

## Ineffectiveness of State Finance Commission: An Analysis of Their Impact on Fiscal Decentralization and Local Governance

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**Abstract:** In aligning with the global trend & international developments, India has taken substantial measures to enhance the decentralization of authority to third strata of govt. since the early 1990s. State Finance Commissions (SFCs) are constitutional bodies established to assist the Local Self-government (LSG) by allocating state funds, ensuring an efficient role in performing their functions as entities of self-government following the 73<sup>rd</sup> and 74<sup>th</sup> CAA in 1992. This paper dealt with fiscal empowerment in the context of examining core issues and implications regarding the recommendations of the latest 5<sup>th</sup> SFC concerning third strata of govt.-PRIs & ULBs (Panchayati Raj institutions and Urban Local Bodies). It's essential to examine whether reports were submitted to State Govt. & transfer of funds & grants to these tiers were accepted or rejected. This article asserts that the functioning of SFCs has influenced the working in terms of the constitution, acceptance, regularity, time taken in report submission, and devolution of funds. The paper used purposive sampling and secondary data & information to achieve the research objective. Secondary data on various parameters has been collected from sources such as SFC reports publications etc. However, the state government in some cases has not successfully implemented the recommendations of the SFC. So the state government must make pivotal recommendations & accordingly, transfer funds to Local Bodies with this imperative.

**Keywords** – Action Taken Report, Constitutional Amendment Act, Decentralisation, Local Self-governments, State Finance Commission & Terms of Reference.

### Introduction:

Our federal structure originally evolved as 2 tier system (Centre & state). Functions & powers of each tier system have been categorically divided under the 7<sup>th</sup> schedule of the constitution. LBs were the responsibilities of the State Govt. Article 40- “the state shall take steps to organize Village Panchayat & endow with authority & power necessary to enable to

functions as self govt.” but state govt. persistently ignored these principles & overpowered by the caste-ridden federal system & political interest of the ruling party (Singh & Kumar Vinod, 2012). GOI had made several attempts to improve LB situations but all measures failed drastically in the absence of constitutional and political mandates<sup>1</sup>. Phase IV with constitutional status -73<sup>rd</sup> & 74<sup>th</sup> CAA,

1992. “The rationale behind the enactment of the 73<sup>rd</sup> & 74<sup>th</sup> CAA was that such self-governance & decentralization would lead to make the provisioning of public goods more equitable and improved decision-making” (Jha et al., 2019).

**Role of State Finance Commission & Local Bodies**

The 73<sup>rd</sup> CAA, 1992, came into force on 24.04.1993 & immediately after this, the 74<sup>th</sup> CAA came into force on 01.06.1993 relating to Municipalities & was passed by the parliament. In the Constitution, the 73<sup>rd</sup> and 74<sup>th</sup> CAA was of historic significance in the history of modern India. After that, the federal structure was constitutionally transformed into three strata of govt.- PRIs & ULBs. “LBs were recognized as independent units of self govt. & state govt. the role has been changed from control to cooperate as Part IX deals with “The Panchayats” and Part IX A deals with the “Municipalities” (Mohan, S.1970).

Articles 243 (I) & (Y) of the Constitution.....

“the Governor of a particular state shall, as soon as may be within 1 year from the commencement of the CAA, 1992, and thereafter at the expiration of every five years, constitute a SFC to review the Local Bodies financial position of the PRIs (Panchayat) & Municipalities..... (Mohapatra & Reddy 2021).”

**Review of Literature**

In developing countries, Decentralising fiscal systems, political and administrative is the idea that accelerates the development and mobilising process & elevates the living standards of the population,

particularly benefiting the marginalised and disadvantaged sections (Rao 2011 & Raghunandan, 2011). The Local Self Govt. can provide efficient governance and administration/ management only when certain conditions i.e. participation, transparency, accountability and fiscal transfers have been fulfilled both ways internally or externally (Mohapatra, 2013). RBI 2011 report analysed the effectiveness of FC in falling fiscal imbalances through distribution (vertical and horizontal) criteria found in their study entitled “Finance Commissions in India: an assessment. In State Finances: A Study of Budgets.” Discusses the main developments in the mandates of different SFCs. The paper summarises that the core functions of the FC have endured approximately unaffected concerning the role of the FC & net proceeds distribution between the Union & the states significant the principles of Grants-in-aid of revenues, have significantly extended as new challenges in the environment, political & economic arisen from time to time. (Oommen, M.A. 2010) outlined in the study entitled "Have the State Finance Commissions Fulfilled Their Constitutional Mandates?", to analyze and examine the history of the SFC’s performance and the number of opportunities they missed. SFC’s performance was not satisfactory as they missed the opportunity to make environmentally friendly, participative, and inclusive fiscal federalism & similarly encourage decentralized government. The blame for unsatisfactory performance will be shared by the three-tier govt (union, state, & local) together and State Finance Commissions are the creatures of the state govt so fewer burdens and problems will be

