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TAX FREE BONDS IN INDIA: THE WAY FORWARD

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ABSTRACT

Due to rapid urbanization the demand for funding urban infrastructure in India has increased dramatically. Municipal bond is one of the important sources of this type of funding several Urban Local Bodies (ULBs) as well as utility organizations have issued municipal bonds. The first ULB in India to issue tax-free municipal bonds was Ahmedabad municipal corporation (AMC) which issued bonds for its water and sewerage projects. It was April 2002 when AMC issued 10 year tax-free bond with an interest rate of 9% p.a. having issue amount of INR 1,000 million. However, not much of municipal bonds were issued so far in India. Government of India is taking every step to revive municipal bond market to achieve funding requirements of ever growing urbanization. This paper is an attempt to analyze current and perspective scenario of tax free bonds in India.

KEYWORDS: *Urban Local Bodies, ULBs, Municipal bonds, Tax-free bonds, India*

INTRODUCTION

After New Industrial Policy, 1991 fiscal reforms were initiated in India the pressures on state finances has been realized in terms of reducing subsidies, grants, loans, and other monetary assistance from the central government to the states. Economic reform paved the way for the private sector to participate in the provision of civic services and urban infrastructure which resulted into amplification of capabilities and resources of the ULBs. Growing urban population has created further demands for infrastructure and related services similarly requirement of funds for their maintenance and creating additional facilities. Government of India has made several efforts to assist ULBs to enter the bond market. Jawaharlal Nehru National Urban Renewal Mission (JNNURM) was launched as an effort to achieve this requirement. FIRE-D project is actively working with national, state and local governments since 1994 in order to build up a market-based municipal bond market in India. Several Urban Local Bodies (ULBs) and utility organisations have issued municipal bonds in India which have mobilized over 12,000 million through taxable bonds, tax-free bonds and pooled financing so far.

'Tax-Free Bonds' commonly termed as 'Municipal Bonds' and 'Tax Exempt Bonds' are issued by the government ensuring tax free return to the investors. It has a unique feature of tax saving on income from interest thereon at the same time many more advantages. Such bonds are issued by the government in order to raise additional money for infrastructural development of the nation. Tax free bonds have emerged as the most loved investment alternative for investors due to its benefits of tax saving and zero risk association. Usually in emerging economy where limited choice of instruments for tax-free income is available such bonds have proved to be a value pick for every conservative investor. Apart from it PPF (Public Provident Fund) is another popular tax free return instruments in India. In present study we have made an effort to discuss every aspect of tax free bonds in India.

