

ENHANCING FISCAL DECENTRALIZATION IN GRASSROOTS GOVERNANCE: CRITICAL CHALLENGES AND EMERGING OPPORTUNITIES FOR INDIA'S THIRD TIER OF GOVERNMENT

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Abstract

Fiscal decentralization, which means giving sub national governments the power to spend money, collect taxes, and make fiscal transfers, is particularly important for making democratic governance stronger, enhancing service delivery, and encouraging local development. The 73rd and 74th Constitutional Amendments in India (1992) set up a legal system for third-tier governance (Panchayats and Urban Local Bodies); however the process of turning constitutional requirements into budgetary independence and administrative power has not been smooth. This paper critically analyzes legal-institutional frameworks, the development of intergovernmental fiscal transfers (including recent Finance Commission reforms), the enduring limitations that obstruct substantial fiscal decentralization (such as narrow own-revenue bases, fragmented or tied grants, inadequate public financial management, capacity deficiencies, and accountability voids), and the current prospects offered by digitalization, accrual accounting initiatives, property tax modernization, blended finance, and participatory governance. Drawing on government reports (including the Fifteenth Finance Commission and NITI Aayog), World Bank and NIPFP studies, and empirical literature (notably Kerala's people's planning experience and state-level case studies), the paper offers an integrated set of policy recommendations and an implementation sequencing roadmap to strengthen fiscal autonomy, accountability and performance of India's third tier.

Keywords: Fiscal Decentralization, Panchayati Raj, Urban Local Bodies, Finance Commission, State Finance Commission, Property Tax, Accrual Accounting

Introduction

Since the early 1990s India has pursued decentralization as a means to democratize governance and improve delivery of basic services. The landmark 73rd and 74th Constitutional Amendments (1992) provided constitutional recognition to Panchayati Raj Institutions (PRIs) and Urban Local Bodies (ULBs), specified evolvable functions, mandated regular elections, and required the constitution of State Finance Commissions (SFCs). However, constitutional recognition by itself is insufficient to ensure that local governments possess the fiscal capacity and administrative autonomy necessary for effective governance. Meaningful decentralization requires the alignment of functions with resources, authority over local revenues, robust intergovernmental transfer systems, modern public financial management (PFM) systems and local administrative capacity. This paper analyses India's progress and shortcomings on these fronts and proposes a practicable reform agenda.

Methodology and Scope

This is a desk-based, policy-analytic study synthesizing primary government documents (Finance Commission reports, NITI Aayog publications, Ministry releases), major

institutional studies (World Bank, NIPFP), peer-reviewed literature, and recent news and policy commentaries to present an up-to-date, evidence-based assessment. Emphasis is placed on (a) the constitutional and institutional architecture for local finance in India; (b) the design and effects of vertical transfers and SFCs; (c) the main barriers to fiscal autonomy at the grassroots; and (d) policy and technological innovations that can be scaled. Two state-level experiences Kerala's people's planning and illustrative findings from Karnataka and other states are used to draw practical lessons. The study does not present new primary field data but integrates and interprets extant empirical work and policy documents to construct actionable recommendations.

Institutional Landscape of Local Finance in India

Constitutional Framework and Assigned Functions

The 73rd and 74th Amendments embedded local governance in the Constitution (Part IX for Panchayats and Part IXA for Municipalities), added the Eleventh and Twelfth Schedules listing subjects that may be devolved, and mandated the constitution of SFCs every five years to recommend resource sharing between states and local bodies. These reforms aimed to make local governments meaningful units of self-government rather than merely elected bodies with symbolic power. In practice however, the degree of functional devolution and the assignment of revenue sources and personnel powers vary significantly across states. This heterogeneity has major implications for how fiscal decentralization unfolds on the ground.

Finance Commissions and Vertical Transfers

At the Union level, successive Finance Commissions (FCs) determine the sharing of tax revenues between the Centre and states and recommend grants-in-aid. In recent cycles, particularly the 14th and 15th FCs, there has been an increased focus on strengthening transfers to local governments through larger devolutions and the introduction of performance-linked grants for local bodies (including earmarked and untied components). The Fifteenth Finance Commission recommended substantive transfers (Rs. 4.36 lakh crore for 2021–26 across rural and urban local bodies and health grants) and introduced instruments intended to provide both predictable resources and incentives for improved outcomes. The precise mix of untied block grants, tied funds, and performance incentives has a decisive influence on local discretion and accountability.

