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MUNICIPAL BONDS AS AN OPTIMISTIC APPROACH FOR FINANCING URBAN INFRASTRUCTURE IN INDIA

SARITA BELE
RESEARCH SCHOLAR
R. A. PODAR COLLEGE OF COMMERCE & ECONOMICS
MUMBAI

SANDHYA BELE
RESEARCH SCHOLAR
INDIAN INSTITUTE OF TECHNOLOGY, BOMBAY
MUMBAI

ABSTRACT

Tremendous growth of population and rapid urbanization has put forward urban infrastructure under severe pressure that results, increasing demand for basic infrastructural services in developing countries where, India is not an exception. Urban local bodies (ULBs) are striving to promote infrastructure development wherein urban infrastructure is a crucial determinant in economic development that has a multiplier effect on the economy. Unplanned urbanization is deterrent in the process of economic and social development. Hence, adequate supply of infrastructure stock is needed to foster economic development. The ULBS are facing resource constraints to finance the growing need of infrastructure investment as they are facing the issue of narrow base revenue crunch and fiscal mismanagement. In market based economy, it has been leading transition from the domain of public funding to private funding. The emergence of municipal bonds in India is an important breakthrough and a potential financial instrument in mobilizing resources from the capital market to finance urban infrastructure though it is at promising stage. The present study seeks to understand the current status and role of Municipal bonds in urban infrastructure financing.

KEYWORDS
Infrastructure Finance, Municipal Bonds, Urban Local Bodies (ULBs).

INTRODUCTION

The Process of industrialization accelerates rapid growth of urbanization which also considered as a significant determining factor in economic development. Urbanization is concern with shift of rural population to urban region leading the demand for basic services include infrastructural facilities. Infrastructure development contributes inclusive development in the form of growing employment opportunities, reducing poverty and thereby it leads to improve the standard of living (PPPA, 2011). The urban infrastructure has linkages in terms of an essential component of industrial development that contributes to the economic growth of any economy. However, the unplanned urbanization also draws attention toward the requisite of policy implication for urban infrastructure development. According to the study of the planning commission (GOI, 2007), 21 per cent of the urban population exists in unlawful tenant settlements, only 89 per cent of the urban population has access to safe drinking water, but there are severe deficiencies with respect to equitable distribution of water, 46 per cent of urban households have water, toilets, but only 36 per cent of the urban households are connected to the public sewerage system. Indian cities are under pressure due to increasing demands on basic services because of inadequacy of these resources. Urban local bodies (ULB) are lacking to provide basic civic infrastructure systems like water supply, sewerage and drainage, solid waste management, etc. as per standard norms stipulated by various committees (Mathur et al. 2007).

The adequate and timely infrastructure investment is very crucial for infrastructural development. In this context, local government must strive to deliver better quality infrastructure and improved public utility services to the local community, where India is not an exception. However, crucial concern that persists is the inadequacy of funding availability for urban infrastructure sector. Although, Urban Local Bodies (ULBs) in India identified modernization of infrastructure and newer infrastructure as high priority targets, ULBs struggle with tight budgets, narrow tax base and fiscal mismanagement. There is raising concern for funding such infrastructural project due to its lumpy requirement. It has been resulting in the transition from public financing toward the capital market. The Municipal bond is emerging as one of the important financing instruments, though Municipal bond market development is at nascent stage in India. Hence, the present study seeks to understand the current status and role of Municipal bonds in urban infrastructure financing.

AN INVESTIGATION INTO THE NEED OF URBAN INFRASTRUCTURE FINANCING AND ROLE OF MUNICIPAL BOND IN INDIA

Infrastructure can be defined as the arrangements and amenities that are necessary for the functioning of the economy and society infrastructure supports economic activity and social services, rather than being an end in itself (Chong et al., 2013). Urban infrastructure is one of the important elements in infrastructure development which significantly influence economic development. The growing numbers of cities are the signs of rapid urbanization wherein unwitting urbanization is restrictive in the process of economic development. Unplanned urbanization with regards to growing population has been leading to the issue of slum dwellers, degradation of quality of life and thereby adverse effect on standard living are the results of unplanned urbanization in India. In this sense, the role of urban infrastructure is crucial for policy makers, whereas financing urban infrastructure is posing critical challenges in which it requires lumpy investment with long gestation period. The Planning Commission of India estimated infrastructure investment requirements to be about $1 trillion from 2012 to 2017.With the advent of the global economy, the demand for heavy infrastructure investment has been leading to transition from public funding to capital market funding. The role of the state is transforming as regulator and facilitator in a market economy. There is growing concern for private stakeholder's participation.

