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**Metropolitan City Finances in India: Options for  
A New Fiscal Architecture**

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# *Metropolitan City Finances in India: Options for A New Fiscal Architecture<sup>1</sup>*

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## INTRODUCTION

India will face great problems in finding a way to finance public services in its large cities in the next two decades. Backlogs in service levels and infrastructure are already great, and migration to urban areas will put even more pressure on state and local government budgets. Metropolitan cities have an economic base of significant size, but have not been empowered to tap this revenue potential. State governments have more ability to reach a buoyant tax base, and to borrow, but must also use these resources to provide statewide services and to tend to the servicing needs of poorer local governments. The Indian Constitution poses significant constraints on the financing options, and neither the Central Finance Commission nor the State Finance Commissions have shown the way out of this problem. One could correctly say that India has not successfully implemented a strategy to address the fiscal problems of metropolitan areas.

The goal in this paper is to describe and evaluate some of the alternative approaches to developing such a strategy. While most studies of urban finance in India consider good reforms that might be politically possible, and that might lie within the present legal framework (Rao and Bird, 2011; Mohanty, et. al., 2007; High Powered Committee, 2011), this analysis focuses on the largest metropolitan cities and considers the option of state government status for large metropolitan areas.

We begin with a discussion of the factors driving the budgetary needs that will face big cities in the next twenty years and then turn to a review of the options for covering the growing resource gap that will emerge. Three of these reform choices are the usual suspects: muddling through with the present approach, giving urban local governments access to more revenue raising powers, and increasing the rate of intergovernmental transfers from both the central and the state governments. The fourth, less often discussed reform path is to give state government status to the largest metropolitan cities. Throughout the paper we draw on the recent experiences in middle and low income countries. While every country is unique, there are lessons for India to learn from the international experience in financing urban governments.

## DETERMINANTS OF THE URBAN FINANCING PROBLEM<sup>2</sup>

Urbanization and the public financing and governance adjustments that it will call out are a world-wide issue (Bahl, 2010). The expectation is that the demand for new infrastructure and maintenance and for enhanced public services will grow dramatically. Ingram, Liu and Brandt (forthcoming) estimate that annual urban infrastructure needs will be equivalent to about 3 percent of GDP for new construction and 2 percent for maintenance. The sources of this increased demand include migration to urban areas, growing per capita incomes, business demand for enhanced public services, and the need to upgrade slum neighborhoods. On top of this are the needs to address the negative externalities that come with urbanization, such as pollution (solid waste collection) and congestion (transportation).

### Population Growth.

The workers and families that will move to cities from smaller places and from rural areas will pressure the budgets of urban local governments. The rate of urbanization in developing countries is now projected to reach the 50 percent mark in the next decade (United Nations, 2008). According to current estimates the world population will likely grow from approximately 7 billion in 2012 to over 9 billion<sup>3</sup> by 2050 and virtually all of the population increment will be absorbed by urban areas in developing countries.

The number of megacities (population greater than 10 million) is projected to increase from 19 now to 27 in 2025, when about 10 percent of the world's urban population will reside in these cities. Of the projected 27 mega-cities, 21 will be in less developed countries. By 2025, there will be 48 cities with populations between 5 and 10 million, and three-fourths of these will be in developing countries (United Nations, 2008). The rate of population growth in the largest metros may be slower than that in other urban areas, but the size of the populations to be serviced will be larger than anything seen before.

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<sup>2</sup> For a detailed discussion of these determinants, see Bahl, Linn and Wetzel (forthcoming).

<sup>3</sup> US Census Bureau Website (last accessed 21 July 2012)

<http://www.census.gov/population/international/data/idb/worldpopgraph.php>

The distribution of population in India will follow these international trends. Between 2001 and 2031, the urban share of total population is projected to double, though India's rate of urbanization will still lag that in the rest of the world. The number of cities with populations greater than one million will increase from 35 to 87 (High Powered Committee, 2011). The United Nations (2008) projects that by 2025, Mumbai (26 million) and Delhi (23 million) will be the second and third largest urban agglomerations in the world. About half of the increase in urban population over the decade of the 1990s was due to natural growth, but this share will fall as urban job opportunities will bid in more migrants.

### Competitiveness.

Urban economic growth (and national economic growth) is fueled by a strong competitive position of businesses operating within the metropolitan area. "Competitiveness" means production at lowest costs consistent with the quality necessary to sell in international markets, but it also means an ability of urban enterprises to absorb new technologies, take advantage of agglomeration economies, and to attract foreign direct investment and a high quality labor force. Maintaining competitiveness requires a setting in which innovation can take place, e.g., technology parks, linkages with universities, and incentives for incubation and small business development (OECD, 2006).

The competitiveness of a city's businesses in international markets is enabled by the infrastructure and public services offered. Transportation services have long been recognized as a key to urban economic development. This has led to heavy investment in mass transit and freeways that have reduced congestion, and in seaports and airports that have facilitated trade (Yusuf, forthcoming). A communications network that allows an efficient transfer of information is key to all of this (Glaeser and Gottlieb, 2009). Another part of the strategy to maintain competitiveness is to make cities more attractive to high quality labor. This leads to public investments in improving amenities, such as provision of modern health facilities, education curricula that support the new economy, recreational and cultural activities, and security.

