Finance Commission Grants to Cities – The issue of limited allocation

Mains: *GS II – Constitutional bodies*

Why in News?

Recently there has been an issue of less grants to urban local bodies (ULB's) by the Finance commission.

What is the issue?

- **Importance of urban centers** – In India they have become the principal engines of economic growth and capital accumulation.
- Nearly 90% of total government revenue and around 67% of India's GDP are generated in cities.
- **Issues** – Despite this centrality to the economy, fiscal transfers to Urban Local Bodies (ULBs) remain modest.
- **Recommendation 0f 16th FC** – The recommendations of the Sixteenth Finance Commission continue the trend of limited devolution to cities while emphasising greater mobilisation of own source revenues (OSR) by urban local governments.
- This raises questions about fiscal autonomy, adequacy of funding, and federal balance in India's urban governance framework.

What is the status of Fiscal Transfers to Urban Local Bodies?

- **Economic contribution VS allocation** – The scale of fiscal transfers to cities remains extremely small when compared with the economic contribution of urban areas.
- Under the Fifteenth Finance Commission, urban local bodies received approximately Rs.1.2–1.3 lakh crore over five years.
- During the same period, India's GDP ranged between Rs.200–210 lakh crore, meaning that transfers to cities amounted to only about 0.12–0.13% of GDP.
- The 16th Finance Commission has proposed around Rs.3.56 lakh crore for urban local bodies between 2026 and 2031, which translates to roughly Rs.75,000 crore annually.
- However, with India's GDP projected to reach Rs.400 lakh crore, the proportion allocated to cities remains almost unchanged at around 0.13% of GDP?
- Thus, despite rising urbanisation and expanding infrastructure needs, the fiscal commitment to cities has not significantly increased.

What are the challenges around the allocation to urban centers?

- **Growing Urban Population and Per Capita Constraints –** Another dimension of the problem lies in the rapid growth of India's urban population.
- Estimates suggest that the urban population will reach about 41% by 2031.
- India already had around 470 million urban residents in 2020, and the number may exceed 600 million during the 2026–2030 Finance Commission cycle.
- When the limited pool of grants is distributed across this expanding population base, per capita transfers stagnate or decline in real terms.
- This creates a widening gap between the growing demand for urban infrastructure—such as housing, mobility, sanitation, and climate resilience—and the fiscal resources available to city governments.
- **Utilisation of Funds** – Apart from the limited volume of grants, utilisation of funds has also been a challenge.
- Under the 15th Finance Commission, total grants to local bodies were around Rs.4.36 lakh crore, yet Rs.90,000–95,000 crore remained unspent or pending utilisation, including roughly Rs.30,000–35,000 crore meant for urban local bodies.
- Several factors contribute to this issue:
    - Limited administrative and technical capacity of local bodies
    - Delays in release of funds by State governments
    - Procedural and compliance requirements attached to grants
- These challenges highlight the need for institutional strengthening of urban local governments, rather than merely increasing conditional funding.
- **The Problem of Tied Grants** – A significant portion of Finance Commission transfers to cities is provided as tied grants, which are earmarked for specific sectors such as water supply, sanitation, and wastewater management.
- While these sectors are critical, tied grants restrict the fiscal autonomy of cities, as funds must be spent only on designated purposes.
- The approach of the 16th Finance Commission further strengthens this conditionality through performance-based grants.
- **Cities must meet criteria such as**:
    - Improving fiscal discipline
    - Conducting regular local body elections
    - Publishing provisional and audited accounts
    - Ensuring the constitution of State Finance Commissions
- Additionally, 20% of the funds are linked to additional conditions, including the requirement that cities raise at least Rs.1,200 per household through property taxes and user charges.
- While improving own-source revenue is desirable, strict conditionalities may disadvantage cities with weaker economic bases or administrative capacities.
- **Federal Concerns in Urban Governance** – Certain recommendations of the 16th Finance Commission have also raised federal concerns.
    - **For instance,** Rs.10,000 crore has been earmarked as a one-time incentive for the merger of peri-urban villages with populations exceeding one lakh into urban areas.
- **This raises two key issues:**
    - **Encroachment on State Jurisdiction** – Urban development is constitutionally a

State subject, and financial incentives from the Union government to influence administrative restructuring may disturb the federal balance.
    - **Administrative Complications** – In States where rural local governance is strong—such as Kerala—forced mergers of rural areas into urban jurisdictions could create governance and service delivery challenges.
- Furthermore, the Finance Commission has paid relatively little attention to climate change, which poses significant risks for cities through flooding, heat waves, and infrastructure stress.
- **The Issue of Cess Revenues** – Another major concern relates to the growing share of cess and surcharge revenues collected by the Union government, which remain outside the divisible pool of taxes shared with States.
- These cess collections now amount to roughly 2.2% of GDP, or about Rs.8.8 lakh crore.
- A substantial portion of this revenue originates from economic activities concentrated in cities.
- However, since these funds are excluded from the divisible pool, States and urban local bodies do not receive a proportional share, limiting the fiscal space available for urban development.

What measures can be taken?

- **Key reforms** – Strengthening urban governance in India requires a more balanced and empowering fiscal framework.
- It could include:
    - Enhancing unconditional transfers to urban local bodies to increase fiscal autonomy.
    - Strengthening property tax systems and user charge mechanisms while providing capacity-building support to cities.
    - Ensuring timely constitution and functioning of State Finance Commissions for better vertical and horizontal fiscal distribution.
    - Integrating climate resilience into urban financing frameworks.
    - Revisiting the treatment of cess revenues to ensure more equitable sharing with States and local bodies.

What lies ahead?

- India’s cities are central to its economic future, yet their fiscal empowerment remains limited.
- While the 16th Finance Commission emphasises fiscal discipline and revenue mobilisation by urban local bodies, the scale and flexibility of grants remain insufficient.
- A sustainable urban future requires greater fiscal decentralisation, stronger institutional capacity, and respect for federal principles, allowing cities to plan and finance their own development while the Union government acts as an enabling partner.

Reference

The Hindu| Limited Finance Commssion Grants to Cities



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