

4. Fiscal Challenges of Indian Municipalities – Polity

Urban India, despite driving two-thirds of GDP, faces severe fiscal weakness as municipalities control less than 1% of tax revenue. Genuine fiscal decentralisation, credit reforms, and empowered municipal financing through bonds are key to reversing this imbalance.

Concerns over the Fiscal Architecture of Municipalities

1. 74th Constitutional Amendment and Functional Responsibilities

The 74th Constitutional Amendment Act (1992) gave constitutional status to Urban Local Bodies (ULBs). It empowered municipalities to perform 18 functions listed in the 12th Schedule, including –

1. Water supply and sanitation
2. Urban planning
3. Solid waste management
4. Public health
5. Fire services and slum improvement

However, while functions have been decentralised, finances have not – creating a mismatch between responsibilities and fiscal powers.

2. Weak Financial Devolution

State governments control the real fiscal power of municipalities. Financial devolution to ULBs remains inconsistent and inadequate across states. Cities depend on State Finance Commission (SFC) recommendations, but many states delay or dilute their implementation. As a result, ULBs often lack predictable and untied revenue streams.

3. Dependence on Higher-Level Transfers

Most urban projects are funded through tied and scheme-based grants such as –

1. Smart Cities Mission
2. Atal Mission for Rejuvenation and Urban Transformation (AMRUT)

These grants restrict local flexibility and innovation since cities must adhere to centrally designed guidelines. This “top-down” model undermines the constitutional goal of urban self-governance.

4. Weak Own-Revenue Base

Property tax, user fees, and local cesses form the mainstay of ULB finances. However, they contribute only 20–25% of potential income due to –

1. Poor property valuation systems.
2. Political resistance to rate revision.
3. Low collection efficiency and outdated records.

In several Indian cities, user charges do not cover even the operation and maintenance costs of urban services like water supply or waste management.

5. Impact of GST

Before GST, cities levied multiple local taxes such as octroi, entry tax, advertisement tax, and local surcharges. These formed nearly 19% of total municipal revenue. The introduction of GST subsumed these taxes into the national framework, effectively removing a crucial source of local revenue. Though States receive GST compensation, municipalities were not included in this fiscal arrangement, leading to greater dependency on State governments.

Constitutional Provisions on Municipal Finances

Constitutional Article	Provision	Key Role
Article 243X	Empowers State Legislatures to authorise municipalities to levy, collect, and appropriate taxes, duties, tolls, and fees.	Provides legal base for municipal taxation.
Article 243Y	Mandates constitution of State Finance Commissions (SFCs) to recommend measures for revenue sharing between the State and ULBs.	Ensures periodic review of municipal financial position.
Article	Empowers the Central Finance Commission (CFC) to	Creates a national-level

280(3)(c)	recommend measures to augment State Consolidated Funds for municipal finance based on SFC recommendations.	linkage between central and local fiscal systems.
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Despite these constitutional safeguards, implementation remains weak, and municipal autonomy remains largely theoretical.

Municipal Bonds – The New Frontier of Local Finance

Definition – Municipal bonds are debt instruments issued by Urban Local Bodies (ULBs) such as municipal corporations or councils to raise funds from investors for infrastructure projects like water supply, roads, or waste treatment.

Examples in India – Pune, Ahmedabad, and Indore have successfully issued municipal bonds in recent years. However, overall participation remains minimal compared to global urban economies.

Current Challenges in Municipal Bonds

1. **Flawed Credit Rating System** – Credit agencies often assess municipal finances without considering regular transfers from States or the Centre. This creates a distorted picture of fiscal health, making cities appear less creditworthy than they actually are.
2. **Low Financial Credibility of Cities** – Many cities lack audited financial statements or timely disclosures. Weak fiscal discipline, political interference, and poor accounting standards reduce investor confidence. As a result, investors fear repayment defaults, deterring participation in municipal bond markets.

Way Forward

1. **Adopt Global Best Practices** – In countries like Denmark, Sweden, and Norway, municipalities have the power to levy local income taxes. This creates direct accountability between citizens and local governments. India can explore similar decentralised fiscal powers while ensuring transparency and checks.
2. **Recognise Transfers as Legitimate Income** – Grants, shared taxes, and state transfers should be treated as part of city income in credit rating frameworks. This will help cities present a more accurate and credible financial position to potential investors.
3. **Reform Credit Rating Mechanisms** – Credit ratings must include governance quality, citizen participation, transparency, and financial discipline, not merely narrow fiscal ratios. Encourage independent auditing and public disclosure of municipal accounts.
4. **Enable Fiscal Innovation** – Allow ULBs to use a portion of GST compensation or State tax share as collateral to back bond issues. Promote pooled financing models – smaller cities can jointly issue bonds with shared guarantees. Encourage municipal infrastructure investment funds supported by public and private institutions.

Conclusion

Urban India's fiscal architecture suffers from a paradox – cities bear the responsibility for delivering essential services but lack the fiscal autonomy and resources to do so effectively. Strengthening municipal finance through genuine fiscal devolution, improved tax collection, restructured credit frameworks, and innovative instruments like municipal bonds is vital to build financially empowered, self-reliant, and accountable urban governments.

Source – <https://www.thehindu.com/news/national/why-is-the-fiscal-architecture-of-municipalities-flawed-explained/article70168668.ece>