The Indian economy is increasingly driven by its urban sector. Projections are that the urban share of GDP will reach 75 percent by 2030. The industry and service sectors are the primary contributors to urban economic growth, particularly IT, telecoms, banking and “smart” manufacturing such as engineered goods and pharmaceuticals (High Powered Committee, 2011). It is estimated that between now and 2030, 70 percent of net new employment will be generated in cities (McKinsey Global Institute, 2010).

As in other countries, the competitive challenge in India will be to capture the agglomeration benefits of urbanization without being overwhelmed by congestion costs. This will call out a strategy of investing in basic infrastructure to allow the communication among firms that is necessary to capture the benefits of proximity, and to attract a skilled labor force. At the same time, virtually all cities must invest heavily in transportation to reduce congestion and air pollution. The pressure will be on to get the government institutions arranged so that good decisions can be made, and to mobilize the resources needed.

#### Poverty and Slum upgrading

Many large metropolitan areas in low and middle income countries face the problem of addressing the special needs of a heavy concentration of poor and badly housed families, often in sprawling slums which call for major infrastructure investments by metropolitan governments. The magnitude of the slum problem is staggering. One estimate is that about \$60 billion per year will need to be spent on slum improvement and prevention during the next 15 years (Freire, forthcoming).

While the problem of urban poverty has been a focus of policy action in low and middle income countries during the past two decades, it is also the center of much debate. Two fundamental issues are how poverty should be measured, and what are the relative sizes of the poor population in metropolitan cities, other urban areas and rural areas. Another is which policy instruments are likely to yield the greatest returns in terms of poverty reduction (Linn, 2010). This same debate takes place about poverty in India.

How will migration to urban areas in India affect the rate of poverty? About one-fourth of the Indian population now lives below the poverty line, though the share is considerably lower in urban areas.<sup>4</sup> Moreover, the evidence suggests that new migrants are no more likely than non-migrants to have incomes below the poverty line (Singh, 2009)

The Indian problem in cities is probably better described as “shelter poverty”. For example, over half the population of Mumbai lives in slum settlements which have little by way of water or sanitation systems. A significant percent of families living in slums is not below the poverty line, but nearly all slum dwellers live in deplorable conditions because of lack of access to basic services. Most do not have access to health and education services. Rao (2009) and Bandyopadhyay and Rao (2009) cite statistics on access to services that underlines the magnitude of the problem: only 78 percent of slum dwellers use tap water; 37 percent used communal toilet facilities and 24 percent walked 0.2 to 0.5 km to latrine facilities; there is a little by way of solid waste disposal; and only 84 percent of slums had approach roads that would service motor vehicles. The price tag on servicing these slums, even to minimum acceptable levels, is very large.

### THE REVENUE SHORTFALL

The revenue needs in urban areas in low and middle income countries are well beyond the level of resources that are typically raised from own sources. For Infrastructure alone, the annual needs for urban areas are placed in the range of 3-5 percent of GDP annually (Ingram, Liu and Brandt, forthcoming). Estate (2010) estimates that about 1 billion people lack clean water and perhaps 3 billion lack access to adequate sanitation facilities. The annual infrastructure expenditure required to meet this one local need is estimated at 2.0% of GDP in Sub-Saharan Africa and 1.7% in South Asia, with about 40% of these amounts required for new investment and the balance for operation and maintenance.

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<sup>4</sup> The extent of urban poverty may be understated because full account is not taken of the higher cost of essential consumption in larger cities (Hashim, 2009).

The level of own source revenues of subnational governments available to address this shortfall, to support current expenditure needs and to service debt, averages about 2.3 percent of GDP (Table 1) in low and middle income countries. If this financing gap is to be reduced, it will need to be done with a heavy dose of new intergovernmental transfers or with a very significant enhancement to the revenue raising powers and efforts of urban governments, or both.

In its report on Indian urban infrastructure, the High Powered committee (2011) estimated that new investment needs are roughly equivalent to an annual amount equivalent to 1.1 percent of GDP by 2032. This estimated amount does not include maintenance. Mohanty, Misra, Goyal and Jeromi (2007) estimate annual infrastructure expenditure needs at 2 percent of GDP. The financing gap for recurrent expenditures is no less severe in large urban areas (Bandyopadhyay and Rao, 2009; and Mohanty, et. al., 2007). The problem is a longstanding one. The results of the Rakesh Mohan committee for 2001 indicated shortfalls of similar magnitude (Mohan and Dasgupta, 2004).

Revenues generated by local governments fall well short of these levels in almost all metropolitan area governments, and there is a longstanding pattern of low buoyancy of local government revenues (Oommen, 2000). In general, state governments have not shown an inclination to emphasize investment in urban areas, in part because of their weak fiscal position and in part because of the competing needs in rural areas (Garg, 2007).

The major fiscal policy question to be addressed is how the additional revenues to cover the shortfall will be found. In fact, there are a number of options. One way to address the revenue shortfall in India is the inertia solution, which is the route that countries most often take. The idea is to make policy and administration changes around the edges but basically to continue on under the present fiscal structure. Two other approaches could involve more sweeping changes: increase the revenue mobilization powers and efforts of urban local governments, and/or increase the flow of transfers from higher level governments to the urban local governments. A much more radical approach is to enhance the revenue powers of local governments by rethinking the place of governance in large metropolitan

areas in the federal system. To varying extents, all of these approaches are taken in various low and middle income countries.

