused on improving service delivery levels. This improvement can only be

achieved by bringing in organisational efficiency and large-scale investments. But the task becomes difficult in light of the ULBs' poor financial situation.

Generalisations across ULBs are a little unfair given that their financial position varies across states. Also, municipal corporations in Maharashtra and Gujarat have access to octroi and hence, are in a relatively better financial condition. Besides, some ULBs have already managed to improve service levels significantly. Nevertheless, cities that have good basic services as well as a financially sound local body are few and far between. Hence, any reform roadmap for ULBs must focus on both these aspects: a financial turnaround that will enable the local body to quickly and visibly improve service levels. Also, while each ULB functions in a unique context, there are common problems that can be applied across the board.

Crisil Infrastructure Advisory has identified some of the problems that need to be addressed for any reform process to be successful and effective.

Inelastic internal revenues

Most ULBs rely on two primary sources of revenue: property tax and transfers from the state government. In addition, octroi accounts for a substantial portion of the revenue of some ULBs that have not yet abolished it.

Property tax is the only key internal source, but it has been an inelastic source. The only natural revenue growth from this tax is related to the growth in housing. Rate increases have not been too common and in any case, face strong resistance. In cities like Mumbai, rate distortions are already high between properties in different localities. As for rate increases in other revenue heads, such as water charges, these are not commensurate with inflation levels and even less so with respect to the growth in expenses incurred by the local body against these heads (such as electricity and manpower costs).

Out-of-control cost increases

Employees account for a large part of a ULB's operating expenses (60 per cent of the revenue expenditure, according to the National Institute of Public Finance and Policy, 2000). Also, wage increases are typically a function of national- and state-level decisions; hence, ULBs are unable to control such increases. A good part of the ULB's remaining expenditure is electricity charges, especially where pumping requirements are large. Some ULBs purchase power at a rate below the cost of generation, and outstanding payments to electricity boards are common. But as reforms in the electricity sector become a

reality, ULBs will increasingly have to pay commercial rates, and promptly at that.

Increasing inability of state governments to support ULBs

So far, ULBs have relied on two key financial avenues available from the state government: revenue transfers and support for capital investments (especially in water supply). In fact, at an all-India level, 35-40 per cent of a ULB's revenues comprise transfers from the state government. Given the condition of state finances today and as states make their own fiscal readjustments, both revenue transfers and capital grants from state governments are likely to come under pressure in the future. Hence, it is imperative that ULBs become financially independent.

High infrastructure backlog but few resource options

ULBs need to make immediate improvements in the service levels of all their core services today. In some cases, such as solid waste disposal, the courts have even dictated such improvements. But this means large investment requirements, often in multiples of a ULB's existing revenues. Yet, local bodies have very limited avenues for mobilising resources.

The ULBs' commercial borrowing experience (whether from the bond market or from banks) is still limited and is restricted largely to corporations that have octroi as a revenue source. Also, most of the borrowings have been structured ones and hence, are not truly replicable across ULBs. The other forms of commercial borrowings have used state government guarantees for grant intercept as a credit enhancement. But there are very few examples of commercial loans that are entirely based on a ULB's own strength without resorting to any of these credit enhancements.

Internal reform a precondition for turnaround

Long-term service delivery improvements require large investments. But these investments are unsustainable in the current context as:

- Investments, whether from banks or the private sector, would only flow if the borrowing entity has a sound credit quality. ULBs lack this and need a financial turnaround first. They also need to create an environment where tariff increases are accepted without undue resistance.
- ULBs also lack the performance orientation required to ensure that projects are implemented effectively and operated efficiently. Investments have to be supported, and often led, by an aggressive focus on performance standards.

Eventually, large-scale investments will be required to improve service delivery levels. But if these investments are not accompanied by a strong internal performance orientation, they will not be able to bring in sustainable service delivery standards. Only a sound financial position and strong performance orientation would provide a strong base for investments and further reforms.

The immediate task I: Sound financial position

Any financial turnaround of the ULBs would depend on three critical factors:

- Improved financial reporting
- Revenue improvement
- Cost control

True financial position: The need of the hour is a transparent financial position that reflects reality. But several factors cloud a ULB's true financial position. For instance, some ULBs have not provided for several liabilities such as unpaid or outstanding loans. Several ULBs have also implemented projects through state water boards. These have been funded by commercial borrowings

that are guaranteed by the state government with intercept of future transfers as a security. Or several ULBs have outstanding dues to the electricity boards that are directly adjusted against state government transfers. Another area where the true financial picture is blurred is employee retirement benefits.

Thus, the ULBs' actual repayments and outstanding liabilities against all these heads need to be identified and fully reported. This will entail a switchover to a double-entry accrual-based accounting system that will provide the ULBs' true and current financial position. Several ULBs in south India have already implemented this change but it needs to be more widely adopted because only a transparent financial position will provide a sound base for evolving a targeted financial position.

