Role of Central & State Finance Commissions in the development of ULB’s

- Recommendations of Central Finance Commissions
- Recommendations of 13th Finance Commissions
- Major recommendation of State Finance Commission
India’s decentralisation initiative, in the form of Seventy-third and Seventy-fourth Amendments, poses challenges and offers opportunities. In addition to ensuring constitutional validity to local bodies, these legislations have also broadened the range of power and functions of local governments. The provisions concerning to the constitution of State Finance Commissions (SFCs) aim to rationalize state-local fiscal relations, assume special significance. The states are required to constitute Finance Commissions, once in every five years, to recommend their legislatures, measures to improve the finances of the Panchayats. The State Finance Commissions have so far not been able to come up with comprehensive mapping of state resources. Accordingly their recommendations do not provide well-defined system for sharing of resources between state and local governments. The central finance commissions generate and use huge data before arriving at their recommendations. These recommendations are based on logical data analysis. But most of SFCs recommendations are adhoc in nature and the State Governments don’t take them too seriously.

**Context:**

Article 243 (I) of the Indian Constitution prescribes that the Governor of a State shall, as soon as may be within one year from the commencement of the Constitution (Seventy-third Amendment) Act, 1992, and thereafter at the expiration of every fifth year, constitute a Finance Commission to review the financial position of the Panchayats and to make recommendations to the Governor as to.

a) The principles which should govern:
• The distribution between the State and the Panchayats of the net proceeds of the taxes, duties, tolls and fees leviable by the State, which may be divided between them under this Part and the allocation between the Panchayats at all levels of their respective shares of such proceeds;
• The determination of the taxes, duties, tolls and fees which may be assigned as, or appropriated by, the Panchayats;
• The grants-in-aid to the Panchayats from the Consolidated Fund of the State;
b) The measures needed to improve the financial position of the Panchayats;

c) Any other matter referred to the Finance Commission by the Governor in the interests of sound finance of the Panchayats.

Article 243 (Y) of the Constitution further provides that Finance Commission constituted under Article 243 (I) shall make similar recommendation vis-à-vis municipalities.

The Governor is required to cause every recommendation made by the State Finance Commission together with an explanatory memorandum as to the action taken thereon to be laid before the Legislature of the State.

In terms of articles 243 (I) and 243 (Y) of the Constitution, the state finance commissions are to recommend.

• The principles that should govern the distribution between the state on the one hand and on the local bodies on the other of the net proceeds of the taxes etc leviable by the state and the inter-se allocation between different panchayats and municipalities;
The determination of the taxes, duties, tolls and fees which may be assigned to, or appropriated by the local bodies;

Grants in aid from the consolidated fund of the state to the local bodies.

The importance of State Finance Commissions (SFCs) in the scheme of financial decentralization is that besides arbitrating on the claims to resources by the state government and the local bodies, their recommendations would impart greater stability and predictability to the transfer mechanism.

State Finance Commission’s recommendations are generally based on the following considerations:

a) Financial review of the local bodies for the last six/seven years
b) Recommendations of the previous state finance Commission
c) Recommendations of the central finance commission
d) State’s financial position
e) Existing system of data collection and its maintenance
f) Revenue resource and its demand for next five years

State Finance Commission: Ways Forward

Unlike National Finance Commission (NFC), the SFC as an institution has to start from scratches and handle a constituency whose units run into large numbers of local governments. NFC’s direct subjects are the Union and State governments whereas those of SFCs are the state concerned and the local bodies in the state.
# National Finance Commission and State Finance Commissions Comparison Chart

<table>
<thead>
<tr>
<th>S. No</th>
<th>Characteristics</th>
<th>National Finance Commission</th>
<th>State Finance Commissions</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Composition</td>
<td>President of India appoints one Chairperson, other members, and secretary in pursuance of article 280 of the Constitution of India.</td>
<td>Governors of the respective state appoints the Chairperson, other members and secretary in pursuance of article 243 of the Constitution of India.</td>
<td>While composition of NFC has well established conventions, this is not the case in case of many SFCs.</td>
</tr>
<tr>
<td>2.</td>
<td>Tenure</td>
<td>As per the notification—normally it is 2 years.</td>
<td>As per the notification—normally it is 2 years.</td>
<td>Adhocism at SFC level.</td>
</tr>
</tbody>
</table>
| 3.    | Terms of Reference (This is issued in continuation of the order with reference to the appointment of the commission) | 1. Nature and Functions of the Commission  
2. Time frame for the different kinds of activities  
3. Area of Recommendations shall be made | 1. Nature and Functions of the Commission  
2. Time frame for the different kinds of activities  
3. Area of Recommendations to be made | Unlike NFC, SFCs are required to first generate data and then analyze it, which is beyond the capacity of SFCs in their present form.                                                                 |                                                                                                                                                                                                                                                                  |
| 4.    | Major Areas of Assessment                            | 1. Assess the existing state of distribution between the Union and the States  
2. Assess the principle that governs the grant-in-aid.  
3. Measures taken to augment the Consolidated Fund and also to supplement the resources | 1. Review the financial status of the rural and urban local bodies the state.  
2. Assess the distribution of finance between the states and the local bodies.  
3. Review the determination of taxes, tolls and fees assigned to the | SFCs terms are clearly non specific; hardly any previous norms are available. Hence they may have to grapple in the dark.                                                                                                                                                                                                 |
<table>
<thead>
<tr>
<th>Areas of Recommendations</th>
<th>1. Measures to enhance resources of the Union Government by means of changes in the context of tax revenue and non-tax revenue.</th>
<th>1. Recommend for improvement of financial position of the local bodies.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2. Measures to generate surplus and reduce fiscal deficit.</td>
<td>2. Recommend for both the state and local bodies to generate surplus to maintain the capital assets.</td>
</tr>
<tr>
<td></td>
<td>3. Resource</td>
<td>3. The revenue resources for the local bodies for 5 years</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Lack of capacity laden with ambiguity in TOR results in adhoc recommendations</td>
</tr>
</tbody>
</table>

5. Areas of Recommendations

- Measures to enhance resources of the Union Government by means of changes in the context of tax revenue and non-tax revenue.
- Measures to generate surplus and reduce fiscal deficit.
- Resource

4. Review the state of finance of the Union.

5. Review the present arrangements with regard to disaster management with reference to national calamity relief fund.

6. Review of shares between the state and the union on profit from non-tax income.

7. Assessment of the debts of the states.

4. Review the appropriate local bodies.

5. Review the grant-in-aid to the local bodies from the state.

6. Review the existing level of devolution and other resource transfer to the local bodies from the state and central government.

7. Review the status of implementation of the recommendatio ns of the earlier finance commission.

7. Review the system of accountability of the local bodies in terms of resource utilization.

Lack of capacity laden with ambiguity in TOR results in adhoc recommendations.
<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>3. Acquire relevant data and information from the concerned.</td>
<td>3. Acquire relevant data and information from the concerned.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>4. Call for Suggestions</td>
<td>4. Call for Suggestions</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. Rural Development</td>
<td>2. Rural Development</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>4. State Planning</td>
</tr>
<tr>
<td>Period of implementation of the recommendations</td>
<td>Alleviation Commission</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-----------------------------------------------</td>
<td>------------------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 years</td>
<td>5 years</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Recommendations of Central Finance Commissions**

There has been considerable progress in the empowerment of Panchayati Raj Institutions (PRIs) and municipalities since the Tenth Finance Commission (FC-X) first made a provision for explicitly supporting local bodies through grants, subsequent to the passage of the 73rd and 74th amendments to the Constitution in 1993. Approximately 30 lakh representatives are regularly elected to about 2.5 lakh local institutions all over the country. Providing basic services at the grassroots level makes them the primary interface of the citizens’ interaction with the government. The principle of subsidiarity implies that matters are best handled by the least centralised competent authority. Following this, these institutions need to be adequately empowered–both functionally and financially—to enable them to fulfil the role envisaged for them in the Constitution. The State Finance Commissions (SFCs), which buttress the functioning of local bodies, also need to be strengthened so as to make their functioning more predictable and the process of implementing their recommendations more transparent. A number of recommendations were made by FC-XI and FC-XII towards this end. Some of these recommendations, though important, have not been implemented so far. More needs to be done to promote effective decentralisation. We also need to put in place a
stronger incentive mechanism aimed at persuading State Governments to decentralise further.