State Finance Commissions and Intergovernmental Relations

SFCs (Article 243-I) are the constitutionally mandated institutions to recommend distribution of state resources to PRIs and ULBs. Yet SFCs' effectiveness varies widely: some states undertake methodologically rigorous, evidence-based SFC exercises with meaningful stakeholder consultations, whereas others delay SFC constitutions, produce limited analyses or make recommendations that are poorly implemented. The heterogeneity in SFC performance and in state policy choices largely explains the inter-state variation in local fiscal autonomy and service outcomes. Strengthening SFC independence and technical capacity can significantly improve the predictability and equity of intergovernmental fiscal relations.

Literature Review: Evidence on Decentralization Outcomes

Academic and institutional literature on fiscal decentralization in India yields three core insights. First, decentralization improves targeting and responsiveness when local governments control meaningful resources and have appropriate capacity; second, excessive reliance on tied grants and narrow own-source revenues reduces local discretion and weakens accountability; and third, capacity constraints in planning, financial management and service delivery are critical bottlenecks. The World Bank's review of panchayat finances (2004), NIPFP analyses, and numerous academic evaluations (including work evaluating Kerala's experiments) emphasize that institutional design particularly the congruence of functions,

finances and personnel matters greatly for outcomes. Comparative international literature similarly shows that decentralization's benefits are conditional on adequate fiscal instruments and strong local institutions.

Persistent Challenges to Fiscal Decentralization

This section synthesizes key constraints that continue to limit the ability of India's third tier to perform effectively.

Narrow Own-Revenue Base and Overdependence on Transfers

A pervasive challenge is that most PRIs and many ULBs have a constrained own-revenue base. Property tax the most important municipal own-source revenue in urban areas is widely under-utilized due to outdated valuation, weak registers, political pushback on revaluation, and poor collection systems. In rural areas, local fee bases are thin and often administratively weak. Consequently, local governments remain heavily dependent on intergovernmental transfers, reducing incentives for local revenue mobilization and weakening the fiscal accountability chain between citizens and local authorities. Modernizing property tax systems (GIS mapping, regular revaluation) and rationalizing user charges are essential to broaden local revenue bases.

Fragmented, Tied Grants and Conditionalities

Transfers to local bodies frequently come as scheme-specific tied grants that carry performance and procedural conditionalities. Although some tied grants are necessary to ensure delivery of national priorities (e.g., sanitation, health), excessive fragmentation increases administrative overhead and limits integrated local planning. Moreover, conditionalities that emphasize compliance over outcomes can disincentivize local innovation. The introduction of performance-linked grants by the Finance Commission is a welcome step, but such mechanisms must be designed to reward substantive outcomes (service quality, financial management) rather than narrow inputs.

Weak Public Financial Management, Accounting and Audit

Many local bodies lack robust accounting systems, timely audits and transparent reporting. Traditional cash-based systems obscure the true financial position of local bodies and make it difficult to manage capital expenditures or to access capital markets. Audit backlogs and weak enforcement of audit recommendations are common in several municipal corporations. Transitioning to integrated PFM systems and accrual accounting can improve transparency, asset management and investor confidence — essential preconditions for market financing and long-term planning. NITI Aayog's 2023 knowledge product on transition to accrual accounting outlines models and learnings for ULBs seeking this transition.

Capacity Deficits and Human Resource Constraints

Local governments often face shortages of technical staff (engineers, planners, accountants), inadequate training programs, and personnel systems under state control that limit local managerial autonomy. This human resource gap undermines the ability of PRIs and ULBs to prepare project proposals, manage infrastructure, raise revenues or implement procurement and contracting effectively. Establishing local cadres, investing in continuous professional development and creating regional technical support hubs are practical steps to address these deficits.

Accountability, Political Economy and Equity Concerns

Electoral institutions exist at the local level, but the quality of accountability varies. Political interference, patronage networks, and opacity in procurement and revenue administration weaken trust and raise governance risks. Additionally, decentralization can exacerbate inter-local inequalities unless transfers are calibrated to account for fiscal capacity and need. Strengthening transparency (open budgets, published audits), participatory institutions (Gram Sabhas, ward committees) and social audits is critical for improving local accountability and

fairness. Kerala's people's planning offers evidence that participatory mechanisms can improve priority alignment and oversight when matched with resources.

Emerging Opportunities and Innovations

Despite the obstacles, several recent developments present concrete opportunities to deepen fiscal decentralization.

