

**FINANCIAL INSTITUTIONS  
REFORM AND EXPANSION PROJECT**

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**Debt Market / Infrastructure Component**

**STATE FINANCE COMMISSIONS  
USER CHARGES FOR URBAN SERVICES  
A Note Submitted to the Working Group IV  
On Augmentation of Resources**

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One of the tasks of the State Finance Commissions is to strengthen the financial capacity of local governments. In this respect, it is important to identify measures for augmenting their resources to fulfil their obligatory functions. This note focuses on the possibility of user charges for this purpose. It, however, also highlights the role of user charges in improving the quality of urban services. Based on the conceptual underpinnings and current practices, a set of recommendations are suggested for the consideration of State Finance Commissions.

**What are User Charges?** User charges for the purpose of this note are defined as 'the charges levied for the use of or for access to a given service.' It is possible to introduce user charges only in those circumstances where the 'principle of exclusion', (that is excluding those who do not pay) can be applied at least in principle. In the context of urban local governments, these may include any of the following services, namely, water, sewerage, primary solid waste collection, parks and playgrounds, education and health facilities and transportation. Their actual use for a given service will depend on the past local practices for that service, prevailing state policies (especially for education and health facilities) and the local political will.

**Need for User Charges:** The levy of user charges is important from three perspectives. First is the narrower view of user charges being an additional source of revenue to augment the resources of local governments. This can of course be of considerable importance, as for many of the services, at present less than a half of the operation and maintenance costs are being recovered. Secondly, however, their value also lies in enabling the authorities to approach the service from a demand perspective. In more political terms, it makes it possible 'to ensure that local citizens get in local services what they want, and are willing to pay for'. It also becomes possible to have more accurate information on service costs and usage. This, however, is dependent on the willingness to charge an appropriate price for this service. The third perspective for user charges, the possibility of improving the rate of return on infrastructure investments through proper user charges, is also dependent on appropriate pricing. This will be critical in the coming years as the limited budgetary allocation for this sector is likely to be constrained further. Experience from some of the developed countries like the US suggests that substantial revenues can be generated through user charges.

**Principles for User Charges:** Charging for services has to serve many functions, including, 'raising revenue, covering costs, the need to meet financial targets or required rates of return on assets, checking abuse of services, the need to target subsidies and the pursuit of equity'. The specific principle of determining charges is based on the function or purpose which is primarily attached to levying of user charges. Specifically, the principle for charges require a

discussion of following aspects;

i. Extent of Costs Covered by Charges. The extent of costs to be recovered through user charges is dependent on the financial position and priorities of local governments. This concern will be relevant, if the main purpose of user charges is to cover costs. Ideally, for full cost recovery, all the costs related to operation and maintenance, debt servicing and depreciation need to be included.

ii. Market based Charges: If the concern is mainly to raise revenue, the effort should be made to assess the market prices or the ability and willingness to pay of different consumer groups. This would be possible only for those services where such alternative markets do exist or through innovative market assessment methods. It would also be useful to explore the possibility of introducing variations in charges over user groups or even over space in relation to variations in service costs and demand.

iii. Average versus Marginal Costs. While for full cost recovery, average costs are considered, for economic pricing to achieve efficiency, marginal cost pricing is generally advocated. The difficulty here may be that in most cases marginal cost linked prices<sup>1</sup> will be too high in relation to current price levels. Secondly, and more importantly, many of the assumptions of economic theory do not really hold in the real world for infrastructure services. Actual evidence of marginal cost pricing is also rather rare.

**Current Practices:** Systematic information regarding user charges for urban services is not readily available for Indian cities. A few studies for water supply and sewerage services, however, indicate that user charges are fairly common and contribute significantly to the total earnings in this sector. However, their contribution, especially in relation to total service costs, varies considerably across cities. Aggregate information for expenditure and earnings suggests that the extent of cost recovery ranges from as low as 20 percent to over 100 percent in different cities. In most cases, charges are for consumption, but often levied as a flat rate on connections. These charges are progressive with either the higher consumption blocks or larger sized connections paying a higher rate. Generally, non-domestic charges are at least 2 to 3 times higher than the domestic rates and help to cross subsidize the latter. Charges for new connections, though commonly practiced, do not contribute significantly to total revenues.<sup>2</sup> Similarly, development charges are levied by many authorities, but these are not clearly linked to actual costs.<sup>3</sup> There is considerable potential for exploring new types of

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<sup>1</sup> For infrastructure investments generally average incremental cost is taken rather than short run marginal cost, due to the lumpy nature of these investments and their long life.

