

User Fees and Charges for Municipal Services

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Rapid urbanization in India has brought with it, new challenges relating to municipal administration, financing and service delivery. According to the Census 2001, out of total population of 1028.6 millions in India about 286 millions live in urban areas. Thus, around 28 out of every 100 persons in the country reside in cities and towns. The percentage of people living in urban areas in the country increased from 11 in 1901 to 28 in 2001.

The 74th Constitutional Amendment Act (CAA) came into force in June, 1993 which sought to strengthen and empower the ULBs, and gave greater responsibilities for urban planning, water supply, social and economic planning, slum up gradation, public health, etc. However, the CAA did not lay down revenue base for ULBs and the power to determine the revenue base continues to remain with state governments through the medium of State Finance Commission(SFC). There is often a mis-match between functional responsibilities and resource generation capacity of local governments. In this context, a review of user charges for various municipal services requires a critical look.

Through Article 243Y, the 74th Amendment Act made it mandatory for the constitution of State Finance Commissions to review:

(a) the principles which should govern -

- i) the distribution between the State and the Municipalities of the net proceeds of the taxes, duties, tolls and fees leviable by the State, which may be divided between them and the allocation between the Municipalities at all levels of their respective shares of such proceeds;

- ii) the determination of the taxes, duties, tolls and fees which may be assigned to, or appropriated by the Municipalities;

- iii) the grants-in-aid to the Municipalities from the Consolidated Fund of the State;

(b) the measures needed to improve the financial position of the Municipalities; and

(c) any other matter referred to the Finance Commission by the Governor in the interest of sound finance of the Municipalities.

A study, entitled "Municipal Finance in India – An Assessment", undertaken by the Reserve Bank of India examines the performance of Urban Local Bodies (ULBs) in India. Using data from 35 Metropolitan Municipal Corporations, the study attempts to analyze the reasons for their differential performance with respect to fiscal parameters and provision of civic amenities. Constitutionally built-in imbalances in functions and finances assigned to various levels of government eventually reflect in the high dependency of local bodies on State Governments and the latter, in turn, on Central Government for funds. Moreover, in the absence of financial support coming from the upper tiers of Government, these bodies may have to resort to borrowings from financial institutions and the capital market. In the light of the findings of the study and international experience in this regard, the study makes suggestions for improving the municipal financial system in India.

The major findings of the Study are summarised as follows :

- There is a mismatch between functions and finances of ULBs, which primarily explains the vertical imbalance.
- Out of 18 functions to be performed by the municipal bodies in India, less than half have a corresponding financing source.
- Own taxes and user charges of the ULBs in India are grossly inadequate to meet the expenditure needs of ULBs.
- Elaborate State Government controls on municipal authorities to levy taxes and user charges, to set rates, to grant exemptions, to borrow funds, etc, and on the design, quantum and timing of inter-governmental transfers constrain the ability of the ULBs in mobilising resources.
- The Study states that the conventional method for assessing municipal finances in terms of analysis of revenue and expenditures of municipalities may not be appropriate as the ULBs are required to generate a revenue surplus due to statutory requirements.
- Overall resource gaps of ULBs, as seen from municipal budgets, are not very large. However, the spending by all the Municipal Corporations are lower than that required for providing a minimum level of civil amenities.
- Based on per capita spending on core services by metropolitan Municipal Corporations, the Study indicates that the level of under spending on an average works out to about 76 per cent. The Study suggests that ULBs have considerable scope for debt financing as they have low debt and interest coverage ratios.
- The backlog, current and growth needs of infrastructure in cities and towns far exceed the resources at the disposal of the ULBs.
- Based on certain assumptions, the study estimates the projected investment requirement of funds for urban infrastructure in the country at

about Rs.63,000 crore per annum for the ten year period (2004-05 to 2013-14). This does not include the needs for redistributive functions like urban poverty alleviation. Assuming a status quo in the federal fiscal relationships in the country, the municipal bodies in India can at best raise up to about Rs.27,285 crore per annum. Within this, the resources available for asset creation after meeting current expenditure would at best be of the order of Rs.17,736 crore, implying an annual shortfall of at least Rs.10,000 crore (2004-05 prices), even for providing core urban services.

The Study suggests that the problems of municipal finance in India need to be addressed in a holistic manner through comprehensive reforms. It suggests that the issues of lack of clarity, consistency and predictability in expenditure assignment and revenue assignment need to be addressed. In particular, the system of taxes, user charges, inter-governmental transfers and borrowings in respect of ULBs need to be reviewed for their adequacy and suitability to match the expenditure needs.

