

# **THE XVI FINANCE COMMISSION – PUTTING INDIA’S URBAN FUTURE AND URBAN LOCAL GOVERNMENTS IN THE FOREFRONT**

**Dr Ravikant Joshi**



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Layout and Design by Aishwarya M

Published in March 2026

Published by  
Centre for Public Policy Research (CPPR)  
First Floor, Mandoli House, New Link Road  
Elamkulam, Kochi, Kerala, India-682020

[www.cppr.in](http://www.cppr.in) | E-mail: [research@cppr.in](mailto:research@cppr.in)

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## Abstract

The XVI Finance Commission submitted its report for the period 2026–2031 in November 2025, which was accepted by the GOI and tabled with the Explanatory Memorandum as to the Action Taken on the Recommendations Made by the Sixteenth Finance Commission in February 2026. The XVI Finance Commission has provided a substantial increase of 230% in allocations compared to XV Finance Commission to urban local governments by adopting the rightly projected share of urban population of 40.73% by 2031, which actually increases to 45% of the total allocation to local bodies due to two special grants: Planned rural–urban transition and Special infrastructure grants for Wastewater treatment in 22 cities; mandating state transfers to ULG at least at the rate of 20% of FC grants; restoring primacy of untied grants (60% of total) with greater autonomy to ULGs to spend funds on needs identified by themselves, thus giving impetus to financial decentralisation and incentivizing systematic rural-urban transition. Besides these, there are other welcoming measures for improving financial sustainability, accountability, transparency and service delivery performance of ULGs, thus firmly putting India’s Urban Future and Urban Local Governments in the forefront. This article takes stock of the XVI Finance Commission’s approach towards the local governments, urban-rural relationship and transitions, issues it tried to address through recommendations about quantum and types of allocations, conditionalities and, finally, what it may have missed out.

## 1. Commission's Approaches

The Commission has viewed ***“Urbanisation as a catalyst for economic development. Cities concentrate resources, including physical and human capital, infrastructure and civil amenities, thereby fostering consumption, innovation and employment opportunities”<sup>1</sup>***.

While acknowledging the importance of urbanisation, the Commission has avoided an exclusive thrust for urbanisation and has adopted a perfect balance for rural and urban in its approach by stating, ***“We recognise that expanding urbanisation is critical to raising the living standards in both urban and rural areas. Workers who migrate to urban areas do so in response to superior economic opportunities that help them raise their own as well as their extended families’ living standards. In addition, such migration increases land per worker in rural areas, thereby boosting average worker productivity in these areas.”<sup>2</sup>*** thus stressing the symbiotic, complementary relationship between urban and rural development.

Elaborating on its approach further Commission underline role of urbanisation in improving overall value added per worker and rural and urban income, which is utmost important for India to become a developed nation (विकसित भारत), as follows –

***“46 per cent of India’s workers are still in agriculture, and only 17.8 per cent value added (at current prices) in agriculture in 2023-24, average value added per worker in industry and services combined is 3.9 times that in agriculture. Therefore, the movement of workers out of rural into urban areas, which is strongly correlated to the movement out of agriculture into industry and services, holds considerable potential to raise the overall value added per worker. Considering this important role of urbanization in contributing to both rural and urban incomes, in our recommendations for ULB grants, we have paid explicit attention to an improvement in urban infrastructure of mid-size cities so that they are better prepared to respond to the rising demands of urbanization. Additionally, we have recognised that there is a pressing need for a good rural-to-urban transition framework to facilitate smooth and timely incorporation of peri-urban areas, administered as rural areas, into existing adjoining ULBs”<sup>3</sup>***.

Another welcoming approach of the Commission is towards rural-urban transition (conversion of census towns to statutory municipal governments). It commissioned a study in this aspect with the support of the World Bank<sup>4</sup>. It states that ***“timely and rule-based identification of urban areas, coupled with proper planning and adequate financing, are crucial for imparting impetus to India’s urbanisation while concurrently enhancing the productivity and liveability of its cities. Ideally, each State should establish a clear transition policy to ensure the timely and rule-based identification of areas attaining urban characteristics.***

<sup>1</sup> Report of XVI Finance Commission, Vol. 1, Para No. 10.53; Page no. 205

<sup>2</sup> Report of XVI Finance Commission, Vol. 1, Para No. 10.46; Page no. 204

<sup>3</sup> Report of XVI Finance Commission, Vol. 1, Para No. 10.47-48; Page no. 205

<sup>4</sup> The writer of this article had a privilege to be part of the World Bank Team which prepared study report for the XVI Finance Commission.

