Smart Cities for Sustainable and Inclusive Urban Transitions: Some options for India

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Some options for India

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Smart cities for sustainable and inclusive urban transitions

Sustainable and inclusive growth is increasingly dependent on clean, compact and connected city design for improved living conditions. Further, ensuring effective access to public services is critical for public and private investments for sustained employment generation. In India as in many emerging market countries, there has been haphazard growth of cities, particularly the mega cities, that continue to attract migrants, often into slums and informal settlements. Critical requirements for sustainable growth involve the reduction of congestion and informality and the reduction of polluting emissions. These involve, inter alia, investment in public transport: e.g., light rail, and clean public transport, including metro systems in some large cities and metropolitan areas. However, financing constraints are binding with weak or absent local taxation systems, and ineffective intergovernmental arrangements. While, India, has bestowed constitutional status to cities under the third tier (Panchayati raj constitutional amendment of the 1990s), many of the instruments, particularly own-source taxes, and other effective financing mechanisms need to be developed further. Indeed, state level legislation clarifying city level responsibilities had not been carried out in all cases, and itself requires additional work including the overall balances and state level transfer/equalization mechanisms.

While national attention typically focuses on ensuring regional connectivity and trading corridors, these require massive investments and funding. However, a coherent and coordinated strategy requires supplemental city-level action, where much of the reduced emissions and additional employment generation take place. Sustainable (new) local “hubs” require local investments (e.g., clean public transport) and improved service delivery, in order to be attractive for both firms as well as qualified workers. Expansion of own-source revenue options is crucial, with the property tax being a prime “handle” at the city level. Own-source revenues allow access to a wide range of private financing mechanisms, while ensuring accountability and effective management of liabilities and risk.

This paper focuses on property taxation. Its main messages are oriented to revamp its role in financing urban transition in India. In particular, we suggest that:

• Simple design matters, as does arms’ length administration and modern information management and transparent governance.


• Intergovernmental transfers, including both equalization and tied special purpose transfers need to be properly designed to provide incentives to use subnational revenue handles.
• Tax administration and institutions are to be designed to prevent rent-seeking behaviour
• Also, linkages with national tax policy and administration framework have to be established.

Indian experience with city design

The British colonial tradition in India was to focus on administration and residential “enclaves” for Europeans, leading to sprawl and poor service delivery for old city inhabitants (New Delhi, Bombay, Madras, etc.).

This tendency was maintained in post-colonial cities: Chandigarh, Navi Mumbai, that focused on providing facilities for new administrative and business elites, with un-coordinated urban development elsewhere. The National Urban Renewal Mission (JnNURM launched in 2005) focused on slums and service delivery, but with emphasis on PPPs for financing. The incentives are mainly to push liabilities to higher jurisdictions, as effective monitoring of PPPs remains weak, and there has been a sharp rise in the non-performing loans of the banking system in the recent past. The Smart Cities Mission 2015 also relied on Special Purpose Vehicles to raise capital, with matching grants from higher levels. This, however also contributes to banking non-performing loans.

None of these initiatives has effectively addressed the basic issues of the local revenue generation base, and of a well-planned urban structure that would lead to cleaner, compact and connected cities, that are required for sustainable job creation.

Viable financing of Indian cities

There is a constant tension at local government level in India between the functions assigned and the funds available to cities. The dependence on national and state government funding is both unsustainable and damaging. However, some state governments have abolished important sources of own revenue for municipalities without providing adequate substitute sources. More specifically, Rajasthan and Haryana abolished the property tax, while Punjab raised the threshold to very high levels on equity grounds.

Own-revenue instruments are not adequately used. Property taxes have constituted between 0.16% and 0.24% of GDP in recent years, which is much below the benchmark for emerging countries (about 1 per cent of GDP). User charges on water supply, sewerage and garbage disposal are the second major funding handle available to municipalities but generate very little revenue. Non-tax revenues from all local governments amount to 0.13% of the GDP.

Effective, predictable generation of own-revenue is a critical financing lever for large urbanization programs (such as Smart Cities) opening access to sources of private finance. While transfers from upper levels are still critical, they cannot be
relied upon as the primary source to leverage private funds (bank loans, bonds or other instruments) provided by capital markets.

