INCREASING POPULARITY OF MUNICIPAL BONDS IN INDIA

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ABSTRACT

Urban Local Bodies (ULBs) or Municipal Corporations are important organizations that provide basic services like water, waste management, and upkeep of roads in addition to other services to the citizens. These bodies depend on their revenues and grants from the state and central government for their revenues. In many cases, they are strapped for funds and unable to provide the required services. This paper reviews the increasing popularity of Municipal Bonds which is one of the diverse options available to the local bodies to raise funds. The paper highlights how some of the local bodies have used the bonds to access public funds and discusses the various steps involved in the public issue of such bonds. The risks associated with the issue of such bonds and some risk mitigation strategies are also discussed. Considering the importance of the services provided by the urban local bodies and the increasing stress on Clean India and waste management, the support provided by the central government is also discussed. Urban Local Bodies would benefit from considering the option of accessing public funds through Municipal Bonds and the paper could be useful to the practitioners as it gives some use cases.

KEY WORDS: Municipal Bonds, Local Urban Bodies

INTRODUCTION

Governance in India happens at three levels – the Center, the State, and the Local Bodies (Urban Local Bodies and Panchayat Raj Institutions). For most of the citizens, it is the local bodies that provide important facilities and services like water, sanitation, public health, roads, street lighting, schools, etc. Interestingly, it was only in 1992 with the 73rd and the 74thamendments to the constitution these local bodies like municipalities were institutionalized. The constitution in its 12th schedule lists several functions that may be undertaken by the local bodies, but the decision on what they do is largely decided by the state governments.

Table 1: Key functions of the municipalities.

The functions of the municipalities.
A. Urban Planning and Development
• Formulating urban and town planning strategies. • Regulating land use and overseeing building construction. • Designing policies for economic and social development.
B. Infrastructure and Public Services
• Development and maintenance of roads and bridges. • Ensuring adequate water supply for residential, industrial, and commercial use. • Managing public health, sanitation, waste disposal, and conservancy services. • Providing fire safety and emergency response services.
C. Ecological and Environmental Management
• Promoting urban forestry, environmental conservation, and ecological balance.
D. Community Development and Social Welfare
• Protecting the rights and well-being of vulnerable groups, including the differently-abled. • Implementing slum redevelopment and improvement projects. • Implementing targeted programs to alleviate urban poverty.
E. Public Facilities and Amenities for Recreation
• Establishing and maintaining parks, gardens, and playgrounds. • Promoting cultural, educational, and artistic projects.
F. Regulatory Functions and Public Infrastructure
• Regulating cattle pounds and ensuring the prevention of animal cruelty. • Maintaining records of births and deaths. • Monitoring and controlling operations of slaughterhouses and tanneries. • Providing essential public utilities such as street lighting, parking facilities, bus stops, and public restrooms. • Managing burial and cremation services, including electric crematoriums.

Source: Schedule 12 of the Constitution of India

With increasing population and urbanization, the urban local bodies are under constant pressure to deliver services to an more citizens spread over a large area. In addition, citizens are also demanding improvements in the quality of service. The biggest challenge to the officials in the ULBs is how to fund their activities. The main sources of revenue for the local bodies are property tax and non-tax revenues like usage charges for water, license fees etc., (Government of Maharashtra, 2022). However, these are largely insufficient, and as such the local bodies largely depend on grants and transfers from the central and state governments for their functioning. A review of the finances of the local bodies (RBI,2022) shows that in 2018,the tax and non-tax revenues of the municipalities accounted for less than 1 % of the Gross State Domestic Product, clearly indicating a mismatch between the responsibilities of the ULBs and their power to generate resources to meet their obligations.

Compared to developing countries, the local bodies in advanced countries, have greater power to tax and levy charges. In most developing countries, the power to tax is retained by the upper tiers of the government, and few countries provide the local bodies access to large and elastic tax bases such as the income tax (Bird and Vaillan court, 1998). In India, while responsibilities for providing services have been passed down through decentralization to the local bodies, it has not been accompanied by commensurate decentralization of financial power.(JLL, nd).

Property tax is regarded as the most important source of revenue for the local bodies across the world (Bird and Vaillan court, 1998; Jll, nd). In some countries the local bodies can tax income, sales of certain goods and services like fuel, liquor, tobacco, hotel occupancy etc. However, in most counties the power to tax income and sales is retained by the state and then the states share the income with the local bodies. In India, the sources of revenue for the local bodies are property tax, user fees& charges, and intergovernmental transfers.