**Previous Finance Commissions’ Flows to Local Bodies**

Framework for Recommendations

There was no reference in the ToR of FC-X about making recommendations relating to local bodies. However, since the 73rd and 74th amendments to the Constitution had become effective before the Commission had finalised its report, it felt obliged to make recommendations regarding measures to augment the consolidated funds of the states for this purpose. It pointed out that it could recommend such measures only after ascertaining the need for them, and the primary basis for this would have to be the SFCs’ reports, which however, were unavailable. Therefore, it recommended ad hoc grants.

The ToR of FC-XI had two specific references to local bodies:

i) A reference to the measures needed to augment the consolidated funds of states to supplement the resources of panchayats and municipalities on the basis of the recommendations made by the Finance Commissions of the concerned states.

ii) Another reference reiterating the need to take into account the recommendations of the SFCs. Where such recommendations were not available, the Commission was directed to make its own assessment about the manner and extent of augmentation of the consolidated fund required. This assessment was to take into account the provisions for emoluments and terminal benefits of
employees (including teachers); the ability of local bodies to raise financial resources and the powers, authority and responsibilities transferred to them under articles 243(G) and 243(W) of the Constitution.

In its report FC-XI noted the following features of SFC reports:

i) Lack of synchronicity in the periods covered by the reports of the SFCs and the Finance Commission.

ii) Extreme diversity in the approach, the content, the period covered as well as quality of the reports of the different SFCs.

iii) Delay on the part of the State Governments in finalising Action Taken Reports (ATRs) and placing them in the state legislatures.

FC-XI, therefore, underlined its inability to take into account the recommendations of the SFC’s. It, therefore, recommended ad hoc grants. The ToR of FC-XII had a single reference relating to the measures needed to augment the consolidated fund of a state to supplement the resources of the panchayats and municipalities on the basis of recommendations made by the Finance Commissions of the concerned states. FC-XII noted that both the data furnished by the states as well as the SFC reports failed to provide a sound basis for estimation of the required augmentation of the consolidated funds of the states. It, therefore, recommended grants on an adhoc basis.

**Quantum of Flow**

FC-X recommended a grant of Rs. 100 per capita of rural population as per the 1971 Census to PRIs, which worked out to a total of Rs. 4380.93 crore. In the case of urban local bodies (ULBs), the Commission recommended an amount of Rs. 1000 crore. The aggregate
grant of Rs. 5380.93 crore represented 1.38 per cent of the divisible pool as estimated by them.

FC-XI recommended a grant of Rs. 8000 crore for PRIs and Rs. 2000 crore for ULBs for the five-year period starting 2000-01. The aggregate grant of Rs. 10,000 crore represented 0.78 per cent of the divisible pool as estimated by them.

FC-XII recommended a sum of Rs. 20,000 crore for the PRIs and Rs. 5,000 crore for municipalities for the five year period starting 2005-06. The aggregate grant of Rs. 25,000 crore represented 1.24 per cent of the divisible pool as estimated by them.

**Basis of Horizontal Distribution**

FC-X distributed the PRI grant amongst the states on the basis of state-wise rural population as per the 1971 Census. The grant for urban local bodies was allocated to the states on the basis of the inter-state ratio of slum population derived from the urban population figures of the 1971 Census.

FC-XI distributed grants amongst the states as per the following parameters:

i) Population: 40 per cent
ii) Distance from highest per capita income: 20 per cent
iii) Revenue effort: 10 per cent
iv) Geographical area: 10 per cent
v) Index of decentralisation: 20 per cent

FC-XII made allocations to states based on the following indicators:

i) Population: 40 per cent
ii) Distance from highest per capita income: 20 per cent
iii) Revenue effort:
   a) With respect to state’s own revenue: 10 per cent
b) With respect to GSDP: 10 per cent

iv) Geographical area: 10 per cent
iv) Index of deprivation: 10 per cent

Table No. 2.1

**Amounts Allocated by Previous FCs**

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Particular</th>
<th>Allocation to ULBs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>FC-X (1995-2000)</td>
<td>1000</td>
</tr>
<tr>
<td>2</td>
<td>FC-XI (2000-05)</td>
<td>2000</td>
</tr>
<tr>
<td>3</td>
<td>FC-XII (2005-09)</td>
<td>4500</td>
</tr>
</tbody>
</table>

**Conditionalities Imposed**

FC-X stipulated that its grant was not to be applied to establishment costs. It also expected local bodies to provide matching contributions for the schemes drawn up to utilise these grants. It mandated that the amount provided would be additional to the normal devolution by the State Governments.

It recommended that this grant be made available in four equal instalments from 1996-97, when it expected that the local bodies would be in place.

FC-XI listed the core civic services which it would support, including primary education, health, drinking water, street lighting and sanitation. It indicated that the funds released should be earmarked for operation and maintenance of these functions. The funds were otherwise untied with the proviso that they should not be used for payment of salaries and wages.

Specific state-wise amounts were earmarked for maintenance of accounts (Rs. 98.60 crore) and creation of a data base of the finances of
local bodies (Rs. 200 crore). FC-XI directed that these activities would have the first charge on the grants.

FC-XII recommended that the grant for PRIs be utilised to improve service delivery in respect of water supply and sanitation schemes subject to their recovering at least 50 per cent of the recurring cost in the form of user charges. It also stipulated that at least 50 per cent of the grants provided to each state for ULBs should be earmarked for solid waste management through public-private partnership.

FC-XII also noted the importance of building data bases and maintenance of accounts by local bodies and urged that part of their support be earmarked by the State Governments for this purpose.

FC-XII made a number of recommendations with regard to the constitution, composition, mode and methodology of working of SFCs aimed at improving their functioning.

FC-XII recognised that the conditionalities imposed for release of funds to local bodies ultimately handicapped the very local bodies for which they were meant. Amounts not drawn essentially reflected nonperformance by State Governments. The Commission felt that conditionalities needed to be discouraged.

**Other Recommendations Relating to Measures to Augment the Consolidated Funds of States**

FC-X made no specific recommendations on the other measures needed to augment the consolidated funds of State Governments.

FC-XI felt that the states could adopt the following measures to augment their consolidated funds to supplement the resources of the panchayats and municipalities:

i) Imposition of taxes on land/farm income.

ii) Surcharge/cess on state taxes.

iii) Levy of profession taxes.
FC-XI suggested improvement in efficiency of collection of property/house tax as well as assignment of a suitable tax with buoyant revenues in lieu of octroi which was abolished. It also recommended levy and periodic revision of user charges.

FC-XI also recommended:

i) Review of the accounting heads under which funds are transferred to local bodies to ensure clarity.

ii) Prescription of the format for maintenance of accounts by the Comptroller and Auditor General (C&AG). State bodies would be responsible for preparing the accounts which would then be supervised by the C&AG.

iii) Audit of accounts by the C&AG, whose report should be placed before a committee of the State Legislature constituted on the same lines as Public Accounts Committee.

