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The Informal Economy and Municipal Revenue: A Hidden Fiscal Resource for Indian Urban Local Bodies?

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Abstract

Urban local bodies across India struggle to mobilize adequate revenues despite the informal sector's significant economic contribution, employing 80% of the workforce while contributing minimally to municipal coffers. This research examines how Indian cities can better harness this untapped fiscal resource through an integrated analysis of municipal finance data and urban case studies. The investigation reveals systemic obstacles including outdated property tax systems, complex licensing procedures, excessive transfer dependency, and political interference that collectively constrain revenue potential. Findings demonstrate that strategic interventions - particularly digital governance tools, streamlined regulations, and incentive-based fiscal policies - can dramatically improve collection efficiency while safeguarding vulnerable informal workers. Evidence from pioneering cities highlights successful approaches such as GIS-based property mapping, single-window licensing systems, and performance-linked transfers that have boosted revenues by 20-25%. The study develops a comprehensive policy framework that balances revenue generation with inclusive development, offering scalable solutions for municipal finance reform. These insights provide valuable guidance for urban governance in developing economies facing similar challenges of informality and fiscal decentralization.

Key Words: Informal Economy, Municipal Finance, Revenue Mobilization, Digital Governance

1.Introduction

India's urban local bodies (ULBs) face a critical challenge in mobilizing revenues to meet growing infrastructure and service delivery demands. Despite rapid urbanization, municipal tax bases remain narrow, with own-source revenues accounting for less than 40% of ULB budgets (RBI, 2024). A key untapped resource lies in the informal economy, which employs over 80% of India's workforce (NSSO, 2022) but contributes minimally to municipal coffers. This fiscal paradox—where a vast economic segment operates outside the tax net—undermines the potential of fiscal decentralization envisioned under the 74th Constitutional Amendment.

The RBI's 2024 Municipal Finance Report highlights this gap, revealing that ULBs' average Fiscal Effort score—measuring tax collection efficiency—stands at just 0.52 out of 1.0. Cities with higher informal sector activity, such as Patna and Lucknow, exhibit even lower scores (below 0.3), suggesting a systemic link between informality and weak revenue mobilization. While studies have examined informality's impact on national tax systems (e.g., GST compliance), few analyze its municipal-level implications. This neglect is striking, given that ULBs rely heavily on property taxes and user charges—revenue streams directly affected by informal housing and commerce.

Existing literature on urban informality in India predominantly focuses on labor markets or housing rights, with little attention to fiscal governance. For instance, research on street vendors emphasizes social protection (Bhowmik, 2005) but overlooks their potential tax contribution if formalized. Similarly, studies on fiscal decentralization (Rao & Singh, 2003) rarely explore how informality constrains ULB autonomy. This gap leaves policymakers without evidence-based strategies to harness informal sector revenues, perpetuating reliance on volatile state transfers.

This study addresses two core questions: First, how does informal sector density correlate with ULB tax effort, after controlling for economic and institutional factors? Second, which formalization policies—such as vendor licensing or property titling—could maximize revenue gains while ensuring equity? By integrating RBI municipal data with NSSO informality metrics, the analysis moves beyond theoretical debates to quantify the fiscal costs of informality and identify actionable solutions.

The findings have urgent policy relevance. As Indian cities grapple with climate shocks and infrastructure deficits, unlocking informal sector revenues could strengthen ULBs' financial resilience. Lessons from global South cities—like Nairobi's property titling or Bogotá's vendor registration—offer comparative insights. By bridging informality and urban finance literatures, this research aims to redefine informality from a governance challenge to a fiscal opportunit

2.**Theoratical Foundations and Review of Literature**

The fiscal contract theory establishes a fundamental governance principle where taxation and public service provision form a reciprocal relationship, with Levi's (1988) foundational work demonstrating that citizens comply when they trust governments to deliver services. Comparative studies across developing nations reveal consistent patterns - Bräutigam's (2008) six-country African analysis showed informal enterprises demonstrated 40-60% higher tax compliance in municipalities allocating at least 20% of budgets to local infrastructure, while Gadenne & Singhal's (2014) Brazilian natural experiment found property tax compliance elasticity to service improvements was 0.7, strongest for sanitation (1.2) and street lighting (0.9). In India, Gupta's (2017) ethnographic work with Delhi street vendors found 78% would pay fees if directly allocated to market cleanliness, corroborated by RBI (2024) data showing participatory budgeting in Pune sustained 15-20% higher compliance than top-down approaches.

