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India's 16th Finance Commission needs to prioritize urbanization

It should demystify its work, widen public participation and address the need for significantly better funded towns and cities

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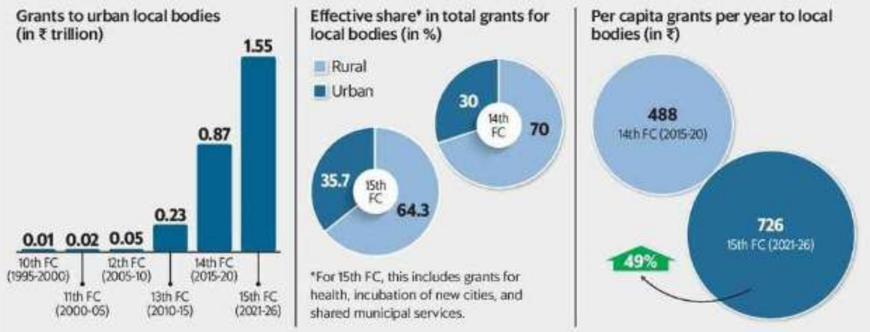
How funds for urban local bodies stack up

Allocations recommended by recent Finance Commissions have risen amid a debate on their sufficiency in the face of rapid urbanization.

	14th FC (2015-16 to 2019-20)	15th FC (2021-22 to 2025-26)
Share of divisible pool for local bodies (in %)	4.31	4.15
Total allocation for local bodies* (in ₹ crore)	287,436	436,361
For urban local bodies (in ₹ crore)		
Urban local bodies' total share in grants	87,144	147,178
Includes: Grants for improving health services	-	26,123
Includes: regular grants		121,055
Grants for incubation of new cities	-	8,000
Grants for shared municipal services	-	450
Total	**87,144**	**155,628**

*In case of 15th FC, this includes grants for health, incubation of new cities, and shared municipal services. Out of the amount excluding these components, urban local bodies have a 30% share under 14th FC, and 33-35% share under 15th FC (33% in FY22 and FY23, 34% in FY24 and FY25, and 35% in FY26)



*For 15th FC, this includes grants for health, incubation of new cities, and shared municipal services.

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Source: Finance Commission reports, authors' calculations

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The wheels have been firmly set in motion for the 16th Finance Commission (FC) with the publication of the Terms of Reference and notification of its chairperson and members. Unlike for the 15th FC, the terms for the latest FC hold no surprises. It sticks to the constitutional mandate, unlike the previous FC, where certain additions triggered debates.

Central FCs have also contributed to the country immensely through thought leadership and policy innovations, governance reforms and the like to advance equitable human development in India, besides discharging their core function of recommending formulae for government resource allocation. They are effective in addressing the gap between the Centre and states on their collected resources, referred to as a 'vertical imbalance,' and inter-state gaps (which states get how much), or 'horizontal imbalances.' The central FC also determines specific allocations for local governments, even as state-level FCs do the same in the context of state finances under Articles 243(I) and 243(Y) introduced by the Constitution (74th Amendment) Act, 1992.

Over the years, central FCs have also pushed the envelope on governance and public finance reforms. Streamlining centrally sponsored schemes and unbundling power utilities, for example, and advocating other power-sector reforms and measures for fiscal sustainability at the central as well as state levels.

They have played a significant role for local governments through resource allocation to panchayati raj institutions (PRIs) and urban local bodies (ULBs). Allocations to local governments have risen by 398% to ₹4.36 trillion between the 13th and 15th FCs. Against the backdrop of Vocal for Local, Lifestyle For Environment (LiFE) and Jan Bhagidari espoused by the prime minister for greater citizen participation in governance, the 16th FC's potential to transform the governance in general and public finance in particular of India's cities is immense.

There has been a significant increase in city funding through centrally sponsored schemes, with a 500% increase in allocations between 2009-10 and 2020-21. The allocations and recommendations of the 15th FC have raised the bar for the 16th FC for cities. Raising the share of funding for cities (within local government share) from 30% to 35%, giving only performance-based grants to metropolitan cities, mandating the publication of audited annual accounts on *Cityfinance.in*, setting base rates and growth rates in property tax as basic eligibility conditions, and pushing for 'whole of government' accounting by aligning ULB and state accounts were all progressive recommendations.

