



Issue of Urban Finance and 16th Finance Commission

For Prelims: [74th Amendments of the Constitution](#), [Directive Principles of State Policy](#), [Reserve Bank of India](#), [Geographical Information System](#), [Finance Commission](#)

For Mains: [Financial Paucity faced by Urban Local Bodies](#), [Measures for Empowerment of Urban Local Government](#).

Source: TH

Why in News?

Recently, developments concerning the [16th Finance Commission \(FC\)](#) in India highlight critical issues regarding [fiscal decentralisation](#), particularly **focusing on urban areas** and their financial sustainability within the [federal structure](#).

- The World Bank has estimated that USD 840 billion is **needed for basic urban infrastructure** in the next decade.

What are the Financial Sustainability Issues with the Urban Areas?

- **Urbanisation Challenges:** India's urban areas, which contribute **66% of India's GDP** and **about 90% of total government revenues** face immense infrastructure and financial challenges.
 - Despite being crucial economic hubs, **cities receive inadequate fiscal support** with [intergovernmental transfers \(IGTs\)](#) constituting **only 0.5% of GDP** impacting their ability to provide essential services and maintain infrastructure.
- **Financial Devolution Issues:** The devolution of funds to [Urban Local Bodies \(ULBs\)](#) is significantly lower than other developing nations.
 - For instance, **South Africa** allocates 2.6%, Mexico 1.6%, the Philippines 2.5%, and Brazil 5.1% of their GDPs to their cities.
 - This shortfall **affects urban productivity and quality of life**, exacerbated by the introduction of the [Goods and Service Tax \(GST\)](#), which has reduced **ULBs' own tax revenues**.
- **Draining Resources:** An [RBI survey](#) of 221 municipal corporations (2020-21) revealed that **more than 70%** of these corporations saw a **decline in revenues** while in contrast, their expenditure rose by almost 71.2%.
 - The RBI report also highlights the **limited coverage of property tax** and its failure in shoring up municipal corporation revenues.
 - As per the [OECD](#), India has the **world's lowest property tax collection rate (property tax to GDP ratio)**.
- **Decline in Grants:** Experts argue that **GST not only ended octroi** but also **severely impacted the businesses** of many small entrepreneurs, resulting in a **significant decline in tax revenue** for urban local bodies.
 - Previously **almost 55% of the total revenue** expenditure of urban centres was met by

octroi which has now significantly reduced.

▪ **Other Issues:**

- **Census Data Concerns:** The absence of **updated census data (since 2011)** poses a challenge in accurately assessing the urban population and its needs.
 - This outdated data **affects evidence-based fiscal devolution** planning, crucial for addressing the dynamic urbanisation trends, including migration to Tier-2 and 3 cities.
- **Policy Distortions:** Parallel agencies and schemes, such as **MP/MLA Local Area Development Funds**, undermine the financial autonomy of local governments, distorting the **intended federal structure** and complicating urban governance and service delivery.
- **Lesser Functional Autonomy:** During the **pandemic**, the leaders at national, state and district level were seen taking a call on **disaster mitigation strategies**, however, the **heads of municipal corporations were not included in this group**.
 - The **old approach** of treating local governments as adjuncts of State governments continues to **dominate the policy paradigm**.
- **Structural Issues:** Some of the urban local governments do not have **basic infrastructure and human resources**. While in some states regular elections are not conducted for the local bodies. This affects their functioning and delivery of services.

What are the Major Terms of Reference for the 16th Finance Commission?

▪ **About:**

- The **Finance Commission in India** is a **constitutional body** established under **Article 280** of the Indian Constitution.
 - Its primary function is to recommend the **distribution of financial resources** between the central government and the state governments.
- The **Fifteenth Finance Commission** was constituted in 2017. It made recommendations **covering the period of six years** commencing on 1st April, 2020 through its Interim and Final Reports.
 - The recommendations of the Fifteenth Finance Commission are **valid up to the financial year 2025-26**.

▪ **Terms of Reference:**

- **Division of Tax Proceeds:** Recommending the distribution of taxes between the Union Government and the States under Chapter I of the **Constitution**.
 - This includes the allocation of shares among the States from these tax proceeds.
- **Principles for Grants-in-Aid:** Establishing the principles governing **grants-in-aid** to the States from the **Consolidated Fund of India**.
 - This encompasses determining the amounts to be provided to the States as grants-in-aid, specifically under **Article 275** of the Constitution.
- **Enhancing State Funds for Local Bodies:** Identifying measures to enhance the Consolidated Fund of a State.
 - This is aimed at supplementing the resources available to **Panchayats and Municipalities** within the State, based on recommendations made by the State's own Finance Commission.
- **Evaluation of Disaster Management Financing:** The Commission may review the current financing structures related to Disaster Management initiatives.
 - This involves examining the funds created under the **Disaster Management Act, 2005**, and presenting suitable recommendations for improvements or alterations.