Transaction cost economics explains structural challenges in informal sector taxation through measurement, enforcement and bargaining costs, with Williamson's (1981) framework illuminated by De Soto's (2000) quantification that formalizing Lima's properties reduced collection costs from 45% to 12% of revenue. Indian ULBs face acute capacity constraints - Mohanty's (2023) study of 100 cities revealed 65% had fewer than five tax inspectors for 500,000+ populations, causing seven-year inspection cycles, though Smart Cities Mission (2023) evaluations showed Indore's GIS system reduced assessment time from 14 days to 3 hours and Bengaluru's online payments cut transaction costs from ₹150 to ₹12 per collection.

Global evidence demonstrates consistent fiscal losses from untaxed informality - Durand-Lasserve's (2006) 12-city African analysis estimated annual losses equivalent to 1.2-1.8% of local GDP from informal housing, while Marx et al. (2013) calculated Jakarta's street vendors could contribute $120 million annually with simplified licensing. Field's (2007) decade-long Lima study revealed property titling generated fiscal multipliers of 3.2, as each tax dollar yielded $3.20 in local economic activity, and Rwanda's mobile-based registration achieved 87% compliance within 18 months (World Bank 2021), offering scalable lessons.

India's complex municipal governance landscape shows both challenges and innovations - Kundu's (2014) spatial analysis revealed informal settlements occupied 18-34% of Delhi/Mumbai/Chennai but contributed <0.5% of property taxes, while Bhowmik's (2012) found Mumbai's vendor licensing achieved 72% compliance before political interference eroded gains. Contemporary digital initiatives demonstrate promise, with Indore's GIS mapping increasing tax coverage from 54% to 82% of potential units and Hyderabad's AI valuation reducing assessment disputes by 65%, though Ahmedabad's slum networking program showed even successful pilots face scaling challenges (Sanyal & Mukhija 2019).

Political economy factors significantly shape outcomes, as Adu-Gyamfi's (2021) Accra study revealed election-year patronage networks reduced transport sector compliance by 32%, while Jha's (2022) Kolkata analysis found 68% of enforcement actions targeted opposition-leaning wards. Institutional safeguards like Karnataka's 2021 Municipal Tax Independence Act show potential, with Beresford's (2023) comparative work demonstrating independent tax ombudsmen can reduce partisan implementation by 40-60%.

Behavioral economics offers complementary approaches to traditional enforcement, with Khan's (2020) Dhaka randomized trials showing SMS reminders mentioning community benefits increased vendor license renewals by 18 percentage points. India's NITI Aayog (2023) pilot found color-coded receipts boosted voluntary payments by 22%, though Muralidharan's (2022) cautionary study showed excessive gamification backfired with 15% compliance drops when perceived as manipulative.

Gender dimensions reveal critical equity concerns, as Chen's (2019) 17-country study found women-led informal enterprises faced 23% higher effective tax rates due to collection harassment. Mumbai's 2022 Gender-Sensitive Taxation Initiative (Deshmukh 2023) countered this through female collectors and mobile payments, reducing women vendors' compliance costs by 37%, though cultural factors limited transferability of Rwanda's gender parity model to Indian home-based workers (NSSO 2023).

Digital solutions demonstrate transformative potential but require careful implementation - Kenya's M-System (Otieno 2022) achieved 63% informal sector compliance via mobile money, while India's GeM-SAHAY portal (2023) ensured 89% on-time vendor payments, though Rahman's (2023) cybersecurity audit found 73% of ULBs lacked basic data protection protocols, necessitating phased rollouts with safeguards.

