

Sustained Finance Reforms for Optimal Resource Mobilization

(Ahmedabad Municipal Corporation, Gujarat)

A) Pre project situation: Despite a very large budget, the Ahmedabad Municipal Corporation (AMC) faced a serious financial crisis in 1993-94 as it had been pending beyond its means. The Corporation implemented effective measures to raise its octroi and property tax collections substantially in a short period of time. Thereafter, it issued municipal bonds in a pioneering format and reformed its system of property tax assessment. Due to the success of these initiatives, the AMC's financial condition has completely turned around. In terms of financial health, the Ahmedabad Municipal Corporation (AMC) is considered to be one of the strongest urban local bodies in India. However, just ten years ago, the financial condition of AMC was rather poor. In the middle of the Financial Year 1993-94, the Corporation faced a major financial crisis. It had accumulated cash losses of Rs. 350 million and drawn a bank overdraft of Rs. 220 million. In each of the preceding ten years, the AMC had spent more than it earned and the deficits were carried forward. It was time for drastic action and major reforms in the functioning of AMC. Coincidentally, the elected body of the Corporation had just been superseded and state government had appointed an Administrator as the Chief Officer. This provided a strong opportunity for the administration to initiate financial reforms. The AMC's system of property tax assessment was very complicated and in many ways irrational. Being based on notional rental value of properties, the assessed values were very low. These could not be revised due to the constraints of the Rent Control Act and related judicial decisions. Consequently, the AMC could only raise the tax rates which stood at 73% of the annual ratable value in the case of residential properties and 83% for non-residential properties. These high rates had a psychological impact on the property owners, which lowered their willingness to pay the tax. Another undesirable outcome of the low assessment of property values was that 72% of the total number of residential properties in Ahmedabad and 31% of the commercial properties were

exempted from paying the general property tax. There was also enormous disparity between assessment of self-occupied and tenant-occupied properties. The ratio of tax burden was 1:15 in favor of the former. The end result of this irrational structure of the property tax system was that people perceived the system to be grossly unfair and non-transparent. It also led to corrupt practices in the tax department of AMC and the system was commonly described as “Inspector *Raj*”. The octroi department of AMC had even worse reputation in 1993-94. People perceived it to be full of corruption. Most people thought that it was easy to evade octroi by under-invoicing the goods, or by dodging the check posts, or by paying small bribes. Till 1993-94, the traditional method of financing infrastructure projects for the city was to obtain grants from the state government or take loans from HUDCO or LIC, backed by state government guarantees. These loans were neither cheap nor easy to obtain. The AMC certainly had little to no control on these sources of financing. As a result, capital projects had to be financed from surplus revenue income or just deferred year after year. It is not surprising that the city’s basic infrastructure (roads, water supply and drainage) was in shambles in 1993-94. Diagnosis of the existing situation showed that while there was need to control expenditure, the critical problem area was revenue enhancement. Specifically, it was concluded that the system of property tax assessment needed to be revamped and rampant evasion of octroi had to be checked. Further, the top management felt that the AMC should explore alternative sources for financing infrastructure projects from capital markets instead of relying exclusively on traditional methods.

B) Project objective:

- i) To enhance the revenue income of AMC to tackle the financial crisis that the civic body was facing.
- ii) To mobilize resources for city’s infrastructure up-gradation.
- iii) To realize the full revenue potential of property tax and octroi.

C) Project planning & implementation:

- i) **Strategy for Improving Octroi Collection:** Octroi is the most important source

of income for the AMC. Octroi continues to contribute almost 60% to AMC's total revenue income.

- The AMC's strategy for improving octroi collection was based on greater vigilance at *nakas*; strict action against tax evaders and corrupt staff; rationalization of rates and procedures; and use of better communication technology.
- The AMC established a Market Research Cell and inducted Cost Accountants for preparing valuation books on the basis of prevailing market rates. This was done to stop under-invoicing.
- The system of random physical verification was introduced to prevent under-invoicing and under-valuation of goods. Thirteen vigilance squads were pressed into service for round-the clock checking of vehicles entering the city.
- Anti-social elements facilitating the evasion of octroi were tackled with the help of police.
- The AMC staff indulging in corrupt practices was punished.
- All octroi checkpoints were equipped with a wireless system for rapid communications. The major *nakas* were computerized.

ii) **Municipal Bonds for Infrastructure Projects:** As the AMC's drive for increasing octroi and property tax collections started showing impressive results within a short period of six months, the Corporation took a bold decision to address the infrastructure needs of the city.

- A corporate plan for infrastructure development was prepared. It included projects worth Rs. 7420 million to be implemented over a period of 3 to 5 years. It was decided that the AMC would raise finances from the capital markets in the form of municipal bonds.
- It was essential to establish credibility in the debt market to be able to raise funds. The AMC carried out a number of institutional strengthening measures by decentralizing administration, recruiting business management professionals, improving the contracts administration system and building internal capacities for managing large projects.