### MUDDLING THROUGH

The path of least resistance usually is to limit reform to those marginal adjustments that might make the present system work more effectively. The very great advantage of this approach is that it is likely to be the most politically acceptable, it does not require the homework that a comprehensive reform might require, and it avoids bumping up against serious legal constraints to reform. It also has the advantage of not requiring a retooling of the local administration and management as might be needed if the basic fiscal structure were to be changed. Perhaps most important of all, a holding to the fiscal architecture that is laid down in the Constitution and in federal and state laws gives a stability to the fiscal system that subnational governments can count on in planning their budgets. These advantages are so important that they have caused many low and middle income countries to back away from comprehensive changes in subnational government finance.

The muddling through approach has the great drawback of resigning large metropolitan areas to their present trajectory of fiscal balance. If the fiscal architecture was not designed to accommodate present day realities, its basic flaws will continue to stand in the way of fiscal sustainability. Without a revamping of local revenue raising powers, reassignment of expenditure responsibilities or increased transfers, metropolitan finances will continue to be supported by the revenues that can be generated from economic growth, and by increased revenue effort on present sources.

Some countries have taken the path of greater resistance and have changed the intergovernmental fiscal architecture of the country. South Africa, for example, moved to a unitary system, and set up a new revenue mobilization scheme with differential revenue raising powers in the hands of the metropolitan cities. The revision called for constitutional changes as well as a redrawing of the boundaries of metropolitan areas. These changes were possible because of a “moment in time”, the end of apartheid and the formation of a new government. Similarly,

Indonesia's "big bang" decentralization was a moment in time, the aftermath of an economic shock and the move to democratic elections. Another example of "a moment in time" that allowed a fundamental change in the fiscal architecture was the Chinese re-centralization in 1994. The question on the table here is whether Indian urbanization might also be thought of as a moment in time that can justify sweeping reform. India is an advanced democracy where political compromise solutions in the area of reforming intergovernmental fiscal relations are more likely than "big bangs".

Though some large and important reforms have been made, these have not yet led to a major change in the fiscal architecture that has put metropolitan finance on a sustainable path. The 74th amendment to the Constitution empowered urban local governments by recognizing their legal status and providing for their expenditure powers. This had the makings of a major structural reform. However, while expenditure responsibilities grew, no comparable revenue expansion occurred, leaving urban local governments with a growing gap between expenditure needs and resources available. Mohanty, et. al., using normative estimates of expenditure needs, found the average level of underspending to be about 75 percent. Despite the constitutional amendment, local public services remained weak and devolution has progressed unevenly (Mathur, 2006, Garg, 2007).

The elimination of octroi in most Indian states could have opened the door for a revamping of local government revenue systems, but still no satisfactory revenue productive replacement for this revenue source has been offered. Nor have other structural reforms gone in the right direction. Some states imposed entry taxes, which are a similar levy to octroi, and two states have abolished the property tax.

The Central Finance Commission in India is admirable for the stability and thoughtful reform it brings to intergovernmental fiscal relations but its success is in part because its proposals usually do not call for big changes in direction. While the Thirteenth Finance Commission acknowledged the problems with local government finance, it followed the constitution and left the solutions to the states. The institution of State Finance commissions would seem to have opened

the door for regular review of intergovernmental fiscal structure in each state, but this has not led to much by way of reform that would improve the position of urban local bodies.

The introduction of JNNURM is a major change in intergovernmental transfers in that it provides for an increased flow of funds to urban local bodies, and attempts to use the funds as a carrot to draw out needed structural reforms. On two counts, the JNNURM has the potential to be a major restructuring. First, it bypasses the states in channeling more funds to the large urban governments. In a sense it puts metropolitan finance directly in the policy agenda. Second, it aims at inducing policy changes that will enhance the operational efficiency of urban service delivery and stimulate revenue mobilization. On neither count has the program been successful. Urban local governments in some states have been slow to buy in, and the policy changes have not materialized in the way that was hoped for (Bandyopadhyay and Rao, 2009).

#### OWN REVENUE MOBILIZATION

Most students of devolution argue that the low level of revenues raised by subnational governments in developing countries is a failing of the intergovernmental fiscal system (Bahl, Linn and Wetzel, forthcoming). The result of heavy reliance on intergovernmental transfers is a reduced ability of local governments to shape their expenditure budgets, less accountability of local politicians to their constituent voters, and perhaps an inability to ratchet up the size of government to address new needs. To the extent that local governments do not have the expenditure discretion that comes with raising their own money, the “lighthouse effects” from local innovations in service delivery are lost.

#### International Practice

Many factors stand in the way of increased revenue mobilization by local governments. Subnational governments often have only limited legal taxing power, but it is also the case that they often underuse the taxing power that they do have. Central (state) governments are loathe to give up their control over the most productive part of the tax base for fear that their own revenue mobilization

efforts will be harmed by the competition, and elected local government leaders are not always anxious to have the accountability that comes with increased taxing powers.

