

Why are Finance Commission grants to cities still so limited?

Can cities plan their future when most funds are tied to Central conditions?

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THE GIST

- Despite urban centres generating a large share of GDP and government revenue, the devolution of funds to urban local bodies remains limited, with transfers continuing at around 0.13% of GDP.
- The 16th Finance Commission links a portion of urban grants to performance conditions and increasing own source revenue, raising concerns about fiscal autonomy and federal intervention in urban development.

The story so far:

Cities continue to be the excruciating centres of capital accumulation at an unprecedented pace. Around 90% of total government revenue and nearly 67% of the country's GDP is generated through urban centres. Yet the recommendations of the 16th Finance Commission (FC) emphasise that cities must find avenues to increase their own source revenue and expand the tax base, even as the overall devolution of funds to urban local bodies remains limited.

What do the numbers reveal?

Under the 15th FC, urban local bodies received roughly ₹1.2-1.3 lakh crore over five years. India's GDP during that period hovered around ₹200-210 lakh crore. The urban transfer, therefore, amounted to approximately 0.12-0.13% of GDP.

Under the 16th FC, urban local bodies are to receive around ₹3.56 lakh crore between 2026 and 2031. This translates to roughly ₹75,000 crore per year, far from adequate for urban transformation. India's GDP by then is projected at roughly ₹400 lakh crore, which means the ratio remains almost unchanged at roughly 0.13% of GDP.

Another catch is defining the 'urban'. The data is drawn from multiple sources which estimate that the urban population will reach around 41% by 2031. In simple terms, this means that per capita devolution does not change significantly.

The illusion deepens when per capita figures are introduced. India's urban population crossed 470 million around 2020 and is projected to approach or exceed 600 million during the 2026-30 FC cycle. When urban grants are distributed across this expanded demographic base, per capita transfers stagnate and may even decline in real terms.

Another issue concerns the utilisation of funds. Under the 15th FC, total grants to local bodies amounted to around ₹4.36 lakh crore. Yet a substantial portion remained unspent or pending utilisation, estimated at roughly ₹90,000-95,000 crore, including about ₹30,000-35,000 crore meant for urban local bodies.

What are tied grants?

Tied grants for cities refer to funds earmarked for specific sectors such as water supply, sanitation, and wastewater management, etc. Tied grants hamper fiscal autonomy because States — and cities — are required to spend the funds only on these specified categories.

The approach of the 16th FC is even more aggressive, leaving less space for cities to use funds, as they are also subject to performance-based grants, which means the grants will be released only when certain performance criteria are met. These include improving fiscal discipline, ensuring the proper constitution of local bodies through regular elections, publishing provisional and audited accounts in the public domain, and constituting State Finance Commissions.

All of these are reasonable. However, the problem arises when 20% of the funds are linked to additional conditions, failing which cities will not receive that share. The key condition relates to increasing own source revenue (OSR) through property taxes and user charges. The benchmark kept by the FC is to raise ₹1,200 per household through such revenues.

Why does it raise federal concerns?

A sum of ₹10,000 crore is kept for the one-time incentive for peri-urban merger of urban villages with a population of more than one lakh.

This has two major problems. First, urban development is constitutionally a State subject, and a federal intervention to induce such a transition is dangerous, as merging the peripheries of just 10% of urban towns may translate into lopsided urban integration, with the primary aim being to generate own source revenues. Second, in many States, take for example Kerala, where rural local governments function robustly, merging rural areas into urban agglomerations could create administrative and civic complications. The 16th FC also remains largely silent on climate change and pays little attention to the growing pool of cess revenues collected by the Centre and kept outside the divisible pool. These cess collections now amount to around 2.2% of GDP — roughly ₹8.8 lakh crore. Much of this revenue is generated from cities, yet it still does not appear in the OSR.

The 16th FC appears to miss a basic fibre in the entire exercise: "let cities plan their own futures," while the Centre acts as an enabler. After all, it is their money, and they have a legitimate right to its utilisation.

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