



V N Alok
Academician

The 16th Finance Commission and the Future of Local Self-Governments in India

Introduction

Local self-governments, both the *Panchayats* and the Municipalities, have a long history of existence in India. While the *Panchayats* have been around since ancient times, the Municipalities too have been governing the urban areas since the 17th century. Recognizing their importance in governing the grassroots level and their primacy in providing basic services, the Constitution of India placed the subject of 'local government' in the State List of the Seventh Schedule. As these institutions did not form part of the formalised government, the transfer of funds and functions had been *ad hoc* in nature until 1993.

With the passage of the 73rd and 74th Constitutional Amendments, 1993, both the *Panchayats* and the Municipalities got recognition in the book of statute as institutions of self-government, respectively. Consequently, Part IX - The *Panchayats* and Part IX A - The Municipalities, were inserted in the Constitution containing sixteen and eighteen articles respectively. The State Legislature was made responsible for devolving the functions and finances to these local governments.

In general, the related public expenditure incurred by the local governments exceeds the revenue generated by them. Hence, certain

arrangements have been made for regular transfers of funds to them. Articles 243 I & Y necessitate every State to constitute, at regular intervals of five years, a finance commission (SFC), and assign it the task of reviewing the financial position of local governments and making recommendations on the sharing and assignment of various taxes, duties, tolls, fees etc. and grants-in-aid to be given to the local governments from the Consolidated Fund of a State. The provision causes stress on state finances.

Hence, an amendment was also made in Article 280, through an insertion of sub-clauses (bb) and (c), and mandated the Union Finance Commission (UFC) to suggest "measures needed to augment the Consolidated Fund of a State to supplement the resources of the *Panchayats* and Municipalities" respectively. Towards this end, devolution of resources from the Union to States and States to *Panchayats* and Municipalities was considered a necessary requirement.

The fact that Article 280 was amended to add clause (3) (bb) & (c) explains that just as the State government has the responsibility under Article 243

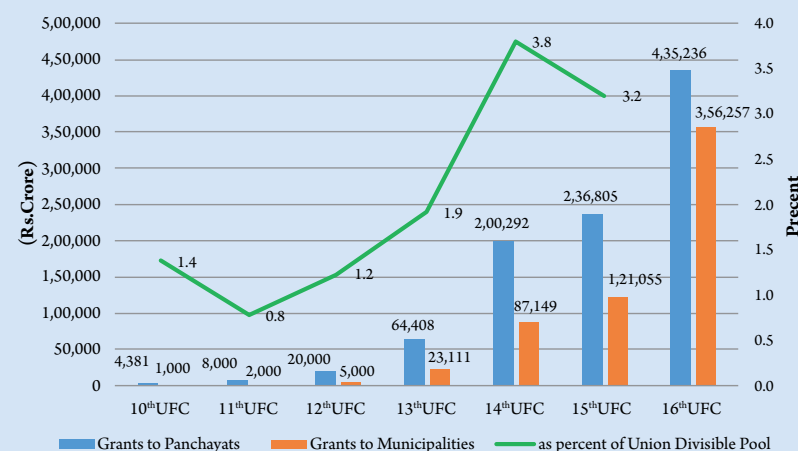
(I & Y) to devolve resources to the *Panchayats* and the Municipalities, the Union government also has a corresponding role and responsibility. It enabled and provided a legal basis for the pass-through of central funds to the local governments, with which the Union has no direct relationship.

Union Finance Commission and Local Governments in the Past

Since 1993, seven Union Finance Commissions (UFCs) have provided grants-in-aid to local governments. Figure 1 below shows grants to local governments by the successive UFCs, in absolute terms and their percentage share in the Union tax divisible pool.

The 10th UFC, chaired by Shri K. C. Pant, recommended a grant of a) Rs. 100 per capita for the rural population amounting to Rs. 4,381 crore for *Panchayats*, and b) Rs. 1,000 crore for Municipalities. This share constituted 1.38 percent of the Union divisible tax pool. Subsequently, the 11th UFC, led by Prof. A. M. Khusro and the 12th UFC headed by Prof. C. Rangarajan,

Figure 1: Transfers to Local Governments by Successive Union Finance Commissions



Source: Report of the 15th and 16th Union Finance Commissions

made certain allocations as shown in Figure 1. Each one of them increased the grants by about three times that of the previous allocation.

The 13th UFC, led by Dr. Vijay Kelkar, marked a departure from the earlier practice of *ad hoc* lump-sum grants and introduced a share of the local governments in the Union tax divisible pool i.e., 1.42 percent for *Panchayats* and 0.51 percent for Municipalities, resulting in a total grant of Rs. 87,519 crore for the period 2010-15. However, the 14th Commission, led by Dr. Y. V. Reddy, reverted to the earlier approach by recommending an *ad hoc* grant of Rs. 2,00,292 crore for *Panchayats* and Rs. 87,149 crore for Municipalities.