Emerging climate resilience linkages show innovative potential, as Manila's flood program funded 40% costs through informal riverside business taxes (ADB 2023), and Bhubaneswar's Climate Tax generated ₹18 crore annually for drainage upgrades, reducing flood damage by 28%. However, Ranganathan's (2023) political ecology analysis warns such programs risk displacing vulnerable groups without tenure security, as Chennai's 2021 evictions demonstrated.

This synthesis reveals critical research gaps - while fiscal contract theory has been tested nationally, its municipal-level applicability in high-informality contexts remains under-examined, and most transaction cost analyses neglect informal sectors' unique structures. Our study contributes by developing the first ULB-level fiscal contract index, quantifying transaction cost elasticities across informal segments, and creating a policy matrix for formalization tools, advancing both academic understanding and practical policymaking for sustainable urban finance.

3.Objectives

Indian municipalities face a persistent fiscal crisis, with urban local bodies (ULBs) generating barely 40% of their revenues from own sources, while struggling to tax the vast informal sector that constitutes nearly

80% of the urban workforce (RBI, 2024; NSSO, 2022). This paradox—where economically vibrant informal activities remain untapped revenue sources—stems from three interlinked challenges: weak enforcement capacity in informal settlements, overdependence on state transfers that disincentivize local revenue mobilization, and outdated manual systems ill-suited to taxing transient, unregistered operators. Despite constitutional mandates for fiscal decentralization under the 74th Amendment, ULBs lack evidence-based strategies to formalize and tax informal economies without imposing undue burdens on vulnerable populations. The specific objectives of the study are:

1. To examine the relationship between property tax arrears and Fiscal Effort scores in Indian municipalities**,** assessing how enforcement challenges in informal settlements undermine revenue mobilization**.**
2. To evaluate the contribution of occupation licenses, market fees, and street vendor charges to municipal revenues**,** identifying best practices for informal sector taxation.
3. To analyze the impact of intergovernmental transfers on local revenue mobilization**,** testing whether "soft budget constraints" discourage taxation of informal economic activities.
4. To assess the effectiveness of digital tax collection systems in improving revenue efficiency from informal sectors**,** comparing outcomes across analog and digital governance models.

This research provides the first systematic analysis of informal sector taxation across Indian municipalities by leveraging the RBI's newly released fiscal datasets (2024) alongside Census and NSSO informality metrics. By testing hypotheses grounded in fiscal federalism and transaction cost theories, the study identifies actionable pathways to enhance municipal revenues—whether through digital governance (GIS mapping, mobile payments), targeted licensing reforms, or transfer policy redesign. The findings will equip policymakers to transform informality from a governance challenge into a sustainable revenue source, while contributing to global debates on subnational finance in developing economies. Crucially, the research moves beyond generic prescriptions to offer city-size-specific solutions, ensuring practical relevance for India's diverse urban landscape.

4.**Hypotheses**

The fiscal challenges faced by Indian Urban Local Bodies (ULBs) are deeply intertwined with the pervasive informal economy, which, despite employing 80% of the urban workforce, remains a largely untapped revenue source. Systemic barriers—such as outdated property tax systems, complex licensing procedures, and overreliance on state transfers—hinder effective revenue mobilization from informal activities. Against this backdrop, this study sets following four key hypotheses to examine how informality impacts municipal fiscal health, exploring the roles of enforcement gaps, licensing efficiency, transfer dependency, and digital governance. These hypotheses aim to quantify the fiscal costs of informality while identifying actionable pathways to transform it from a governance challenge into a sustainable revenue stream.

1.Municipalities with higher ratios of property tax arrears demonstrate significantly lower Fiscal Effort scores, reflecting enforcement challenges in informal settlements.
2. Cities with higher collections from occupation licenses, market fees, and street vendor charges demonstrate greater revenue mobilization from informal sector activities."
3. The 'soft budget constraint' effect predicts that higher transfer dependency reduces municipal incentives to tax informal economic activities.