While we have been brought up on the adage

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"India lives in its villages," we should be aware that India is urbanizing at a rapid pace, and over half of us will be living in urban areas by 2050.

Despite the significant increase in funding for cities, city dwellers are gasping due to challenges of flooding, air pollution, availability of quality housing, sanitation, water supply and public transport, among others. India's major cities face challenges that rival those of mid-sized countries in providing for their residents. The country needs to prioritize urbanization as a distinct development agenda to accomplish its goal of becoming a developed economy by 2047.

Here we offer specific suggestions for raising the salience of the 16th FC by making its work more accessible and visible to citizens at large. These steps would be catalytic as they could set a virtuous cycle of reforms in motion.

First, the 16th FC should consider revamping the Finance Commission of India's website to publish the rich data that successive FCs have collected. An open data microsite would have a significant catalytic effect on public finance in India, particularly at the state level. The seminal work of FCs across data, research and reform recommendations deserve to be digitally democratized.

Second, it should build a modern and contemporary user interface to crowdsource inputs for their recommendations, with built-in checks for relevance and quality. This would lend an innovative yet much-needed participatory character to its work. The complexity arising from India's heterogeneity and contextual differences, say every 100km, would benefit significantly from broader engagement and feedback mechanisms.

Third, to ensure diversity, equity and inclusion in its participatory outreach, the new FC could consider meeting with many more mayors and councillors, women's self-help groups, which are increasingly engaged in public-service delivery, and civil society organizations in not just various state capitals, but also smaller cities and towns. The significance of the long tail of 4,500 small towns with populations of under 100,000 in India's urbanization and development cannot be overemphasized, nor the need to mainstream the voices of women, youth and the urban poor in government resource-allocation decisions.

Fourth, the 16th FC should engage the public more on social media to demystify its work and generate wider engagement. Notably, real-time updates on who they meet, and, to the extent they deem it appropriate, a synopsis of the discussions and views represented at such meetings would be extremely useful to generate greater public discourse on this critical agenda.

The 16th FC can be a force for a generational shift in urban public finance and could alter the trajectory of human development in India. Broader public engagement and recognition of its salience is a much-needed first step.

This is the first of a three-part series.

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Updated urban definitions could optimize our resource allocation

The 16th Finance Commission should redefine cities and rework the formula used for determining urban fund devolutions

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ULB coverage

Urban local bodies could be the focus of a new formula for resource allocation.

City population category	Urban local bodies in the category	ULBs + census towns in 60-km radius	Total urban population in 60-km radius	Share (%) in India's total urban population
>4 mn	8	971	110.4	29
>1 mn	45	2,242	188.4	50
>0.5 mn	86	3,331	237.3	63
>0.1 mn	470	6,310	348.2	92

The population cuts across state boundaries if the 60-km radius of a ULB also flows into a neighbouring state.
Analysis excludes Jammu and Kashmir and cantonment boards.

City population category	Number of urban local bodies	Population	Share of population of urban local bodies (%)
>4 mn	8	57.8	18.2
1-4 mn	38	57.8	18.2
0.5-1 mn	42	28.9	9.1
0.1-0.5 mn	388	75.1	23.6
<0.1 mn	3,565	98.7	31
Total	**4,041**	**318.5**	**100**

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Source: Janaagraha's Annual Survey of India's City-Systems (2023); Analysis based on Census 2011

India's local governments are weak despite the 73rd and 74th Constitutional amendments. They effectively serve as extended implementation arms of state governments, rather than as an independent tier of government. If India has to deliver on its promise of Viksit Bharat by 2047, we must radically change how we view our local governments. Most economies that have graduated to developed status, including a totalitarian China that is fast moving towards it, have done so through the economic growth generated in and by cities, catalysed in turn by strong local governments. A paltry 4% of the divisible pool is allocated to local governments by Finance Commissions (FCs), with cities getting a minuscule 1.4%. India's investment in cities averaged 0.6% of GDP during 2011-2018 as against 2.8% of GDP for China during 2000-2014 (*World Bank, 2022*). If India has to develop rapidly, we need to empower cities and transfer resources commensurate with 18 constitutionally identified functions to realize the vision of the 74th Amendment of the Constitution.