At the beginning, the share of *Panchayats* in the total local government grants was substantially high, which consistently declined over the years, only to assign increasing importance to Municipalities. Figure 2 shows that Municipalities have been given a consistent rise in their share, from 19 percent in the 10th UFC to a significant 45 percent in 16th UFC, highlighting the increasing importance to urban governance in the context of urbanisation.

Recent Background for the 16th UFC

The 15th UFC, chaired by Shri N. K. Singh, proposed Rs. 2.37 lakh crore

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for *Panchayats* and Rs. 1.21 lakh crore for Municipalities during 2021-26 as shown in Figure 1. Amid the backdrop of COVID-19, the Commission also recommended special grants of Rs. 70 thousand crore exclusively for primary health care systems. Further, the grants recommended for Municipalities were categorized as: basic grants of Rs. 82.9 thousand crore for smaller cities (<1 million population), and 100 percent performance-linked grants of Rs. 38.2 crore for million-plus cities *via* a Challenge Fund. It also provided Rs. 8000 crore as performance-based grants for the incubation of new cities, and Rs. 450 crore for shared municipal services. The 15th UFC's total grants, including special grants accounted for 3.2 percent of the Union's divisible tax pool.

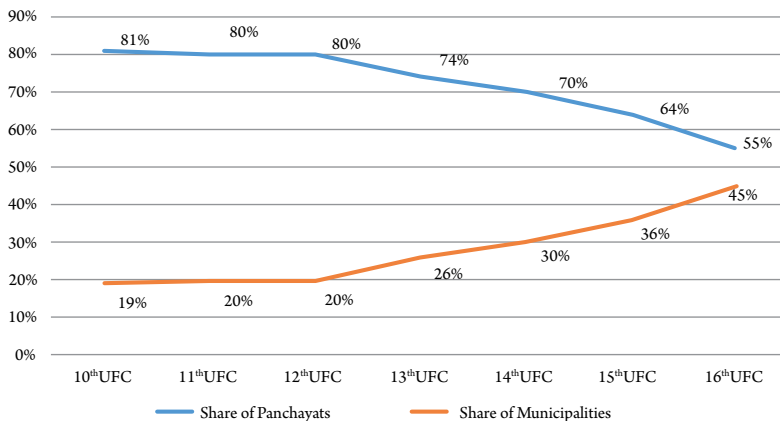
The grants for *Panchayats* and the basic grants for cities other than million-plus cities were to be utilized as follows: 40 percent as untied grants to address local felt needs as per the 11th and 12th schedules (excluding salaries and other establishment costs), 30 percent earmarked for drinking water and water management, and the remaining 30 percent for sanitation, including the maintenance of open defecation free (ODF), solid waste, and faecal sludge management. Performance grants for Municipalities, on the other hand, incentivized service level benchmarks (SLBs) for urban drinking water supply, sanitation, and solid waste management and air quality improvements in larger cities.

As part of the eligibility criteria for availing grants, the Commission required states to set up the State Finance Commission (SFC) and follow its recommendations by March, 2024, in order to qualify for grants for 2024-25 and 2025-26. Additionally, to strengthen accountability, states were mandated to ensure that *Panchayats* publish provisional and audited accounts online. However, Municipalities were expected to go beyond this and fix minimum property tax floor rates and improve collection efficiency.

Transfers to Local Government by the 16th UFC

The 16th UFC, under the leadership of Prof. Arvind Panagariya, has scaled up allocations to Rs. 4.35 lakh crore for *Panchayats* and Rs. 3.56 lakh crore for Municipalities for a period of five years commencing April 1, 2026. The grants for Municipalities include targeted support to growth centres through components such as the Urbanisation Premium of Rs. 10 thousand crore and the Special Infrastructure Component of Rs. 56.1 thousand crore. The Urbanisation Premium supports planned rural-urban transitions by helping states in building administrative structures and delivering basic services in expanding

Figure 2: Trend in Respective Shares of Panchayats and Municipalities in Total Grants by Successive Union Finance Commissions



Source: Various Union Finance Commission Reports



urban areas, while the Special Infrastructure Component is aimed at boosting wastewater management systems in 22 cities with populations between 1-4 million.

Both rural and urban¹ grants are subdivided into basic and performance grants in an 80:20 ratio. Of the basic grant, 50 percent is tied to sanitation and solid waste management, and/or water management. Funds can also be utilized toward operation and maintenance expenditure of these items. The remaining 50 percent of the basic grant and the entire performance grant are untied in nature, with a proviso that these cannot be used for salaries or establishment expenses, with a cap of 20 percent on road-related spending. The entry-level conditions for availing basic grants promote better governance through continued reforms such as mandatory audits, regular elections, and the formation of SFC and tabling of its Action Taken Report (ATR) within six months of the submission of SFC report, etc., thereby improving transparency, accountability, and the overall functioning of the local governments.