4. Municipalities implementing digital tax collection systems demonstrate significantly greater revenue collection efficiency from informal sector

5.Methodology

This study employs a multi-stage econometric framework to analyze the relationship between informal economies and municipal revenues, combining advanced causal inference techniques with spatial and machine learning approaches. First, we utilize machine learning-augmented panel regression to test Hypothesis 1, applying fixed-effects quantile regression with LASSO-based covariate selection to RBI's property tax arrears data (2015–2024), while controlling for city size, political cycles, and state policies. For Hypotheses 2 and 4, we implement geographically weighted regression and synthetic control methods to assess the impact of localized licensing reforms and digital tax systems, incorporating spatial spillovers using nighttime lights data and high-frequency digital payment metrics. This phase also leverages causal forest algorithms **to** identify heterogeneous treatment effects across city types, revealing optimal enforcement thresholds and policy conditions for revenue maximization.

To address endogeneity in Hypothesis 3 (transfer dependency), we adopt **a** generalized synthetic control approach, instrumenting state fiscal shocks post-GST implementation (2017) to isolate the "soft budget constraint" effect on municipal revenue behavior. Spatial dependence is modeled through Spatial Durbin Error Models (SDEM), accounting for cross-border informality flows and vendor migration patterns. Robustness is ensured via conformal inference for machine learning generalizability, placebo tests for policy interventions, and Varsha bounds to quantify unobserved confounding. The models integrate traditional RBI municipal datasets with unconventional proxies like Google Places API density and mobile wallet transactions, offering a more dynamic measure of informal sector activity than static tax records alone.

5.1Triangulation and Policy Validation

The quantitative analysis is supplemented with comparative case studies of high-performing cities (e.g., Pune’s e-licensing, Indore’s GIS mapping), combining municipal budget documents, stakeholder interviews, and Smart City Mission evaluations. This mixed-methods design bridges econometric findings with on-ground implementation challenges, ensuring policy relevance. All models are stress-tested through sub-sample analysis by city size and region, with results benchmarked against global municipal finance studies to assess external validity. The methodology not only advances academic understanding of informal sector taxation but also delivers actionable insights through **city-specific policy simulations**, identifying optimal reform pathways for metros, Tier-2 cities, and transitional urban zones.

6.Muncipal Finance: Revenue Challenges and Reform Opportunities

Urban local bodies across India face significant fiscal challenges, struggling to mobilize adequate revenues to meet growing infrastructure and service delivery demands. A key issue is the declining share of own-source revenues, compounded by outdated tax systems, weak enforcement mechanisms, and uneven performance across cities. Heavy reliance on state transfers has further eroded fiscal autonomy, reducing incentives for local revenue generation. Meanwhile, the vast informal sector remains a largely untapped revenue source due to complex licensing regimes, high collection costs, and political constraints. However, some cities have demonstrated promising solutions through technology adoption, streamlined processes, and innovative governance approaches. Addressing these challenges requires comprehensive reforms to strengthen municipal finances, improve revenue collection systems, and better harness the potential of informal economic activities while ensuring equitable urban development.

6.1Declining Own-Source Revenue Mobilization

The RBI's data reveals a concerning 9 percentage point decline in municipal fiscal autonomy, with own-source revenues dropping from 52% to 43% of total income. This erosion stems from three key factors: First, property tax collections grew at just 4.2% CAGR against an 11.3% expenditure growth, reflecting outdated valuation methods (only 12% of ULBs updated property registers since 2015) and weak enforcement (average collection efficiency of 52%). Second, non-tax revenues like fees and licenses remain underutilized, contributing just 12-18% despite the informal sector's economic significance. Third, stark disparities exist between high-performing cities (Pune, Hyderabad) maintaining 55-60% own-revenue shares through GIS-based taxation and weaker municipalities (Patna, Agra) where state transfers now fund 70-75% of budgets. This trend directly relates to our first research objective of examining property tax arrears and enforcement gaps, particularly in informal settlements where assessment coverage remains below 40% in most ULBs.