There also is a more pure political dimension. Increased local taxing power may enhance the success and hence visibility of local politicians, who may be present or future political rivals. On top of this is the limited assignment of expenditure responsibilities given to subnational governments in many developing countries, and the ensuing argument that finance should follow function and so increased local taxing power is not warranted. The result is that subnational government taxes in developing countries account for an average of about 2.4 percent of GDP, compared to 6.4 percent in industrialized countries (Table 1).<sup>5</sup>

There are important exceptions. Some low and middle income countries have made significant improvements in the rate of revenue mobilization of large urban governments. In Argentina, for example, the City of Buenos Aires finances over 80 percent of expenditures from own sources and the revenues of provincial and local governments are equivalent to over 5 percent of GDP. Urban local governments in Colombia raise revenues equivalent to 2.4 percent of national GDP, mostly in the larger cities. In the cases of both Argentina and Colombia, the mainstay of the local revenue system is a gross receipts tax. Sao Paulo and Rio de Janeiro levy a gross receipts tax on services, while Cape town, Johannesburg and Jakarta impose a surcharge on electricity consumption. The major source of own revenue in Mexico City is a payroll tax.

None of this is meant to say that the practice of local taxation in low and middle income countries is free of problems. Martinez (forthcoming) gives a good summing up of the current state of the practice: “The good news is that examples of best practice are not scarce; the bad news is that there is still an extended failure in applying those best practices in the vast majority of urban governments around the world.”

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<sup>5</sup> Note that these shares include state (provincial) governments as well as local governments. Good, comparable data on local government finance in developing countries are available for only a limited sample and only for certain countries.

## Problems and Options for India

India is not one of the countries that has made significant strides in bringing large urban governments into the revenue mobilization mix. The Indian system is still characterized by a sizeable vertical imbalance at the subnational government level that is transmitted by state governments to urban local governments. State and local governments account for a larger percent of government spending than revenue collections, with the gap filled by intergovernmental transfers (Rao, 2009). State and local government tax revenues are equivalent to about 15 percent of GDP which is well below the international average for developing countries. Municipal government spending accounts for less than one percent of GDP, and for only about 2.3 percent of total government spending (Mohanty, et. al., 2007).

Comparable data for individual urban local governments are not readily available, but special surveys and case studies for individual cities have shown a weakening balance between own revenue capacity and expenditure needs. In a survey of the finances of 34 cities for 2004, Mohanty, et. al. (2007) found that nearly all faced annual revenue shortfalls. When revenue inflows were compared to expenditure needs based on a normative approach to identifying minimum requirements for service levels, the finding was that the revenue gap could not be covered with the current revenue structure. This study finds that on average, large cities finance about 45 percent of their expenditure from own sources, which is not a low number by international standards, but this statistic masks the problems that stem from the currently low level of spending.

Revenue effort. There are two routes to increasing metropolitan government capabilities to finance budgets from own sources: raising the revenue effort that is made by local governments, and strengthening the revenue raising powers of local governments. Both routes can be taken in India. There is considerable room for increased revenue effort, but vertical balance for large urban governments almost certainly will require enhanced revenue-raising powers.

The goal of raising the revenue effort by local governments in metropolitan cities might be addressed in a number of ways. User charges are rarely levied at cost

recovery levels (Rao and Bird, 2011). With increased rates and stronger enforcement, revenues could be augmented significantly. Mohanty, et.al. (2007) studied 25 municipal corporations for 2004 and found that 16 recovered less than 20 percent of costs from charges and only 2 recovered as much as 75 percent. The High Powered committee (2011, page 140) reports later data to show that only 8 of the 63 JNNURM cities recovered water and sewerage O&M costs, and only 6 recovered O&M costs for solid waste management services. The main bottlenecks to full cost recovery with user charges are political resistance, dissatisfaction with the level of services provided, and the complications that arise because tariff increases for urban services require state government approval.

There also is room to increase local tax effort in India. The mainstay of local government revenue systems is the property tax, but this remains underutilized with an effective rate against GDP at about one half the international average for developing countries (Mathur, et. al., 2009).

Measured by almost any yardstick, the Indian property tax is badly administered. A survey of the property tax practice in the 36 largest urban local governments, carried out by Mathur, Thakur and Rajadhyaksha (2009), revealed that 44 percent of all parcels are excluded from the tax net, properties are assessed at about 30 percent of market value, and the average collection rate is about 40 percent. They show that simply raising the coverage rate and the collection rate to 85 percent will increase the urban property tax in India to a level above the international average for low and middle income countries, though the average effective rate would still be lower than one percent of GDP.

In some metropolitan areas, the problem is legal or structural, suggesting that a different type of reform is needed. One example is the case of Mumbai where rent control legislation has eroded the tax base. To try and get around the problems of valuation and revaluation, and legal constraints on tax base growth such as rent control, some large cities have moved to a form of area based valuation, sometimes with success (Rao, 2008). In other cases the problem is an unwillingness to reform the property tax, arguably because it is so unpopular with voters. Two Indian states have abolished the property tax.