The Study highlights that a national consensus needs to evolve on a 'municipal finance schedule' for assignment to the ULBs to match the list of functions included in the 12th Schedule of the Constitution.

The Study also emphasises the function-finance mapping to ensure that each function to be performed by the ULBs is backed by a corresponding financing source.

According to the Study, revenues and expenditure have to be carefully matched by reforming property tax, using land by adopting 'user pay', 'beneficiaries pay' and 'polluters pay' principles, linking individual services with user charges and collective services with benefit taxes.

The Study further suggests for restructuring inter-governmental transfers with a simple distributive formula that gives due weights to needs, rights to minimum basic services, incentives to performance and inter-jurisdictional equity.

Further more, it suggests easing of borrowing restrictions on ULBs and for financing urban infrastructure through exploring the options of:

(i) municipal bond markets, (ii) specialised municipal funds and (iii) public-private partnerships.

The Study also suggests improvement in expenditure management, professionalisation of staff and efficiency in service delivery of the ULBs.

The Study further suggests for improvement in the budgeting and accounting systems of ULBs and disclosure of adequate information by ULBs to the public at regular intervals.

Most importantly, the Study emphasises the need for developing costs of municipal services in India by constituting new groups and by undertaking primary studies.

In the context of the above findings of the study, user charges and user fees for various services rendered by the local body assume importance, not only as means of reimbursement of costs but also for reducing the dependency on the state government. 'It is a fact' that till now, user fees and user charges have not developed as a significant source of revenue. However, there is vast potential in this regard. Some of the points discussed by various economists, financial planners and administrators have been discussed in the following paragraphs:

The ULB has the power to levy user charges for -

- (i) Provision of water-supply, drainage and sewerage,
- (ii) Solid waste management,
- (iii) Parking of different types of vehicles in different areas and for different periods
- (iv) Stacking of materials or rubbish on public streets for construction, alteration, repair or demolition work of any type, and
- (v) other specific services rendered in pursuance of the provisions of Act, governing the ULB at such rates as may be determined from time to time by regulations-Provided that a ULB may, having regard to the conditions obtaining in the

municipal area, decide not to levy, or postpone the levying of, any of the user charges as aforesaid :

The State Government may direct the ULB to levy any of the user charges as aforesaid, not levied, or postponed, by the Municipality.

According to a paper published by the National Institute of Urban Affairs, Levy of user charges in respect of services offered by Municipalities in India is a matter of recent concern. Accordingly, there are not too many enabling provisions in the existing municipal laws.

(1) The Maharashtra, Karnataka and Andhra Pradesh Acts have enabling provisions for levy of water charges and sewerage charges in lieu of water tax, sewerage tax and, in case of Bombay, water benefit tax and sewerage benefit tax.

The issue in this regard, however, is as to the base correlated to which such taxes are levied. As argued earlier, correlation of the same to the property tax base is not helpful from the point of view of cost recovery.

Also, the proposed practice in Calcutta where this tax is correlated to the "ferrule sizes" which, in turn, are correlated to annual values as determined for levy of property tax, is not correct.

(2) In most municipal laws in India, provisions exist for levy of rents/charges for use of any stall, shop, slaughterhouse, burning ghat or crematorium. In Karnataka, provisions exist for charging fees for use of public halting places, cart stands, cattle sheds, public bath houses, etc.

(3) Wherever transport and electric supply are provided by the Municipalities, provisions exist for levying charges for the same.

The Calcutta Municipal Corporation Act, 1980, while providing for levy of user charges for water supply, sewerage and drainage and disposal of solid wastes makes a distinction between charges levied for residential and non-residential purposes.

Section 238 of the model municipal Act, defines the non-domestic purpose for use of water to include,

inter alia, water used for washing of animals kept for sale or hire, trade, manufacture or business, fountains or swimming pools, building purpose and for washing cards, carriages and vehicles.

Calcutta Municipal Corporation now collects charges for washing of vehicles, at the time of payment of Motor Vehicles Tax, a charge of Rs.50 per annum in case of cars and Rs.75 in case of other larger vehicles.

Also, the relevant provisions in the Act specify that in the case of water supply, charges shall be calculated having regard to the cost of operation, maintenance, depreciation, interest payments and other costs including those for distribution losses, if any.