FC-XI further recommended the following legislative changes:

i) Transfer of functions and schemes to local bodies to be specifically mandated by legislation and made operational at the earliest.

ii) Enactment of legislation to clearly delineate the functions of all three tiers of the PRIs

iii) Integration of the district rural development agencies and urban development agencies with the PRIs/ULBs.

iv) Review of the Constitutional provision mandating states having a population of more than 20 lakh to have a three-tier Panchayati Raj system.

v) Defining a strategy for extension of the 73rd and 74th amendments to uncovered areas in states like Meghalaya, Mizoram, Manipur and Nagaland, which have been excluded from the purview of these amendments.

vi) Revitalisation of district planning committees.
FC-XII noted that the recommendations by FC-XI relating to maintenance of accounts and audit of local bodies had still to be implemented. It suggested that the SFCs should follow the procedure for data acquisition as well as report writing adopted by the Finance Commissions, by using a similar format and recommending transfer of resources in a like fashion.

FC-XII identified 14 best practices which PRIs could usefully adopt, including enhancing taxation powers, levy of user charges, setting up of SFCs in a timely manner and regular maintenance of accounts and audit.

High priority was to be given to creation of a data base and maintenance of accounts through the use of modern technology and management systems.

**Recommendations of Thirteenth Finance Commission**

The Thirteenth Finance Commission (FC-XIII) was constituted by the President under Article 280 of the Constitution on 13 November 2007 to make recommendations for the period 2010-15. Dr. Vijay Kelkar was appointed the Chairman of the Commission. Dr. Indira Rajaraman, Professor Emeritus, National Institute of Public Finance & Policy (NIPFP), Dr. Abusaleh Shariff, Chief Economist, National Council of Applied Economic Research (NCAER), and Professor Atul Sarma, Former Vice-Chancellor, Rajiv Gandhi University (formerly Arunachal University) were appointed full time Members. Shri B.K. Chaturvedi, Member, Planning Commission was appointed as a part-time Member. Shri Sumit Bose was appointed as Secretary to the Commission. Subsequently, the President appointed Dr. Sanjiv Misra, Former Secretary (Expenditure), Ministry of Finance as Member of the Commission in place of Dr. Abusaleh Shariff, who was unable to join.
The overall task of the Finance Commission is to discharge the mandate laid down in articles 270, 275 and 280 of the Constitution, consistent with the principles of federal finance, taking into account the current and likely future macroeconomic and fiscal scenarios, so as to secure fiscal stability and adequate resource availability for the Centre, the states and the local bodies. There has been considerable progress in the empowerment of Panchayati Raj Institutions (PRIs) and municipalities since the Tenth Finance Commission (FC-X) first made a provision for explicitly supporting local bodies through grants, subsequent to the passage of the 73rd and 74th amendments to the Constitution in 1993.

The Commission was required to make recommendations on ‘the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of recommendations made by the Finance Commission of the State.’

Thirteenth Finance Commission-TFC, recommended that local bodies be transferred a percentage of the divisible pool of taxes, over and above the share of the states. The volume of the divisible pool for the previous year (t-1) be used as a basis for computing the grant eligibility of local bodies for a particular year (t). For example, the grants-in-aid for local bodies in 2010-11 would be based on a percentage of the divisible pool of 2009-10 (Revised Estimates).

The grant will consist of two components a basic component and a performance-based component. The basic grant will be equivalent to 1.50 per cent of the previous year’s divisible pool i.e. Rs. 57133 Crore. Basic component again divided into two part, general basic grant and
special areas basic grant. All states will have access to this grant for all the five years as per the criteria and weights mentioned by the commission.

The performance grant—effective from 2011-12—will be 0.50 per cent for the year 2011-12 and 1 per cent thereafter, up to 2014-15. Only those states which meet the stipulations outlined, by the commission, will have access to the performance grant. It amounts to Rs. 30385 Crore for the whole period. Like the basic grant, the performance grant is also divided into two parts, general performance grant and special area performance grant. Grants given to local bodies are detailed in Table A.

Table No. 2.2
Recommended Grants for Local Bodies

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Percentage of the previous years’ divisible pool to be given to all states as grant under Article 275 of the Constitution—General Basic Grant and Total Special Areas Grant</strong></td>
<td>1.50%</td>
<td>1.50%</td>
<td>1.50%</td>
<td>1.50%</td>
<td>1.50%</td>
<td>1.50%</td>
<td></td>
</tr>
<tr>
<td>General Performance Grants</td>
<td>0.50%</td>
<td>1.00%</td>
<td>1.00%</td>
<td>1.00%</td>
<td>% 1.00%</td>
<td>0.78%</td>
<td></td>
</tr>
<tr>
<td><strong>Aggregate Grants to Local Bodies</strong></td>
<td>1.50%</td>
<td>2.00%</td>
<td>2.50%</td>
<td>2.50%</td>
<td>2.50%</td>
<td>2.28%</td>
<td></td>
</tr>
<tr>
<td><strong>Projected (Rs crore) Divisible Pool: 2009-14</strong></td>
<td>545463</td>
<td>636183</td>
<td>746179</td>
<td>880156</td>
<td>1038188</td>
<td>1224595</td>
<td>3846169</td>
</tr>
<tr>
<td>General Basic Grant and Total Special Areas Grant</td>
<td>8182</td>
<td>9543</td>
<td>11193</td>
<td>13202</td>
<td>15573</td>
<td>57693</td>
<td></td>
</tr>
<tr>
<td>General Basic Grant</td>
<td>8022</td>
<td>9303</td>
<td>10873</td>
<td>12883</td>
<td>15253</td>
<td>56335</td>
<td></td>
</tr>
<tr>
<td>General Performance Grant</td>
<td>0</td>
<td>3181</td>
<td>7462</td>
<td>8802</td>
<td>10382</td>
<td>29826</td>
<td></td>
</tr>
<tr>
<td><strong>General Basic Grant &amp; General Performance Grant</strong></td>
<td>8022</td>
<td>12484</td>
<td>18335</td>
<td>21685</td>
<td>25635</td>
<td>86161</td>
<td></td>
</tr>
<tr>
<td><strong>Total Special Areas Grant</strong></td>
<td>160</td>
<td>239</td>
<td>319</td>
<td>319</td>
<td>319</td>
<td>1357</td>
<td></td>
</tr>
<tr>
<td><strong>Special Areas Basic Grant</strong></td>
<td>160</td>
<td>160</td>
<td>160</td>
<td>160</td>
<td>160</td>
<td>798</td>
<td></td>
</tr>
<tr>
<td><strong>Special Areas Performance Grant</strong></td>
<td>0 80</td>
<td>160</td>
<td>160</td>
<td>160</td>
<td>160</td>
<td>559</td>
<td></td>
</tr>
<tr>
<td><strong>Aggregate Grants to Local Bodies</strong></td>
<td>8182</td>
<td>12724</td>
<td>18654</td>
<td>22004</td>
<td>25955</td>
<td>87519</td>
<td></td>
</tr>
</tbody>
</table>
Commission felt the need of special support for areas covered by the V and VI Schedules and the areas exempted from the purview of Part IX and IX A of the Constitution. To strengthen the areas, Commission carved out a small portion of the basic grant and allocated it exclusively for the development of these areas, which is termed ‘special areas’. Eligibility for the special areas grants has been computed on the basis of population in these areas. An amount of Rs. 20 per capita per year has been allocated as the ‘special area basic grant’. This special area basic grant will be accessible by all the eligible states for all five years. A special areas performance grant of Rs. 10 per capita for 2011-12 and Rs. 20 per capita for the subsequent three years will be made available to only those states which meet the stipulations laid down by the commission. Total Special area grant is Rs. 1357 Crore, out of it Rs. 798 Crore is Total Special Area Basic Grant and Rs. 559 Crore is Special Areas Performance Grant.