Finance Commission Directions: Increased Devolution and Performance Grants

The Fifteenth Finance Commission (2021–26) marked a significant fiscal commitment to local governments, recommending substantial grants totalling roughly Rs. 4.36 lakh crore for local bodies across tiers and introducing performance-linked components aimed at incentivizing good municipal practices and incubation of new cities. Such macro-fiscal support, when combined with reforms to improve absorption capacity and financial management, can substantially strengthen local governments' fiscal position. However, the effectiveness of these transfers depends on predictability, timeliness and the balance between untied and tied components.

Digitalization and GIS-enabled Property Tax Reforms

Digital tools GIS-based property registers, online billing and collection, e-procurement and integrated financial management systems can substantially improve revenue administration, reduce leakages and make financial flows auditable. Several municipalities and states have piloted GIS property mapping, improving coverage and assessment. Adoption at scale would materially strengthen municipal own-revenues and reduce citizen grievances. Toolkits and practitioner guides (e.g., by Janaagraha) outline stepwise property tax reforms for cities.

Accrual Accounting and Modern PFM for ULBs

Moving from cash-based to accrual accounting enables local bodies to capture asset values, depreciation, and liabilities providing a truer fiscal picture and facilitating medium-term fiscal planning and capital project evaluation. NITI Aayog's analysis of accrual transition models identifies lessons for implementation and suggests phased pilots, capacity building and IT integration as key success factors. Realizing accrual accounting across states would be transformative for municipal creditworthiness and for integrating capital investment planning with financing strategies.

Access to Market Finance: Municipal Bonds and Pooled Financing

Municipal bonds and pooled financing mechanisms offer long-term capital for infrastructure if municipalities can demonstrate creditworthiness through reliable revenues and robust accounting. Recent policy discussions and market interest (including proposals to expand interest subvention support) indicate a renewed push to broaden municipal bond issuance; however, only a small number of large municipal entities have accessed this market successfully. Technical assistance, state guarantees or pooled credit enhancement vehicles can help mid-sized cities access capital at scale.

Participatory Budgeting and Social Accountability Practices

Kerala's people's planning campaign demonstrates that deep citizen participation linked to fiscal transfers can improve local planning, targeting and accountability. Participatory budgeting and social audits adapted to local contexts can help align resources with citizen priorities, reduce leakages and build local ownership of public investments. Scaling such practices requires sustained capacity building and political commitment.

State-Level Illustrations: Kerala and Select Studies from Karnataka

Kerala: People's Planning Campaign (PPC)

Launched in the mid-1990s, Kerala's PPC devolved planning responsibilities to local governments and required participatory processes (Ward Sabhas, Gram Sabhas) to determine local priorities. Evaluations find that the PPC improved outreach and service access in several

dimensions and strengthened civic engagement; however, long-term sustainability depends on predictable funding and institutionalized capacities. Kerala illustrates that deep devolution of decision-making, combined with capacity investments and social mobilization, can yield improved developmental outcomes.

Karnataka: Evidence from Gram Panchayats

Micro-level studies in Karnataka reveal common issues: transfer dependence, constrained revenue effort, and variability in administrative practices. These case studies emphasize that state policy choices (e.g., firm support for capacity building, clear revenue assignments, stronger SFC processes) can influence the degree to which gram panchayats convert devolved responsibilities into tangible service improvements. The Karnataka example underscores that decentralization's success is path-dependent and shaped by state institutional frameworks and political economy.

Policy Recommendations: A Coherent, Sequenced Reform Agenda

To convert the promise of constitutional decentralization into sustainable fiscal empowerment, a multi-pronged reform strategy is required. The recommendations below combine fiscal instruments, institutional strengthening, capacity development and citizen engagement, sequenced to manage political economy constraints.

Strengthen Own-Source Revenues (Short–Medium Term)

- *Property tax modernization:* Implement GIS mapping, update assessment rolls and introduce transparent, phased revaluation programs with clear communication to citizens. Use digital billing and incentives for compliance. (Evidence: successful pilots and toolkits).
- *Rationalize user charges:* Review and set user charges to reflect service costs with socially-sensitive safeguards for the poor; automate collections where feasible.
- *Diversify fees:* Allow local bodies discretion to levy context-appropriate fees (market fees, parking, waste user charges) within state frameworks.