One of the first challenges is defining a city. We have 88 municipal acts across 28 states and seven Union territories, and five different criteria to define a city—comprising population, density, employment, revenue generation and those from guidelines under Article 243Q of the 74th Amendment. These do not cover modern criteria, such as data on mobility and labour markets, density and built-up forms, and night-time data. Census 2011, already outdated in a rapidly urbanizing India, had identified 3,892 "census towns" governed as village panchayats but actually urban in character based on three criteria: Population of over 5,000, density of at least 400 persons per sq km and an outdated, gendered one of at least 70% of the male main working population being in non-farm jobs. There were 4,041 statutory towns governed as municipal areas. Census 2011 also identified 53 urban agglomerations (UAs). These UAs are not just large cities as defined by their municipal boundaries, but form a larger metropolitan area, including smaller urban local bodies (ULBs) and panchayati raj institutions (PRIs). However, PRIs falling within UAs were still treated as rural. We need a far more coherent way of thinking about urbanization and the central government must provide thought-leadership on it. The Odisha government has published a rural-urban transition policy for a more systematic approach to preparing urbanizing panchayats for urban governance that could serve as a reference point.

We make five recommendations to ensure that urban allocations do not undercount urban populations and serve as a catalyst for higher economic growth and human development.

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First, the 16th FC should consider identifying cities using advanced geospatial tools and alternate data as an additional dimension, instead of relying only on the 2011 census for resource allocations. Solely relying on 13-year-old data to identify cities would be sub-optimal, given a pace of urbanization that makes it one of the world's most significant demographic transitions. With geospatial tools accessible now, the FC may explore the use of advanced mapping capabilities and alternative data to identify cities. For example, population projections of the Union ministry of health and family welfare, night-time luminosity and consumption expenditure, apart from vehicle and property registrations. The FC has an opportunity to break new ground.

Second, allocations for metropolitan areas must continue to be treated differently, with outcome-based funding for ambitious goals linked to economic growth and jobs, environment sustainability and equity considerations. This should cover the entire metropolitan area, essentially the UA as per census 2011 data but further informed by geospatial analysis. Census towns in metropolitan areas too need to be treated as urban rather than rural for resource allocation purposes. The UK's model of 'city deals' may be appropriate to learn from and adapt to our context.

Third, the 16th FC needs to support the progressive trend of differentiating between the needs and capabilities of different types of cities and suitably tailoring resource allocations. Our larger metropolitan areas have the economic might and scale to raise their own resources to finance development. However, mid-sized cities with a population range of 100,000 to 1 million may need support for some more time to create capabilities that will help them grow economically. The long tail of 4,200-plus smaller cities would need more long-term unconditional support to evolve as robust institutions. A one-size-fits-all approach will not work.

Fourth, the 16th FC should carefully evaluate the role and relevance of the district as a unit of resource allocation, particularly from the standpoint of Indian cities' spatial contiguity. Districts continue to be the best understood and capacitated level of administrative governance in India and are best placed to rise above the rural-urban binary and plan for integrated and coordinated economic and ecological development. The FC needs to evolve this concept further and consider spatial contiguity arising out of India's unique pattern of urbanization for better resource optimization and efficiency.

Fifth, and most importantly, while the 15th FC ascertained a state's share of local-government grants on the basis of total state population and then worked its way to individual ULB shares through a complicated process, we would recommend a simpler local-government-centric (rather than state-centric) approach to ascertain individual ULB shares across India. It should be done directly on the basis of their individual share in total ULB population (excluding metropolitan areas as mentioned in the second recommendation).

The 16th FC has an opportunity to redefine and reimagine urban allocations, albeit grounded in sound logic and spatial data. Allocations using new and improved underlying principles could help usher in Viksit Bharat ahead of time, particularly for the 4,200-plus cities in the under-100,000 population category, by placing them on the path of planned urbanization.