Revenue reforms: This is the next step in improving the ULBs' financial position. A large potential exists to streamline the ULBs' existing system and thereby improve revenues. The municipalities of Ahmedabad, Hyderabad and Indore provide striking examples of how this potential has been realised in a very short period.

A good property and asset survey will reveal a ULB's complete revenue base and can unearth undeclared and underassessed properties, illegal water connections and illegal hoardings. This has the potential to expand the revenue base significantly.

More importantly, in an electronic form, this revenue base can be synchronised and compared with other information such as the census, electricity connections and building permissions. It also enables the local body to monitor billing and improve collection efficiencies, besides attracting the private sector in these activities. The most important benefit of a revenue database is, however, financial planning. This provides the local body a true bottom-up estimate of its full rev-

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enue potential, which is vital for budgeting and controlling expenditure.

Expenditure control: Even though a ULB does not have complete control over expenses, budgeting can help it to plan and better manage its expenditure. Two improvements in this area can help in sound financial management. The first is realistic budgeting related to realisable revenue estimates and the second is prioritisation of operating and capital expenditure to match cash inflows.

Together, these two measures can provide the basic framework with which a ULB can implement financial management, a necessary precondition for improving service levels.

The immediate task II: Performance orientation

Together with a sound financial position, another key reform area that needs to be simultaneously addressed is performance orientation. Several ULBs have shown that service improvement is possible with simple performance orientation measures. This is also substantiated by the fact that service levels that are unrelated to a ULB's financial position vary across local bodies.

Identifying achievable performance standards: In areas such as solid waste collection, performance improvement would largely depend on how the ULB uses its existing manpower and resources. Thus, to start off, a ULB can focus on performance standards that are internally achievable and that do not require large investments.

Organisational accountability: Strong local leadership has often shown that accountability improvements are possible within the existing constraints. These have been made possible by identifying accountability for individual employees and by creating a mechanism to measure performance and to isolate underperformance. By identifying its own “lost performance”, the ULB can demonstrate its willingness to reform to citizens.

State as enabler

While internal reforms are necessary, they may not be sufficient to transform ULBs, given their poor financial position. Hence, state governments have a large role to play in supplementing the ULBs' reform efforts, especially where ULBs are unable to turn around their finances because of flaws in the revenue model. In such cases, the state government would need to step in, often by providing a viable alternative to octroi. Moreover, in order to fully leverage its internal reforms, a ULB requires state government support in two areas: facilitating municipal borrowing, and removing tariff increase bottlenecks. By the time the local body is ready to seek private sector investment, the state needs to have in place a framework that encourages and protects private sector investment.

How can local bodies leverage internal reforms?

A sound financial position and performance orientation are only the first steps. Having achieved these, ULBs can leverage these to spur further reforms. Three specific areas in which ULBs can leverage these are:

- In a number of service areas that do not have a direct revenue source like roads, commercial borrowings are often the only source of investments. If the ULB provides the market with a sound, true and current financial position, the market can fund a significant part of the investment requirements. Thus, a sound financial position can enable the ULB to unleash large-scale investments through commercial borrowings. Also, the financial discipline and commitments that a local body needs for commercial borrowings is significantly lower than that required when private sector investment is involved.
- Performance orientation can help bring in sensible private sector involvement by identifying areas where internal performance is not sufficient. Outsourcing to improve per-

formance and/or to reduce costs is possible if the local body has clarity on the standards that it wants to achieve.

- Both improved financial position and performance also provide a significant leverage to the ULB to increase tariff levels. Tariffs can be gradually raised to meet financial gaps. A good tariff culture then opens up investment possibilities both through commercial borrowings by the ULB and through private sector participation. Local improvements in these areas also help build a strong opinion to convince the state government to play its part in streamlining transfers and in facilitating tariff increases.

The way ahead

The reform roadmap for ULBs relies on two critical internal reforms: discovering “lost income” through financial management and discovering “lost performance” through performance orientation. These are the essential first steps that most ULBs that are unable to deliver services effectively need to take. These are also inexpensive measures that mainly require a strong and focused local leadership. Very often, this is more readily visible in cities than in large state-level entities or at the state government itself and it is possible to quickly turn around a local body than larger public entities. Once this “lost income” and “lost performance” are discovered, tariff increases, commercial borrowings and private sector participation would become a reality. These, in turn, combined with state facilitation, can help the local body to build a strong financial position to sustain services effectively.

The Govt's recent initiatives are also focused on helping ULBs achieve this turnaround by funding reform costs.

Thus, both the techniques and funding for revitalising ULBs are now available. What is needed is strong local leadership and commitment to reforms. ▀