The general basic grant and the general performance grant will initially be segmented into rural and urban shares on the basis of their respective populations as per the 2001 Census, with 26.82 per cent as the urban share and 73.18 per cent as the rural share. The grant for rural and urban local bodies will then be separately allocated amongst states as Table No. 1. However, the special areas grants, both general and performance will be distributed as per Annexure 2.1 without distinguishing between urban and rural areas.
Table No. 2.3

Weights Allotted to Criteria for Grants to Local Bodies

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Criterion</th>
<th>Weights allotted Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>PRIs</td>
</tr>
<tr>
<td>1</td>
<td>Population</td>
<td>50</td>
</tr>
<tr>
<td>2</td>
<td>Area</td>
<td>10</td>
</tr>
<tr>
<td>3</td>
<td>Distance from highest per capita sectoral income</td>
<td>10</td>
</tr>
<tr>
<td>4</td>
<td>Index of devolution</td>
<td>15</td>
</tr>
<tr>
<td>5</td>
<td>SC/STs proportion in the population</td>
<td>10</td>
</tr>
<tr>
<td>6</td>
<td>FC local body grants utilization index</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>100</td>
</tr>
</tbody>
</table>

Based upon the above criteria and the weights allotted, the state-wise percentage share of the basic grant to be transferred to PRIs and ULBs is given in Annexure 2.2 and 2.3 respectively. The state-wise composite percentage has been worked out in Annexure 2.4. The same shares apply to the performance grant although access to that grant is subject to the conditionalities fulfilled by the state. The projected share of each state has been worked out in Annexure 2.5A to 2.5D as under:

i) The state-wise general basic grants is detailed in Annexure 2.5A.

ii) The state-wise general performance grant is detailed in Annexure 2.5B.

iv) The state-wise special areas basic grant is detailed in Annexure 2.5C.

v) The state-wise special areas performance grant is detailed in Annexure 2.5C.
Share of those states who are not able to draw general performance grant, their share will be distributed amongst all states. Fifty per cent of the PRI amount so forfeited will be divided amongst all the states (both performing and non-performing) by the shares indicated in Annexure 2.2 and 50 per cent of the ULB amount forfeited will be distributed by the share indicated in Annexure 2.3. The remaining 50 per cent of the forfeited PRI & ULB performance grants will be distributed only amongst the performing states which have complied with the stipulated conditions. If no state is eligible, this amount shall not be disbursed.

If any or more than one state is unable to draw down the special area performance component of the grant allocated to them, their 50 per cent share will be distributed amongst all performing and non-performing states who are eligible for special area grant listed in Table No. 2.1 and 50 per cent will be distributed amongst, who are performing states from the special area grant list states. If no state is eligible, this amount shall not be disbursed.

States will be eligible to draw down their share of the general performance grant, only if they comply with the following nine conditions. These conditions must be met by the end of a fiscal year (31 March)

1. The State Government must put in place a supplement to the budget documents for local bodies, separately for PRIs and ULBs. Supplement should show the details of plan- and non-plan-wise classification of transfers separately for all categories of ULBs and all tiers of PRIs. PRIs must maintain their accounts as per Model Panchayat Accounting system and ULBs must use accounting pattern which is suggested in the National Municipal Accounts. To demonstrate compliance with this condition, (a)
State will submit the relevant supplement to the budget documents and (b) certify that the accounting systems as recommended have been introduced in all rural and urban local bodies.

2. The State Government must put in place an audit system for all local bodies all categories of ULBs and all tiers of PRIs. Annual Technical Inspection Report as well as the Annual Report of the Director of Local Fund Audit must be placed before the state legislature. Certification from the C&AG will demonstrate compliance with this condition.

3. The State Government must put in place a system of independent local body ombudsmen who will look into complaints of corruption and maladministration against the functionaries of local bodies, for both elected members and officials. The passage of relevant legislation and its notification will demonstrate compliance with this condition. Self certification by State Governments will be needed to comply with this condition.

4. The State Governments must put in place a system to electronically transfer local body grants provided by this Commission to the respective local bodies within five days of their receipt from the Central Government. Wherever it is not possible, alternative system must place so that funds are transferred within ten days of their receipt. Self-certification by the State Governments with a description of the arrangements in place will demonstrate compliance with this condition.

5. The State Governments must prescribe through an Act the qualifications of persons eligible for appointment as members of the SFC consistent with Article 243I (2) of the Constitution. The
passage of relevant legislation and its notification will demonstrate compliance with this condition.

6. All local bodies should be fully enabled to levy property tax (including tax for all types of residential and commercial properties) and any hindrances in this regard must be removed. Self-certification by the State Government will demonstrate compliance with this condition.

7. State Governments must put in place a state level Property Tax Board, which will assist all municipalities and municipal corporations in the state to put in place an independent and transparent procedure for assessing property tax. Passage of the relevant legislation or issue of the necessary executive instructions by the State Government for creation of the Property Tax Board as well as publication of the work plan by the Board in the State Government gazette will demonstrate compliance with this condition.

8. State Governments must gradually put in place standards for delivery of all essential services provided by local bodies. For a start, State Governments must notify or cause all the municipal corporations and municipalities to notify by the end of a fiscal year (31 March) the service standards for four service sectors—water supply, sewerage, storm water drainage, and solid waste management proposed to be achieved by them by the end of the succeeding fiscal year. These levels may be different for different municipalities. Such a notification will be published in the State Government gazette and the fact of publication will demonstrate compliance with this condition.

9. All municipal corporations with a population of more than 1 million (2001 census) must put in place a fire hazard response
and mitigation plan for their respective jurisdictions. Publication of these plans in the respective State Government gazettes will demonstrate compliance with this condition.

A state will be able to draw down its special area performance grant only if it satisfies the following conditions:

1. It should be indicated in supplement of budget for PRIs and ULBs, that, which agency will receive the special area basic and performance grant and the conditions under which it is given including the procedure for auditing these expenditures. If agency is panchayat it must fulfill initial 4 conditions which are laid down to get basic performance grant.

2. If these agencies are not panchayats, they must maintain accounts consistent with the instructions in force. These accounts should be audited by the C&AG, and the audit reports tabled, wherever so mandated. Compliance will be demonstrated by a certificate from the C&AG to this effect.

3. At least, the district level elected functionaries and officials of these agencies must be brought under the ombudsman. The passage of relevant legislation and its notification will demonstrate compliance with this condition.

4. Transfer of funds to specified agency should be within the stipulated time as specified for general performance grant. Self certification by the State Government with a description of the arrangements in place will demonstrate compliance with this condition.
Other Recommendations

Payment of Service Charges

Article 285 (1) of the Constitution exempts all properties of the Central Government, from tax imposed by local bodies in the states. However, FC-XI had recommended that all government properties of the Centre as well as the states should be subject to levy of user charges which should be regulated by suitable legislations. Thirteenth Finance Commission has endorsed the recommendation of the FC-XI that payment of service charges by Central and State Governments should be regulated by suitable legislation. This may take time. Until such legislation is made both Government of India and the State Governments may issue executive instructions that all their respective departments pay appropriate service charges to the local bodies. Commission is of the view that user charges levied on Central Government properties should not exceed the charges levied on similarly placed State Government properties, and where no charges are collected by the local bodies in respect of State Government properties, Central Government properties should be equally exempted.

