

Fiscal Architecture of Municipalities - Issues and Solutions

Mains: GS II - Devolution of Powers and Finances up to Local Levels and Challenges Therein

Why in News?

Recently, urban local bodies faces a sharp financial constraints and municipal finance is dependent on intergovernmental transfers, loans, and schemes.

How did cities lose its tax revenues?

- **Effect of GST** After the introduction of the Goods and Services Tax (GST), Indian cities lost nearly 19% of their own revenue sources.
 - **For instance**, Octroi, entry tax, and local surcharges which are the traditional lifelines of municipal budgets were subsumed into the GST framework.
- **Unfulfilled promises** Assured compensatory mechanisms have largely bypassed the municipal level, deepening cities' dependence on State and Central grants.
- Therefore, municipalities lack both fiscal autonomy and predictable revenue streams.
- **Downturn of democracy** The result is a peculiar inversion of democracy, where power is centralised and responsibility decentralised.
- Indian cities are not generating revenue, not because they are inefficient, but because the fiscal architecture has failed them.
- The core of the problem lies in the centralisation of taxation powers.
- **Responsibility without authority** Cities are expected to deliver solid waste management, affordable housing, climate resilience, and digital infrastructure, but without the resources to fund such services.
 - **For example,** urban India generates nearly two-thirds of the national GDP, yet its municipalities control less than 1% of the country's tax revenue.

What are the issues with the municipal finances?

- Flawed framework of municipal bonds It is not merely that cities are unable to generate capital to back their bonds, it is that the very framework of assessing credibility is skewed.
- Every major policy pronouncement from NITI Aayog's urban strategy to the latest reform-linked incentive grant promotes bonds as the new frontier of local finance.
- However, the credibility of Indian municipal bonds remains abysmally low.

Municipal bonds are debt securities issued by states, cities, and other local governments to raise money for public projects like building schools, highways,

and water systems.

- **Ideological error** A city's creditworthiness is often judged narrowly by its own revenue performance such as, property taxes, user charges, and fees.
- But it completely discounting the regular flow of grants and transfers from higher levels of government.
- When the RBI or credit rating agencies discount grants as non-recurring income, they propagate the myth that cities survive on charity.
- In truth, these grants are legitimate entitlements, part of a redistributive compact enshrined in the Constitution.
- The 74th Amendment consider of cities as the equal tiers of governance entitled to a share of the tax pool.

World Bank and Asian Development Bank have long argued that cities should become "self-reliant" by focusing on property tax collection and user fees.

- While property tax reform is important, this narrow prescription is inadequate and unjust.
- **Inadequacy of property tax** It is inadequate because property tax typically accounts for only 20-25% of a city's total revenue potential, and is often politically and administratively constrained.
- It is unjust because it shifts the burden of urban financing disproportionately onto residents, especially in lower-income settlements already struggling with poor services.
- **Issues with user fees** The obsession with "user pays" logic converts public goods into private commodities.
- Clean water, sanitation, public lighting, and mobility these are not marketable products but collective entitlements.

What is the way ahead?

- **Decentralizing more financial powers** India must democratise the fiscal contract to empower the local bodies.
- In Scandinavian countries, the cities enjoy strong fiscal health, the local tax base is the foundation of the welfare state.
 - For instance, Municipalities in Denmark, Sweden, and Norway have the right to levy and collect income taxes directly, ensuring a transparent and accountable relationship between citizens and local governments.
- This decentralised model has produced both efficiency and equity.
- Citizens can see where their money goes, and cities have the flexibility to plan for the long term.
- Most importantly, transfers from higher levels of government are treated as part of a shared fiscal ecosystem, not as discretionary favours.
- Implement different models There is a need for reimagined model of fiscal federalism, where municipalities have predictable, adequate, and untied revenues.

- These revenues are both from their own sources and from constitutionally mandated transfers.
- **Legitimatize the grants** For municipal bonds to become credible instruments, the first step is to recognise grants and shared taxes as legitimate components of city income.
- Only then can cities build a trustworthy balance sheet.
- **Redesign the rating system** The rating system must account for the governance capacity of a city which includes, transparency, audit compliance, citizen participation, rather than solely relying on financial metrics.
- **Allocation for collateral** Cities should be empowered to earmark a portion of their GST compensation or State share as collateral for municipal borrowing.
- Such reforms would restore the principle of cooperative federalism that the Constitution envisaged.

What lies ahead?

- India's urban future depends on fiscal justice.
- Municipal finance must be seen not as a bookkeeping exercise but as a moral and political question.
- The grants that flow to cities are not gifts; they are part of a social contract.
- The revenues that cities generate are not charity; they are a right.
- True reform will begin only when India accepts that cities are not cost centres, they are the foundation of national prosperity.

Reference

The Hindu Flawed Financial Architecture of ULB's

