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The Impact of GST on Municipal Finances in India: A Case Study of Mumbai

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ABSTRACT The post-GST Municipal Corporation of Greater Mumbai (MCGM) Budget of 2018–19 was the first to contend with the abolition of octroi, which was previously its largest and most robust source of revenue. One year after the introduction of the General Services Tax (GST) by the central government, the MCGM has been forced to find new financing sources. While the state government of Maharashtra has assured that the loss of octroi will be compensated, this move raises larger questions about financial power in the hands of urban local bodies (ULBs). It is imperative to discuss issues such as the need to give ULBs a share in the GST, the role of toothless state machineries such as the state finance commission, the failure to implement the 74th Amendment of the Constitution, and the need for long-term strategies to improve the financial situation and level of services offered by large municipal corporations such as MCGM.

INTRODUCTION

Municipal finance is directly correlated with the economic growth of a city, contributes to fulfilling the targets of urban policy and planning agendas, and is responsible for municipal-service delivery. Municipal bodies being the powerhouses of growing economies, it is essential to keep their engines well-oiled. Indeed, India's long-term economic prosperity will depend largely on how its cities perform.[1]

Municipal bodies are local self-governments whose mandate includes the provision of basic services such as healthcare, water supply, educational institutions, housing, transport and waste management. Historically, Indian municipalities have suffered from weak fiscal capacity, relying heavily on state contributions to finance their budgets. They are authorised to collect various taxes, e.g. those levied on

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property, entertainment, advertisements through hoardings and billboards, and articles entering the region (octroi duty or entry tax). These taxes ensure that ULBs practice a certain degree of financial autonomy.[2] With the introduction of the Goods and Services Tax (GST) in 2017, this financial autonomy has been restricted. Several taxes have been subsumed under the GST.

At the central level:

a. Central Excise Duty
b. Additional Excise Duty
c. Service Tax
d. Additional Customs Duty, commonly known as Countervailing Duty
e. Special Additional Duty of Customs.

And at the state level:

a. State Value Added Tax/Sales Tax
b. Entertainment Tax (other than the tax levied by the local bodies) and Central Sales Tax (levied by the Centre and collected by the States)
c. Octroi and Entry Tax
d. Purchase Tax
e. Luxury Tax
f. Taxes on Lottery, Betting and Gambling.

In compliance with the new GST regime, the Municipal Corporation of Greater Mumbai (MCGM) has had to abolish octroi, which on average had contributed almost 35 percent of its annual total revenue. MCGM is one of the largest municipal corporations in India and is responsible for running Mumbai, the country's financial capital. Its budget is equal to the combined budgets of several small states in the country.

For other municipal bodies in the states of Maharashtra and Gujarat, the Local Body Tax (LBT) was a major source of revenue, superseding the octroi and cess system of taxation. Local civic bodies of India would impose the LBT on the entry of goods into a local area for consumption, use or sale therein. The LBT has now been discontinued, and most state indirect tax levies such as VAT, CST and entry tax have been subsumed under the GST, as listed earlier.

The GST Constitutional Amendment Bill accounts for the compensation owed to states by the central government for losses to the state exchequer due to the implementation of GST. States, in turn, must assess revenue losses for civic bodies and compensate them for the same. However, this is not mandated, since the decision is taken at the state level and not mentioned in the Amendment Bill.[3]

The 74th Constitution Amendment Act, 1992 (CAA) recognises municipal corporations as the third tier of the government. The 12th schedule mandates 18 functions[4] that municipal bodies must carry out. These functions are categorised into three sections: regulatory functions, provision of services, and infrastructure development.

As part of the devolution process, State Finance Commissions (SFCs) were set up to formulate principles for disbursing adequate finances from the state to local governments. In addition to their own revenue handles, these ULBs were to be empowered through grants from the centre and respective state governments (which may or may not be tied) as well as transfers formulated by the finance commission.[5] The expectation was that SFCs

would follow the Central Finance Commission (CFC), which devolves funds from the Government of India to state governments. However, so far, this has not happened.[6]

While the constitutional amendment called for the devolution of powers and finances from the centre and state to municipal bodies, the GST has not been implemented with the city in mind.[7] Municipal corporations must be better funded to allow their finances to match their functions. They should be aligned with a predictable and growing source of self-sustaining revenue, independent of state and central government interventions.