Sharing of Mining Royalties

Thirteenth Finance Commission, during its field visits observed that, there is a general feeling that while natural resources are extracted from resource-rich areas, but local population does not benefit from the exploitation of these resources. They, however, have to bear the negative externalities. Taking this into considerations TFC recommend that State Governments share a portion of their income from royalties with those local bodies from whose Jurisdiction such income originates.
State Finance Commission-SFC recommendations

The SFCs are also required to suggest measures needed to improve the financial position of the different panchayats and municipalities. The recommendations by the state Finance commission can be so far grouped into three major categories. These are:

- Assignment of taxes, duties, tolls and fees to ULBs
- Transfer from the states to ULBs in the form of revenue sharing:
  - and
- Transfer from the state to ULBs in the form of grant-in-aid

A close examination of some of the SFC reports show that these Finance Commissions have tried to rationalize the local tax structure by suggesting reforms in assessment and administration of taxes besides giving power to local bodies.

Finance Commission of Kerala, Karnataka, Tamil Nadu and Uttar Pradesh for example, have recommended for reform in property taxes and have suggested the ‘area based’ or “site valuation” system for assessment of property tax. A majority of SFCs also recommended for autonomy to local bodies for fixing tax rates and user charges.

Most of the State Finance Commissions have recommended sharing of state level resources in addition to the grants-in aid to local bodies. However variations have been noticed among different states in terms of scope of resources to be pooled and it’s sharing principles among the PRIs and ULBs. Major recommendations of first SFCs are given below:
Table No. 2.4

Major recommendations of First State Finance Commissions 1995-2000

<table>
<thead>
<tr>
<th>Name of State</th>
<th>Major Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Andhra Pradesh</td>
<td>39.24% of state revenue from tax and non-tax (30 per cent for urban areas), 10% of betting tax to MC Hyderabad, 95% of profession tax, Rs. 25 lakh grant to newly formed municipal corporations. Increase of per capita grant; GPs- Rs. One to four; MPs- Rs. Five to eight and ZPs- Rs. Two to four.</td>
</tr>
<tr>
<td>2. Arunachal Pradesh</td>
<td>Data not available</td>
</tr>
<tr>
<td>3. Assam</td>
<td>1. 2% per annum of tax revenue of the state; Grants-in-aid: 1996-97: Rs. 36.89 crore; 1997-98: Rs. 37.15 crore; 1998-99: Rs. 37.02 crore; 1999-2000: Rs. 37.02 crore. 2. property tax through tax mapping and record keeping, change in method of assessment, periodic review in assessment, simplification of procedures. 3. Transfer of 10 per cent of net proceeds of motor vehicle tax.</td>
</tr>
<tr>
<td>4. Bihar</td>
<td>Report not yet submitted</td>
</tr>
</tbody>
</table>
5. Chhattisgarh

6. Goa

1. 27% of SOTR and share in central taxes for devolution of zilla panchayats under non-plan and 13% of annual state plan under plan head.

2. 9% of SOTR to municipal councils under non-plan head and 3% of annual state plan under plan head.

7. Gujarat

1. Additional taxation of Rs. 293.09 crore per annum. Profession tax 50%; entertainment tax 75%; other grants

2. Gram Panchayats mandated to levy property tax, water tax and conservancy tax.

3. Land revenue distribution to be based on the average of last three years.

4. Panchayat Finance Board, having an independent status, to be re-constituted.

5. A share of professional tax should be given to Panchayats.

8. Haryana

1. 20% of royalty on monor minerals be devolved to the ULBs and Gram Panchayats

2. 7.5% of net receipts under ‘stamp duty and registration fees’ be devolved to PRIs

3. Tax on motor vehicle 20%; entertainment tax 50% to ULBs.
4. The levy of Haryana Rural Development Fund to be increased from 1 per cent to 2 per cent.

5. Incentive grants in the form of cash award for the three best performing Panchayats at the district, block and village level.

9. Himachal Pradesh
1. Rs. 138.75 crore devolved to LBs
2. A Rural Infrastructure Maintenance Cropus to be set up to take care of maintenance of already created rural assets, viz., primary schools, health centres, veterinary dispensaries etc.
3. Gram Panchayats and Panchayat Samities to be provided with Rs. 1395.47 lakh and Rs. 63.39 lakh respectively for the payment of honoraria and office expenses.

10. Jammu & Kashmir
Not yet submitted

11. Jharkhand
Date not available

12. Karnataka
1. 36% of non-loan gross own revenue receipts to the LBs, 85% to Panchayats and 15% to Municipalities.
2. Five indicators for devolving finances: population (33.33%); area (33.33%); illiteracy rate (11.11%); number of persons per square km (11.12%)
3. Share of each tier: 25% Gram panchayat, 35% Taluk panchayat, and 40% Zilla panchayat.
13. Kerala

1. 25% surcharge on stamp duty be levied on behalf of ULBs. The surcharge on stamp duty as well as basic tax collected from Corporation area be transferred to them on collection basis.

2. Land tax be doubled and 60% of the additional income generated therefrom be given to block panchayats and balance to district panchayats

3. Vehicle Tax Compensation (VTC) which maybe 25% of net collection of motor vehicle tax to be distributed among local bodies.


5. Allocation of State revenue between Panchayats at the ratio of 15% to Taluk Panchayats and 70% to Gram Panchayats.

14. Madhya Pradesh

1. 2.91% of total tax and non-tax to PRIs and 0.514% share of the divisible pool to ULBs; specific grant Rs 67.66 crore to PRIs

2. A one-time non-recurring grant for furnishing and maintaining the offices of PRIs.

3. Devolution criteria; 15% in proportion to SC/ST population; 85% based on population area, no. of agricultural labour, per hectare gross value of agricultural output, number of workers in registered factories per lakh og
population, per capita consumption of electricity and literacy rate. For Gram Panchayats- 75% population and area 25%

15. Maharashtra

1. 10% of the professional tax collected by the state should be given to LBs

2. 66.67% of the demand of land revenue and cess thereon should be given to PRIs as advance grants

3. Irrigation cess grant equal to 66.67% of the demand should be given to zilla parishads as advance grants

4. 25% of net income from motor vehicle tax be given to ULBs

16. Manipur

1. 5.229% of the state share in the Union taxes to LBs was suggested for the first year of SFC recommendations i.e. for the year 1996-97. Thereafter a fixed sum of Rs.8.67 crore per annum was to be devolved to LBs for the remaining period.

2. 50% of land revenue to PRIs.

17. Meghalaya

Exempt under Article 243M

18. Mizoram

Exempt under Article 243M

19. Nagaland

Exempt under Article 243M. SFC constituted under state act. No specific devolution has been recommended for LBs
20. Orissa

1. Government is bearing the full salary and other recurring and non-recurring cost of staff deployed by various line departments in PRIs. The quantum of money to be provided for salary of the staff of panchayat samities should be treated as direct devolution of funds to RLBs.

2. Massive external assistance to local bodies to upgrade basic civil services.

3. Surcharge on stamp duty for transfer of properties in rural areas.

21. Punjab

20% of 5 taxes i.e. stamp duty; motor vehicle tax; electricity duty; entertainment tax; cinema shows be devolved to the LBs (both urban and rural).

22. Rajasthan

1. 2.18% of net tax proceeds of the state to be devolved to the local bodies.

2. To set up a Finance Corporation in rural and urban areas.

3. Panchayats to make matching contributions to avail most of centrally sponsored schemes.

4. Government grant-in-aid to Panchayats be raised from Rs. 5 to Rs. 11 per head (1995-96).

23. Sikkim

1% of the state annual tax revenue to the panchayats.
24. Tamil Nadu

1. Assigning local cess surcharge on stamp duty to Panchayats.

2. Reserving 15% of resource devolution as ‘equalisation and incentive fund’ and sharing the same between Panchayats and municipalities at the ratio of 60:40.

3. Criteria for distribution of funds- population (50%), SC/ST population (15%), per capita house tax collection (15%), core civil services/infrastructure maintenance deficiencies (20%).