shared by them. (Oommen, M. A. 2005) states in their research entitled “Twelfth Finance Commission and Local Bodies” that the prime concern in explaining recommendations of the 12<sup>th</sup> FC in terms of Local Bodies. No state finance commission can formulate an economic expansion plan that guarantees social justice & tasks to be reformulated & making expenditure of ULBs and PRIs. (Geetha, P. 1999) revealed a study entitled "State Finance Commission and Rural Local Bodies: Devolution of resources", It was suggested that SFCs ensure that the function allocated to LBs will match financial power, equalize vertically (improves revenue adequacy), Inter-jurisdictional redistribution and the extra fund should be provided to LBs to levy revenue sources (tax & non- tax) and spillovers externalities.

**Research Objectives**

1. How SFCs have been working in the seven selected states? What are the key recommendations for strengthening the Local Bodies (periodicity of the SFCs constitution, reason for the delay in report submissions)?

**Data Source and Methodology**

The paper used purposive sampling and secondary data & information to achieve the research objective. Secondary data on various parameters has been collected from sources such as SFC reports publications and NIPFP, ICRIER & the selected State publications (Assam, Maharashtra, Bihar, Punjab, Tamil Nadu, Uttar Pradesh and Rajasthan).

According to Chakraborty et al., 2018, given the table below four states have established their sixth SFC. In addition, nine states have established their fifth SFC while many other states are still in the process. 28 states were addressed but purposive sampling techniques and activity mapping were done using GDP criteria & 5<sup>th</sup> SFC performance was assessed through 4\*4 income states such as High, middle, low and special categories. The paper selected seven states. Assam (Special category), Bihar (Low income) Maharashtra(High), Punjab (High), Tamil Nadu (Middle), Rajasthan and Uttar Pradesh (Low income). Selection of 4\*4 based on literature work and paper for example: Mathur et.al. 2013, M.G. Rao paper.

**A. State Finance Commission Working in Seven Selected States**

The SFC plays a vital role in enhancing & fortifying the Local Self Govt. financial status. The SFC is responsible and accountable for minimizing the mismatch between the capacity to generate revenue & expenditure responsibilities of the local.

- C.1 To analyse the periodicity of the SFCs constitution by the selected states.
- C.2 Devolution of funds and the key recommendations of the 5<sup>th</sup> SFC.
- C.3 Different reasons & causes of the delay in the submission of SFC reports before the state finance commission.

**TABLE:1 A. Status of the SFC Has Been Constituted in Different States**

States (28)	State Finance Commissions					
	6 <sup>th</sup>	5 <sup>th</sup>	4 <sup>th</sup>	3 <sup>rd</sup>	2 <sup>nd</sup>	1 <sup>st</sup>
J& K, Mizoram &Telangana {3}						Y
Arunachal Pradesh, Jharkhand & Nagaland {3}					Y	
Chhattisgarh, Goa, Gujarat & Manipur {4}				Y		
AP, Karnataka, Tripura, Uttarakhand & WB {5}			Y			
HP, Kerala, MP, Haryana, Maharashtra (High), Odisha, Sikkim, TN ( Middle) & UP (Low) {9}		Y				
Assam (Special), Bihar (Low), Punjab (High) & Rajasthan (Low) {4}	Y					

Source: SFC report of respective States

**Table 2  
C.1 (A) CONSTITUTION OF 5<sup>th</sup> STATE FINANCE COMMISSION**

State	Award period	DOA*	Actual time taken	Delay in Submission
Assam	2016-20	30-11-16	3 yrs. 8 months	2 years 7 months
Bihar	2015-20	02-02-2016	3yrs. 2 months	11 months
Maharashtra	2019-25	Oct 2017	6 yrs. 8 months	5 years
Punjab	2016-21	29-6-2016	2 yrs. 8 months	5 months
Rajasthan	2015-16 Interim (1 <sup>st</sup> ) 2016-17(2 <sup>nd</sup> )	2-09-2013	2 yrs. 5 months	1 year 9 months
TN	2017-23	27-12-16	2 yrs.	7 months
UP	2015-20	16-12-2014	3 yrs.	No delay

Source: SFC reports of respective States. Note: DOA\*-Date of Actual Submission.