***This policy should include a well-defined and time-bound mechanism and a phased approach for their transition to urban administrative units. The transition period should be utilised to establish appropriate urban administrative capacities and mechanisms for urban planning, the provision of urban services and infrastructure to citizens and the seamless transfer of records and information to the new administration. In essence, such policies should be aimed at raising the resources, infrastructure, services and political and administrative capacities to urban levels<sup>5</sup>.***

The issue of Census Towns not having urban administration that is not getting converted to statutory municipal governments has been identified by earlier finance commissions and many other reports. A negative incentive was also prescribed to incentivise the conversion of census towns into statutory municipal bodies by the States, but as evident from the above, the XVI Commission has taken a pragmatic approach towards this issue and provided special allocation for incentivising such transition.

Another significant and pertinent approach it has taken is about the role a Finance Commission should play through allocations. It has rightly rejected a gap-filling role, but more importantly and for the first time, it has linked FC grants to the States' own grants to local bodies. In unambiguous words it states its approach – ***“it has been suggested that FC should play a gap-filling role, based on the expenditure requirements of local bodies and revenues from their own sources and grants from the States assessed by the SFCs. Such an approach runs the risk of making the States and the local bodies complacent in their revenue-raising efforts. A better alternative is to link the FC grants to States' own grants to local bodies and revenue efforts by the local bodies themselves. The primary responsibility of making adequate financial resources available to local bodies rests with the States. Transfers from Union, based on the recommendations of FCs, are meant to only supplement the State consolidated funds.<sup>6</sup>”***

Commission substantiates its approach by stating the fact that ***“Our data analysis shows that there is significant heterogeneity in transfers of resources to local bodies by the States. While some States are making substantial transfers to local bodies, others provide at best limited funding to them”.***

XVI Finance Commission's recommendations are based on the above detailed and other related approaches.

<sup>5</sup> Report of XVI Finance Commission, Vol. 1, Para No. 10.55; Page no. 206

<sup>6</sup> Report of XVI Finance Commission, Vol. 1, Para No. 10.80; Page no. 213

## 2. Recommendations

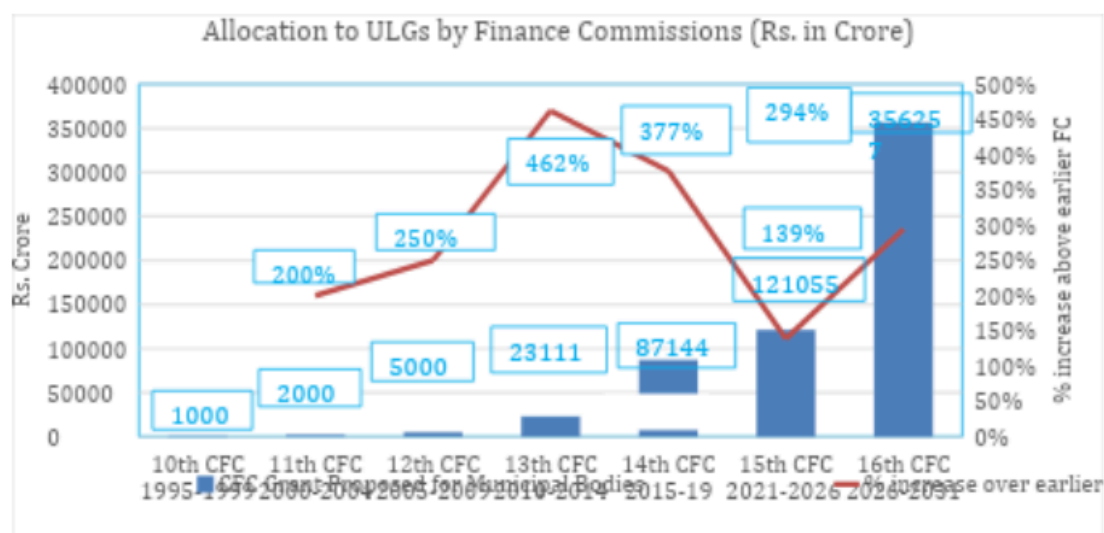
The XVI Finance Commission outlines its recommendations in detail as follows:

- 1. Own Source Revenue improvement by ULGs as a criterion for horizontal distribution of Grants** – the XVI FC has adopted an important change which may go unnoticed: a change in criteria for horizontal (inter se) distribution of grants to Urban Local Governments (ULGs). Earlier FCs adopted various criteria, but XIV and XV FCs adopted only two criteria – population (90% weightage) and area (10% weightage) for inter se distribution.