- Having set its house in order, the AMC approached CRISIL, the top credit rating agency in India, to evaluate the Corporation's credit worthiness. This was a pioneering step, as no other urban local body in the country had gone for credit rating until then. It was given the rating "A+" in 1995-96, signifying high safety for timely payment of interest and principal for raising resources from the capital market.
- On obtaining the rating, the AMC floated the first issue of municipal bonds in India for Rs. 1000 million to be used for financing the planned water supply and sewerage projects. The bonds carried a coupon rate of 14% per annum. The issue, which eventually materialized in January 2002, was oversubscribed. While Rs. 750 million worth of bonds were issued under firm allotment to financial institutions, the remaining bonds worth Rs. 250 million were subscribed by public at large. Further, these bonds were secured through the escrow mechanism tied to AMC's revenue from octroi, unlike the bonds issued by the Bangalore City Corporation that were backed by a guarantee from the state government.
- The AMC repeated its innovative approach for financing infrastructure projects in March 2002 by becoming the first urban local body in India to issue tax-free municipal bonds. Once again Rs. 1000 million were mobilized with a coupon rate of 9%. Unlike the first time, this issue was fully under private placement with firm allotment. AMC has since then issued two more municipal bonds in the year 2004 and 2005. These were worth Rs. 580 million and Rs. 1000 million respectively. Both were privately placed and issued to 5 and 12 investors respectively.
- The AMC has also been restructuring its debts in the changing market scenario so as to minimize its losses. The first and the second municipal bond money has been repaid and regular by the provision of escrow account. Funding from the first two municipal bonds were used for the construction of the Rask Weir for provision of surface water supply to AMC, in construction of a water treatment plant and partly for construction of roads and bridges. The funding from the third and fourth municipal bonds was used partly for

water and sanitation projects and mainly for roads and bridges project including the Bus Rapid Transit System.

- Highlights of a systematic approach to infrastructure development in the city.
 - Issue Size - Rs.1000 million; of which Rs.750 million is on a firm allotment basis
 - Underwriting - Net public offer of Rs.250 million fully Commitment underwritten
 - Face Value - Rs.1000 at par Redemption - In three trenches of Rs.333, Rs.333 and Rs.334 at the end of 5th, 6th and 7th year
 - Interest - Interest @ 14% per annum payable semi annually on the outstanding principal
 - Deemed date of allotment - February 01, 1998
 - Credit Rating - AA(SO) - By CRISIL
 - Security - Charge/Mortgage on AMC's properties
 - Structured obligation - Escrow on Octroi revenues of AMC
 - Listing - ASE, NSE

iii) P roperty Tax Reforms: Property tax is the second most important source of revenue for the AMC, though significantly lesser than octroi. Property tax consistently accounts for 20% of the total revenue income of AMC. The AMC administration understood the deficiencies of the existing system of property taxation and they were determined to replace it with an alternative more rational system. However, it was obvious that the process of changeover to a new system would take a long time while the financial problems of the corporation needed immediate response.

- In the first phase of reforms, a number of effective steps were taken to increase property tax collection with immediate effect:
 - First, the municipal records of properties were updated and a large number of previously unrecorded properties were added.
 - Next, all existing properties whose assessed value was grossly inadequate were reassessed.

- Finally, a number of punitive actions were taken against property tax defaulters. These included disconnection of water supply and drainage services; attachment of movable and immovable properties; and occasionally auction of properties for tax recovery.
- In the second phase of reforms, the AMC decided to evolve an “area-based property tax system” to replace the existing system based on annual ratable value.
 - The ground work that began in 1999 was an elaborate exercise. It involved large-scale survey of properties throughout the city and computerization of data. Nearly one million properties were surveyed.
 - At the same time certain amendments had to be made to the Bombay Provincial Municipal Corporation Act (applicable in Gujarat) to accommodate the new system. This in turn involved issuing of special notices and bills to property owners; conducting hearings to receive objections; piloting the proposed changes through the standing committee; and seeking approval of the state government.
- The entire process was completed in about two years and the new system was introduced in the second half of 2001-02. Under the new formula, the property tax is computed by applying a per unit tax rate to the total carpet area of the property and adjusting for location, age, type of use and whether the property is owner or tenant occupied. Main features of the new system are as follows:
 - The standard factor is one (‘1’) in all the cases.
 - The value of each factor is raised or lowered depending on the type of locality, the type of the building, the age of the building and the occupancy of the residential building.
 - The factors are determined by the Corporation as prescribed under the rules.
 - The prevailing market value of the land determines the location factor of the area.
 - Independent bungalows pay higher rates than ordinary flats.
 - The properties above 10 years of age get discount of 15% which extends up to 50% for properties which are more than 40 years old.
 - The self-occupied property pays half the tax as compared to tenanted property.