<sup>2</sup> In recent years, many cities have, however, started using these successfully. For example, in Orissa, advanced registration charges have been introduced. In Tiruppur, Tamilnadu, advanced charges for water supply connections have yielded surplus revenues after meeting the distribution system costs.

<sup>3</sup> An exception worth noting here is the approach followed by City and Industrial Development Corporation, Bombay, for pricing land. CIDCO incorporates the present value of all on-site and off-site

user charges, like impact fees, valorization charges, capacity allocations, etc. in Indian cities. Another important aspect of current practice relates to the state level control on the rates for user charges. In many states, the local governments have little real autonomy in fixing these rates, as state-wide prices are fixed or state approval is essential for any revisions.

On the whole, it appears that user charges are probably one of the least tapped of potential sources of revenue for local governments. However, the world over there is probably now a greater realization of this, as the information for some of the developed countries suggests that the share of user charges in total income of local governments has increased during the last decade. In India, the notion of public services attached to most urban infrastructure, has so far rendered this option rather unattractive. However, these also represent considerable potential, especially as the logic of local provision and delivery of services is based on the premise that the proximity to the user groups makes it possible to make the service more effective and relevant. It is likely that the necessary increases in user charges can become possible more easily with concomitant institutional changes which make the service more user responsive, rather than being supply dominated.

**Overcoming Constraints to User Charges:** Despite their potential usefulness, actual practice suggests a limited use of user charges so far. It is thus necessary to review the constraints which are likely to hamper their use in practice and identify means to overcome these.

Affordability for the Poor: One of the most often voiced concerns is the probability of pricing out the poor as their affordability levels may be lower than the required price levels. While this may be a genuine concern, at present, the low and highly subsidized services for many of the urban services in fact do not accrue to the poor at all. There are several possible ways of ensuring 'life line rates for the poor'. In case the charges are based on level of consumption, it is possible to keep very low rates for the lowest consumption block to ensure life line rates at affordable prices. Progressive charges on higher consumption blocks can help to provide the necessary cross subsidies. In case of flat rates, it would be possible to levy lower affordable rates for localities or residential areas which are dominated by urban poor communities.

Information Base on Costs and Demand: The second constraint relates to a lack of adequate information on costs and the ability and willingness to pay of different groups. For the cost information, it would be necessary to build this up through separate accounts or funds for specific groups of services (e.g. water and sewerage) and adopting commercial accounting for these sectors. This has already been recognized and adopted in some local governments. In the state of Maharashtra, the new ordinance under the 74th Constitution Amendment, requires such separate accounts for some of the important services. For the demand side, information is difficult, especially when there is no market for these services. This may, however, be done by using contingent valuation methods or market research techniques used

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costs in fixing a reserve price. It also varies the actual price in relation to affordability of different user groups.

for other commercial products. This may be supported later by monitoring customer satisfaction and complaints for the given service.

State Policy Framework For many of the services, charges (or provision of near free services) are determined at the state level. It is clear that to satisfy many of the principles discussed above, greater local autonomy in setting the charges is essential. In order to overcome the problem of lack of local political will to introduce the required revisions, the power to force upward revision (or refuse downward revision), may be kept with the state government. However, the power to introduce upward revision may be with the local governments. This becomes especially relevant in view of their constitutional status and the assurance of political representation.

Inefficiencies in Service Provision and Collection of Charges: Another major concern, especially for introducing full cost recovery (or efficiency) charges, is the persistent inefficiencies in service provision (as evident from very high administrative costs or a high level of system leakages) and in collection of charges (as evident from on an average only a half of the actual demand being collected). These would introduce inequities and push up the charges to unnecessarily high levels. To reduce inefficiencies, it would be necessary to introduce greater transparency in the system of setting the charges and collection procedures,<sup>4</sup> as well through necessary management improvements. With greater transparency through such measures, public pressure would force a reduction in service inefficiencies.