XVI FC has retained both population and area criteria for inter se distribution of grants to Rural Local Governments, but has dropped the criteria of area for ULGs and adopted an index based on Own Source Revenue (OSR) with 10% weightage, while retaining the criteria of population with 90% weightage. (Para 10.89)

This change in the inter se distribution of grant criteria has rewarded States in which the % share of OSR of ULGs is high with higher allocation in grants, which will incentivise States to take steps to improve the OSR of their ULGs.

- 2. Substantial increase in allocations for ULGs** – it can be observed from Figure A that the XVI commission has increased allocation by 294% compared to the XV finance commission. There has been an increase in the past, which was higher in percentage terms, but the base was very small. Here, the increase is over a higher base, and therefore it is substantial and unprecedented.

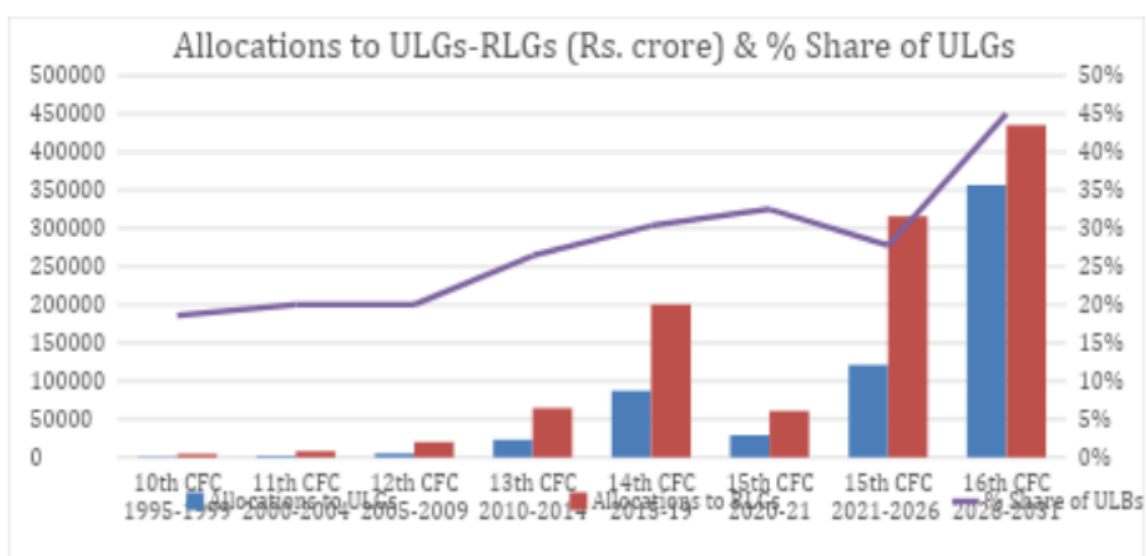


**Table 1 – Allocations Proposed by Central Finance Commissions for ULGs (Rs. in Crore)**

|   | 10th CFC<br>1995-<br>1999 | 11th<br>CFC<br>2000-<br>2004 | 12th CFC<br>200-2009 | 13th<br>CFC<br>2010-<br>2014 | 14th<br>CFC<br>2015-<br>2019 | 15th<br>CFC<br>2020-<br>2021 | 15th<br>CFC<br>2021-<br>2026 | 16th<br>CFC<br>2026-<br>2031 |
|---|---------------------------|------------------------------|----------------------|------------------------------|------------------------------|------------------------------|------------------------------|------------------------------|
| CFC Grant<br>Proposed for<br>Municipal Bodies | 1000                      | 2000                         | 5000                 | 23111                        | 87144                        | 29250                        | 121055                       | 356257                       |
| % increase over<br>earlier                    |                           | 200%                         | 250%                 | 462%                         | 377%                         | Interim                      | 139%                         | 294%                         |

The % increase in allocation by XVI FC over XV FC is even more (of 327%) if pass-through allocation of Rs. 12139 crores given by XV FC from ULGs’ allocation for Ambient Air Quality, which was not a municipal function.