Economic principles of charging user charges:

David Amborski states as follows: "With regard to economic principles, two approaches upon which taxes are charged or revenues are raised: the "ability to pay principle", and the "benefit principle". With the ability to pay principle those who have greater ability or economic means should make greater contributions. Applying the benefit principle means that people should pay or contribute for a good or service in accordance with the benefits that they receive. It is the benefit principle, that is the basis upon which user charges are applied. This application in itself provides insight into the type of services for which the application. This application in itself provides insight into the type of services for which the application of user charges may be appropriate. It is those government provided goods or services where the beneficiary can be identified and consequently charged. Where a good or service has "public good" characteristics user charges may not be appropriate. There are some generally accepted reasons for the application of user charges. First and foremost is that they promote economic efficiency in terms of the use of the good or service and allocation of public sector resources. This is important in local government as of the three economic functions of government, the efficient allocation of resources is the function that is central to local government.

A second benefit is that it rations the use of the good or service. Rationing may take place by price or

congestion. However, where price signals exist it provides insight to the providing government regarding how much of the good or service to provide for its residents. Local government decision makers in providing good and services have the annual problem when setting the budget in determining how much of a specific good or service to provide. The use of fees to replicate prices and the associated demand provide some insight for the decision makers at budget time regarding how much of a service to provide. This will help to promote the efficient allocation of resources:

Finally, user charges generate revenue for the municipality. This is important simply in terms of providing revenue to fund all or part of the provision of the service. In addition, the injections of this revenue may provide the government to either provide a higher level of the service than what would be provided in the absence of the charge, or a broader range of services for its residents. This leads to an enhancement in the quality and/or quantity of services for residents. When some revenue is generated from these programmes, a municipality will then have the ability to provide a broader range of programmes and services to its residents."

According to Dewees, the economic principles for public service pricing are based on achieving Economic Efficiency. Economists have identified several conditions that must be met for public enterprises to maximize the welfare of the public whom they serve.

1. The first is allocative efficiency. Allocative efficiency arises when the efficient level of output is produced, and that occurs when the cost of the last unit produced just equals the value of that unit.¹ The true cost of an added unit of output is the variable cost or "marginal cost." If we price a service at the marginal, or variable, cost of provision, users will face a price that represents the cost of the service. If the value of the service to a resident is equal to or greater than the cost of provision, the resident will consume it. If the value of the service is less than the cost of provision, she will not consume it. Each resident can adjust his or her consumption in response to

the price, so that the last unit of the service consumed² is valued at the price, which equals the marginal cost of supply. Setting the price at any other level will lead to waste of one sort or another. If the service is priced below marginal cost, some users will consume it even though it costs more to supply them than the service is worth to them. It is wasteful to produce something for a consumer who values it at less than the cost of production. Alternatively, if the service is priced above marginal cost, some residents will be discouraged from consuming it even though the value of the service to them exceeds its marginal cost of production. Those residents are deprived of something for which they would willingly pay more than the cost of production. Again, society loses. Of course, some services are not subject to this principle. Most of us believe that the benefits of schooling extend not only to the student but to society at large; therefore, our governments provide public schooling at no charge through high school. Indeed, we are so convinced of the value to society and to the individual of this schooling that we compel our children to attend school for many years. In this case, the positive externality of the service renders the marginal cost pricing principle irrelevant. However, for services whose benefits accrue principally to the consumer, marginal cost pricing retains its attraction; it allocates resources efficiently, and it delivers goods and services to those who value them most highly.

2. The second condition for maximizing the welfare of users of public services is rationing efficiency. If there is a limit on the amount that can be produced, it is important to allocate those units of production to the users who value them most. To do otherwise is to lose value that could be achieved by reallocation. Rationing efficiency means that in times of shortages, the price should be above the marginal cost of production. If the water system or electrical system has reached its capacity, the product may have to be priced above marginal cost in order to allocate the

limited supply efficiently to those who value it most.

3. The third condition is cost efficiency. This means that the output should be produced at the minimum social cost. Cost efficiency requires that there be no waste in the production process and that investment in plant and equipment be made judiciously to minimize the total cost of producing the efficient amount."

Cost of service and charging the user: When it comes to costing any public service, accurate working becomes difficult in view of poor record keeping, poor accounting and hidden subsidies. In fact, it is only after the introduction of 74th CAA, that ULBs are switching over to commercial accounts and cost accounts which are yet to stabilize. Ideally Charge should be based on the marginal cost of providing the good or service where the cost includes both the operating and capital cost of providing the service. The capital cost of existing infrastructure is difficult to determine due to age of the capital installation, actual costs incurred, depreciation etc. Average costs provide another basis.