Table 2 shows the divergence between the submission dates (mandated) and the report actually submitted by the State Finance Commission. It specifies the time interval between SFCs report submission&

ATR placement before the State legislature {doesn't mean the state govt. has accepted SFC's recommendations, acceptance, and considerations -partly & wholly by govt.

**C.2 Table: 3 Latest 5<sup>th</sup>SFC recommendations- Devolution to the third strata of gov.- PRIs & ULBs**

<b>A.State govt. involvement in executing these Accepted(A) /Rejected (R)recommendations</b>					
<b>Tax and Grants-in-aids Recommendations</b>					
State	Devolution, grants and other		ATR status		(A) (R)
Assam	1.	The devolution scheme consisted of three important components	1. Tax devolution 2. Grants routed through PRIs & ULBs 3. line departments		(A)
	2.	During the period 2016-2020-Tax devolution was recommended	PRI	ULB	(A)
			Rs. 580.39 Cr	Rs 811.48 Cr	
			Rs 1391.87 Cr(total)		
1244.23 Cr.(total)					
Bihar	3.	On specific criteria and principles -(%) wise devolution from the net proceeds of taxes/ duties determined.	2015-16	15.5%	(A)
			2016-17	15%	
			2017-18	14.50%	
			2018-19	14%	
			2019-20	13.5%	
4.	Global sharing concept , panchayat assignment of any particular tax was				(R)
Bihar	1.	In the tax devolution and grants, total State revenues from previous financial year will be transferred to Local bodies for period 2015 to 2020 <sup>2</sup>	2.5%		(A)
	2.	Allocation of the state net own tax revenue share to the divisible pool was	8.5% (2015-2016) Rs 2450 Cr. 9% (2016 to 2020)		(A)
Maharashtra	1.	Total combined revenue generated by the state from tax and non-tax sources (portion of own revenue receipts) & income from forest	40% (ZP) 60% (PS) 15%		(R)
	2.	The average annual own income of ZP in Maharashtra	Rs 20.94 Cr.		(R)
	3.	Commission recommended a share collected on Professional tax (respective to LBs)	50%		(A)
	1.	Commission recommended a net total revenue of the state for 5 years 2016-2017 to 2020-21 (Transferred to LBs)	4%		* <sup>3</sup>
	2.	Share of the PRIs & ULBs	2727.75 Cr. & 1636.65 Cr.		*

<sup>2</sup> The calculation of the divisible pool involved subtracting collection cost and appropriated tax (Entrainment) from the state's own tax revenue as given in the state budget

<sup>3</sup> Action taken report only summarizes all the core recommendations and the govt. has not issued an official decision on these recommendations

Punjab	3.	PRIs may experience a surplus and ULBs will be deficit 2016-2017 to 2020-2021 <sup>4</sup>	40% share, totalling amounting Rs 2909.60 Cr. allocated exclusively to ULBs alone	*		
Rajasthan	1.	The state govt.net own tax revenue not including Entry Tax & Land Revenue ) was devolve to third strata (2010-2015)	Total Devolution earmarked Rs. 10183.96 Cr.	(A) <sup>5</sup>		
	2.	States NOTR(Net Own Tax Revenue)(excluding Entry Tax and Land revenue )	Rs.7214.66 Cr Share of PRIs – Rs 5418.21 Cr and Rs 1796.45Cr.	(A) <sup>6</sup>		
	3.	The difference of funds to be devolved in the Interim report compliance (2010-13) – CorpusFund	Corpus created at the PRIs level	(A)		
	1.	The cumulative arrears RLBS& ULBs were incorporated into the divisible pool during the initial yr.of the 2017- 2018 period and subsequently disbursed to the LBs as with the devolution scheme	PRIs Rs 156.90	ULBs Rs. 395.11	(A)	
	2.	The state Govt. should provide compensations to the third strata for loss of Entertainment tax revenue when (a separate legislation to collect tax has not been enacted)	On the destination principle distributed shows -90% of GST revenue collected by the state is derived from entertainment services		(R)	
	1.	<b>All recommendations of Grants-in-aids in Tamil Nadu state</b>			(A)	
UP	1.	The share of own revenues receipts Included the net collection cost of States tax and Non tax revenue	15%	(A) <sup>7</sup>		
	2.	Until new SFC report issues following the 4 <sup>th</sup> SFC. The govt. can continue to utilize SFC recommendations by previous SFC reports	The mechanism for working environment of SFCs requires constant enhancements, improvements with focus on particularly progress extends beyond the recommendations .	(A) <sup>8</sup>		
<b>All recommendations of Grants-in-aids in Assam, Bihar, Punjab, TN, UP state but in Maharashtra state</b>				(A)		
But Commission recommended the VP (Village Panchayat) population exceeds 5000 should have a VDO (Village development officer) to manage activities. <sup>9</sup> Octroi in ULBs				(A)		

<sup>4</sup> On the basis of gaps projection in revenue and expenditure 2016 to 2021, share of state taxes be distributed between the third strata of govt. (PRIs & ULBs).