- 1. Recognising Share of Urban Population and Role of Urbanisation provided 45% share in allocations for ULGs** - taking into consideration projected urban population share of 40.73% in 2031 and the need to convert census towns and peri-urban areas under statutory municipal governments, the XVI Commission increased the share of allocations to ULGs to 45%, is a very timely and appropriate decision.



**Table 2 – Share of ULGs (%) in Allocation to Local Governments by Central Finance Commissions**

| Rs. in Crore          | 10th CFC<br>1995-1999 | 11th CFC<br>2000-2004 | 12th CFC<br>2005-2009 | 13th CFC<br>2010-2014 | 14th CFC<br>2015-2019 | 15th CFC<br>2020-2021 | 15th CFC<br>2021-2026 | 16th CFC<br>2026-2031 |
|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| Allocations to ULGs   | 1000                  | 2000                  | 5000                  | 23111                 | 87144                 | 29250                 | 121055                | 356257                |
| Allocations to RLGs   | 4381                  | 8000                  | 20000                 | 64407                 | 200292                | 60750                 | 31530                 | 435236                |
| Total Allocations LGs | 5381                  | 10000                 | 25000                 | 87518                 | 287436                | 90000                 | 436361                | 791493                |
| % Share of ULGs       | 19%                   | 20%                   | 20%                   | 26%                   | 30%                   | 33%                   | 28%                   | 45%                   |

**2. Restored balance between tied and untied components of grants** – the share of untied grants in total grants is one of the important indicators of financial decentralisation, as untied grants allow LGs to spend funds on local needs. A higher share of untied grants indicates a higher degree of financial decentralisation. On the other hand, tied grants are also important to ensure grants are spent on certain basic priorities or national priorities by the ULGs. There exists a need for balance between tied and untied grants. This balance had been disturbed by XV FC, which allocated only 21% grants as untied compared to the untied grant's share of 75% under XIII FC and 80% under XIV FC allocation. The XVI FC has tried to correct this imbalance. It states that, ***“we recommend tying 50 per cent of the basic component and leaving the remaining 50 per cent of the basic component and the entire performance component untied. The tied component should be directed towards ‘Sanitation and Solid Waste Management’ and/or ‘Water Management’. Within the tied component, full flexibility should be available to local bodies to address their needs, including O&M expenditures for the above tied items. The untied component of the local body grants would be 50 per cent of the basic component which is 80 per cent of the total LB grants (40 per cent) and 100 per cent of the performance component which is 20 per cent of the total LB grants (20 per cent), subject to fulfilment of both the performance conditions, adding up to a total of 60 per cent of the basic plus performance grants”***<sup>7</sup>.

<sup>7</sup> Report of XVI Finance Commission, Vol. 1, Para No. 10.107-108; Page no. 220

This way, the XVI FC has tried to provide 60% share to untied grants with full freedom to ULGs regarding its use. If the two special grants—the Special Infrastructure grant, valued at Rs. 56100 crore, and the Urban Transition grant, valued at Rs. 10000 crore—are considered tied grants, they will be included in the calculation. Urban transition of Rs. 10,000 is considered as tied grants and is considered in the calculation; still, untied grants share works out to 50%. Thus, XVI FC has achieved a perfect balance of 50:50% between the tied and untied nature of grants and has corrected the imbalance created under XV FC allocations.

1. **Ensuring linkage of State Transfers to ULGs to FC Allocation through State Performance Grant Component** – How much funding should states transfer to ULGs? There is no minimum-maximum ceiling or benchmark. There cannot be, and there should not be a maximum limit, but a minimum ceiling can be suggested, and XVI FC has tried to do that by clearly articulating the constitutional position – that the primary responsibility of making adequate financial resources available to local bodies rests with the States. Going further to incentivise such linkage of state transfers to ULGs to FC allocation, it has provided a state performance grant component of Rs. 29016 crores.
2. **Primacy of Funding for Municipal Functions Only** – The 12th Schedule, introduced vide the 74th constitutional amendment, lists 18 functions which have been traditionally managed by the ULGs and the XVI FC has not provided its allocations outside these functions like the XV FC which provided funds for ambient air quality and even though Ministry of Environment, Forest and Climate Change proposed continuation of air quality grant for 42 MPCs and inclusion of three more MPCs (Kannur, Kochi and Kollam), which were excluded under the FC-15 period. Further, the Ministry proposed the inclusion of 51 cities with a population of 5-10 lakh for air quality grants.