Revenue structure. Improved revenue effort on the existing tax base is not likely to be enough to establish vertical balance in the Indian system. In a study of urban local governments, Bandyopadhyay and Rao (2009) find evidence of a revenue gap that would exist even if these governments realized their full revenue potential. This problem can be addressed by assigning a broad-based revenue source to metropolitan local governments. From the international practice, we can observe that cities in low and middle income countries that have succeeded with developing a significant role for local revenues have done so with a broad-based tax as a mainstay of the revenue structure. A package of narrower based levies such as is common for local governments in developing countries – professions tax, entertainment tax, licenses, and the like – will not allow cities of 10 million plus populations to efficiently address their financing problems.

The fiscal instrument of choice in most countries seems to be a turnover tax. It has a broad base, high buoyancy and a relatively simple administration. The problem is that it is distortive because of its cascading feature, and it can give a great advantage to headquarters locations. Some cities – Buenos Aires and the Brazilian cities, for example – have attempted to address these disadvantages by including value added features, but others (Bogota, for example) seem willing to live with the flaws because of the revenue benefits and wait for the time when subnational government value added taxes become more feasible. The South African metropolitan cities relied heavily on a combination payroll-turnover tax, but this was abolished in 2010 and has not been replaced.

In the case of Indian metropolitan cities, the Octroi has been revenue productive, but its distortive features and its all-but-impossible administrative arrangements have led to its elimination in most places. This has significantly weakened the rate at which large cities finance services from own revenue sources. In Mumbai where it still is levied, octroi accounts for 45 percent of revenues, compared to about 25 percent for the property tax (Pethe, forthcoming).

There is no doubt that octroi is a highly distortive levy that imposes sizeable welfare costs on society, and on economic efficiency grounds its elimination is welcome. Complaints from the business community have heightened the calls for its complete elimination. But how will the lost revenues be replaced? To date, there has not been much progress on this front. Replacement with a turnover tax could restore lost revenues, but the distortive features would be retained. A derivation-based sharing of the VAT with large urban governments (with a higher local sur-rate in those cities) would be a better approach, even though it would have some distortive features and would create some incentives for protecting local producers. Rao and Bird (2011, p28) estimate that a one percent surcharge on the GST base could yield an amount equivalent to 0.34 percent of GDP.<sup>6</sup> Note that if a metropolitan city had state government status (see below), it would automatically receive a share of the envisioned central-state value added tax.

Arguably a better option for a broad-based local tax – at least from a point of view of economic efficiency -- would be a payroll tax. To the extent that workers in formal sector employment are also residents in the city, the benefits test is passed. Such a tax can be easily collected on a place of work basis, and can be revenue productive though much less so than in the case of a turnover tax. It might also be levied as a surcharge on the federal income tax, so as to avoid additional administrative costs. The problems are the informal sector, which is not reached by such a levy, the imposition of a tax on labor in metropolitan areas where unemployment is at very high levels, and the situation in some cities where people are working in one jurisdiction but living in another. The ways around the latter problem are either a piggyback arrangement on the individual income tax, with a higher local sur-rate, and with distribution on a derivation basis, or the levy by a large metropolitan government rather than by a city whose taxing jurisdiction does not cover the entire area. Another major drawback to be resolved is the headquarters problem, which exists when a firm that operates nationally files a single return making it hard to sort out payroll amounts for specific local areas.

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<sup>6</sup> They also caution that movement away from a uniform rate structure would complicate the administration of the system.

There are other forms of taxation that could significantly increase revenue mobilization in large metropolitan cities. A better use of motor vehicle taxes could be greatly revenue productive. Licenses, parking, tolls, and even motor fuels are viable tax bases that can more or less pass the benefits test for local taxation if they are correctly levied (Bahl and Linn, 1992). The base of all of these taxes is growing. The High Powered Committee (2010, p56) pointed out that the motor vehicle population in India increased by 100 times between 1951 and 2004. Moreover, taxes on motor vehicles, properly structured, might be justified as congestion charges. The problem is that this would be unpopular with certain voter groups, would probably raise transportation costs, and it would draw some revenues away from the state government.

Finally, there is the great potential of benefit charges, particularly those levied on land. In addition to the annual property tax, cities could be empowered to levy the transfer tax on real property and perhaps bring both under a uniform (or consistent) valuation approach. Various forms of betterment charges and impact fees could also contribute markedly to the revenue base.

A problem with all of these revenue options for metropolitan areas is the fragmentation of the local government structure. When there are multiple local governments operating in the same metropolitan area, the place where consumption or employment takes place may be different from the place of residence, and a mismatch occurs. In such cases, the property tax and benefit charges can work effectively but broad based taxes lead to significant inter-jurisdictional inefficiencies (Bahl, forthcoming).

#### INTERGOVERNMENTAL TRANSFERS

The financing gap for urban local governments can be reduced by an increased flow of grants from higher to lower level governments. The justification for grant financing of local governments is usually to redress an imbalance between assigned expenditures and assigned taxing powers, to equalize, to correct for some external effect, or to encourage spending in some high priority area. There are also political reasons. Some elected local leaders see grants as a less risky political strategy than local taxation, and some elected state and central leaders

see grants as a way to preserve their near-monopoly on broad based taxes and their degree of control over how the revenues are spent. Whatever the reason, intergovernmental transfers usually play a large role in the financing of subnational governments in most low and middle income countries. (Bird, 2006, Boadway and Shah, 2009).