Recurrent property taxation in India is based on the standard “ownership and valuation model.” Taxable property values are based on an estimate of the annual rental or capital value of the property (Valuation (Metropolis) Act of 1869). However, the information base for the property tax is severely deficient and unreliable. This is partly because the cadaster is out of date, and the valuation system has not kept pace with market price changes and problematic valuation methodologies are used (Twelfth Finance Commission).

Other reasons for the weak performance of property taxation include poor assessment rate of properties at 56% of market values, and low collection efficiency at 37%.

Presumptive approximation of values, based on location and size has been tried in Pune, Delhi and Bangalore to minimize the contact between the local tax administrators and the taxpayers. An arms’ length arrangement is being devised to minimize the opportunities for rent seeking and corruption. This reform was initiated in Patna in 1992/3, but failed to yield additional revenues. A similar outcome occurred in Delhi. However, in Bangalore it led to a virtual doubling of the property tax revenues between 2007/8 and 2008/9 (Bird and Rao, 2012). However, it has proved difficult to adjust the tax to reflect new investments in connectivity. A 40% increase in valuations due to the new airport led to inequities within Bangalore, and had to be rescinded and increases were capped at 25%.

Fine-tuning the valuations to specific neighborhoods might yield more accurate changes. However, this opens the system to possible collusion and rent-seeking.

**Options for Property taxation**

1. **Role in sustainable development**

   There is a growing recognition of the potential role of property taxation in the sustainable development agenda, even if the revenue potential remains relatively small in comparison with an overall target of around 18-20% of GDP for general government revenues for the MDGs/SDGs (Ahmad, 2017). This is for several reasons. First, as many of the basic public services are carried out at the local level, an own-source of revenue for which the local government can decide on rates at the margin has positive effects both on overall accountability as well as improved decision-making vis a vis devolved or decentralized spending responsibilities.

   A second related reason is that own-sources of revenues permit an access to credit for public investments in a sustainable manner. Further, paying taxes also

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facilitates household access to credit, even if they might not own the property. This is particularly useful for the informal sector. These measures could result in more responsible decision-making at the household and local government levels. However, these important effects are hard to quantify precisely, as they depend also on the institutional elements.

A system of property taxation can also begin to provide information on assets. This is a significant element in moving towards more effective taxation of income and capital gains—which are hard to tax bases in most emerging market economies. More importantly, information from the property tax valuations and transactions could be used to cross-check income tax statements by individuals.

**Property taxation: design**

There are different specific instruments to tax immovable property, land and improvements, i.e., buildings of various types. These can be taxed on a recurrent basis; yearly in practice; or non-recurrently at the time of transfer through sale, or inheritance/donation. There are, in addition, two non-recurrent selective instruments targeted to tax variations in the value of property. They are the tax on capital gains and betterment taxes aiming at capturing the increase in value derived from public infrastructure work. Table 1 provides an illustration of the basic characteristics of the system of property taxes.

The recurrent property tax is the most visible of taxes, and may generate the most opposition, unless it is closely linked with benefits, approximating the Marshallian “benefit tax”.

Although there are many variants, two broad categories emerge from the international practice. The typical model of property taxation used in industrial countries and followed in most emerging market economies, is based on ownership, as in the US, Canada, and many European countries. The second is based on occupancy of properties, as in the UK, or both occupancy and valuation, as in France. To make the model fully operational, there needs to be an accurate record of the property, as well as ownership/or occupancy, and changes in prices and valuations. Records of properties, ownership and values are typically kept in cadasters.

Market forces drive valuations and should be typically timely and provide accurate information on property values and sales, tracked both by the market as well as the (local) tax administrations. With proper administration, the tax can generate substantial revenue with the US reportedly collecting 2.6% of GDP (IMF 2017)\(^5\). In principle, (yardstick) competition limits both tax rates and burdens as well as the level and quality of public services. Improvements in infrastructure—e.g., opening of a new metro line or stop, are immediately reflected in property values, hence taxes, and affect the local government’s ability to issue bonds or borrow for the improvements in infrastructure.

