Indian Municipal Bond Market: High Potential, Slow Progress

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Synopsis

CareEdge Ratings published a report on Municipal Bond potential in February 2024, during which we discussed the critical role of municipal corporations in financing the urban infrastructure development requirement and articulated municipal bonds as a financing catalyst. The report also provided an overview of the financial profile of Municipal Corporations. Continuing with the series, in the current report, CareEdge provides an updated overview of Municipal Corporations, the bond potential and steps undertaken by the Government to address the financing requirement of growing urban infrastructure capex.

- The Union Budget' (2025-26) includes a proposal for an **"Urban Challenge Fund**" of Rs 1.0 lakh crore towards financing the incremental urban infrastructure requirement. The initial outlay is Rs 10,000 crore for the year 2025-26. As per the proposal, the fund would invest 25% of cost projects with 50% financing through bonds, bank loans and Public Private Partnership. The budget also focused on the **National Geospatial Mission**, which aims to modernise land records and enhance urban planning nationwide. This development corroborates CareEdge Ratings' view of the untapped bond market essential to finance growing urban infrastructure requirements. CareEdge Ratings estimates the municipal bond potential of ~Rs 30,000 crore to bridge the urban infrastructure financing.
- The Municipal Bond market in the country is receiving heightened attention as Urban Local Body (ULBs) integrate debt issuances into their capital budgeting plans. From 2017 to 2024, ~Rs 3,000 crore was raised through Municipal bonds, with one-third of these issuances occurring in 2023-2024. Most issuances have come from established issuers. However, CareEdge Ratings anticipates that several first-time issuers are now prepared to launch their municipal bond offerings, which have faced delays until now. CareEdge Ratings projects that municipal corporations could raise an additional debt of ~Rs 28,000 crore, indicating the municipal bond market's potential for growth of approximately 15 times from FY26 to FY34. Numerous initiatives by the Government and Regulatory bodies are in place to capitalise on these opportunities. While the outlook is positive, actual municipal bond issuances have yet to take off steam.
- ULBs have primarily financed their capital expenditure requirement from their revenue sources besides grants from the State/Centre. As per financial analysis undertaken for ~30 key municipal corporations (representing metros, tier I and tier II cities), the ULBs generate own revenue of ~65%, of which property tax revenue share alone contributes ~60%.
- According to the study, the total outstanding debt of 30 municipal corporations in the country was approximately Rs 13,000 crore as of March 31, 2024 (estimated), with bonds accounting for 18%. Additionally, municipal bonds represent around 0.06% of the total outstanding corporate bond issuances as of September 30, 2024. Compared to US Municipal Bond issuances, this figure is significantly low, making up less than 0.01% of the US Municipal Bond market issuances.

Municipal bonds- Bridging gaps in urban infrastructure financing

India is experiencing an unprecedented increase in its urban population, growing from approximately 28% in 2004 to around 36% in 2024 and projected to reach 40% by 2036. This trend requires not only enhancing current infrastructure but also developing new facilities. A few prominent infrastructure development responsibilities of ULBs include public roads, drinking water supply, sewage disposal, solid waste management, street lighting, public health services, Government schools and hospitals and other public amenities, etc., necessitating capex outlay.

Financing avenues for the above include municipal revenue, fiscal transfer, projects under Public-Private Partnership (PPP) and borrowings.

(i) Municipal revenue sources are limited, forming just over 1% of the **country's** GDP and recording CAGR growth of ~15% over FY21-24. **State-level policies and limited autonomy curb abilities to raise taxes and** user charges. This results in inadequate cost recovery **and impedes** municipal revenue growth.

(ii) Fiscal transfers are the grants or devolution received from the Central or State**, which** may burden the state exchequer.

(iii) PPP investments have not been encouraging for the **ULBs** due to **revenue autonomy and growth limitations**.

(iv) Bank borrowings have **limitations in terms of the cost of funding, tenure**, etc. Thus, bond financing could be **explored to ease the capital requirement of urban infra-growth** capex and is an **essential** tool in the overall capital budgeting plan.