- The non-residential properties get similar benefits for location, age, occupancy but they pay higher rates according to the use of property.

D) Leadership Roles and Political Support: The initiatives described here are spread over nearly a decade. During this period from different Municipal Commissioner were appointed to the post. No doubt that they led the initiatives with equal vigor. However, it is also true that the Municipal Commissioners were supported by three Deputy Commissioners who were looking after the departments of general administration, finance and octroi. The individuals who served in these posts had many years of experience in municipal administration. This reflected in the quality of operational leadership they provided during the implementation of these initiatives. The elected body of the AMC was solidly behind these initiatives. They discharged their responsibility as elected representatives to facilitate the due process of debating the issues and shaping policies.

E) Results Achieved:

- *Revenue income from octroi:* It is no exaggeration that the measures taken by the AMC to plug the leakages of octroi income were enormously successful. It is said that the heavy crackdown on octroi evasion started showing results within one week. In fact, the daily income from octroi jumped from Rs. 30 lakh a day to Rs. 70 lakh a day in less than five years. At present, the AMC receives nearly Rs. 150 lakh per day from octroi.
- *Water supply and drainage infrastructure:* Over the last ten years the AMC has successfully implemented a number of projects related to water supply and sewerage systems. A study of inter-city comparisons of quality of life (City Monitor, 2002) has given a high rating to Ahmedabad's infrastructure in these two sectors. The AMC implemented an ambitious water pipeline project for bulk transmission of water from the Raska weir located at a distance of 120 km from the city. The city has more than adequate water treatment capacity. The sewerage system covers 100% of the city area. The funds raised through municipal bonds met a significant part of the cost of this infrastructure.

- *Revenue income from property taxes:* The various initiatives of the AMC for increasing property tax revenues have also shown impressive results. The initial drive to increase the properties in the tax net and actions against the defaulters produced immediate results. The tax revenue income doubled within two years and has increased steadily since then. Another major jump came in 2001-02 when the new area-based system was introduced. The graph shows steady increase in property tax revenues.
- *Other impacts of property tax reforms:* There are several other tangible impacts of the new system. The number of exempted properties has come down drastically. The disparity between owner-occupied and renter-occupied properties was reduced drastically. Other inequities, such as between old and new properties, have also been reduced. Another impressive outcome is that there have been no cases of litigation against the assessments done under the new system.
- *Overall financial condition:* The AMC is considered to be one of the most successful urban local bodies in India in terms of revenue mobilization. The initiatives described above have resulted in the corporation being able to generate a surplus on revenue account year after year. This revenue surplus is used to fund small capital projects or to leverage financing for larger projects.

F) Sustainability: In the area of octroi collection, the issue of sustainability is most pertinent because there is uncertainty about whether this form of taxation would continue in the future. The national policy on this issue is that octroi should be abolished altogether. However, as octroi is a state subject, it continues to be imposed in the states of Gujarat, Maharashtra and a couple of other states. In all other states octroi was either never imposed or it has been abolished. In Gujarat, octroi is imposed only in seven municipal corporations whereas it has been discontinued in municipalities since 2001. If one assumes that the octroi policy of the state would not change in the near future, then the AMC's initiative, which resulted in improvement of collection efficiency, is sustainable as most of the practices have been internalized in the department. The department heads would have to ensure that the effective vigilance is maintained. Regarding the initiative of using municipal bonds to finance

infrastructure projects, it is not clear as to how well and how fast the market for municipal bonds would develop at the national level. So far it has grown very slowly despite the fact that cities can obtain tax-free status for these bonds. AMC has shown sustained improvements in the property tax revenue collection. The new formula has been accepted by the public as indicated by the fact that the number of cases of litigation against assessment has gone down to negligible levels and is practically nil. There is also greater transparency in the system on account of the e-governance system implemented by the AMC. Citizens can access information about assessment of any property in the city and can pay their taxes either online using credit cards or at banks or at any of the seventeen civic centres that have been established by the AMC.

G) Lessons Learned: The main lesson of Ahmedabad's initiative on octroi collection is that the urban local body must project strength and determination, and above all, political will, to deal with those who break the laws in order to evade taxes. Similarly strict action against corrupt staff is also necessary. However, the most effective tool to check tax evasion is to set up vigilance systems equipped with best available technologies. Cooperation between the urban local body and the police department is essential for effective enforcement. The AMC's experience with municipal bonds shows that if a city wishes to earn credit worthiness in debt markets, it must set its house in order in terms of fiscal discipline. It is also important to introduce professional management approach in various departments. The property tax reforms at AMC show that a rational, equitable and transparent system of property taxation can be more acceptable to taxpayers while generating higher revenues for the urban local body. To administer the system, an excellent database is essential. It is very important to ensure that taxpayers are not inconvenienced by the procedures and facilities for obtaining information or making payments. There should be clear policies and rules to deal with tax defaulters and corrupt staff and these should be strictly enforced.