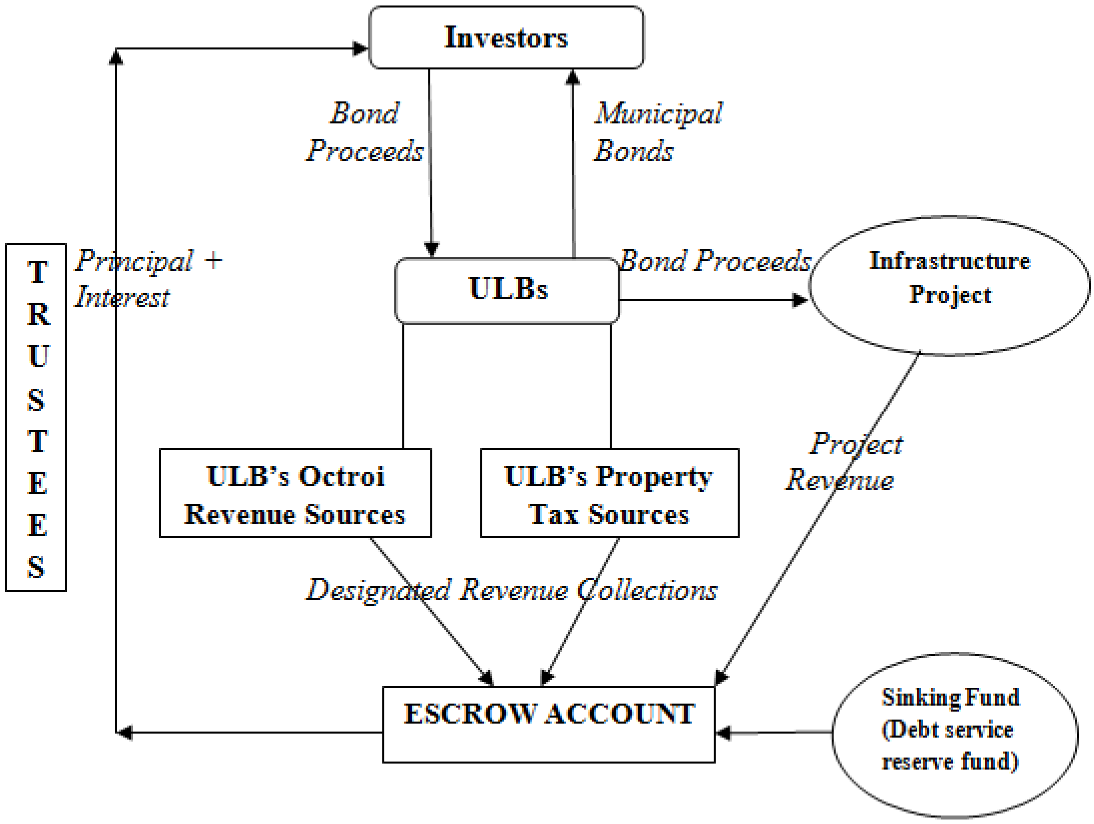
OBJECTIVE AND METHODOLOGY OF THE STUDY

The present paper has been prepared with an overall view to examine status and need of municipal bond market in India. The study is chiefly exploratory in nature and based on secondary data. Secondary data collected from a variety of reports on municipal bond in India published by Government of India, RBI, World bank etc. Journals and websites have also been used for the study.

Tax Free Bonds:-

The return on tax free bonds by way of interest is fully exempt in India which is not added to total Income of an individual as per provisions under section 10 (15) (iv) (h) Income Tax Act, 1961. As such bonds are issued by Government managed undertakings they bear almost zero default risk. The interest offered to these bonds is a benchmark to the Government securities of parallel maturity which subjects to conditions laid down by the act. These bonds however, do not provide any additional tax benefits.

Flow of fund of an Indian ULB's Municipal Bond Scheme



Source: *Pradhan, H. K. 'Local Government Finance and Bond Market Financing in India, 2003.*

Features of Tax-Free Bonds:-

1. Understanding Tax-free Bonds: 'Tax-Free Bonds' are generally issued by the government with a promise to pay a fixed rate of interest (also known as coupon rate) over a specified period of time. Tax-free Bonds are of a long term maturity 10 to 30 years and invested in infrastructure and other projects.

2. Suitability: 'Tax-Free Bonds' are suitable for investors aiming at steady passive return annually and not willing to get their capital back over a long period.

3. Tax Exemption: Under Income Tax Act, 1961 return on account of interest earned on tax-free bonds is fully exempted. In fact the interest availed from these bonds does not form any part of liability on total income of an individual. Moreover there is no any provision of deduction of tax at source (TDS).

4. Coupon rate: 'Tax-Free Bonds' comprises of pre-fixed interest rate i.e. coupon rate and they are linked with on-going rates of government securities. Tax-Free Bonds are much loved instrument in an economy where there is high interest rate in the financial system.

5. Regular flow of income: The interest payable on these bonds is directly credited in the bank account of the bondholder annually.

6. Better alternative to Fixed deposits (FDs): As the interest earned on fixed deposits and similar bonds are added to the GTI of an individual it is taxed as per the income-tax slabs and creates a tax burden on them. As far as tax free bonds are concerned interest earned from it are not taxed and directly credited in the bank account of the bondholder and for bondholders in higher tax slabs it secures a better post-tax return than that of FDs. However, on the parameter of liquidity FDs get a better score over these bonds because of longer maturity period of bonds.

7. Least credit risk: As tax-free bonds are issued by government with the help of ULBs, so credit risk becomes very low or negligible.

Other Features are:-

- One can buy Municipal bonds in physical form or in electronic form through demat account.
- These bonds usually are of long tenures of 10, 15 and 20 years hence investors can beat declining trend of bank rate.
- The best part is; these bonds are traded on the listed exchange.
- There is no upper limit of investment in these bonds.
- In comparison with institutional investors retail investors get higher interest rates, however for an Individual and HUF to be qualified for higher rate of return need to restrict maximum investment up to Rs. 10 Lac.

A HISTORY OF MUNICIPAL BONDS IN INDIA

Municipal bonds/Tax-free bonds is also termed as 'Muni' are instruments having debt obligation. This is same as corporate bonds i.e. in form of an acknowledgement to the bondholder of the amount owed by the issuer. In case of such bonds a municipal body is issuer and investors are bondholders. The holder of the bonds is of course entitled to fixed rate of return in form of interest usually termed as coupon rate.