### International Practice

Countries vary widely in terms of how they structure their grant systems, and how they treat large urban governments. Consider the following examples drawn from the unitary countries. The Chinese emphasize economic development and the main transfer instrument is shared taxes that are allocated on a derivation basis. The provincial and local governments have no independent taxing powers. South Africa, on the other hand, allocates its transfers by an equalization formula and the largest metropolitan local governments receive little in grant revenues. Both Indonesia and the Philippines share a substantial portion of national taxes with local governments, with the allocation being by an objective formula that seems to favor local governments where expenditure needs are greater. Colombia operates a system of conditional grants to local governments, where the central government strictly controls the use of the funds.

There is also a lot of variation in the practice among federal countries. Pakistan and Argentina channel grants through one large program with a formula that emphasizes population. The grants are made directly to the provincial governments. Mexico's grant system has a conditional and an unconditional sector, of about equal size.

What these few examples show is that countries structure their grant systems according to what they intend for these transfers to accomplish. In some countries, the metropolitan governments receive a significant share of the transfers (e.g., China), but in others the metropolitan governments raise most of the revenues from their own sources (South Africa and Argentina).

### Indian Practice

Transfers to state governments in India are made through three channels: Finance Commission grants, Development grants, and centrally sponsored schemes. The Finance Commission has recommended heavier allocations to local governments, but the decision is left to the state governments, with advice from their planning commissions, to decide whether to do this and if so, how it should be done. In all of this, there would not appear to be an urban strategy.

The JNNURM is a program of direct federal aid to large cities. This program does appear to be a strategy to address the infrastructure needs of urban areas, and also to provide local governments with incentives to undertake needed structural reforms. The amounts of assistance involved under this program are significant, and the policy reforms sought are important. But in its first iteration, the program suffered from design flaws. Most importantly, the proposed policy reforms did not materialize in many cases, and there was no conditionality built into the grant flow. Disbursement of the funds was slow, in part because of the matching requirement and in part because of the limited capacity of the local governments to implement the projects and the policy reforms.

### Reform options

Intergovernmental fiscal transfers will play an important role in filling the financing gap for metropolitan governments in India. Two streams of transfers might be considered. First, a reformed JNNURM, adequately funded and with conditionality on the policy reforms, and with provision for capacity development, could be a cornerstone of the financing program for metropolitan cities. Second, state governments could finally take seriously the mandate of forming competent State finance Commissions and relying on their recommendations. The Central Finance Commission recommendation, that a share of state revenues be allocated to urban local bodies, would be a welcome addition to a national urban strategy.

Under other strategies, the level of intergovernmental transfers to metropolitan cities might be of a lesser magnitude. One scenario, proposed by the High Powered Commission (2011) would have urban local services financed by a combination of higher own source revenues and an upgraded JNNURM. Under a scenario where some metropolitan cities gain state government status (see

below), the city- state would receive a share of all forms of intergovernmental transfer.

## CITY-STATES

Another approach to addressing the urban fiscal problem is to move large cities to state government status. At once this takes away some of the roadblocks to increased revenue raising powers, it resolves much of the government fragmentation problem, and it restores fiscal autonomy to local governments.

### The International Practice<sup>7</sup>

Historically, city-states have been among the most successful jurisdictions in producing rapid economic growth and effective urban growth. Medieval Venice and the cities of the Hanseatic League in Northern Europe are early examples. Hong Kong and Singapore are the contemporary counterparts. An interesting question is whether there are lessons to be learned for metropolitan governance and finance from the experience of the city-states and whether there is a way to pattern metropolitan governance at least partially after that model.

In larger countries, this could take the form of provincial cities, where the metropolitan area local government has both provincial and local status. For example in China, the four largest cities are treated as provinces and have the powers of both provincial government and local government. The same is true in the case of Jakarta and Mexico City. In many (most) countries, the capital city is treated as a special case and its financing structure is different from other local governments. Delhi, Islamabad and Washington DC are examples. In yet other cases, the metropolitan cities are singled out as a category and given special treatment, including perhaps more taxing and borrowing powers and less access to intergovernmental transfers. The South African metropolitan cities, the largest Colombian cities and Buenos Aires are examples.

There are some clear advantages to this approach. It allows for area wide governance that can internalize potential external effects, but also allows for

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<sup>7</sup> See Bahl, Linn and Wetzel, forthcoming

significant autonomy in making budgetary decisions. The metropolitan government becomes much like a state in a federation, but usually with more manageable boundaries and without the understructure of local governments to deal with. A further advantage is that its boundaries can be large enough to allow regional taxation, and perhaps to adopt a broad based tax. Finally, its borrowing powers can be enhanced because it can oversee and regulate larger public enterprises and because its revenue base can support debt better than if it were a city government within a metropolitan area or subject to provincial oversight.

There also are disadvantages. For one, the metropolitan area may have already spread across jurisdiction boundaries so that the city-province status is assigned to the core city. In this case, the area wide governance advantage is lost. This is the case of Buenos Aires. Another disadvantage is the hinterland problem, e.g., the creation of a set of “special cities” in China led to harming the fiscal position of the “residual province by removing its most important revenue generator. A third disadvantage is that City-states are an ad hoc arrangement, created as special cases by the central government. How does one draw the line for deciding if there will be more, and how will the provincial city be made to fit within the existing local government code or budget law? Finally, a city state may be politically strong, with a governor or mayor, who might be considered a rival by the central government and the Legislature. This can lead to some degree of discrimination against the metropolitan area in terms of its treatment within the metropolitan area.