In addition, they may have access to investment income, property sales, licenses, and permits. The income generated from property tax and user fees is in almost all cases is insufficient to meet their expenses and they are largely dependent on the state and the central governments for fund transfers to support their activities. According to some researchers, the greater dependency of Local governments on upper tiers for meeting their expenditure needs makes them more vulnerable and less efficient (JLL, nd).

Studies on municipal finances and Finance Commission reports in India clearly indicate that there is a mismatch between the functions and financing of the local bodies with less than 50% of the functions they perform being funded by a revenue source (Venkatachalam, 2007). With an increasing population in urban areas and an increased demand for better services, infrastructure development becomes critical. As the local bodies are dependent on grants from the higher levels of government for their functioning, infrastructure development has taken a back seat and does not keep pace with the growth of the population.

The problem faced by them is that the municipalities are not sure of the availability of funds from the higher levels and in many cases, the funds transferred are used for administrative expenses and wages. To bridge the gap, it is suggested that the local bodies look at other sources of funding for infrastructure development.

Sources of funding for infrastructure development:

While predominantly, grants from the state or the central government are the source of funding for infrastructure development, the development charges levied by the municipalities when new areas are being developed can augment this. However, the charges levied are not sufficient to meet the cost of infrastructure development, because these charges in many cases are kept low due to political pressures. Another, albeit less preferred source for funding infrastructure development has been bank loans. While bank loans have been used by many local bodies, there is a reluctance to use loans because the interest charges are high, and the interest has to be paid at regular (short) intervals. As such there is an increasing trend to access funding from the markets through bonds known as municipal bonds.

Municipal Bonds: A historical perspective

The history of municipal bonds can be traced back to ancient times. The concept of local governments borrowing money for public projects and services can be found in ancient civilizations such as ancient Rome, Greece, and Mesopotamia (GoldenPi, 2018). These early forms of municipal borrowing laid the foundation for the development of modern municipal bonds. In 1717, the Corporation of London issued the first recorded municipal bond in England. These bonds were used to finance infrastructure projects such as bridges and roads.

In 1812, the issuance of the first official municipal bond by New York City to fund a canal marked the inception of municipal bond financing in the United States of America (Hennion & Wash, 2014). Over the next decade, 42 bond issues were instrumental in funding the successful Erie Canal project, contributing to significant economic growth.

By 1843, the popularity of municipal bonds surged as urban improvement and free public education initiatives led to a rapid increase in municipal debt. (Jenna Ross, 2019).Following the American Civil War, railroads in the USA saw rapid expansion as it was expected to play a key role in fostering economic development. Substantial investments in railroads were financed through the issue of municipal bonds.

The 20th century witnessed significant milestones in the evolution of municipal bonds. In 1913, when the US Congress introduced federal income tax, they excluded municipal bond income from taxation, granting them a unique advantage. The exemption from federal taxes incentivized investments in municipal bonds, making them an attractive option for investors. (Scott Greenberg, 2016).

The latter half of the 20th century witnessed exponential growth in outstanding public debt, reaching $66 billion in 1960 and $361 billion in 1981. New developments such as municipal bond insurance and the establishment of the Municipal Securities Rulemaking Board (MSRB) in 1975 brought increased investor protection and market regulations, further bolstering the municipal bond market (MSRB, nd).

In recent years, state and local governments have leveraged municipal bonds to finance vital projects across the United States. Notable examples include the financing of the New York Bridge Project, water management infrastructure in California, and capital improvements at the Denver International Airport.

Additionally, municipal bonds have expanded their reach to address sustainable initiatives, with green bonds supporting environmental projects and voters approving financing for supportive housing. Today, municipal bonds present a sizable investment opportunity, with a $3.8 trillion capital market, one million outstanding securities, and substantial daily trading volumes. Municipal bonds continue to provide attractive after-tax yields, making them an appealing choice for investors seeking tax-efficient returns (J.P. Morgan, 2023).

Municipal Bonds in India

Municipal Bonds also known as (Munis bonds) are fixed-income instruments or debt securities issued by municipal corporations, governments, and semi-government institutions to raise funds. Two types of bonds commonly used are,

1. General obligation bonds - issued for enhancing civic amenities such as water, sanitation, and other works.
2. Revenue bonds - issued for a particular purpose such as the construction of a toll road or a toll bridge (Financial Express, 2018).

To facilitate the issue and listing of the bonds, The Securities and Exchange Board of India (SEBI) introduced a regulation in 2015. The regulation requires the issuer to make detailed disclosures and specifies certain criteria such as the need for the municipal corporations to have a positive net worth (SEBI, 2015). A detailed process flow for the issue of these bonds is also available on the SEBI website.