4. Revision of house tax every third year based on plinth area rental value.

25. Tripura

PRI

1. 25% of the revenue earned from sales tax, additional sales tax, purchase tax and luxury tax; 35% of professional tax; 15% of forest revenue be devolved to PRIs. 30% to Gram panchayat, 15% to Panchayat Samiti and 5% to Zilla Parishads.

2. Rs. 200/- per head per annum should be given as grant to PRIs.

3. Passing on 32% of the collection from agricultural income and land revenue to the intermediate tier at uniform rate of 2 per cent per samiti.

ULB
5.5% of state tax revenue to ULBs; 90% of this to ULBs till 2001-02 and 10% after reviewing their performance.

26. Uttar Pradesh

1. 4% of net tax proceeds to PRIs; discontinued grants-in-aid; 7% of net tax proceed to ULBs for a five-year period starting from 1996.

2. All Zilla Panchayats to levy circumstances and property tax.

27. Uttarakhand

11% of state’s net tax revenue to LBs at the ratio of 42.23:57.77 to PRIs and ULBs.

28. West Bengal

1. Entertainment tax: 90%; road & PW cess: 80%

2. Sharing of 16% of the net proceeds of all the taxes collected by the State government with Panchayats and municipalities.

Out of 28 states 26 have constituted State Finance Commissions, Meghalaya and Mizoram exempted under Article 243M. Only 23 State Finance Commissions have submitted their reports. Bihar, Jammu & Kashmir and Jharkhand State Finance Commissions did not submit their report. In two states Arunachal Pradesh and Nagaland reports of SFCs are under considerations.

**Recommendations of Second State Finance Commissions**

Most of the states constituted the second State Finance Commissions but period covered by the SFCs are not same. Only few states followed the period covered by National Finance Commission i.e.

Table No. 2.5

**Major recommendations of Second SFCs**

<table>
<thead>
<tr>
<th>Name of State</th>
<th>Major Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Andhra Pradesh</td>
<td>40.92% per annum of the tax and non-tax revenues of the Government including the share of central taxes to LBs</td>
</tr>
<tr>
<td>2. Arunachal Pradesh</td>
<td>Not constituted</td>
</tr>
<tr>
<td>3. Assam</td>
<td>1. 3.5% per annum of aggregate tax revenue of the state to LBs</td>
</tr>
<tr>
<td></td>
<td>2. Grant-in-aid of Rs.10 crore per annum for ULBs</td>
</tr>
<tr>
<td>4. Bihar</td>
<td>Data not available</td>
</tr>
<tr>
<td>5. Chhattisgarh</td>
<td>Not constituted</td>
</tr>
<tr>
<td>6. Goa</td>
<td>2% of state’s own revenue to PRIs out of which 25% to ZPs and the rest 75% to the GPs and PSs</td>
</tr>
<tr>
<td>7. Gujarat</td>
<td>Data not available</td>
</tr>
<tr>
<td>8. Haryana</td>
<td>1. 20% of annual income from royalty on minor minerals to gram panchayats and municipalities</td>
</tr>
<tr>
<td></td>
<td>2. 3% of the net receipts from ‘stamp duty and registration fees’ to PRIs</td>
</tr>
<tr>
<td></td>
<td>3. 65% of the net proceeds of LADT to PRIs</td>
</tr>
</tbody>
</table>
4. 50% of the entertainment tax, 20% of motor vehicle tax and 35% of LADT to ULBs

9. Himachal Pradesh  Rs. 253.19 crore devolved to the LBs

10. Jammu & Kashmir  Not constituted

11. Jharkhand  Not constituted

12. Karnataka  40% of non loan net own revenue receipts to the local bodies; Rs. 5 crore to be common purpose fund each year

13. Kerala  1. Government may devolve to the LSGIs, plan funds (excluding state sponsored schemes) not less than one-third the annual size of state plan as fixed by government from time to time

2. 5.5 per cent of the annual own tax revenue of the state government may be devolved to the LSGIs as Grant-in-aid for maintenance of assets under control of the LSGIs including the transfer of assets

3. 3.5 per cent of the own tax revenue of the state government based on the figures certified by the accountant general could be devolved to LSGIs as general purpose grant, in lieu of assigned taxes, shared taxes and various statutory and non-statutory grant-in-aid, both specific purpose and general purpose

14. Madhya Pradesh  2.93% of total tax and non-tax to PRIs and 1.07% to ULBs. Assignment of taxes to LBs after deduction of 10% collection charges;
establishment grant Rs. 28.40 crore to PRIs and Rs. 5 crore to ZPs for training

15. Maharashtra  40% of state’s tax, duties, tolls proceeds to the LBs

16. Manipur  10% of tax and non-tax and state’s share in central taxes of state; PRIs: 34.38 % and 20.60 % to ULBs

17. Meghalaya  Exempt under Article 243M

18. Mizoram  Exempt under Article 243M

19. Nagaland  Exempt under Article 243M.

20. Orissa  10% of average of state’s gross own tax revenue from 1999-2000 to 2001-02 be devolved to LBs. 10% of the state’s gross own tax revenue for the year 2002-03 minus devolvable amount was recommended as grants-in-aid for various specific purposes

21. Punjab  4% of net proceeds from all state taxes be devolved to the LBs

22. Rajasthan  2.25% of net tax proceeds to the LBs; entertainment tax 15%; royalty on minerals 1%

23. Sikkim  Grants-in-aid of Rs. 525 lakh to PRIs for 2004-05; for subsequent years a growth of 5-7% to be allowed each year. Local area development fund Rs. 3 lakh per annum

24. Tamil Nadu  The share of SOTR after excluding entertainment tax of local bodies has been recommended as
under: i) 2002-04: 8%; ii) 2004-06: 9%; and iii) for 2006-07: 10%; 5% of the central devolution should also be passed on to the local bodies; 10% of SFC devolution may be used for capital works in municipalities and corporations, 15% by town panchayats and 20% by village panchayats

<table>
<thead>
<tr>
<th>State</th>
<th>Devolution as per 1st SFC continued</th>
</tr>
</thead>
<tbody>
<tr>
<td>25. Tripura</td>
<td></td>
</tr>
<tr>
<td>26. Uttar Pradesh</td>
<td>5% of divisible pool to PRIs; 7.50% of state’s net proceeds of tax revenue to ULBs; grants in aid: nil</td>
</tr>
<tr>
<td>27. Uttarakhand</td>
<td>10% of tax and non-tax of state; grants in aid: Rs 6.24 lakh to ZP per annum; Rs.42.75 lakh per annum to BP; Rs.737.15 lakh per annum to GP; Buildings of Almora and Pauri Rs. 105 lakh; Bhagirathi river front: Rs 50 lakh</td>
</tr>
<tr>
<td>28. West Bengal</td>
<td>Annual untied funds of Rs. 350 crore; entertainment and amusement tax 90% to LBs; cess on road and public works 80%</td>
</tr>
</tbody>
</table>

Out of 28 states 21 constituted Second State Finance Commissions. Arunachal Pradesh, Chhattisgarh, Jammu & Kashmir and Jharkhand did not constitute SFCs. Meghalaya, Mizoram and Nagaland are already exempted by Article 243M. All 21 second SFCs submitted their report. Only 17 states have submitted their Action Taken Reports ATRs. In Bihar, Goa, Gujarat and Karnataka SFCs are under consideration.
Recommendations of Third State Finance Commissions

Recommended period of third SFC’s should have been 2005-06 to 2009-10. Only Andhra Pradesh and Rajasthan followed the period. All other SFCs recommended period does not match to others. Major recommendations of third SFCs are as under:

Table No. 2.6
Major recommendations of third SFCs

<table>
<thead>
<tr>
<th>Name of State</th>
<th>Major Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Andhra Pradesh</td>
<td>ATR is under consideration</td>
</tr>
<tr>
<td>2. Arunachal Pradesh</td>
<td>Not constituted</td>
</tr>
<tr>
<td>3. Assam</td>
<td>1. No devolution for the year 2006-07.</td>
</tr>
<tr>
<td></td>
<td>2. 10% of non loan gross own tax revenue receipts after deducting actual collection charges for the year 2007-08</td>
</tr>
<tr>
<td></td>
<td>3. 25% of non loan gross own tax revenue receipts after deducting actual collection charges for the year 2008-11</td>
</tr>
<tr>
<td>4. Bihar</td>
<td>3 per cent of net proceeds from state.</td>
</tr>
<tr>
<td>5. Chhattisgarh</td>
<td>Not constituted</td>
</tr>
<tr>
<td>6. Goa</td>
<td>Data not available</td>
</tr>
<tr>
<td>7. Gujarat</td>
<td>Not constituted</td>
</tr>
<tr>
<td>8. Haryana</td>
<td>4 per cent of the net tax revenue to LBs</td>
</tr>
<tr>
<td>9. Himachal Pradesh</td>
<td>Cess on liquor to be transferred to LBs; incentive fund at the rate of Rs. 10 crore to LBs; Gap</td>
</tr>
</tbody>
</table>
filling grant of Rs. 228.28 crore. Grant-in-aid to LSGIs; and maintenance expenditure for roads.

<table>
<thead>
<tr>
<th>State</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jammu &amp; Kashmir</td>
<td>Data not Available</td>
</tr>
<tr>
<td>Jharkhand</td>
<td>Data not Available</td>
</tr>
</tbody>
</table>
| Karnataka      | 1. 33% of state’s own revenue receipt to be devolved to PRIs and ULBs in the ratio of 70:30  
2. Salary component of officials working in the PRIs should be delinked while working out the total share of PRIs and ULBs |
| Kerala         | 25% of the total state tax revenue of the year 2003-04 be transferred to LBs during the year 2006-07. For subsequent years, annual growth rate of 10% may be applied for transfer of funds to the LBs |
| Madhya Pradesh | Under consideration                                                                                                                                |
| Maharashtra    | Under consideration                                                                                                                                |
| Manipur        | Constitution is under process                                                                                                                       |
| Meghalaya      | Exempt under Article 243M                                                                                                                           |
| Mizoram        | Exempt under Article 243M                                                                                                                           |
| Nagaland       | Exempt under Article 243M.                                                                                                                         |
| Orissa         | 15% of the average gross tax revenue of the state for the years 2005-06 to 2007-08 @ Rs. 896.17 crore per annum be devolved to the LBs                                                                 |
21. Punjab  4% of net proceeds from all state taxes be devolved to the LBs
22. Rajasthan  3.50% of net own tax proceeds of the state; entertainment tax 100%; royalty on minerals 1%
23. Sikkim  Report yet to be submitted
24. Tamil Nadu  10% of the state’s own tax revenue be devolved to the LBs; Specific purpose grant shall be at 0.5% to 1% of the state’s own tax revenue
25. Tripura  Report yet to be submitted
26. Uttar Pradesh  6% of net tax proceeds to PRIs and 9% to ULBs which is under consideration
27. Uttarakhand  6% of net tax proceeds to PRIs and 9% to ULBs which is under consideration
28. West Bengal  Untied fund of Rs. 850 crore from 2009-10 with annual increase of 12% on a cumulative basis for the subsequent years

Out of 28 states 19 have constituted third State Finance Commissions and 13 have submitted their reports. Only 9 states have submitted Action Taken Report ATR. As per SFC recommendations, many of the state government have agreed to give a specific percentage in some of the state taxes or total proceeds to local bodies. In the case of Kerala 25% of the total state tax revenue of the year 2003-04 be transferred to LBs during the year 2006-07. For subsequent years, annual growth rate of 10% may be applied for transfer of funds to the LBs. In Karnataka, 33% of state’s own revenue receipt to be devolved to PRIs and ULBs in the ratio of 70:30. Salary component of officials working in the PRIs should be delinked while working out the total share of PRIs and
ULBs. In Bihar 3 per cent of net proceeds of the state will be devolve to PRIIs and ULBs. In West Bengal Untied fund of Rs. 850 crore, is being provided to local Bodies, from 2009-10 with annual increase of 12% on a cumulative basis for the subsequent years.

All the SFCs have put great emphasis on internal revenue mobilization, but no one has suggested any effective mechanism for Local bodies to generate their own revenue. This area needs to be paid greater emphasis if Local Bodies have to become financially self-sufficient.

**Experience of the State Finance Commissions in India**

Some of the experiences of the working of the first two generation of the SFCs are summarised below:

- There has not been genuine efforts by the states to make clear expenditure assignments to the local bodies and corresponding restructuring of states’ set-up;
- The state government staff transfers to the local bodies have not been accompanied by revenue source transfers;
- The SFCs waste much of their time to collect financial data from the local bodies that the states should have collected in a routine manner; collection of qualitative data for policy purposes, e.g., fiscal autonomy/revenue dependency, expenditure/revenue decentralisation, is not attempted;
- There is inadequate realisation that the SFCs are supposed to recommend fiscal transfers in aid of local revenues and not finance for creating local infrastructure;
- The SFCs have not paid much attention to improve fiscal administration of the local bodies, which might be more important that fiscal transfers *per se*;
• The SFCs are not required to cover issues of local taxation or borrowings, in case some of these are required to be examined ‘in the interest of sound finance’ these should be specifically included in their terms of reference;

• The SFCs do not start their work after first reviewing state finances, nor did they suggest significant transfer of, or surcharging on, the state taxes;

• SFCs take long time to give report. It is mainly due to lack of requisite expertise and insufficient staff.

• Inadequate attention is given by the SFCs to the adverse consequences of grants on local revenue efforts and local fiscal autonomy;

• The state governments treat the SFCs with scant respect, partly due to their membership composition that includes serving civil servants; and

• The state governments generally take a long time to accept and act on the SFC’s recommendation.

Central Finance Commissions view on the SFCs

In Eleventh and Twelfth Finance Commission’s report they have expressed their view regarding SFCs

Eleventh Finance Commission

• Absence of synchronisation of the periods covered by the SFCs with that of the Finance Commission; the solution lies in amending article 243I to enable a State to set up the SFC ‘at the expiration of every fifth year or earlier’.

• SFC reports should contain specific chapters narrating:
  - the approach adopted by it;
  - an analysis of the resources of the State Government;
- an analysis of the resources of each tier of the rural local bodies and each level of urban local bodies;
- the principles for distribution between the State and the local bodies of the net proceeds of the taxes, duties, tolls, and fees leviable by the State, the principles on which these may be distributed among different tiers/levels of rural/urban local bodies; and the grants-in-aid to be given by the State to the panchayats and the municipalities.

- A separate chapter may also be devoted to specific measures that need to be taken for improving the financial position of these bodies to make them institutions of self-government.

- State Governments should take their decisions on the recommendations of the SFC within six months from the date of submission of the report by the SFC.

- The constitutional requirement (article 280(3) imposed on the CFC to recommend grants for the local bodies ‘on the basis of the recommendations made by the Finance Commission of the State’ be deleted.

**Twelfth Finance Commission**

- Article 243 I (1) of the Constitution should be amended to include the phrase “at such earlier time” after the words “every fifth year”.

- Each State should prescribe through an Act, the qualifications of persons eligible to be appointed as Members of the State Finance Commission.

