2. 16th Finance Commission- Economy

The 16th Finance Commission chaired by Arvind Panagariya, recommended ₹7,91,493 crore in grants to rural and urban local bodies along with structural reforms to strengthen local governance

Finance Commission- Constitutional Position and Role

The Finance Commission is a constitutional body established under Article 280 of the Indian Constitution. It is constituted by the President of India every five years or earlier if required. The Commission acts as a neutral arbiter of fiscal federalism, balancing the financial interests of the Union and the States.

Its recommendations cover-

1. Distribution of net tax proceeds between Centre and States.
2. Allocation of States' share among individual States.
3. Grants-in-aid to States and local governments.

Although its recommendations are not legally binding, conventionally they are largely accepted to preserve cooperative federalism. The Centre must, however, place an Action Taken Report (ATR) before Parliament explaining acceptance or deviation.

Tax Devolution Mechanism

Vertical Devolution (Centre–State Share)

Vertical devolution determines the percentage of the Centre's divisible pool of taxes transferred to States.

It directly affects-

1. Fiscal autonomy of States.
2. Ability of States to finance social sector and capital expenditure.

A higher vertical devolution strengthens fiscal decentralisation but reduces Centre's discretionary spending capacity.

Horizontal Devolution (Inter-State Distribution)

Horizontal devolution distributes the States' share among individual States based on an objective formula.

Common criteria include-

1. Population (both 1971 and 2011 census to balance equity and demographic performance).
2. Income distance (to support poorer States).
3. Demographic performance (fertility control).
4. Area and forest cover (ecological services).
5. Tax and fiscal effort.

This ensures-

1. Equity between richer and poorer States.
2. Incentivisation for governance and fiscal discipline.

Grants Beyond Tax Devolution

Apart from tax devolution, the Centre supports States through-

1. Sector-specific grants.
2. Performance-linked grants.
3. Grants for local bodies (Panchayats and Municipalities).

These grants are crucial for addressing horizontal imbalances not fully resolved by tax sharing alone.

Challenges in Financing Local Bodies

Low Own-Source Revenue

Local bodies' revenues account for around 0.4% of GDP, far below global benchmarks.

Property tax-

1. Under-assessed.
2. Poorly administered.
3. Politically sensitive, leading to low collection efficiency.

User charges for water, sanitation, and solid waste management are often irrational or absent.

Excessive Dependence on Transfers

Panchayats and municipalities rely heavily on-

1. Central Finance Commission grants.
2. State government transfers.

This limits-

1. Fiscal autonomy.
2. Long-term planning.
3. Accountability to local citizens.

Weak State Finance Commissions (SFCs)

Many States-

1. Delay constitution of SFCs.
2. Ignore or selectively implement SFC recommendations.

This disrupts-

1. Predictable fiscal flows.
2. Constitutional decentralisation under Articles 243I and 243Y.

Administrative and Technical Capacity Constraints

Lack of trained personnel in-

1. Budgeting.
2. Accounting.
3. Project appraisal.

Weak internal audit mechanisms lead to-

1. Under-utilisation of funds.
2. Delays in service delivery.

Key Recommendations for Strengthening Local Bodies (2026–31)

Financial Allocations- Total allocation of ₹7,91,493 crore for local bodies during 2026–31. Reflects growing recognition of local governments as third tier of governance.

Rural–Urban Distribution

Grants divided in a 60-40 ratio-

1. Rural Local Bodies (RLBs)- 60%.
2. Urban Local Bodies (ULBs)- 40%.

Aims to balance-

1. Rural development needs.
2. Rapid urbanisation pressures.

Mandatory Entry-Level Conditions

Release of grants conditional upon-

1. Constitutional compliance- Proper and regular constitution of elected local bodies.
2. Financial transparency- Timely publication of provisional and audited accounts.
3. Institutional discipline- Timely constitution of State Finance Commissions.

These conditions promote-

1. Accountability.
2. Rule-based fiscal decentralisation.

Urbanisation and Infrastructure Reforms

Urbanisation Premium

₹10,000 crore one-time incentive grant.

Encourages States to-

1. Merge peri-urban villages with urban local bodies (population >1 lakh).
2. Prepare a Rural-to-Urban Transition Policy.

Addresses challenges of-

1. Urban sprawl.
2. Unplanned growth.
3. Service delivery gaps in census towns.

Special Infrastructure Component

₹56,100 crore earmarked for-

1. Wastewater and sanitation infrastructure.
2. Cities with populations between **10–40 lakh**.

Aims to-

1. Improve urban public health.
2. Reduce river and groundwater pollution.
3. Support sustainable urbanisation.

Way Forward- Strengthening Fiscal Federalism at the Grassroots

Expand own-source revenues through-

1. Rationalised property tax structures.
2. GIS-based property mapping and valuation.
3. Improved user charge recovery mechanisms.

Make State Finance Commission processes-

1. Time-bound.
2. Rule-based.
3. Transparent, with mandatory Action Taken Reports.

Institutionalise-

1. Dedicated municipal and panchayat cadres.
2. Continuous capacity-building and professional training.

Standardise digital governance tools-

1. Unified accounting software.
2. Real-time auditing systems.
3. Public disclosure and citizen dashboards.

Conclusion

A robust Finance Commission framework, coupled with empowered local governments, is essential for-

1. Deepening cooperative and competitive federalism.
2. Achieving inclusive growth.
3. Realising the constitutional vision of grassroots democracy.

Source- https-//www.downtoearth.org.in/governance/16th-finance-commission-recommends-rs-8-lakh-crore-grant-to-local-bodies-for-next-5-years