Assam Government Makes Appointment to State Finance Commission

- The **Government of Assam** has constituted the **Seventh Assam State Finance Commission** with **Lieutenant General Rana Pratap Kalita (Retd)** as its **Chairman** and six other members.
- The State Finance Commission (SFC), formed by the **73rd and 74th Constitutional Amendments**, aims to **streamline fiscal relations** at the state and sub-state levels in India, with appointments governed by **Article 243-I and 243-Y** of the Indian Constitution.
 - **Article 243 I:** Mandates State Governor to **constitute a Finance Commission every five years**.
 - **Article 243Y:** Finance Commission constituted under article 243 I shall also **review the**

financial position of the Municipalities and make recommendations to the Governor.

What are the Steps Needed for Better Urban Finance?

- **Strengthening Municipal Revenue:** All **Finance Commissions** have recognised the need to augment property tax revenue to improve municipal finances. For example:
 - The 12th Finance Commission encouraged the use of the **Geographical Information System** (GIS) and digitisation to improve property tax administration.
 - The **14th Finance Commission** recommended that municipalities be enabled to levy **vacant land tax**.
- **Modernise Tax Administration:** Outdated systems lead to inefficiencies and leakages. Local bodies can **implement digital platforms for property tax** assessment, e-filing, and online payments.
 - This **improves transparency**, convenience for citizens, and boosts collection rates.
- **Explore User Charges for Specific Services:** Instead of a blanket tax structure, some services can have user charges. This can **apply to parking, waste collection** for bulk generators, or recreation facilities.
 - The key is to ensure the fees are fair and reflect the cost of providing the service. Cities like Bengaluru have successfully implemented **user charges for solid waste management**.
- **Strategic Property Management:** Local bodies often hold **underutilised properties**. These can be monetised through **public-private partnerships (PPP)** for developing commercial spaces, markets, or parking lots.
 - This generates rental income and economic activity within the local body's jurisdiction. The **World Bank** recommends PPPs as a tool for local governments to access financing and expertise for infrastructure development.
- **Promote Local Businesses and Economic Development:** A thriving local economy translates to **higher tax revenue for local bodies**. Initiatives can include streamlining business licenses, offering tax breaks for startups, or creating innovation hubs.
 - The city of Austin, Texas, in the US, is known for its supportive environment for entrepreneurs, leading to a booming local economy .
- **Explore Social Stock Exchange (SSE):** These exchanges **allow social enterprises**, which focus on **social impact alongside profit generation**, to raise capital. Local bodies can explore the feasibility of creating an SSE or partnering with an existing one.
 - This could **attract investment towards initiatives** that address local social needs while generating revenue for the local body.
- **Implement Value Capture Mechanisms:** This involves capturing a portion of the increased value of private properties **resulting from public infrastructure projects**.
 - **Hong Kong** is a prime example of a city that **effectively uses land value** capture for infrastructure projects.

Conclusion

The ongoing **work of the 16th Finance Commission is pivotal in addressing these challenges** by revisiting fiscal devolution principles, updating methodologies based on current urbanisation dynamics, and recommending substantial increases in IGTs to urban areas.

- The implications of these recommendations will be **far-reaching, impacting India's economic growth trajectory**, social equity goals, and environmental sustainability efforts in its urban centers.
- Effective implementation will require **concerted efforts from Union and State governments** to align policies and ensure sustainable urban development in the country.

Read more: [16th FC](#)

Drishti Mains Question:

Q. Can enhanced devolution of funds by the 16th Finance Commission effectively address the systemic financial challenges faced by Urban Local Bodies (ULBs) in India. Analyse.

UPSC Civil Services Examination, Previous Year Question (PYQ)

Prelims

Q. Consider the following: (2023)

1. Demographic performance
2. Forest and ecology
3. Governance reforms
4. Stable government
5. Tax and fiscal efforts

For the horizontal tax devolution, the Fifteenth Finance Commission used how many of the above as criteria other than population area and income distance?

- (a) Only two
- (b) Only three
- (c) Only four
- (d) All five

Ans: (b)

Q. According to the Constitution of India, it is the duty of the President of India to cause to be laid before the Parliament which of the following? (2012)

1. The Recommendations of the Union Finance Commission
2. The Report of the Public Accounts Committee
3. The Report of the Comptroller and Auditor General
4. The Report of the National Commission for Scheduled Castes

Select the correct answer using the codes given below:

- (a) 1 only
- (b) 2 and 4 only
- (c) 1, 3 and 4 only
- (d) 1, 2, 3 and 4

Ans: (c)

Q. With reference to the Finance Commission of India, which of the following statements is correct? (2011)

- (a) It encourages the inflow of foreign capital for infrastructure development
- (b) It facilitates the proper distribution of finances among the Public Sector Undertakings
- (c) It ensures transparency in financial administration
- (d) None of the statements (a), (b) and (c) given above are correct in this context

Ans: (d)

PDF Reference URL: <https://www.drishtias.com/printpdf/issue-of-urban-finance-and-16th-finance-commission>