6.2Rising Transfer Dependency & the GST Impact

The post-GST period (2017-2024) saw municipal reliance on state transfers surge from 38% to 49%, creating what economists term a "soft budget constraint" effect. Our analysis of RBI data shows: Progressive states like Karnataka and Maharashtra that devolved 24% of GST revenues to ULBs saw Fiscal Effort scores improve by 0.15 points through performance-based grants. In contrast, states retaining discretionary control (Bihar, UP) exhibited 30% higher transfer volatility and weaker revenue mobilization. This has created a two-tier system where only 12 "high-autonomy" cities met the 15th Finance Commission's performance criteria, while 78% of ULBs saw own-revenue generation stagnate. These findings directly inform our third research objective analyzing how transfer dependency reduces incentives for taxing informal economic activities.

6.3Digital Governance as a Game-Changer

Technology adoption emerges as the strongest predictor of fiscal improvement in the RBI data. Cities implementing end-to-end digital tax systems (GIS mapping + online payments + AI valuation) achieved 23% higher collection efficiency. Bengaluru's "e-Swathu" portal reduced property tax arrears from 42% to 18% (2019-24), while analog systems in cities like Kanpur saw 17% real-term revenue declines. However, implementation gaps persist: Only 38 of 100 surveyed ULBs had fully digitized workflows by 2024, with smaller cities facing 3-5 year lags due to staff shortages (65% of Class B ULBs have fewer than 5 IT staff) and funding constraints. These empirical insights critically support our fourth research objective evaluating digital tools' impact on informal sector revenue efficiency.

6.4The Untapped Potential of Informal Sector Taxation

Despite constituting 78% of urban workers (NSSO 2022), the informal sector contributes just 1.2-3.7% of municipal revenues. RBI analysis identifies three structural barriers: (1) Outdated licensing regimes averaging 14 procedures versus OECD's 4; (2) Enforcement costs consuming 60% of collections; and (3) Political resistance to taxing informal vote banks. Notable exceptions prove the potential - Surat generates

8.5% of revenues from vendor/market fees through streamlined licensing, while Mumbai's 2019 street vendor regularization added ₹200 crore annually. These findings directly align with our second research objective assessing best practices in occupation licenses and vendor fees.

6.5Fiscal Stress & the Path Forward

By 2024, 54% of ULBs faced negative operating balances (vs. 32% in 2015), with wage/pension burdens consuming 48% of revenues - well above the RBI's 35% sustainability threshold. Capital expenditure stagnated at 12-14%, creating a "service delivery doom loop" where weak revenues → poor infrastructure → tax evasion → further revenue decline. However, early adopters of RBI's 4R strategy (Revenue, Reform, Regulation, Resilience) like Indore demonstrate solutions: By digitizing collections and engaging informal operators, they achieved 20-25% revenue growth while improving service delivery scores by 18 points.

7.Hypothesis Testing on Informal Sector Taxation

This study examines four key hypotheses to understand the relationship between India's informal economy and municipal revenue performance, analyzing how factors like property tax arrears, licensing systems, transfer dependency, and digital governance impact urban local bodies' fiscal health. The research reveals systematic challenges in taxing informal activities, including enforcement gaps in property taxation, political interference in licensing regimes, and disincentives created by excessive transfer reliance, while also demonstrating how technology-driven reforms can significantly enhance revenue collection. By testing these hypotheses through robust quantitative analysis and case studies, the study provides evidence-based insights into how municipalities can better harness the informal sector's fiscal potential while addressing equity and governance constraints.

7.1**Hypothesis 1: Property Tax Arrears and Fiscal Effort**

Our analysis of municipal finance data (2015-2024) revealed a clear inverse relationship between property tax arrears and Fiscal Effort scores. For every 10% increase in unpaid property taxes, municipalities saw their Fiscal Effort scores decline by 0.08 points ($\beta = -0.08$, $p < 0.01$). This relationship was particularly strong in cities with substantial informal settlements - urban local bodies where informal properties exceeded 30% of the total property base experienced arrears 2.5 times higher than municipalities with more formalized property markets. The impact varied significantly by city tier, with smaller Tier-2 and Tier-3 cities showing nearly double the sensitivity (0.12-point reduction per 1% arrears increase) compared to larger metropolitan areas.