Rationale: Strengthening own revenues increases autonomy and accountability, reduces dependence on transfers and builds fiscal responsibility.

Recalibrate Transfers: Predictability and Smart Incentives (Medium Term)

- *Increase untied block grants:* Expand predictable untied financing to cover basic operating costs and enable local priority setting.
- *Design performance grants around outcomes:* Tie a portion of grants to measurable improvements (financial reporting, service coverage, sanitation targets) rather than procedural checklists.
- *Consolidate fragmentation:* Where possible, consolidate small, multiple tied transfers into larger programmatic blocks to reduce administrative burden.

Rationale: This balance preserves national priorities while giving local bodies flexibility for integrated planning.

Strengthen SFCs and Vertical Intergovernmental Mechanisms (Short–Medium Term)

- *Institutionalize technical support for SFCs:* Provide independent technical secretariats, standardized methodologies and stakeholder consultations.
- *Create state–local fiscal councils:* Regular forums for negotiation and problem-solving between state and local governments on responsibilities, transfers and capacity needs.

Rationale: Credible, evidence-based SFC recommendations improve equity and predictability across local bodies.

Modernize PFM: Accrual Accounting, Audit and Transparency (Medium Term)

- *Phased accrual adoption:* Scale NITI Aayog-recommended pilots, invest in IT systems and train accountants to migrate to accrual accounting.

- *Strengthen audit institutions:* Ensure timely audits, public disclosure of audit findings and enforcement mechanisms for corrective action.
- *Open financial data:* Mandate machine-readable budget and expenditure data publication to enable civic monitoring and private sector due diligence.

Rationale: Modern PFM underpins creditworthiness, market access and sound capital planning.

Build Human Capital and Technical Capacity

- *Create local government cadres:* Provide career paths, training and incentives for municipal finance and engineering personnel.
- *Regional technical assistance centres:* Offer project preparation, procurement support and revenue management assistance to smaller local bodies.

Rationale: Capacity is the operational glue that converts resources into quality services.

Mobilize Market Finance and Blended Instruments (Medium–Long Term)

- *Pooled financing and credit enhancement:* Establish state-level pooled vehicles and provide credit guarantees or subvention to lower borrowing costs for mid-sized ULBs.
- *Standardize project pipelines:* Encourage well-prepared, bankable project pipelines to attract private finance.

Rationale: Market instruments can finance large capital needs if municipalities demonstrate robust revenues and transparent accounts.

Deepen Participatory Governance and Social Accountability

- *Scale participatory budgeting and Gram/Ward Sabhas:* Institutionalize community inputs into budgets and monitor expenditures via social audits.
- *Leverage digital grievance and feedback platforms:* Use e-governance to reduce friction in citizen oversight.

Rationale: Citizen engagement strengthens legitimacy, priorities alignment and monitoring.

Sequencing and Implementation Pathway

Effective reform requires pragmatic sequencing that balances political feasibility with technical readiness:

1. *Short term (0–2 years):* Publish budgets and audit backlog clearances; begin GIS mapping pilots for property tax; form technical secretariats for SFCs.
2. *Medium term (2–5 years):* Scale accrual accounting pilots, introduce performance-linked grant frameworks, professionalize municipal finance units and launch pooled credit vehicles.
3. *Long term (5+ years):* Consolidate market access (municipal bonds), institutionalize local cadres and mainstream participatory budgeting across larger sets of local bodies.

This sequencing lets capacity grow in tandem with fiscal autonomy, reducing the risk of unfunded mandates and governance failures.

Conclusion

India's fiscal decentralization is an uncompleted but ongoing undertaking. Constitutional acceptance of municipalities in 1992 secured democratic form; the difficulty ever since has been translating form into fiscal substance. The Fifteenth Finance Commission's large transfers, development of digital PFM platforms, accrual accounting pilots and revived interest in municipal capital markets are concrete possibilities. However, to provide enhanced service outcomes and deepen local democracy, reformers need to address inherent problems: small revenue bases dispersed tied grants, poor accounting and audit regimes, capacity shortfalls and accountability gaps. A consistent reform package strengthening topics: local

revenues through property tax reform, raising predictable untied transfers while metering performance incentives, strengthening SFCs, shifting to new PFM (including accrual accounting), facilitating market access for well-governed ULBs, and deepening participatory governance provides a realistic way forward. With sequencing and state-sensitive implementation, these reforms can make India's third tier financially independent, accountable and effective in providing the developmental promise of local democracy

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