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