According to Ambroski, "In attempting to apply either marginal or average cost pricing to the user charge a decision has to be made regarding which costs to include in the calculation, capital costs, operating costs, or both. Obviously to apply full cost pricing, both or all costs should be used in the calculation. However, there may be circumstances when only one of the two cost components is appropriate to be used in the calculation for the user fee. For example, there could be a situation where the capital costs for transit are provided by a grant from senior levels of government. If the objective of a user charge transit fee is cost recovery for the charging government unit, then the charge would only reflect the operating costs. On the other hand when municipalities impose charges for growth related capital costs, the quantum of the charge would only be based on capital costs with the operating costs being borne via property tax revenues.

There are also examples such as those often applied for the provision of water in which both the

operating and capital costs may be used calculate the charge. There may be situations or policy decisions where there is a desire to determine charges not only for the purpose of revenue generation but to meet some additional policy objective. This may lead to variations on the pricing applications. These pricing applications include peakload pricing, geographic variations, differentiation by user, and the inclusion of externalities in the pricing.

Peak load or time related pricing refers to varying the price charges in a temporal fashion. The idea is to charge a higher price when there is peak demand for the specific service. In this way the higher price will lead to a reduction in demand for the peak period, and people will be enticed to use the service during non peak periods. The benefit from this approach is that the infrastructure or capital needs for the service will not have to provide as much capacity as would be required without this pricing approach. Consequently, less expenditure is required for capital/infrastructure expenditures. Furthermore, better use of the capital/infrastructure is encouraged when it would otherwise be underutilized.

Another variation in user charge pricing for some services is to vary the charge by geographic location. This can be the result of applying one of the earlier identified pricing rules, or be the result of a policy decision to try and alter the user fee by geographic locations. In the first instance where costs of providing a service vary by location, one might expect charges to vary by location. For example providing sewer and water services to a remote location will result in a higher charge than providing the same services contiguous to existing development where services are already being provided. An alternative approach would be to apply different charges in various locations in such a way not to accurately reflect the cost of service provision but to achieve some additional policy agenda. Higher charges could be applied to certain areas to discourage development of low charges may be used to encourage growth and activity in certain areas.

It is also possible to alter the application of the charges based on the type of user for a specific type of service. For example, it may be desirable to set lower

charges on some fees for certain groups of users. Some recreation programs or athletic rental fees may be set lower for certain groups such as children or youth as compared to adults. Adults who are income earners may be expected to pay higher rental fees for ice time in areas to play hockey relative to youth groups. This reflects the groups' ability to pay or recognition of the need to provide athletic facilities to youth and children. Other variations in the application for different groups could relate to different charges being set for senior citizens or adult groups. There could also be differential charges applied to different members by obtaining and understanding the need to alter the charges various income levels.

Another variation would be not to only include the actual private costs, however they are defined, but also include any social or external costs that are also present in the need and or delivery of the good or service. This is a more theoretical approach that takes into account the economic concept of externalities. An example of these costs not being taken into account is the case when there was the need to rationalize user fees when the New City of Toronto was created by the from seven local government units. The new city undertook a study to determine the appropriate user charges that previously were set differently in each of the seven jurisdictions. One of the results was that some of the recreation user charges increased or now were imposed for certain programmes and facilities."

Donald N. Dewees of Dept. of Economics-University of Toronto, in his paper titled "Pricing Municipal Services: The Economics of User Fees" states that "User fees for municipal services may generate revenue for municipalities and their utility commissions, but they are equally important as prices for those services. Pricing services at marginal cost can lead to efficient production and consumption of the service, and efficient allocation of the service when capacity limits are reached; and it can help to guide investment on an efficient basis. Marginal costs should never be lower than operating costs and may be much higher in certain situations. It is important to include opportunity costs and environmental costs in the calculation of marginal costs."

Regarding pricing municipal services, Dewees argues that such pricing gives opportunity for consumers to save costs by reducing their consumption of the service. He further says that if user fees are established, they should be consistent among users. When public bodies set prices, there is often pressure to give special prices to special interest groups. Politically influential individuals or groups may demand a discount or a special rate. In general, such demands should be resisted. If the rationale for user fees is sound, they should be implemented as uniformly as possible, for both efficiency and equity reasons. If one set of users is thought to be particularly needy, those consumers could be given independent subsidies rather than reduced rates, so that the subsidy is transparent and the price is not distorted.

Public private partnership, privatization and user fees: It has been widely accepted that there is need for very large scale investment to augment the infrastructure and provide better services to the citizens. Given the inadequate resource base, the alternative to purely public investment is public-private partnership as well as privatisation. Most of the ULBs have gone in for large scale PPP ventures, ranging from building infrastructure projects to providing user services such as solid waste management, water supply etc. Privatisation has also been introduced selectively.