### Table 1. Instruments for immovable property taxation: a synthesis

<table>
<thead>
<tr>
<th>Recurrent taxes (yearly)</th>
<th>Non-recurrent taxes</th>
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</thead>
<tbody>
<tr>
<td><strong>Property tax/land tax</strong></td>
<td><strong>Registration/ stamp duties</strong></td>
</tr>
<tr>
<td><strong>Fact originating taxation</strong></td>
<td>Ownership/ occupancy</td>
</tr>
<tr>
<td><strong>Tax base</strong></td>
<td>Value of land only/ of buildings only/ of land + buildings An alternative: physical size of property.</td>
</tr>
<tr>
<td><strong>Tax payer</strong></td>
<td>Owner/ Occupant</td>
</tr>
<tr>
<td><strong>Determination of the tax base</strong></td>
<td>Assessment of market value/ parametric systems (flat taxes)</td>
</tr>
</tbody>
</table>
Maintaining cadasters is the bedrock of property management systems. However, maintaining cadasters and keeping them up to date is typically a difficult, complex and costly task. In many developing and emerging market countries, little is known about what properties are located and where. One of the principal difficulties with valuation and changes in valuation is that markets in developing countries do not operate as efficiently as in advanced industrial countries. Furthermore, the information based on ownership is often much more complicated than in the simple market-based model in countries like the US. This limits the usefulness of the ownership-valuation model to most emerging market and developing countries. On the other hand, a simple registration may be undertaken easily, and can be linked to a redesigned tax base, as discussed below.

Valuation is one of the most difficult administrative tasks and is hugely problematic in many developing and emerging market economies.

A flat tax based on key parameters of properties provides a viable alternative. With a flat tax, the tax liability is determined through the application of a unit tariff (for example $n$ dollars per square meter). This could be linked to indicators or parameters of property size and value of use. Mauritius has experimented with the simplest possible flat tax based only on square meters. Colombia uses for non-registered properties a flat tax based on size, type of building and use. Bolivia tries to approximate market values with a more sophisticated version making use of a set of indicators describing the main features of properties. This approach is clearly appropriate for countries with complex ownership/leasehold structures (China, Senegal).

Self-declaration of parameters by taxpayers, largely applied around the world for the main taxes, circumvents problems of information and administration capacity. It makes the flat tax a viable solution for most emerging and developing countries.

A flat tax, often on occupancy rather than ownership, can be adapted to local circumstances, choosing the model according to the availability of information and capacity.

A flat tax can be implemented quickly with satellite technology, and an easy registration mechanism. To the extent that it actually begins to tax high-end properties, this would be an improvement over the un-implementable ownership-valuation model. The issue of taxpayers’ resistance would be addressed if the tax were linked to the provision of basic local services—enhancing accountability and meeting the SDGs more effectively.

This approach introduces also separation between cadaster and taxation issues, enhancing at the same time the role of cadaster for legal purposes and establishing titles.

A critical component is the setting of rates at the margin within bands in unitary states (Indian states act as unitary states in this respect) rather than administration. Property taxation has to be submitted to modern functional tax administration and requires putting distance between administration and taxpayers to control corruption and rent-seeking. This in turn is achievable with centralized administrations, while local administration is a possible alternative in some advanced metropolitan areas.
Conclusions

The Sustainable Development Goals agenda is largely based on actions at the city and local levels, while financing for investments and local services requires adequate own-source revenues. A property tax is the key instrument to unlock local/municipal bonds in a sustainable manner.

A simple design of the property tax, based on occupancy and linked to service delivery, makes this instrument relatively easy to implement. It can also generate considerably more revenues than the current US-type systems that are too complex for most emerging market countries. Streamlined administration can also benefit the wide area taxes.

The own-source revenues can then anchor access to credit and additional financing for clean infrastructure and forms the basis for sustainable “hubs” for growth and employment generation. The simplified property tax has to be part of a coordinated set of policy actions, including the full set of taxes, transfers, investment design and full transparency (including local balance sheets).