The performance grant, both for *Panchayats* and Municipalities, is further split equally between the rural/

urban performance component and state performance component. Under the first component, the Commission aims to strengthen fiscal capacity by considering local governments' own source revenue (OSR) performance. Under the second component, it requires states to transfer at least 20 percent of the UFC's basic grant equivalent to local governments from their own sources. These are the qualifying conditions for availing the performance grant.

Additionally, to access the urbanization premium, states need to merge peri-urban villages into adjoining larger municipalities with a population of at least one lakh and formulate a rural-to-urban transition policy. For the Special Infrastructure Component, municipalities are required to undertake a detailed study in the first year of the award and enter into an MoU with MoHUA and the state government.

Focus of UFCs on Good Accounting Practices

Successive UFCs have made important recommendations to improve the accounting practices of the local governments. The 11th UFC required the Comptroller and Auditor General (CAG) to supervise the record-keeping and auditing of the local government accounts, with audit reports to be inspected by the designated state legislative committee. The 12th UFC emphasized the need for disaggregated financial data (as per CAG formats) and a modern accounting system and databases. The 13th UFC supported the continuation of CAG guidance over Local Fund Audit Departments (LFADs) and proposed measures to strengthen them. The 14th UFC underscored the need to distinguish between various revenue sources in local government accounts, ensure timely auditing and compilation of accounts, and made the submission of audited accounts – up to two years prior – a condition for eligibility for performance

grants for both *gram panchayats* and Municipalities. It also supported the continuation of the technical guidance by the CAG to LFADs as suggested by the 13th UFC. The 15th UFC further reinforced these requirements by mandating the online availability of both provisional and audited accounts as a prerequisite for receiving local government grants. This practice has been carried forward in the 16th UFC recommendations.

While these reforms have significantly improved transparency, accountability, and the availability of financial information, enabling more informed decision-making for both *Panchayats* and Municipalities, the 16th UFC notes that there is a lot that remains yet to be completed to assure the obtainability of exact accounts and their audits in a timely manner.

Implications

A trend towards progressive fiscal transfers to local governments by the successive UFCs since the 73rd and 74th CAAs shows the strengthening of these institutions through a predictable channel of funds. Anchored in the Constitutional amendments, these grants have supplemented the resources of the third-tier of the government, enabling better service delivery and stronger democracy.

Allocation of Funds as Tied and Untied Grants

Successive UFCs have recommended tied grants to basic services like sanitation, solid waste management, health, drinking water, education, etc., to improve service delivery outcomes. At the same time, untied funds have been provided for the locally felt needs of these governments. Lastly, the 16th UFC has rebalanced the composition of basic grants by moving from the 15th UFC's 60:40 tied-untied ratio to a 50:50 distribution. While this shift increases the share of untied funds, tied grants continue to support essential services. The higher share of untied

¹ Excluding the share of urban premium and special infrastructure component.

grants enables local governments to use such funds according to their own priorities and community needs, whether that involves repairing a road, supporting cultural activities, or investing in small-scale infrastructure projects. This flexibility strengthens fiscal decentralisation and enhances their ability to respond effectively to local demands.

Revenue Mobilisation Efforts

The 15th UFC recommended performance grants exclusively for the urban sector, requiring Municipalities to set property floor rates in the first year, and ensure that property tax collections grew in line with GSDP in subsequent years for the remaining years of the award period. However, this condition led to fewer states qualifying for grants, with numbers falling from 22 in 2023-24 to 16 in 2024-25, as per MoHUA's submission to the 16th UFC.

In contrast, the 16th UFC has suggested performance-linked grants based on the growth in OSR for both *Panchayats* and Municipalities. *Panchayats* are expected to increase their OSR annually by a minimum of 2.5 percent in 2027-28, or achieve 2.5 percent annual compound growth over OSR of 2025-26, whichever is lower, subject to Rs. 1200 per household per annum.



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For Municipalities, the requirement is a 5 percent annual growth, with an emphasis on increasing OSR from all sources, comprising rent earnings, income from holdings, service fees and the like. Since the local governments have the necessary powers to tax and levy user charges, the expected revenue mobilization efforts can lead to significant improvements in OSR.

Accountability and Audits

As mentioned above, the UFCs over the years have emphasized timely preparation and auditing of accounts with oversight by the CAG. Eligibility for performance grants was linked to the submission of audited accounts, compelling compliance. Both the 15th and 16th UFCs have mandated the online publication of provisional and audited accounts, making financial data accessible to the public. These reform measures may result in significantly enhanced transparency and availability of financial data for informed policy-making.