Air pollution is certainly a serious issue in Indian cities and must be addressed by providing the necessary funds to the respective central ministries, state departments, and institutions mandated for controlling it. Controlling air pollution is not a function of ULGs under municipal or any other legislation in India. ULGs do not have control, powers or an institutional structure to control air pollution; still, XV FC allocated Rs. 12139 crores out of a total of Rs. 121055 crores to ULGs. ULGs were required to transfer these funds to the police department or use them for installing air quality monitors for pollution control boards, which consequently reduced the funds available for basic municipal functions such as water supply, sewerage, and solid waste management. XVI FC has rightly corrected this aberration / misallocation.

3. **Funding for planned rural-urban transition** – Census towns and peri-urban areas do not get converted to statutory municipal areas, which is an old issue and whenever they get converted, they get converted in most of the cases on an ad hoc basis. The XVI FC has provided for the first time a special one-time grant of Rs. 10,000 crores for census towns/peri-urban areas merged with adjoining ULGs with a population of more than 1 lakh, provided States formulating a rural-urban transition policy. This grant is aimed at supporting existing ULGs to upgrade basic infrastructure and capacity to deliver services in newly included areas. (Para 10.113 – 10.114)

- 4. Special Infrastructure Grant for Wastewater Management System** – of Rs. 56,100 crores for selected 22 cities (two per State) with populations less than 40 lakhs but more than 10 lakhs, as per the 2011 Census. This amount will finance projects worth up to ₹5,000 crore in cities with populations of 15 lakh or more, and up to ₹3,500 crore in cities with populations of less than 15 lakh, with the Union Government covering 60 per cent of the project cost and the State Government contributing the remaining amount. (Para 10.117)
- 5. Continuing with financial accountability and constitutional mandate conditionalities** – XVI FC has retained entry-level eligibility conditions introduced by XV FC with regard to conducting ULG elections, timely constitution of SFCs and mandatory tabling of the Action Taken Report in the state legislature within six months of submission of the SFC report by the State Government and publication of audited accounts by the ULGs. (Para 10.92 to 10.95)
- 6. Improving predictability, accountability and transparency regarding transfers by State to ULGs** – One more important recommendation XVI FC has made is about States transparently reporting all transfers to local bodies, including those from the Consolidated Fund of India on the recommendation of the Finance Commission, transfers under centrally sponsored schemes, State Finance Commission grants and other grants from the State Government, separately for ULBs and RLBs in their budgets. These transfers, with all their components, should also be reported in Appendix III of the State Finance Accounts. (Para 10.78)
- 7. Emphasizing, Extending Scope of Various Other Reforms – as follows -**
- a. **Service Level Benchmarks** - Building on reforms introduced by XV FC, the XVI FC has made publication of Service Level Benchmarks (SLBs) by all ULGs. Recognising that the quality and reliability of SLB data published by some ULGs is inadequate, the FC has requested MoHUA to develop a third-party assessment, audit, or similar mechanism to ensure the quality and reliability of SLB data, in consultation with state governments, ULGs, and the Auditor General of India. (Para 10.110)
  - b. **Timely Disbursement of Grants** – The XVI FC recommended that instead of waiting for Statewide Compliance (where all ULGs meet the conditions) for the release of grants, which delays disbursement, grants should be disbursed to ULGs that meet the eligibility criteria. (Para 10.122)
  - c. **Property Tax Reforms** – Like earlier FCs, the XVI FC has stressed property tax reforms and has asked State Governments to develop a citizen-friendly GIS-based property tax IT system and link it to all other databases. (para 10.67)
  - d. **Extending the Urban Data platform's capabilities** by the State Governments to support ULBs in preparing accounts and financial reports. (para 10.71)
  - e. **Learning Management System to be developed by MoHUA & MoPR** – for the functionaries and staff of local bodies, so that the functionaries in the local bodies are geared up to meet the present-day challenges. (Para 10.103)

## Missed Out Directions, Reforms

The XVI FC has done a commendable job as discussed above and has put India's Urban Future and Urban Local Governments in the forefront, yet it missed out on certain directions and reforms which would have added more density and dynamism to urban sector reforms. The following are the missed opportunities and reforms. Even if the FC report has not covered or recommended them, the Government of India and the State Governments can adopt and implement them to complement the XVI FC endeavour.