Past Practices and Political Will: The most important constraint probably relates to a lack of political will to introduce the substantial price revisions which are required due to the past practice of very low charges. This necessitates that revisions are phased out over a three to five year period and introduced in politically opportune times. The main concern in willingness to pay for services also relates to a skepticism regarding any concrete improvement in services. It may thus be necessary to show results, even in smaller more manageable areas, before introducing revisions. While the political opposition is often emphasized, it will reduce if studies and actual practice indicate a far greater willingness to pay for services than the present highly subsidized rates which permit only low service levels and quality and are often regressive in their impact on the poor. Another measure which may be used for some selected services is to move towards private provision of services through franchise or concessions. This would help to take the pricing decision out of the political realm. However, the interest of low-income consumers will need to be protected in such arrangements.

**Recommendations for State Finance Commissions:** Based on the above review, a set of recommendations are suggested for the consideration of State Finance Commissions which would both help to more fully realize the potential of user charges as well as improve the

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<sup>4</sup> For example, according to the Maharashtra ordinance for the 74th CAA, the Commissioner is required to make an annual statement on the subsidies accruing for different municipal services.

quality and coverage of urban services.

**1. Need for User Charges:**

1. All municipal authorities should introduce user charges for any of the following services which they provide  
Water supply, sewerage, solid waste collection, parks and playgrounds, transportation
- ii For education and health services, if there is any municipal contribution, user charges need to be introduced. For the state or central contributions, levy of user charges will depend on the larger policy framework
- iii For any other services where it is possible to levy user charges, these must be encouraged

**2. Type of charges:**

- 1 User charges need to be introduced for both access and consumption. The former would essentially be in the form of a one time charge or entry fee for taking a connection. It could also include specific annual charges per connection. Consumption charges, on the other hand, would be periodic in nature and should ideally be linked to volume of consumption.
- ii Consumption charges for water and sewerage need be combined in a single periodic charge.
- iii Municipal authorities need to explore the use of more innovative land based measures, impact fees, linkage, etc. to augment the total revenues and reduce the pressure on direct user charges.

**3. Principles for user charges:**

- i. On the whole, principle of at least full cost recovery should be used for water, sewerage and solid waste collection services. Full cost recovery means including the following components in the cost estimates.
  - . Operation and maintenance of the system, including manpower, materials, buildings, for running the service and billing and collection
  - . Debt servicing on all outstanding loans/borrowing for the service
  - . Depreciation on fully paid up portion of fixed assets
  - . Appropriate share of general administration for this service, provident fund contribution, etc
  - . Payments for raw or bulk water to external agencies, if any
  - . Any outstanding dues/arrears for this service (for raw or bulk water, electricity) in phased manner based on state level policy
- ii Municipal authorities should be encouraged to use volumetric consumption charges. Ideally this should be based on 3 to 5 consumption blocks, with the lowest priced at levels which will ensure minimum life line rates to at affordable prices to all

consumers. For others, appropriate progressive rates should be used to ensure full cost recovery

- iii A grace period of 5 years may be given for all municipal authorities to increase rates gradually to ensure full cost recovery. Exception can, however, be made for those municipal authorities where the unit costs of water/sewerage are higher than a state level median. In such cases up to 50 percent of the revenue surpluses may be assigned to these services
- iv User charges in all municipal authorities must be indexed for inflation, as measured by the CPI (urban manual) for the state.
- v. Adjustments in the proposed rates for the next year may be made to the extent that total revenues exceed the total costs in the previous year
- vi The authority for determining the exact level of user charges, once the above principles are met, should vest with the authority supplying the service

**4. Incentives for performance:**

- i. SFCs should consider linking the performance on user charges to transfers of grants and share in taxes
- ii Incentives for enhancing user charges may also be linked to permission for and support to municipal market borrowing for infrastructure
- iii Another form of incentive may be credit enhancement through a state guaranty fund created by pooling available grants for these services

**5. Support for introducing changes:**

- i. SFCs should consider small grants for municipal authorities to introduce the necessary changes in their accounting systems, create a necessary data base on costs and market prices, training in rate setting and financial management, etc