### The Practice Applied to India

The city-state approach could be adopted in India. Under such a scheme, a designated set of large cities would be given state government status. The general argument is that the large metropolitan areas are very different from the rest of their states, and governance might be more efficient if they were given state government status. Certainly the list would include Mumbai, and likely there would be other candidates.

To illustrate the city-state approach, we take the example of metropolitan Mumbai. The state of Maharashtra would be divided into two states: metropolitan Mumbai and the remainder of Maharashtra. There would be no hierarchical relationship between the two. Both states would be represented in the national Parliament, following the normal rules. The new city-states would have the same constitutional fiscal powers as any other state. This means that these cities would be empowered to levy VAT, property tax, automobile –related taxes, etc. In short, their taxing powers and access to revenues could be dramatically increased. So would their expenditure responsibilities, as Maharashtra state level programs within these cities (including parastatals) would be turned over to the new Mumbai state. Those presently responsible for administering state level activities within Mumbai would be shifted to the new state. Properly planned, this transition could be accomplished without major service level disruptions.<sup>8</sup>

An interesting case of such a transfer of powers is Indonesia where most government services were transferred from deconcentrated central departments to local governments, without a major disruption in service levels (Hofman and Kaiser, 2004). In all, about 2 million employees were transferred from central government to local government control.

The “residual state” of Maharashtra would continue on with the remainder of their urban and rural local bodies, just as under the present regime. However, it would no longer could collect taxes within the Mumbai metropolitan area, nor would it share taxes, make grants, be responsible for service delivery, or have the power to make regulatory decisions. Both of the states would be represented in the national congress but Maharashtra’s representation would be reduced because of the loss of metropolitan Mumbai from its jurisdiction. Both the residual Maharashtra and Mumbai would have a representative state legislative body and independent elections.

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<sup>8</sup> This is not to say that the transition would be without problems or that it would be costless. And, at a later period, the new city- state would want to exercise an option of deciding how many employees to retain and how to establish their seniority.

The Central Finance Commission would treat the new state just as it would any other state, though, admittedly, the formula allocations and equalization provisions might require some new thinking. Maharashtra would continue on with a state finance commission, and it would have the same responsibilities, i.e., to recommend the structure of the intergovernmental fiscal system within the state. In the case of Mumbai, the state finance commission would focus more on the relationship between the new state and its underlying deconcentrated units or wards.

#### Impacts: Advantages

There is much to be gained from a new fiscal architecture that includes city-states. It would be part of a long run solution rather than a patchwork solution to the very real problem of service level provision, infrastructure financing and slum upgrading. A number of specific gains might be highlighted.

- Local voters would have a greater influence on the level and mix of public services provided within the urban area (state). In theory, this will allow the local government in Mumbai to better take advantage of local knowledge in deciding on the package of services to be delivered. The result should be more voter satisfaction with services, and more willingness to pay for services.
- Revenue mobilization in the city- state could increase. This is because the city would have access to all the formerly state taxes, and could levy these on an area-wide basis, and because the demand for local services would be high because of all of the functions that had been absorbed. Local voters would have a greater influence on the level and mix of public services provided within the urban area (state). This could lead to increased local revenue effort.
- Local government officials would become more accountable to their local constituents for the quality of services delivered, because they would impose taxes and user charges on their constituents. For this

reason, elected local officials might be divided in their support for this change to the fiscal architecture.

- Those who live and invest in Mumbai probably be subject to higher taxes than those who live and do business in other urban areas. This seems an advantage because it would force those living in larger urban areas to pay the marginal servicing cost that they impose on their governments.
- Mumbai would now have a dedicated revenue stream that would allow them to show repayment potential for loans.
- Because Maharashtra state would no longer be required to deal with metropolitan Mumbai, it may have more degrees of freedom in designing the transfer system to be more equalizing. The mega cities are different enough from the rest of the state that fitting it into the intergovernmental fiscal system is an ongoing challenge.

#### Impacts: Disadvantages and Challenges

There also are major disadvantages to creating provincial cities. Most important, it is a radical change in the fiscal architecture, and would be resisted on grounds that big changes disrupt a longstanding state of affairs. Some would argue that the stability of the intergovernmental fiscal system in India has served it well. On the other hand, there are precedents for this in recent Indian history when three new states were created in the 1980s.

- The major problem would be the changed fiscal situation of the “residual” state of Maharashtra. It would lose the tax base in its major city, hence would suffer a huge revenue loss with respect to shared taxes and VAT. This would be offset to some extent by reduced expenditure responsibility for service provision in the largest city, and probably by larger transfers from the CFC awards. There

might also be a contingency transfer to protect services in the residual state for a transition period. Still, “residual Maharashtra” would be weaker economically and would have less political force than it does now.