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The 16th FC and Indian cities: A blueprint for municipal finance

It can catalyse municipal-level financial reforms through decentralization, transparency in reporting and accountability

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The new Lok Sabha and Union government are in place. It is now time to get back to business as usual. In our first two pieces on the 16th Finance Commission (FC) and India's cities, we covered specific measures to make the Finance Commission and its work more easily accessible to citizens and the spatial aspects of urbanization that need to be considered. In this final piece, we focus on a substantive public finance reform agenda for India's cities and how the 16th FC could catalyse it.

India's cities have far less money than they need, inadequate absorptive capacity for the money they have, and no accountability for how the monies they spend improve citizens' lives. There are five areas we need to reform:

Fiscal decentralization: Our cities need predictability in the quantum and timing of fiscal transfers. This is directly a function of how well the central FC and the various state FCs approach these tasks and how well their recommendations are implemented. While successive central FCs have established a stellar track record, state governments are not even constituting state FCs on time, let alone implementing their recommendations. While the 15th FC has made the placement of Action Taken Reports of state FCs a grant condition, the failure of state governments to meet this condition will hurt urban local bodies and citizens. We, therefore, need a different incentive mechanism to ensure state FCs live up to the spirit of the 74th Constitution Amendment, which can be built into recommendations of the 16th FC.

In addition to predictable fiscal transfers, our cities also need access to buoyant revenue streams. Stamp duties and real-estate registration charges, vehicle registration charges and GST—all of which are related to the functioning of city governments and their expenditure obligations—have not been devolved to cities through a transparent mechanism. We need to evolve mechanisms whereby a fair share of such revenue streams are devolved to cities, making them partners with stakes in economic development.

An oft overlooked aspect of fiscal decentralization is expenditure power. Very often, the mayor and council of a city do not have delegated authority to incur expenditure that is reasonable relative to the city's budget. They are required to seek approval of the state government for relatively small amounts, which militates against decentralization, besides causing avoidable delays. There is no reason why elected governments at the city level need to be subservient to state-level bureaucrats. This needs to be corrected.

Revenue optimization: Cities do not presently fully exploit the revenue powers devolved to them. There are five stages in the life-cycle of own revenues that cities need to reform: enumeration, valuation, assessment or metering (in the case of user charges), billing and collection, and reporting. Of these, generally, valuation powers rest with the state government. The spirit of decentralization, which is often invoked zealously by the states with the Union government, has not been extended to the third tier. At the very least, states need to update guidance values or circle rates to keep them in line with market values. Cities need to undertake reforms throughout the life-cycle.

Fiscal responsibility and budget management: The legal framework around financial accounting, reporting and budgeting in cities has to be significantly improved. There is no standardized and thus comparable format for budgets and audited accounts in most states, no definite date for filing audited annual accounts or penal consequences for delays, no mandatory accounting standards based on which accounts are to be prepared, and no management accounting systems and processes. Karnataka's pioneering effort close to two decades ago needs to be emulated nationwide.

Transparency and accountability: There is a need for radical transparency and citizen participation in municipal budgets and works. We need details of all tenders, works and payments to be publicly disclosed in machine-readable formats. We also need participatory budgeting to be meaningfully implemented. If actionable information on neighbourhood-level projects is publicly available, it will encourage citizen participation in governance and unleash a virtuous cycle of accountability.

State capacity: The finance and accounts and revenue functions are beset with staff shortages and vacancies, apart from inadequate skills. They need to be professionalized and brought up to private-sector standards. Digitalization needs to be accompanied by process reforms. Parallel systems (one or more digital systems alongside manual records) prevalent in most Indian cities need to be replaced with a single source of truth that is digital.

Most of these reforms fall within the remit of state governments and a few within that of local governments (where too the *de facto* decision-maker is the state government). The 16th FC needs to assume thought leadership and provide guidance and incentives like its predecessors, given the long journey ahead on these reforms.

It should also incentivize the ministry of housing and urban affairs to revise the National Municipal Accounts Manual to bring it up to date with modern standards in accounting, reporting and technology. It should raise the bar further on the quality of audited annual accounts, public disclosure of projects and works, and service-level benchmarks by mandating machine-readable public disclosures. Ensuring high-quality financial and performance reporting would set in motion a virtuous cycle that enables several of the other reforms. If there is one reform that the 16th FC needs to focus on, this is it.

This is the third and final article of a three-part series on the 16th FC and India's cities.