Temel (2001) define term municipal bond as a promise by state or local governmental units (called the issuers) or other qualified issuers to repay to lenders (investors) an amount of money borrowed, called the principal, along with interest according to a fixed schedule. Municipal bonds have advantages in terms of the size of borrowing and the maturity period, often 10 to 20 years. Both these features are considered as ideal for urban infrastructure financing probably because of nature, of infrastructure sector which consist of long gestation period. Globally, municipal bonds have long been considered as a lucrative investment option for tax sensitive investors, as tax free bonds are exempt from income tax and sometimes may also be exempt from local taxes where the bond is issued. Generally, compared to other taxable or corporate bonds, municipal bond has relatively higher credit quality and lower price volatility (Spiegelman, 2013). Tax free bonds are exempt from income taxes and may also be exempt from local taxes for bond investors where the bond is issued.

INVESTMENT BY CENTRAL & STATE GOVERNMENT WITH REFERENCE TO PRIVATE SECTOR INVESTMENT

(Billion Us $ At Nominal Prices 1 US$=Rs52.)

	10th Plan Actual	11th Plan Anticipated	12th Plan Projected
Central	3,52,504 $68 bn	8,56,717 $165 bn	16,01,061 $308 bn
States	2,98,633 $57 bn	6,80,056 $131 bn	12,89,762 $248 bn
Private	1,86,023 $36 bn	8,87,504 $171 bn	26,83,840 $516 bn
Total	837759 $161 bn	2424277 $466 bn	5574663 $1072 bn

Source: planning commission 12th plan

The gain of using municipal bonds to finance, urban infrastructure is progressively evident in India. There are several characteristics that make the municipal bond desirable for investors. First of all, there is a central or state tax exemption status on interest income. Municipal bonds might be popular among the investors due to additional benefits, such as tax exemptions that investors are bucketing into municipal bonds, driving yields to record lows and hoping for a safe hiding place at a time when taxes are almost certain to rise. Additionally, if properly structured, municipal bonds can be issued at interest costs that are lesser than the risk-return profile of individual ULBs. High income tax bracket investors get significantly more benefits than lower income tax bracket investors' i.e. after-tax yield is higher for high income tax bracket investors (Financial Planning Association, 2013). However the earning from municipal bonds receives certain tax exemption, municipal bonds are still subject to capital gains tax or may be subject to alternative minimum tax or state and local taxes for some investors. Since the capital intensive public infrastructure project requires an immense investment for a longer period and at lower cost of capital. In this backdrop, tax exempted municipal bond recognized as an appropriate option to raise capital at lowering the cost of capital to the local government. However, tax exempted municipal bonds directly cost to local government in the form of individual and corporate income tax revenue forgone (Maguire, 2012). Their performance might attract new investors into a certain municipal bond market. This particularly concerns the interest of the foreign financial institutions or private investors that would like to vary their investment portfolios.

THE CURRENT STATUS AND DEVELOPMENT OF MUNICIPAL BOND MARKET IN INDIA

The functioning of the municipal bond market is firmly associated with the existence of the functional capital market, institutional mechanisms for assessing the credit rating or a proper autonomy and credibility of local public sector. The administrative structure in India for municipal governance and urban service delivery mainly composed of the Constitutional provisions, State, Municipal Laws, State Finance Commission (SFC) and Central Finance Commission (CFC), and status of ULBs. The municipal bond is regulated by legislation of concern government, which gives directives for issuance of municipal bond and related issues. Article 293 of the Constitution of India makes certain provisions as to borrowing by the Centre government and the States government. It's necessary for every state government to take permission from the central government before borrowing money from the market, which may be in the form of municipal bonds also. For the local authorities, all borrowing is governed by municipal legislation in different states. In most of these, the current provisions do permit market borrowing, but only with permission from the state government. At the state level, permissions for local borrowing generally rely on some assessment of the agency, capacity to service the total outstanding debt.

Since 1994, the Indo-US Financial Institution Reform and Expansion (FIRE-D) project is working with national, state and local governments to develop a market-based municipal bond market. In municipal financing, Several ULBs and utility organizations so far have mobilized over Rs.12884 million that includes taxable bonds, tax-free bonds and pooled financing (Vaidya et al 2008). The Government of India (GOI), recognizing an infrastructure's key role in the process of economic development, set up the expert group on the commercialization of Infrastructure, often known as the Rakesh Mohan Committee, in 1994. The FIRE-D project worked closely with this Committee to provide international experience on tax-free municipal bonds. The Committee recommended private sector participation in urban infrastructure development and accessing the capital markets through issuing municipal bonds.