<sup>5</sup> Accepted with the modification for the period 2014-15.

<sup>6</sup> Recommendations accepted for the share third strata in divisible pool based on the 2011 population. 75.1% Rural population and 24.95 –urban population and total population of 6.85cr.

<sup>7</sup> The recommendations have been accepted with some changes. Consequently, the results show, the govt. has determined that only a portion of the States Net Tax Revenue(SNTR) will be earmarked to establish the Local Bodies divisible pool.

<sup>8</sup> State Govt recommendations will continue the next till the acceptance of the SFC recommendations.

<sup>9</sup> Rejected and Octroi in ULBs – Abolished in 2006

**C.3 Reason for submission delay in the SFCs reports- problems listed in the following table 4.**

Administrative & Intervention challenges. The tenure was also extended by months/yrs./ repeated time-to-time extension as a consequence of a significant delay in submitting SFCs. (Assam)/ (Punjab)( (Rajasthan).
Due to technical/administrative/ managerial issues. Dela in info. from officials, the perspective of the elected bodies & the line department. Interestingly TOR for the commission was issued and the Constitutionof the commission was done after the start of the award period. (Bihar)/ (UP)
Delayed due to several appointment issues and re-appointment issues (chairperson’s /member’s appointment)from time to time. Fixing a time frame & problem of accommodations for starting the office work. (Maharashtra)
No such information was available in the report. (TN)

Source: State Finance Commission reports of selected states.

**Conclusion, Findings & Suggestion:**

1. State Finances Commissions of selected states have been constituted & have submitted their reports to the government in Table 2. It is clearly shown that there has been no synchronization in the reporting and constitution State Finance Commission over time. For adequate resource transfer & better analysis, the State Finance Commission report must be available for the Centre Finance Commission's consideration. But even after more than 2 decades of the existence of local bodies (LBs), the State Govt. of selected states could not even synchronize the constitution of the SFC with the Centre Finance Commission to make the report available for better assessment & analysis of financial requirements of the local bodies. Regarding the constitution shows that the

State govt. is not serious about constituting & implementing the SFC recommendations in time.

□ The Chairman's and member's appointments are made just to serve the political obligations of the ruling party and should be from the public finance field. Moreover, reports & recommendations are kept pending by the govt. for 2 years to 3 years without any reason. Merely State Finance Commission constitution and its recommendations do not serve the landmark objective of the amendment passed by the parliament of India in the award period 1992.

□ The Local bodies in selected States are just fulfilling their constitutional obligations and the Finance Commission constitution is merely a quinquennial ritual.

2. State govt. involvement in executing these accepted /rejected Recommendations-Table 3.

3. Reason for delay in submission and data challenges in the SFCs reports- various factors are mentioned in Table 4.

In some instances, the state govt. has not successfully executed the SFC recommendations. So it is imperative for the state govt. to pivotal recommendations & accordingly, allocate funds to Local Bodies. Our analysis reveals differences in approaches of the SFC aren't based on the principle of rationale. As far as operational aspects despite having statutory provisions, there is a lack of consistency and consistency in report submission timelines and the timely reports submission. Decentralization of RLBs is significant only when the Panchayats have sufficient funds to provide better public services allocated to them. The government should assign appropriate proper revenue sources to RLGs (Rural Local Governments) because of the high dependency on fiscal transfer, the inability to allocate proper revenue sources leads to PSD (poor service delivery), low Grant-in-aid & fiscal autonomy. For better analysis of demand by the CFC the State govt. should remove the diversity in the period of the SFC constitution and efforts should be made to synchronize the SFC period. The chairman of the commission or members should have expertise in handling public finance technicalities. The State legislature should receive the ATR on SFC recommendations within 6 months of the report submission. The SFC plays a pivotal role in LB finance but the appointment chairman's and

member's appointments are often influenced by political obligations. Additionally, recommendations & various reports made by these Finance Commissions are kept pending by the State Govt. even for 2 to 3 years without any reason which subverts the fundamental objective of LBs as an independent unit of self-govt. The devolution of functionaries & functions has not been fully executed. Given the various issues and problems discussed, this article emphasized the significance of implementing the SFC recommendations and subsequently, fund allocating to the third strata of govt. fostering sound fiscal federalism within the state.

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