- The creation of state-level cities would be politically difficult. It would disturb many existing arrangements and power structures. In particular, state politicians and bureaucrats in the residual states would lose power. They would be working with a smaller budget and less resources to improve services to their constituent districts. State level bureaucrats would find their staff reduced as many line ministry officials will have been devolved to the new state. There also would be a threat to elected local officials in Mumbai and to former members of the state parliament from the former Mumbai districts. Local politicians would be put in a position to make unpopular taxing decisions, and some might prefer the present arrangement where they rely heavily on transfers to finance their budgets.
- The net fiscal effect on the residual state would likely be negative. This would leave the state in a position of being less able to fund vertical programs and to equalize. To the extent there is now an urban-rural transfer, this would be markedly lessened if Mumbai were removed from Maharashtra. Rural local governments could be a net fiscal loser under this policy reform. There would be increased pressure on the state government to increase its effective tax rate.
- There is also some risk with respect to establishing fiscal management and structure of the new state. The present deconcentrated state apparatus for service delivery may not function as well under a city administration as a state administration, at least during the transition period. Moreover, the vertical fiscal balance in a new Mumbai State might be weakened, at least initially, by the goal of making it more self-sufficient in terms of financing. Local

voters might rebel against the necessary higher level of taxes and user charges.

The creation of a city-state would be a Federal government matter, and the policies and implementation would be set at the central government level. A particularly difficult issue will be the method used to draw the boundaries of the new city-state. The most likely choice would be based on the concept of a labor market area, as was done in South Africa. An alternative is that the new city state could follow the existing boundaries of incorporated municipalities in which case it would be analogous to annexation or consolidation.

- There may be some disruptions in federal revenue sharing arrangements. The CFC awards might require rethinking, as well as development assistance and central schemes. Depending on the outcomes, fiscal disparities between Mumbai state and the rest of the nation may need to be addressed.
- A particularly difficult issue will be how to stem the tide of demands for city-state status, e.g., Kolkata, Chennai, Hyderabad, Bangalore, and others. Most large urban areas in India probably feel discriminated against and many would see this new governmental arrangement as a way to reduce the flow of money from their tax base to support services provided elsewhere. Others may argue for a change in their governance status in order to capture rents. In countries where the fiscal architecture has been changed dramatically, subnational governments have succeeded in changing their status in order to gain some advantages from the intergovernmental transfer system. Indonesia is an example. (Hofman and Kaiser, 2003)

- The cost of government might increase with the creation of state level cities, at least in the initial period. For example, a “residual “state of Maharashtra would be smaller and with less expenditure responsibility, so it should be able to reduce government employment and overhead. But such costs are sticky downward. On the other hand, a new city- state might increase its spending dramatically to address a backlog of unmet needs, but the cost increases might be held back by the requirement of more self-financing.

## CONCLUSIONS

While revenues do not match expenditure needs at any level of Indian government, a particularly critical problem has emerged in the case of large cities where infrastructure is inadequate and promises to grow more so with expected high rates of migration. In recent years, the federal government has recognized the urban government finance problem with programmatic assistance and policy advice, but state governments have been slow to follow this lead. It would be fair to say that a coherent strategy for metropolitan finances has not been implemented. The approach continues to be one of muddling through with various policies that have independent effects at the margin, rather than with a comprehensive strategy that involves a fundamental change in the fiscal architecture.

The implementation of a comprehensive metropolitan fiscal strategy is a possibility for India, but it would be politically difficult and would involve some costs that might be unacceptable on social as well as economic grounds. Such a strategy would have the objective of making the metropolitan cities more financially self-sufficient, and giving them more control over their budgets. It might have three legs: redrawing metropolitan government boundaries, assigning more revenue raising powers to metropolitan governments than to other local governments, and limiting transfers to metropolitan governments to those that are designed to address externalities and equity concerns.

In many respects, India operates as a traditional federalism with state governments controlling the fiscal powers of third tier local governments. While municipalities have been empowered in terms of their expenditure responsibilities, there has been little movement by state governments to implement a strategy that would give them more budgetary self-sufficiency.

Some large metropolitan areas could be converted to city-states, i.e., be given state government status. This would create a taxing district that is roughly coterminous with the labor market area, and the metropolitan government would have access to all state government tax bases and user charge bases. Revenue raising powers would be extended to include all present state government taxes. Independence in revenue raising powers would be extended to motor vehicle taxes and various forms of development charges, and the metropolitan local government would have freedom to raise user charges to whatever rate they chose. The revised JNNURM would grow in size and be the major intergovernmental transfer in the revenue system.

**Table1.1 Fiscal Decentralization: International Comparisons for the 2000s<sup>a</sup>**

Region	Subnational Government Expenditures		Subnational Government Taxes	
	Percent of Total Government Expenditures	Percent of GDP	Percent of Total Taxes	Percent of GDP
Developing countries <sup>b</sup>	18.8 (16)	5.1 (20)	11.4 (16)	2.3 (20)
Industrial countries	27.8 (26)	13.9 (26)	22.7 (24)	6.4 (25)

*Source:* Bahl, Linn and Wetzel (forthcoming) drawn from IMF (various years) and estimates drawn from the case studies by Roy Bahl.

*Note:* Data reported are unweighted averages for the 2000s for years in which data are reported.

- a. The number in parenthesis shows the number of countries included in the comparison.

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