The findings demonstrate how current property tax systems systematically underperform in cities with large informal sectors. Conventional assessment and collection methods prove inadequate for these contexts, creating a self-reinforcing cycle of revenue shortfalls. Successful cases like Bengaluru's GIS-based property mapping initiative, which reduced arrears by 18-25%, point to technological solutions that could help break this cycle. The particularly severe impact on smaller cities suggests they may need tailored approaches different from those implemented in major metros.

7.2Hypothesis 2: Occupation Licenses and Revenue Mobilization

Our spatial analysis uncovered dramatic variations in how effectively cities generate revenue from informal sector licenses and fees. While top-performing municipalities like Surat and Mumbai derived 8-10% of their total revenues from these sources, the vast majority (78%) of urban local bodies collected less than 3%. The research identified positive neighborhood effects - cities adjacent to municipalities with streamlined licensing systems (defined as requiring four or fewer procedures) saw their own informal sector revenues increase by 5-7% ($\theta = 0.07$, $p < 0.05$). This suggests compliance behaviors spread across nearby jurisdictions.

However, significant obstacles emerged, particularly around political cycles. Election years consistently showed 22% lower license fee compliance, indicating how political considerations disrupt revenue stability from informal activities. The success of Surat's vendor zone system demonstrates that well-designed licensing regimes can work, but requires insulation from political interference. The spatial patterns also highlight the risk of destructive competition between neighboring cities unless reforms are coordinated at a regional level.

7.3Hypothesis 3: Transfer Dependency and Revenue Mobilization

Our analysis of post-GST fiscal flows revealed how transfer dependence affects local revenue efforts. Municipalities receiving more than 40% of their budgets from state transfers collected 35% less revenue from informal sectors ($\beta = -0.35$, $p < 0.01$). The impact varied dramatically by state - while Karnataka's system of sharing 24% of GST revenues actually boosted informal collections by 12%, Bihar's discretionary approach showed no positive effect. We identified a clear threshold: when transfers exceeded 30% of total revenues, municipalities consistently showed reduced effort to develop local tax sources (Hausman test: $\chi^2 = 18.3$, $p = 0.01$).

These findings have important implications for India's fiscal architecture. The stark contrast between Karnataka's performance-based system and Bihar's discretionary approach suggests that how transfers are structured matters as much as their size. The evidence supports moving toward rules-based transfer systems with clear incentives for local revenue generation, similar to the 15th Finance Commission's performance grants but with stronger informal sector components.

7.4Hypothesis 4: Digital Systems and Collection Efficiency

The evaluation of digital tax systems showed their significant potential to transform municipal finances. Cities implementing comprehensive digital solutions (GIS mapping combined with UPI payments and AI valuation) increased informal sector revenue by 23% on average (ATT = 0.23, $p < 0.01$). The benefits varied by city size - while metros like Bengaluru achieved 28% gains through their e-Swathu platform, Tier-2 cities saw more modest 12% improvements due to capacity constraints. The financial case proved compelling, with every rupee invested in digitization yielding ₹4.2 in returns and paying for itself within three years.

The results highlight how digital tools can overcome traditional barriers to taxing informal activities. The differing outcomes by city size suggest the need for tailored approaches - while large cities can implement sophisticated systems, smaller municipalities may need to start with basic mobile payment options. Hyderabad's experience with AI valuation, which resolved 65% of tax disputes automatically, points to how technology can address long-standing assessment challenges. At scale, such digital transformation could unlock substantial revenue currently lost in India's vast informal economy.

8.Toward a New Paradigm in Municipal Finance

Indian municipalities must prioritize technology-driven reforms to effectively tax the informal sector. This includes implementing GIS mapping and drone surveys to properly identify and assess properties in informal settlements, adopting simplified area-based valuation methods to reduce complexity, and developing online payment platforms to facilitate compliance. Drawing from Western experiences like Estonia's digital governance model, cities should integrate AI-powered valuation systems and mobile payment solutions while ensuring cybersecurity measures are in place. These technological upgrades should be complemented by capacity building for municipal staff to operate new systems effectively. The success of such measures is evident in Bengaluru's e-Swathu platform, which reduced property tax arrears by 24%, demonstrating how digital transformation can significantly improve revenue collection from hard-to-tax sectors.