The Indian government has unveiled the "Urban Challenge Fund" with a budget of Rs 1.0 lakh crore for urban infrastructure development. For the fiscal year 2025-26, an initial allocation of Rs 10,000 crore will be made. This fund is set to cover 25% of the financing for viable projects outlined in the proposal, which calls for 50% funding through bonds, bank loans, and public-private partnerships. The stress on bond issuances highlights the vital role of capital market instruments within the municipal sector, which continues to be unharnessed.

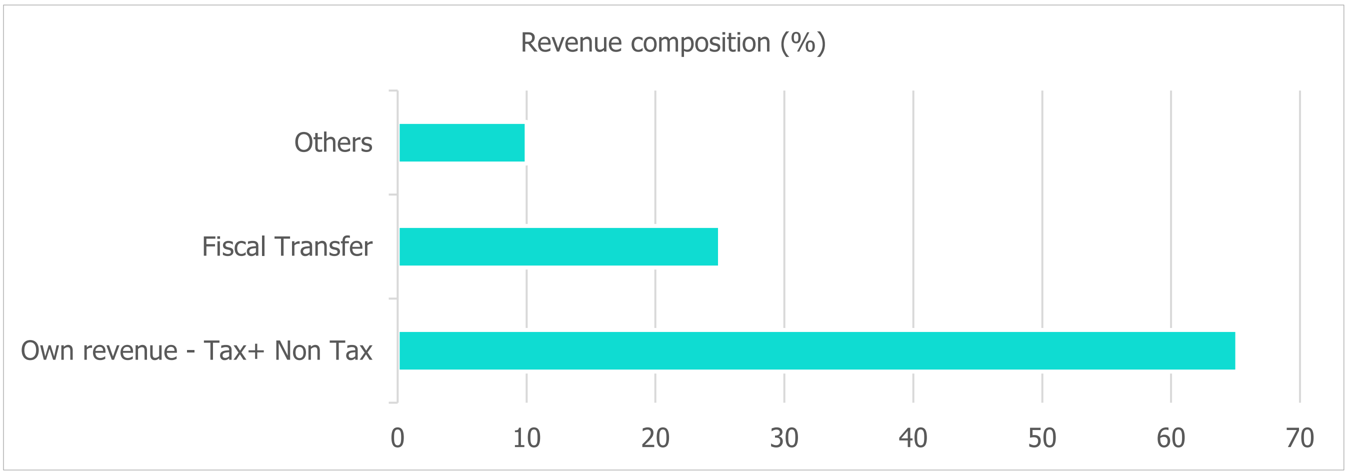
Exhibit 1: Financial Health of Municipal Corporations

Particulars	FY21	FY22	FY23	FY24 E
Revenue growth (%)	20	16	12	17
Revenue Receipts/Revenue Surplus (%)	22.35	25.85	24.27	22.31
Debt/Revenue Surplus (x)	0.99	0.75	0.84	0.91

Source: CareEdge Ratings

Exhibit 1 above represents the financial performance of 30 ULBs. Brihanmumbai Municipal Corporation has been excluded from the sample given the sheer large size **compared to the rest**. The revenue of the stated sample ULBs has witnessed a CAGR growth of ~15% over the last four years (FY21-FY24E), with a consistent revenue surplus being reported by them. **Only five entities have reported revenue deficits. Increased property tax has driven revenue growth and is** majorly led by a rise in non-tax revenue in fees and user charges. In CareEdge **Rating's experience, real estate development and related rises** in building and permit fees have primarily driven the non-tax revenue.

Exhibit 2: Revenue Composition



Source: CareEdge Ratings

An analysis of the ULB's financial performance reveals that the own revenue share of ULBs stands at about 60 - 65% (illustrated in Exhibit 2). This own revenue share comprising tax and non-tax revenue, highlights the corporation's ability to generate income independently. This is vital for maintaining its financial health. On average, property tax revenue constitutes almost 60% of the own revenue sources, showcasing a compound annual growth rate (CAGR) of less than 10% during FY21-FY24E.