- SFCs should evolve objective and transparent norms for devolution and distribution of funds. The norms should include area-wise indices for backwardness. State Finance Commissions should link
the devolution of funds to the level/quality of civic amenities that the citizens could expect. This could then form the basis of an impact evaluation.

- The Action Taken Report on the recommendations of the SFC must compulsorily be placed in the concerned State Legislature within six months of submission and followed with an annual statement on the devolution made and grants given to individual local bodies and the implementation of other recommendations through an appendix to the State budget documents.
- Incentives can be built into devolution from the Union to the States to take care of the need to improve devolution from the States to the third tier of governments.
- Common formats, as recommended by the Twelfth Finance Commission (TFC) must be adopted, and annual accounts and other data must be compiled and updated for use by the SFCs.

**Thirteenth Finance Commission**

- Urgent need exists to ensure that SFCs are appointed on time
- The period covered by SFCs is synchronous with the period covered by the National Finance Commission.
- SFCs should submit their report in time. State Governments should be empowered to constitute and direct their respective SFCs to give their report well before the National Finance Commission finalises its recommendations.
- The mandate given to an SFC should be applicable only for a period of five years and should not be extended.
- Commission endorsed the recommendation of TFC that Article 243-I(1) of the Constitution should be amended to include the phrase ‘or earlier’ after the words ‘every fifth year’
• SFC member should be of the field, related to work as recommended by TFC.
• Commission has made one of the nine conditions to qualify for performance grant that the State Governments must prescribed through and Act the qualifications of persons eligible for appointment as members of the SFC consistent with Article 243I(2) of The Constitution.
• State Governments must ensure that the recommendations of SFCs are implemented without delay and the Action Taken Report is placed promptly before the legislation.

The Issue

In general the governor of the state appoints the chairperson, other members and secretary in pursuance of article 243 of the Constitution of India. Transfer of the serving officials and frequent reconstitution of the SFC act as a major hindrance for smooth functioning of the commission. To deal with the problem Twelfth Finance Commission has recommended that experts should be drawn from specific fields like economics, Public finance, public administration, and law. In order to ensure that the concerns of both the rural and urban local bodies are adequately addressed, it is also suggested by the Commission, that at least one member with specialization or experience relating to the Panchayati Raj Institutions and another well versed in municipal affairs must be appointed. As per the recommendations, SFC should not have more than five members including the Chairperson.

Thirteenth Finance Commission has put one of the nine conditions for qualifying performance grant that the State Government must prescribe through an act the qualification of persons eligible for
appointment as member of the SFC consistent with article 243I(2) of the constitution.

**Reporting Constrains**

A reading of the different SFC reports highlight that the structure of the report and the methodologies adopted varies from state to state. In most cases, SFC are required to review the financial status of the rural and urban local bodies in the state, assess the distribution of finances between the states and the local bodies, review the determination of taxes, tolls and fees assigned to the appropriate local bodies etc. But in order to assess these factors, the SFC needs to first generate its own data and then analyse it. Unfortunately in most cases it is beyond the ability of the SFC to collect the required data and analyse it. In some cases, due to lack of relevant data, SFC recommendations are forecasted on historical trends and tend to be unrealistic in nature.

Twelfth Finance Commission has recommended that the report should contain an estimation and analysis of the finances of the state government as well as the local bodies at the pre and post transfer stages along with a quantification of the revenues that could be generated additionally by the local bodies by adopting the measures recommended therein. The gaps that may still exist would then constitute the basis for the measures to be recommended by the central finance commission.

State Governments do not except recommendations of SFCs fully. Often, even the accepted recommendations are not fully
implemented, citing resource constrains and this defeats the very purpose of constituting the SFCs.

**Framework for the SFCs Task**

The Eleventh Finance Commission did not find the first generation SFC report to be useful for its purposes and accordingly suggested that the future SFCs could cover at least the following areas:

- The SFC approach
- An Analysis of State finances
- An analysis of the Finances of each tier (Panchayat) and each level (Municipalities) of local governments.
- The principles of distribution of the Net leviable revenues by the State to the Rural and Urban local Governments.
- The Principles of inter se distribution of the net leviable revenues by the state among the different tiers and local Government.
- The grants to be given to the Rural and Urban Local Governments.

The quality of SFC reports continues to be patchy. Twelfth Finance Commission also taken into consideration the SFC report and prepared some formats for the SFCs for collection of data. SFCs have not been followed the advice uniformly.

Thirteenth Finance Commission is of the view that the basis for determination of support is not uniform across SFCs. Further, the recommendations of the SFCs do not follow a uniform pattern, thus detracting from their usability. To address the issue commission constituted the task force to prepare a template for SFC reports. Commission finalized the template after comprehensive consultation process and recommended the same to SFCs to consider for adoption.
**Future Course of Action**

In order to facilitate the process of much needed financial devolution, it is important to provide more support to the State Finance Commissions. It is important to create an environment in which the states are in a situation to appreciate the importance of the State Finance Commission in terms of its potential to carry the process of democratic decentralization further and evolve competencies at cutting edge level by strengthening the PRIs and the ULBs.

The following measures needed to be taken to strengthen the functioning of SFCs:

(a) Providing guideline and determining a few model methodologies for the SFC report:

   It has been felt that a model structures with basic guidelines need to be prepared to facilitate the SFCs to prepare reports uniformly. In order to make the report uniform some common indicators need to be finalized by carefully studying the basic data required for preparation of the report. Hence in nutshell the following are required:

   - The financial indicators required for preparation of the report.
   - The methodologies that can be adopted for preparation of the report.
   - Means to generate relevant data required for preparation of State Finance Reports.
- Guidelines for preparation of the report, which should be easily available to the Central Finance Commission, to assess the state’s need on the basis of uniform principles.

(b) Clear cut mandate for constitution of SFC and delineating the expectations from their reports:

As per the recommendations of the Twelfth Finance Commission, the SFC, must be constituted with people of eminence and competence with qualification and experience in the relevant field.

(c) Creating a platform for interaction and mutual exchange of experience within SFCs and also with the CFCs

It has been noted that there are no formal channel of communication of platform for interaction between the different State Finance Commissions to share their experiences between themselves. In most cases, the SFCs are working in isolation and their recommendations are also not given due weight age by the State Governments. Efforts will have to be made to establish a formal channel for interaction and communication between the different SFCs. Some steps in this direction can be described as follows:

(i) **Composition:** The State Finance Commission should be headed by a person who has been associated with processes of development and decentralization at local level. The chairperson should be supported by at least two other members who have specific subject knowledge in Economics, Development, Finance and Legislations. These members must be provided with support of a team of specialists and options to outsource specific studies.
(ii) **Nodal Department:** The department of Panchayat and Urban Development should act as nodal departments for coordinating consultations and compiling memoranda for rural and urban governance respectively. Finance Department in the State Government should support the SFCs in data generation.

(iii) **Consultation:** SFC must visit each district to undertake systematic consultations with PRIs (represented/coordinated by ZP), Municipalities and District Planning Committee (including district administration).

(iv) Conventions should be established so that

1. Autonomy of SFCs in making recommendations is respected.
2. SFC consultations include the views of Civil Society including NGOs and academia, line departments and other interested parties.
3. The State Governments in the same spirit with which Union Government accepts National Finance Commission’s recommendations must accept recommendations of their respective SFC.
4. There should be specially designated cells in Panchayat and Municipal departments of state government to follow up the SFC recommendations.

As Thirteenth Finance Commission has made some points in favor of SFCs, mandatory and made compulsory condition for qualifying performance grant, some of the above mentioned points can also linked
with performance grant. Ministry of Panchayat Raj in Government of India and similarly Ministry of Urban Development may issue suitable guidelines to facilitate working of SFCs.

...