FIGURE 1: TAXABLE MUNICIPAL BONDS IN INDIA

City Government	Projects	Amount of Tax-free Municipal Bond (Rs. million)
Ahmedabad Municipal Corporation (2002)	Water supply and sewerage project	1,000
Hyderabad Municipal Corporation (2003)	Road construction and widening	825
Nashik Municipal Corporation (2002)	Underground sewerage scheme and storm water drainage system	500
Visakhapatnam Municipal Corporation (2004)	Water supply system	500
Hyderabad Metropolitan Water Supply and Sewerage Board (2003)	Drinking water project	500
Ahmedabad Municipal Corporation (2004)	Water supply project, storm water drainage project, road project, bridges and flyovers	580
Chennai Metropolitan Water Supply & Sewerage Board (2003)	Chennai water supply augmentation project	420
Chennai Metropolitan Water Supply & Sewerage Board (2005)	Chennai water supply augmentation project	500
Chennai Municipal Corporation (2005)	Roads	458
Ahmedabad Municipal Corporation (2005)	Roads and water supply	1,000
Nagpur (2007)	Nagpur water supply and sewerage project	212
TOTAL		6,495

Source: Vaidya, C. and Vaidya, H. (2010), "Market-Based Financing of Urban Infrastructure in India" in Kochar, S. and Ramchandran, M. (Ed.), Building from the Bottom, Academic Foundation.

FIGURE 2: TAX-FREE MUNICIPAL BONDS IN INDIA

City	Amount (in Rs. Million)	Placement	Guarantee	Annual Interest	Escrow	Purpose	Rating
Bangalore (1997)	1,250	Private	State Government	13%	State Government grants and property tax	City roads/street drains	A- (SO)
Ahmedabad (1998)	1,000	Public & Private	No	14%	Octroi from 10 Octroi collection points	WS&S project	AA- (SO)
Ludhiana (1999)	100	Private	No	13.5% to 14%	Water & Sewerage taxes and charges	WS&S Project	LAA-(SO)
Nagpur (2001)	500	Private	No	13%	Property tax and water charges	WS project	LAA-(SO)
Nashik (1999)	1,000	Private	No	14.75%	Octroi from four collection points	WS&S project	AA- (SO)
Indore (2000)	100	Private	State Government	13.0%	Grants/property tax	Improvement of city roads	A (SO
Madurai (2001)	300	Private	No	12.25%	Toll tax collection	City road project	LA+(SO)
Visakhapatnam (2004)	200	Private	No	7.75%	Property tax	Water supply project	AA-(SO)
TOTAL	**4,450**						

Source: Vaidya, C. and Vaidya, H. (2010), "Market-Based Financing of Urban Infrastructure in India" in Kochar, S. and Ramchandran, M. (Ed.), Building from the Bottom, Academic Foundation.

CONCLUSIONS

In the phase of Globalization, the significant role of infrastructure development in economic growth is well recognized across the globe. The infrastructure development is essential for all economic and social activities as our daily life depend on different types of infrastructural services which includes transport, power, telecommunication etc. in terms of reducing the gap while satisfying human need. The infrastructure development also produces externality in terms of increase employment opportunity, reduces poverty and thereby leads to improve the standard of living. Infrastructure finance is prerequisite to foster such prompt infrastructure development, whereas urban infrastructure is a crucial factor in these economic developments. The infrastructure finance is posing challenges for policy makers with the rapid growth of urbanization that creates heavy investment needs. The urban local bodies are facing resource constraint to finance huge infrastructure investment, experiencing a transition from public spending to the capital market in a market based economy. The present level of urban infrastructure and services in urban cities has lagged behind the pace of urbanization.

In this backdrop, the municipal bond is leading as an alternative, optimistic financing instrument to the gap of deficit finance in the urban infrastructure in India. The success of Municipal bond financing is well evident across the globe e.g.US, China economy. Municipal bond possesses several advantages in terms of longer maturity periods, tax free status, and size of borrowings. The municipal bond market development in India is at promising stage. In India, The growth potential for the development, municipal bond is very large wherein traditional public funding proved to be insufficient and less convenient for increasing institutional stakeholder's participations. The first Ahmadabad Municipal bond was a huge success that leads to the exposure of a new arena in bond financing. So far till 2010, 28 municipal bonds have been issued, however no single municipal bonds were issued after 2010 due to lack of effective institutional and regulatory framework. In this context the role credit rating agencies are also crucially important in terms of attracting potential investors. The policy maker should strive to promote municipal bonds by adopting structural changes as it is essential, as with growing demand for urban infrastructure finance. With regards to this, the present study attempts to highlight the significant aspects of municipal bonds with reference its scope in infrastructure development. Further, Policy makers seeking to contribute the economic development should concentrate their efforts on establishing a favorable investment climate.

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