CareEdge Ratings has also observed that all the municipal bond issuances typically stipulate the escrowing of property tax with coverage of 1.5-2x, thus underscoring the importance of own revenues and strengthening the bond structure.

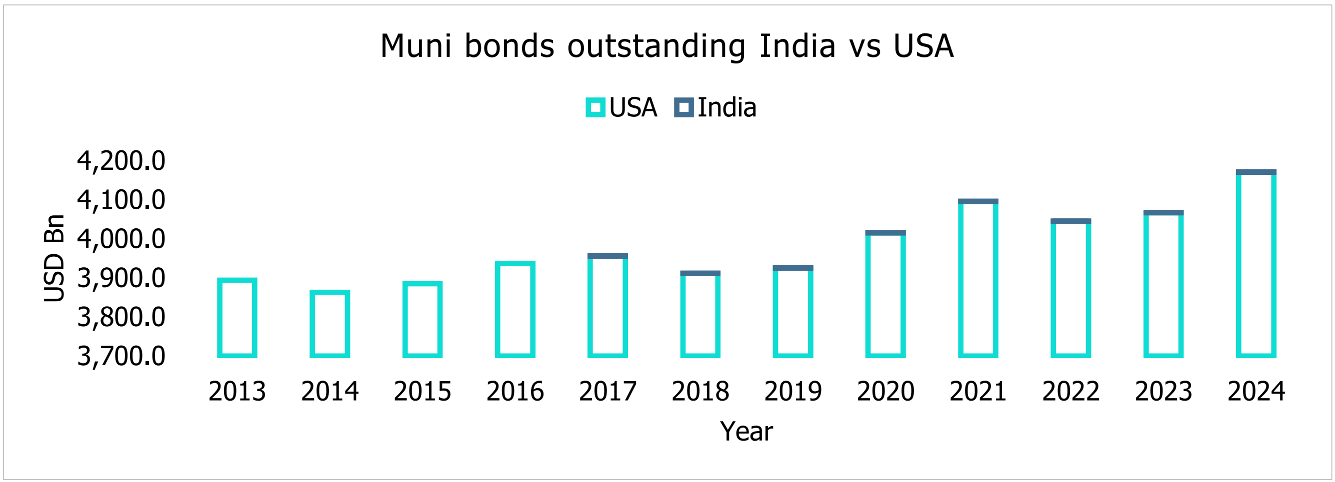
Receipts from the State Government (approximately 20-25%) and other income sources (around 10-15%) together account for the remaining ~35-40% of revenue for Municipal Corporations (Exhibit 2). This reliance on fiscal transfers strains the government's treasury, and unpredictable State or Central funding timelines may delay the necessary capital expenditures. Moreover, increased dependence of local governments on the State for their financial needs may lead to inefficiency and vulnerability. Therefore, it is crucial to consistently grow own revenue share and/or investigate alternative financing options mechanisms.

Exhibit 1 also shows that the borrowing level of the ULBs has been low, with the debt/revenue surplus comfortably below unity. Thereby, ULB can benefit from increased financial leverage.

Indian Municipal Bond Market: Present Status and Potential

The municipal bond market remains at a nascent stage of development. As compared to the USA bond market, the aggregate issuance in India has been ~Rs 3,000 crore (~USD 35 million) of bonds raised during the past two and half decades ended October 2024 as against ~USD 512 billion by USA Municipal bodies in calendar year 2024 alone.

Exhibit 3: Comparison of Indian and US Municipal Bond Market



Source: SEBI and SIFMA

As of December 2024, outstanding municipal bonds in the USA totalled USD 4,171 billion, compared to USD 0.28 billion in India. According to a study by CareEdge Ratings, ULBs in India had total borrowings of approximately USD 1.44 billion as of March 31, 2024, with bonds constituting a mere 18% of the overall borrowing. Nevertheless, the robust profitability, indicated by a 20-25% revenue surplus and a low leverage ratio (debt/revenue surplus below one), presents opportunities for additional borrowings. These corporations are expected to have financial flexibility by raising incremental debt of around Rs 28,000 crore. This also signifies the municipal bond market's potential to grow by 15x. The liquidity available with the ULBs in cash and cash equivalents provides additional financing support for urban infra-capex requirements.