The GST has levied a steep tax increase in civic services, especially on labour works carried out by contractors, resulting in increased costs for road construction and repairs, desilting, conservancy, housekeeping, street lighting, and other similar activities.[8] This has raised concerns about credit availability for contractors and corporations, as funds are currently blocked. Municipalities in India do not have access to taxes from income, business, sales, value added or goods and services as base, to keep up with the economic growth.[9]

This raises several questions on how corporations like MCGM are dealing with this change. Will it impact the compositions of capital and revenue expenditure? How can it be ensured that after these changes, the budget still caters to the people's needs?

MCGM BUDGET 2018–19 AND CHANGES THEREIN

Mumbai is the nation's financial capital and the epicentre of commerce and entertainment. It is home to over 13 million people and has an estimated GDP of INR 21,162 billion. It contributes more than six percent of the nation's GDP, 10 percent of factory employment, 60 percent of customs-duty collection, and 30 percent of income-tax collections.

Being a global city hosting some of the world's top financial and commercial institutions puts an added pressure on the Mumbai municipality to uphold requirements such as adequate infrastructure. For 2018–19, the total budget outlay presented by the MCGM is INR 272,580 million. As such, the city must perform a complex and large set of functions, including that of a regulator, service provider and creator of infrastructure assets. It must also ensure the effective and efficient administration of these functions. However, with the launch of the GST, the MCGM has lost its primary source of revenue, the octroi, which accounted for nearly 35 percent of its direct income source and about 17–20 percent of the total budget amount (See Table 1).

Table 1: Past Budgets of the MCGM and Annual Octroi Collections (as per BMC Books)

Year	Budget (in INR)	Octroi (in INR)
2015–16	335,140 million	62,760 million
2016–17	370,520 million	72,440 million
2017–18	247,770 million	Subsumed under the GST

With the discontinuation of octroi, the MCGM has had to depend largely on property tax as its revenue source, which makes up 22 percent of its income. However, the collection of property tax is riddled with issues: there are pending litigations and few people and establishments comply, given the lack of strong laws against non-compliance. The income from 'building proposals' is around INR 39,000 million, which has seen a steady drop in the last couple of years because of the slowdown in Mumbai's real-estate market.

The introduction of GST on 1 July 2017 has raised various concerns. Octroi was a buoyant tax, which meant that it increased as the prices of commodities did, without any need to raise the tax percentage. GST, on the other hand, is an indirect tax and not directly linked with the prices of goods. Thus, there has been apprehension about whether GST would take care of annual increases in interest rates, since there is no direct mechanism by which it would get passed on to the MCGM. However, the state amendment in Maharashtra, which fixed a compensation clause to the loss of octroi, has resolved this to some extent.

The local bodies need assurance that GST—to be collected by the central and state governments —will be channelled to the MCGM, since the transfers from the state governments in India are neither guaranteed nor predictable. Moreover, octroi's daily cash-collection method ensured cash inflow to the MCGM, taking care of its urgent needs. On the other hand, the GST compensation is a fixed amount given on a fixed date, forcing the corporation to borrow from banks during emergencies. The situation further depends on the state's own finances, i.e. if finances worsen, the state will not be able to fulfil commitments.

To protect the interests of the MCGM, after several negotiations, the government passed the Maharashtra Goods & Services (Compensation to Local Bodies) Act, 2017, which guarantees compensation for the loss of revenue following the abolition of octroi. The law protects the current financial year's octroi collection and ensures that the state pays the current amount of octroi with an eight percent compounded interest in perpetuity to the MCGM every year, in monthly instalments. This process is ongoing and has already gained momentum. The perpetual arrangement is guaranteed through an escrow account to ensure an annual direct deduction of the promised compensation amount to the MCGM.

The MCGM has been assured that the revenue resource would be completely protected. However, for 2018–19, the Mumbai civic body is promised only INR 85,000 million from the government as compensation for its loss of revenue from octroi, despite the revenue being pegged at INR 240,000 million. The expenditure is estimated to be INR 275,000 million, and the corporation thus faces a deficit of INR 35,000 million. The abolition of octroi has also meant less cashflow for ongoing and new projects.