The first municipal body to issue bonds in India was Bangalore Municipal Corporation; it issued muni bonds worth Rs.125 crore with state guarantee in 1997. The first successful bond issue without state guarantee was The Ahmedabad Municipal Corporation worth Rs.100 crore in 1998. Municipal bodies were allowed to issue tax-free bonds in 2001 under specified guidelines. These guidelines authorized municipal bodies to issue bonds only for capital expenditure on urban infrastructure program and for specific projects only. Further Municipal bodies were required to maintain an escrow account to congregate the debt servicing obligations like property tax from specified zones. The designated body for approval of tax-free bonds i.e. Ministry of Urban Development under notified guidelines put a ceiling on the interest rate on these bonds at 8%. However many states like Karnataka and Tamil Nadu in order to raise funds through a pooled funding mechanism have also created corporate entities.

Table -1; Tax free municipal bond issued so far in India

Name of the municipal corporation	Amount of Tax-free Municipal Bond (Rs. million)	Purpose	Year of issue
Ahmedabad Municipal Corporation	1,000	Water supply and sewerage project	2002
Nashik Municipal Corporation	500	Underground sewerage scheme and storm water drainage system	2002
Hyderabad Municipal Corporation	825	Road construction and widening	2003
Hyderabad Metropolitan Water Supply and Sewerage Board	500	Drinking water project	2003
Visakhapatnam Municipal Corporation	500	Water supply system	2004
Chennai Metropolitan Water Supply & Sewerage Board	420	Chennai water supply augmentation project	2003
Ahmedabad Municipal Corporation	580	Water supply project, storm water drainage project, road project, bridges and fly-overs	2004
Chennai Metropolitan Water Supply & Sewerage Board	500	Chennai water supply project	2005
Chennai Municipal Corporation	458	Roads	2005
Ahmedabad Municipal Corporation	1,000	Roads and water supply	2005
Nagpur Municipal Corporation	212	Nagpur water supply and sewerage project	2007
Greater Vishakhapatnam Municipal Corporation	300	Greater Vishakhapatnam water supply project	2010

The first ULB in India to issue tax-free municipal bonds was Ahmedabad municipal corporation (AMC) which issued bonds for its water and sewerage projects. It was April 2002 when AMC issued 10 year tax-free bond with an interest rate of 9% p.a. having issue amount of INR 1,000 million.

CURRENT FRAMEWORK

In 2011 The Ministry of Urban Development based on the World Bank report on Regulatory Framework recommended SEBI to draft a regulatory framework for issue of municipal bonds for in India (based on the 2001 guidelines). Further in July 2015, the SEBI (Securities and Exchanges Board of India) notified a new regulatory framework as to issue of municipal bonds in India. As per new regulations SEBI allowed municipal bodies and corporate municipal entities to issue municipal bonds in the course of private placement or public issue. For this purpose the body corporate should be registered under the Companies Act or a subsidiary unit of the municipality formed for the purpose of raising funds.

In order to do a public issue ULBs must have an investment grade of BBB- or higher rating, there should not be any default in past 365 days and should be positive net worth. In addition municipal bodies must adhere to municipal account standards of the state concern or the National Municipal Accounts Manual. Rating has been made mandatory for all bond issues by a recognized credit agency. There should be 100% asset coverage on the debt and a provision of a buy-back option as per the current regulation. In case of public issue where the ULBs deposit debt amounts in the designated bank account at least 10 working days before due date of payment, a State Government, Central Government or a structured payment mechanism guarantee is mandatory.

CONCLUSION

Municipal bonds are excellent tool of filling the gap between the requirement and available resources of Urban Local Bodies (ULBs). As per the past experience it is apparent that the ULBs have not been enthusiastic to utilize this financing mechanism as a principal source of funding. Among 65 ULBs assigned with credit ratings and requirement of additional funds only a couple of cities have knocked the market for funds through this source. The main reason behind it is the lack of operational efficiency which diminished the creditworthiness of the ULBs and made their bonds less attractive. As per the 14th Finance Commission report, the recovery cost and the collection efficiency of user charges are still far below the benchmark. In reality only bigger municipal bodies go for bond issuances while the smaller municipalities due to lack of capacity and scale always find it complex. Municipal bonds though are excellent tool of filling the gap between the requirement and available resources of Urban Local Bodies (ULBs) and it can be a massive boost up for the investment requirement in the urban infrastructure sector yet for achievement of bursting prospective lots of efforts still to be made by the ULBs and the state governments in order to secure financial viability and operational efficiency in urban projects.

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