Impediments to the growth and way forward

- The lack of emphasis on capital budgeting policies and hesitancy to take on debt have significantly contributed to the low borrowing rates ULBs. Typically, ULB budget plans are drawn up for just one year rather than for long-term capital expenditure financing, leading to misaligned fund allocations and delays in project completion.
- A socialistic mindset and hesitance to raise fees due to concerns over public backlash have also contributed to the modest rise in property tax revenue in India over time. Additionally, the insufficient recovery of user charges has further restricted their ability to generate revenue.
- CareEdge Ratings asserts that reforms aimed at improving the collection of user charges, promoting long-term financial planning, and enhancing revenue collection efficiency (including outstanding dues) are crucial for increasing municipal corporations' revenues. Some suggested actions include standardising property tax regulations nationwide, linking property tax evaluations to capital value, enhancing service delivery, and embracing digitalisation. For example, employing Geographical Information System (GIS) mapping integrated with tax collection efforts, implementing smart metering for water services, and transitioning from physical assessments of property tax to digitised self-assessments could all significantly improve the efficiency of tax collection and user charge recovery. Consequently, effectively executing these reforms could greatly facilitate the uptake of municipal bonds.
- ULBs function as quasi-governmental entities whose operations differ from corporate structures. Bond investors and credit assessments demand similar standards, necessitating enhanced disclosure norms, adherence to regulatory frameworks, and improved management information systems to access the bond market.

Additionally, issues such as disorganised internal records, inadequate Detailed Project Reports (DPR), and sluggish approvals from State Governments have further prolonged the bond issuance timeline.

- The relatively small size of many ULBs across the country may limit their bond issuance capabilities; therefore, pooling bonds presents an opportunity for them to gain prominence. Investors, particularly insurance and pension funds, are often restricted by investment guidelines that favour higher-rated bonds in limited supply. As a result, encouraging current issuers to re-issue bonds, fostering retail investor participation, and establishing additional credit enhancement measures for bond issuance can create a supportive framework for developing the municipal bond market.
- Globally, there is a growing emphasis on environmental and social governance (ESG), driven by increasing interest from investors in funding sustainable development initiatives. ULBs have the potential to implement a wide array of sustainable projects, such as energy and water conservation as well as sanitation improvements. They can finance these efforts through the issuance of green bonds.

CareEdge view

The Union Budget for 2025-26 strongly emphasises sustaining a vigorous pace of infrastructure development, particularly in urban infrastructure financing. Key announcements include the introduction of an Urban Challenge Fund worth Rs 1.0 lakh crore, the extension of the Jal Jeevan Mission to 2028 with a financial allocation of Rs 60,000 crore, and the initiation of a National Geospatial Mission designed to update land records for better urban planning.

Puja Jalan, Director, adds "In this context, along with government support, Municipal Corporations must also improve their financial independence to meet the capital expenditure needs linked to demographic growth effectively. Reforming property taxes by tying assessments to capital value, utilising GIS mapping, focusing on consistent collection efforts, and actively recovering arrears and existing demands are essential for boosting municipal revenue corporations"

Well-performing municipal corporations with sufficient surpluses are positioned to increase their debt by approximately Rs 28,000 crore and can use their substantial cash reserves to finance urban infrastructure initiatives. This indicates the possibility of a 15-fold expansion in the municipal bond market. As per Tej Kiran, Assistant Director, "To effectively tap into the bond market, ULBs must boost transparency, fortify internal controls, ensure compliance with regulations, and improve their management information systems. Pooling bonds also presents an opportunity for relatively smaller issuers to gain prominence. Furthermore, implementing credit enhancement strategies for bond issuances could serve as a viable means to broaden the municipal bond market's reach in India".

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