In 2018–19, the MCGM, for the first time, decided to draw funds from the corporation's special reserves of INR 690,000 million to tackle this deficit over the next few years. These are fixed deposits in 31 banks drawing an annual interest of 7.5 percent, available to the corporation on zero-interest loans. While INR 210,000 million is kept aside in the banks as fiduciary fund for provident fund, gratuity, deposits and bank guarantees, the remaining INR 480,000 million has been allocated for infrastructure projects that need cashflow, e.g. the coastal highway, Goregaon–Mulund Link Road, Gargai–Pinjal water sources, hospital bed-capacity upgradation in suburban Mumbai, and Sewage Treatment Plants (STPs). These will be withdrawn as and when needed. Additionally, a fund of INR 27,440 million has been set aside for mega projects.

The launch of the GST has weakened the cash-holding status of the MCGM. The only sizeable source of tax revenue that has remained with it post-GST is the property tax. In the case of the MCGM, when the share of other sources

of revenue—such as fees, user charges and penalties—are added to the revenue from property tax, the total is only 50 percent of the amount that the corporation needs to perform its functions. When octroi was still an active income source, the MCGM made 86 percent of the total funds required. Under the GST system, therefore, Mumbai will not be able to independently generate more than 50 percent of its revenue requirements.

Moreover, almost half of the functions of the MCGM are mandated but not funded. No finance is provided, for instance, for education, health, running a bus company and providing electricity. This situation will only exacerbate with the continuing and rapid urbanisation of Mumbai.

Some changes must be made within the GST regime to mitigate this predictable crisis:

1. *Reconsidering Revenue Sharing from States to ULBs*

It is necessary to consider adequate revenue-sharing between the centre and the states on the one hand and the cities on the other. A formula must be drawn up based on indicators, so that a share of the GST is mandatorily passed on to cities. This must not be left to states to be paid as compensation.

According to a news report, Maharashtra recorded a 26-percent jump in revenue collection from GST in 2017–18. The state received INR 1,140,000 million in revenue from taxes.[10] This increase should be shared with the ULBs as a fixed amount transferred on the basis of a mutually agreed-upon percentage. This idea was also mooted by the Union Ministry of Urban Development in 2015, when the GST was being formulated. The ministry had suggested that 25–30 percent of the state's share of GST be given to the municipal bodies. This was to compensate for the losses that they were bound to suffer because of the GST regime. However, this suggestion was not factored in when the GST Act was finalised. Since no devolution formula was part of the Act, it resulted in a loss of revenue by removing an important tax like octroi and not compensating the ULBs adequately.

While any form of octroi is undesirable, and the LBT is not a good replacement for octroi in theory, the legitimate concern of cities across India to have one or more taxes that match the revenue potential and buoyancy of octroi is a key municipal reform that must be addressed by the central and state governments.[11] Some more revenue could come out of property tax with proper compliance systems in place, but it will not have the capacity to compensate the entirety of the projected losses on account of octroi's abolition. Various other measures of earning more revenue for municipal corporations have been proposed, including developer exactions, wherein a land developer or builder must contribute towards on-site and off-site infrastructure facilities needed to serve new development. Suggestions have also been made to have a local-body grant and municipal incentive funds to help local bodies access the capital market.

2. *Strengthening State Finance Commissions*

The 74th Amendment to the Indian Constitution instituted SFCs, which were entrusted with the task of identifying the functions to be performed by the municipal corporations and mapping the financial requirements to do so. The objective was to

articulate a mechanism by which the centre and the states would devolve funds to the city corporations. Such SFCs mimic the role of the CFC at the city level.

Article 243Y of the Constitution of India mandates that SFCs must review and recommend "measures" to improve municipal finances. However, no SFCs in the past have provided any road map for property-tax reforms. Moreover, the recommendations made by committee members often get rejected or inordinately postponed.

In his commentary[12] for ORF, Abhay Pethe, who was a member of the Maharashtra SFC, says that almost all states reject the awards of their SFCs and that there is no formulaic devolution of resources from a state to the local bodies. "It is not as if there is no fund flow downwards from the states, but it is largely of the type of inflexible 'agency transfer' not necessarily catering to the felt needs of the local bodies or indeed, riddled with pure political pork barrelling," he wrote.

Several urban economists have suggested that a measure of decentralisation should be included in the devolution formula for a share in central taxes and that release of any grants should be done evenly over a fiscal year. It has also been recommended that the way SFCs function must change, and until then, the central government must have direct conversations with the local bodies.

With the implementation of GST, it is time for SFCs to proactively address the issue of having abysmally low user charges for services such as water supply, sewage and solid-waste.