According to Dr. Mukesh Mathur, "Municipal services are wide ranging in character and the potential for involvement of the private sector varies across the services and indifferent stages within a particular service. The services that are amendable to user charges have a high potential for provision by the private sector, like street lights are unlikely to attract private sector.

Studies show that cost recovery in some of the basic services like water supply is extremely low. On an average, local governments cover only 20-30 per cent of the total expenditure that incurred on the operation and maintenance of water supply. Therefore, rationalisation of user charges for services is expected to mobilize substantial revenues for financing urban infrastructure and services. The Finance Commission of many states have

recommended for effective pricing of municipal services. Kerala Finance Commission has suggested that with a view to balance revenue and expenditure of urban local bodies, the cost of public utility services should be recovered by charging appropriate fees from the user of services. Punjab has suggested that domain of user charges be extended to water supply sewerage, parking and solid waste management. Tamil Nadu has suggested that charges for water supply may be increased by more than 200 per cent than the existing rates, with a view to have a full cost.

According to Dr. Mathur, in the recent years, there has been a major paradigm shift in thinking about provision of urban services, such as water supply, sewerage, solid waste disposal, road maintenance, street lighting, etc. It is no longer considered that these services have to be provided by the local authority as free public goods or as obligatory services offered in return of general taxes levied by the municipal governments. Increasingly, these services are being viewed as commodities which are to be provided on commercially viable basis, that is as goods for which a service charge or user fee has to be paid, at times in addition to the general taxes paid by urban inhabitants. The service charge or user fee is in the long-run expected to be adequate to meet the entire cost of supplying these services, that is both capital cost and operation and maintenance cost.

The idea of commercialisation of urban services is becoming increasingly acceptable to planners and administrators in most developing countries. Commercialisation implies rate of return on investments that is commensurate with market rate of return. This calls for cost optimisation, rational pricing and efficient cost recovery. Cost recovery is the crux of commercialisation of urban services and it is essential for : (i) recovery of costs incurred by the agencies concerned with provision of these services, (ii) demand management and conservation of resources by making consumers more cautious, (iii) generating revenues for extending the services to meet the existing unmet demand as well as the increasing demand, and (iv) to ensure access to all user groups, particularly those who may have remained unserved if the supply was limited."

Benefits, beneficiaries and user fees: Where there are identifiable benefits and identifiable beneficiaries, the costs by way of user charges have to be recovered by a ULB. Where such benefits are identifiable but beneficiaries are not easily identifiable, then the desirable way is by specific taxation. Where neither benefits nor beneficiaries are identifiable, the costs can be recovered through taxes. Further, there should be consultation of the ULB and citizens' groups in identifying benefits and deciding on rates of taxation, commensurate with the service.

The theory of public finance suggests the following guiding principles for levying user charges and benefit taxes:

- (1) Wherever possible, user charges may be levied for the services provided as the first resort;
- (2) For achieving efficiency, user charges should be levied on the direct recipients of benefits;
- (3) The poor may be subsidised directly if needed, rather than through reduced prices and distortions in the entire market for services;
- (4) Where charging is impracticable, specific benefit taxes should be levied on local residents;
- (5) Inter-governmental transfers may be used to finance services only if user charges and benefit taxes are not adequate.

There is a lot of scope for improving municipal finances in India through the levy user of charges and benefit taxes. "Users pay", "Beneficiaries pay" and "Polluters pay" are the cornerstones of local public finance. There has not been much rationality in pricing infrastructure / services in most of the cities of the country. The existing tariff structure for different

core services has not been sufficient to meet the production / operation / maintenance costs. The subsidization of services further worsens the financial condition of the implementing agencies. With the inadequate return from the provision of services and the huge gap between demand and supply of the services the Local Bodies are not able to cope up with the pressure.

Conclusion: For a ULB to have a sound financial position, user charges / fees should be related to the cost of maintenance/operation and the total expenditure incurred on the creation of asset. In any case, user charges should be enough to cover at least the cost of maintenance. Where it is decided to subsidise marginalized groups, the same can be done based on geographical demarcation such as slum pockets etc. Most importantly, efficiencies can be brought in provision of service and effective delivery. Stakeholder consultation can be made before fixing tariffs. Participation of citizens' groups in evaluating the quality of service, efficiency and effectiveness of service delivery and whether or not the user charges are appropriate will add value to the entire exercise.

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