It is felt that through this innovative way to raise capital, the cities will no longer have to depend on the state or central government for money to finance every small project. On 25th June 2015, the central government launched AMRUT (Atal Mission for Rejuvenation and Urban Transformation) in 500 cities and towns across the country. The Mission focused on the development of basic infrastructure, like water supply; sewerage and septage management; storm water drainage; green spaces and parks; and non-motorized urban transport. A set of urban reforms and capacity-building initiatives have been included in the Mission (PIB, 2022).

One important aspect of the scheme is that the central government moved from funding projects proposed by the State and Urban Local Bodies (ULBs) to encouraging the ULBs to become self-sufficient by exploring various methods of funding projects that are associated with the scheme. In this direction, the central government provided an incentive of Rs. 13 crores to every Rs. 100 crores generated through Municipal bonds up to a maximum of Rs. 200 crores generated. Table below lists some Municipal bonds issued in India.

Table 2. YEAR-WISE LIST OF SOME MUNICIPAL BONDS LISTED ON THE STOCK EXCHANGE OF INDIA

Sr. No	Year	No. of Bonds issued in the Year	Name of Municipality	Amount (Rs. In cr.)	Coupon (%)	Tenure (in years)
1	2017	1	Pune Municipal Corporation	200.00	7.59	10
2	2018	5	Greater Hyderabad Municipal Corporation	200.00	8.90	10
			Indore Municipal Corporation	139.90	9.25	10
			Greater Hyderabad Municipal Corporation	195.00	9.38	10
			Bhopal Municipal Corporation	175.00	9.55	10
			Greater Vishakhapatnam Municipal Corporation	80.00	10.00	10
3	2019	3	Ahmedabad Municipal Corporation	200.00	8.70	5
			Surat Municipal Corporation	200.00	8.68	5
			Greater Hyderabad Municipal Corporation	100.00	10.23	10
4	2020	1	Lucknow Municipal Corporation	200.00	8.50	10
5	2021	1	Ghaziabad Nagar Nigam	150.00	8.10	10
6	2022	1	Vadodara Municipal Corporation	100.00	7.15	5
7	2023	2	Indore Municipal Corporation	244.00	8.25	9
			Pimpri Chinchwad Municipal Corporation	200.00	8.15	5
8	2024	1	Ahmadabad Municipal Corporation	200.00	7.9	5

Source: https://www.sebi.gov.in/statistics/municipalbonds.html

CONCLUSION:

With increasing urbanization, Urban Local Bodies (municipalities) have no choice but to look at diverse options to fund their growth in infrastructure. As their power to tax is limited and their ability to increase user charges to commensurate with the cost of providing the service is also limited due to political reasons, municipalities will have to explore alternate sources of revenues and ways by which their revenues keep increasing to keep up with the cost of living. Using bank loans or issuing Municipal Bonds are alternatives to consider when fund transfers from the state or central government are unlikely.

While bank loans are easy to obtain, they have the disadvantage of having a higher interest rate and also require frequent payment of interest. Municipal Bonds on the other hand are more time-consuming and involve an elaborate process to be followed. There is also no guarantee that the public and investors will subscribe to the bond issue. If the issue of bonds is successful, the ULBs will be able to receive funds at a lower interest rate (coupon rate) and the tenure of the loan (bond repayment) can be long. Another advantage of a successful bond issue is that the interest repayments can be planned on a quarterly or half-yearly basis, unlike bank interest which is required to be paid at much shorter intervals.

One of the issues or problems with most municipal corporations is their accounting system. These are often not up to date and unaudited. If the municipalities decide to raise funds through the issue of bonds, they will be required to get a credit rating from a reputed agency, and this would require submission of up-to-date accounts for the agency to arrive at a rating. This will ensure discipline in their accounting systems which will benefit the municipalities in the long run.

A bond issue would be a good idea where the infrastructure development would result in a lowering of the cost of operation of some facilities or if the infrastructure developed can generate revenue. For example, if electricity is being used on a large scale for some operation, the development of a solar farm can be considered to reduce the expense towards electricity.

If the interest and principal amount can be repaid from the reduction in expenses, the savings after the bond repayment will augment the finances of the municipality.

Some innovative ways to deal with the issue of financing infrastructure development and their activities are listed below.

1. Use Public Private Partnerships to provide services for which the user pays.
2. Link some of the service charges or tax with an index like the cost-of-living index so that the revenues and tax collections also go up with time.
3. Get private establishments to partner with them and take up the responsibility for the upkeep of certain public spaces like parks, gardens etc.

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