Increasing Share of Municipalities

The share of Municipalities has increased steadily from 19 percent in the 10th UFC to 45 percent in the 16th UFC, reflecting India's urban transition and the growing demands on urban infrastructure and governance. The 15th UFC highlighted that India's economic growth depends on well-managed urbanization. It recognised cities as

key drivers of growth, investment, and poverty reduction, and stressed the need for better financing and governance of Municipalities. Building on this, the 16th Finance Commission emphasized planned urbanisation through timely identification of emerging urban areas, clear transition policies, and stronger administrative capacity, along with adequate financing and sound planning to improve productivity and liveability.

The growing emphasis of the UFC on increased transfers to municipalities reflects a clear recognition of cities as engines of economic growth. By strengthening financial support, improving governance frameworks, and enabling better planning, these measures are likely to enhance urban infrastructure, service delivery, and institutional capacity.

Timely Constitution of SFC

The UFC is required to make transfers to the local governments based on the recommendations of the SFC reports. Since the 73rd and 74th CAAs, the states were expected to constitute their seventh SFC by 2024; however, only six states, viz., Assam, Haryana, Himachal Pradesh, Kerala, Tamil Nadu, and Rajasthan, have done so. This has made it difficult for the UFCs to base their recommendations on the SFC reports.

In order to fulfil this constitutional mandate, there has been a consistent push for reforms from the successive UFCs. The 15th UFC made the constitution of SFCs and the laying of an explanatory memorandum before the State Legislature a mandatory condition for availing local government grants. This resulted in a significant positive influence on the constitution of SFCs by various states and the subsequent laying of their reports along with the corresponding Action Taken Report (ATR) in the respective State Legislatures.

The 16th UFC has continued this conditionality and further mandated that the ATR must be tabled in the State Legislature within six months of submission of the SFC report.

This measure is expected to improve compliance further and strengthen the institutional framework.

Impact of Census Operations

The 16th Census began in April 2026 with the first phase, covering house-listing and housing census, while the main population enumeration is scheduled for February 2027. All the administrative units have been frozen for the period January 1, 2026 to March 31, 2027, including *Panchayats* and Municipalities, until the census is completed. It is to be noted, however, that the resultant delimitation of constituencies and administrative divisions may affect the disbursal of grants to the local governments. The 16th UFC has not addressed this matter, making it necessary to put arrangements in place to ensure the smooth transfer of funds to these institutions.

Conclusion

The 16th Finance Commission, like its predecessors, has supported the local governments through increased allocation with a stronger accountability framework for transparent and responsive governance. However, States have to come forward to comply with the 16th UFC's conditions i.e., a) strengthen the institution of SFC, b) conduct regular elections at local levels, c) publish

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annual accounts regularly, d) empower and incentivize the local governments to collect their OSRs efficiently, and e) provide matching contribution of 20%. They also need to meet the preconditions for special grants, such as the urbanization premium and special infrastructure component.

With respect to accounts and audit, it is expected that the CAG will provide Technical Guidance and Supervision to the LEADs. Due to these conditions, the state governments will enhance their skills and address the issue of manpower shortage.

Notably, *Panchayats* have advanced in accounts reporting through the eGram Swaraj portal, covering over 2.6 lakh *Panchayats*. They follow the cash-based Model Accounting System (MAS), which simplifies accounting for all tiers of *panchayats*, tracks scheme-wise fund flows, and aligns with Union and state government accounts. Building on this momentum, efforts are underway to standardize municipal accounting practices, with the CAG-initiated revision of National Municipal Accounts Manuals (NMAM) 2.0, in consultation with reputed agencies, including the Institute of Chartered Accountants of India (ICAI).

Successive UFCs have also recommended raising the ceiling on professional tax from Rs. 2,500 per annum, as prescribed in the Constitution. This ceiling was last

revised in 1988 through the sixtieth Constitutional Amendment. In some states, professional tax is levied and collected by the state government, while in others, it is administered by Municipalities. Given that nearly four decades have elapsed since the last revision and considering inflation as well as expansion of the tax base, it is imperative to undertake appropriate legislative amendments to enhance the permissible limit to supplement the resources of the local governments.

Additionally, an amendment to Article 285 of the Constitution is necessary to enable state and local governments to levy property tax on Union government properties, or at the very least, to recover the cost of local services provided to such properties.

All UFCs, except the 14th edition, have recommended grants to local institutions in the tribal areas falling under the Fifth and Sixth Schedules. These grants were designed largely on the lines of *Panchayats*, with varied approaches. The 16th UFC has also reaffirmed the importance of supporting representative institutions in exempted areas and has recommended state government to make allocations to these areas at par with local governments in other areas. Since the Constitution (125th Amendment) Bill, 2019, is pending in the Parliament, a robust framework for the intergovernmental fiscal transfers to these areas will take time.



Author may be reached at
vnalok@gmail.com and
eboard@icai.in