1. **Lack of differential approach for OSR improvement by ULGs** - The XV FC introduced a condition that the rise in property tax be at the same rate as nominal GSDP, which most of the ULGs failed to attain and therefore failed to claim FC grant. Data provided by MoHUA also suggested that the number of State claims for FC grants went down from 22 States in 2023-24 to 16 States in 2024-25 due to the mandatory condition of the property tax growth. The data also indicated that the overwhelming majority of the ULBs that could not meet this condition of FC-15 belong to the category of cities with a population of less than 1 lakh.

In light of the above, the XVI FC replaced the XV FC condition of a rise in property tax at the same rate as nominal GSDP and adopted OSR, which is a broader base, as it comprises all tax and non-tax resources of ULGs in place of a single-source base property tax for measuring ULGs' performance and reduced the rise in OSR to 5 per cent per annum compounded growth applied over OSR of 2025-26 for a ULG to qualify for the ULG Performance Component Grant. (Para 10.99).

Thus, XVI FC adopted a better, broad-based indicator of OSR in place of property tax for performance measurement of ULGs, but a reduction in the rate of increase in OSR to 5% per annum in place of nominal SGDP as a performance grant condition was necessary only for cities having less than 1 lakh population. The reduction in the rate of increase in revenue should not have been applied for all the ULGs across the board, the way XV FC had applied the '**same size fits all**' approach for all ULGs. This is because ULGs with more than a million people have the potential to increase their OSR (including property tax, other taxes and non-tax resources) at a rate equal to or even more than the nominal GSDP growth rate. FC should have adopted differential performance conditions for ULGs as follows:

- ULGs with a population of a million or more – OSR to increase at the same rate as nominal GSDP
- ULGs with a population from 1 lakh to 1 million – OSR to increase at the rate of 75% of the nominal SGDP growth rate
- ULGs with a population of less than 1 lakh – OSR to increase at the rate of 5 per cent per annum, as XVI rightly recommended.

**A. Non-mandating Participatory Capital Investment Plan (CIP)/City Infrastructure Development Plan (CIDP)** – ULGs in India lack long-term capital investment or city infrastructure development vision and planning; as a result, they lack effective prioritisation of projects and funding

for the projects. ULGs also lack citizen engagement in the planning and governance of the city. The absence of these two aspects is the root cause of various planning and implementation issues at the ULG level. XVI FC should have mandated preparation of CIP/CIDP in a participatory manner to avail ULGs performance grant component, or should have provided a special grant for this purpose.

***B. Inadequate push for transparency – As noted earlier, XVI FC retained the entry-level condition of online availability in the public domain of audited accounts for all ULBs and RLBs of a State for the introduced by XV FC. (Para 10.93) But it failed to strengthen transparency further even though it observed that, “Owing to the conditionalities stipulated by previous FCs, the availability of local body data has significantly improved over the years, the reliability and consistency issues impeded our analysis of data as well. Multiple rounds of efforts were required to obtain data free of obvious errors. Nevertheless, some data quality issues persisted until the very end. This experience has led us to conclude that there is an urgent need to address issues related to the quality and reliability of financial data relating to local bodies” (Para 10.74 & 10.75).***

XVI FC faced issues regarding the availability, quality, and reliability of financial data related to ULGs because, in order to qualify for XV FC's grant, ULGs have begun to publish their annual accounts publicly; however, there is no independent agency mandated to verify whether these publicly available accounts are audited, timely, and of adequate quality. It has been found that no ULGs has placed in the public domain the auditor's observations and objections on annual accounts. Also, various other performance data placed in the public domain are quite different from the actual situation.

In light of the quality and reliability of financial data problems it faced, the XVI FC should have mandated faster publication of annual accounts by ULGs, an independent statutory audit of annual accounts of ULGs with full disclosure of the auditor's observations and an independent mechanism guided and supervised by CAG to verify availability, timeliness, quality and reliability of financial and other performance data of ULGs to improve transparency and accountability of ULGs.

### Summing Up

Though XVI FC missed some reforms and opportunities to take forward local government reforms, it can be said it has done a commendable job of putting India's Urban Future and Urban Local Governments in the forefront for attaining Vikasit Bharat (विकसित भारत). The reforms which it missed to guide can easily be undertaken by the Government of India, State Governments and ULGs to attain the Viksit Bharat (विकसित भारत) dream.



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