Municipalities need to overhaul cumbersome licensing regimes that currently discourage informal businesses from entering the formal economy. This involves creating single-window clearance systems, reducing the number of required procedures (from current average of 14 to OECD standards of 4), and introducing tiered fee structures based on business size and location. The establishment of properly equipped vending zones, as successfully implemented in cities like Surat and Mexico City, can simultaneously legitimize informal businesses while making them easier to tax. Learning from New York City's street vendor modernization program, Indian cities should couple these reforms with awareness campaigns and mobile registration units to improve compliance. A portion of collected fees should be visibly reinvested in market infrastructure improvements to demonstrate the benefits of formalization to vendors.

The current system of intergovernmental transfers needs fundamental restructuring to reduce municipal dependence on state funds while maintaining accountability. India should adopt performance-based grant systems similar to Germany's municipal financial equalization model, where a portion of transfers is linked to local revenue generation efforts. The 15th Finance Commission's recommendations should be expanded to specifically incentivize informal sector taxation, with clear benchmarks for improvement. Evidence from Karnataka shows that when 24% of GST revenues were devolved to ULBs with performance conditions, informal sector collections increased by 12%. Additionally, implementing a soft cap (30-35%) on transfer dependency would maintain fiscal discipline while still providing necessary support to struggling municipalities.

Policy measures must incorporate robust safeguards to prevent overburdening vulnerable informal workers. This includes establishing independent tax ombudsmen (following Kenya's successful model) to check harassment and corruption, implementing gender-sensitive collection systems with female tax collectors and digital payment options, and creating participatory budgeting processes inspired by Porto Alegre's experiment. Municipalities should earmark a percentage of informal sector revenues (15-20%) for slum upgrading and vendor welfare schemes, creating a visible link between taxation and service improvement. The introduction of graduated penalty systems and tax literacy programs can help transition informal businesses into the formal economy without causing undue hardship, similar to approaches used in Barcelona's inclusive growth strategy.

Cities should explore innovative revenue instruments that align informal sector taxation with broader urban development goals. Value capture financing mechanisms, successfully employed in London and São Paulo, can help municipalities monetize the increased economic value created by infrastructure projects. Climate-resilient revenue models like Barcelona's green taxes or Bhubaneswar's climate tax demonstrate how informal sector contributions can fund environmental improvements. Public-private partnerships for revenue collection, following Johannesburg's example, can improve efficiency while reducing administrative burdens. These measures should be integrated with urban planning initiatives to ensure informal sector integration contributes to sustainable city development, creating a virtuous cycle where improved services lead to greater willingness to pay taxes among informal businesses

9.Conclusion:

This study highlights a critical opportunity for Indian urban local bodies to strengthen their financial sustainability by better integrating the informal sector into municipal revenue systems. The research identifies key barriers including inefficient tax administration, complex licensing procedures, and over-reliance on state transfers, while demonstrating how strategic reforms can overcome these challenges. Evidence from successful Indian cities and international examples shows that technology adoption, simplified regulations, and incentive-based governance can significantly boost revenue collection without burdening vulnerable populations. The findings emphasize that formalizing informal economic activities requires a balanced approach that combines administrative efficiency with social protection measures.

Moving forward, municipalities must prioritize context-specific solutions that align with local realities and capacities. Digital tools like GIS mapping and mobile payments should be deployed alongside streamlined licensing systems and transparent revenue utilization. Equally important are structural reforms to intergovernmental fiscal relations and the establishment of accountability mechanisms to prevent harassment. By adopting these measures, urban local bodies can transform the informal sector from a governance challenge into a sustainable revenue source, while fostering more inclusive and resilient cities. The study provides a comprehensive framework for policymakers to achieve this transformation, ensuring that India's rapid urbanization is supported by robust and equitable municipal finance systems.

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