3. Pushing the Tax Portfolio for ULBs

Despite several recommendations from different committees, an alternative to octroi is yet to be formulated.

In 1985, a committee on octroi had recommended that the tax be replaced with alternatives such as surcharge in sales tax, entry tax, terminal tax, road tax and tax on motor vehicles. The proposal suggested that if this was found insufficient, additional funds could be obtained from property tax, entertainment tax and profession tax. Only if the total was still insufficient would the state be allowed a grant-in-aid.

In 2011, the High-Powered Committee in its Report on Indian Urban Infrastructure and Services examined this issue of revenues assigned to municipal bodies and recommended a "municipal finance list" of revenue sources to be included in the constitution as an alternative to octroi.

It categorised the taxes into three brackets:

i. "exclusive taxes," which included property tax as well as vacant-land tax, profession tax, entertainment tax and advertisement tax;

ii. "revenue-sharing taxes," including all taxes on goods and services levied by the state government, which is now GST; and

iii. "non-revenue taxes," such as user charges, trade-licensing fee, floor-space index (FSI) charge, betterment charges, impact fee and development charge.

CONCLUSION

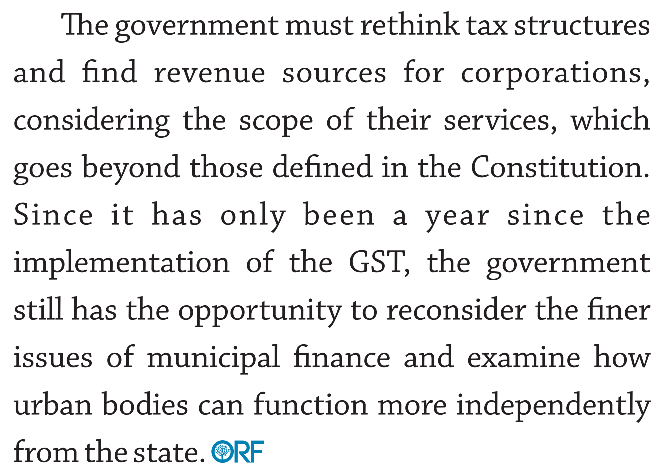
While a 'one nation–one tax' regime is a move towards better transparency and accountability, the GST has not been well thought-out for municipal bodies. It has replaced a buoyant

tax—octroi—that provided flexibility in cash spending. Although municipal bodies are being remunerated for the loss, it is in the form of compensation. This cannot be compared to an arrangement where the ULBs share the GST with state governments. Following the implementation of the GST, civic bodies have lost their autonomy and have become increasingly dependent on states for financing, thus defeating the intent of the 74th Amendment, which sought to give ULBs greater autonomy.

If MCGM, one of the most robust municipal bodies in the country contributing to a sizable portion of the GDP is feeling the heat, then the smaller ULBs are even more likely to be affected. They are, after all, much more dependent on intergovernmental transfers. Prior to GST, municipal bodies' own revenues comprised 53 percent of the total revenue, and the balance was accounted for by assignment, devolution and grants-in-aid from states (33.4 percent), central government grants (5.3 percent), and grants from the finance commissions (two percent).[13]

Globally, India's municipal corporations are the least funded; the implementation of GST has made them even weaker. The country's municipal tax-to-GDP ratio is small and is declining with each passing year. The figure, which was 0.39 percent in 2002–03 and 0.40 percent in 2007–08, declined to 0.33 percent in 2012–13. In contrast, the local tax-to-GDP ratio was more than two percent in 22 of the 34 OECD countries in 2010. It was 16.1 percent in Sweden, 12.7 percent in Denmark, 10.4 percent in Finland, 7.2 percent in Japan, 4.2 percent in Korea, and four percent in the United States.[14] However, under the GST system, the local tax-to-GDP ratio is bound to go down, unless revenue gains are included in it.

The 74th Constitution Amendment Act, 1992 (CAA) declares municipal corporations as the third tier of the government and mentions devolving powers, which includes financial independence. The GST system undercuts this idea.



The government must rethink tax structures and find revenue sources for corporations, considering the scope of their services, which goes beyond those defined in the Constitution. Since it has only been a year since the implementation of the GST, the government still has the opportunity to reconsider the finer issues of municipal finance and examine how urban bodies can function more independently from the state. ORF

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