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Strengthening State Finance Commissions for Empowered Local Governments

A Study of Challenges and Reform Pathways

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Why do State Finance Commissions matter for India's local governments?

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There are three core dimensions of municipal finance that together underpin sound financial management in India's cities

Financial Sustainability

Adequacy and availability of funds for infrastructure and service delivery

- There are adequate funds (transfers, assigned revenues, innovative financing, borrowings) with ULGs.
- **Transfers are formula-based, predictable, and timely.**

Financial Efficiency

Optimal utilisation of available funds

- Budgets are comprehensive and formulated with a focus on service delivery, establishing government priorities.
- Salaries are paid in a timely fashion; goods and services are procured when planned, at appropriate quality and price, and payments are done on time.
- Actual spending reflects budgeted priorities.
- Fund flows, expenditure, and outputs can be tracked in real time.

Financial Accountability

Public disclosure and accountability of public finances

- Outlays are linked to citizen outcomes.
- Financial reports are comprehensive, timely, allow for comparison between actual spending and budget decisions, and are publicly-available in a citizen-friendly format.

Financial Sustainability: Our ULGs are severely under-resourced, relative to global benchmarks and their own needs

Required investment for 2021-36[1]
INR 61.4 lakh Cr. or 1.2% of GDP p.a.

Required per capita p.a. infra investment[1].
INR 7,884 (at 2020 prices)

Total ULG revenue as % of GDP India: ~ 1%
South Africa: 6% | Brazil: 7.4%

Total ULG revenue per annum:
INR 1.7 lakh cr[2].

Investment by cities is tremendously low:

1. Own-source revenues cover about 60–70% of ULGs' recurrent expenditure, let alone their capital investment needs.
2. Total ULG revenues are significantly lower compared to international standards.

1. 72% of urban infrastructure is financed by central and state govts.
2. Scheme funding is typically sector-linked and its continuity cannot always be guaranteed. By comparison, devolution recommended by the Union Finance Commission (UFC) and SFCs is meant to provide predictable, flexible, and autonomous funding to meet local needs

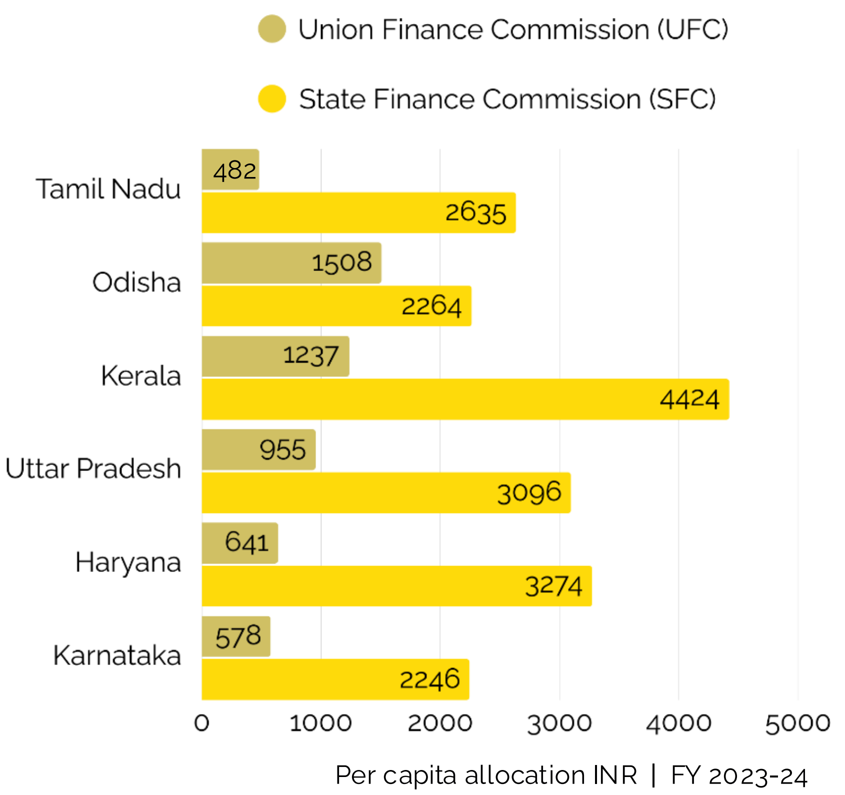
In this context, SFC grants are a key source of reliable funding for India's cities

1 Per year estimation from World Bank report (2022),. Cities require an estimated capital investment of USD 840 billion over next 15 years (till 2036). 1 USD = 73 INR, at 2020 rate.
2 Pan-India Performance metrics (extrapolated from audited accounts of 2,580 ULGs for 2020-21) from www.cityfinance.in

Anchored by the State Finance Commission, SFC grants provide core stability to ULGs' finances:

- In volume, SFC grants are larger than UFC grants – across six states, per capita SFC grants are **nearly 4 times** higher than per capita UFC grants.
- In Karnataka, for instance, SFC grants constitute over 75% of total receipts in smaller ULGs, and 40–50% in larger ULGs.
- In many states, SFC grants are the only predictable source of funds for ULGs, not just for creation of assets but also for payment of salaries of ULG staff and O&M needs.

SFC grants far exceed UFC grants to ULGs across states



Note - Per capita calculations are based on statutory town population, as per Census 2011.

Source – Janaagraha's analysis of XV FC report and budget volumes of respective states

SFCs are vested with a unique mandate of anchoring India's fiscal decentralisation journey

State Finance Commissions embody a unique constitutional space in our fiscal federal structure.

Though technical in form, SFCs' decisions have far-reaching consequences for India's cities and villages. They are critical to realising the Constitutional vision of empowering the third tier of Government.

Deriving its constitutional authority from Articles 243I and 243Y, SFCs are **mandated with two roles**.

(1) Allocation role:
To define principles and parameters for vertical and horizontal devolution to Local Governments (LGs)

(2) Advisory role:
To recommend measures to improve the financial health and governance of Local Governments

Despite their critical role, SFCs do not enjoy the same level of empowerment as the Union Finance Commission

Successive UFCs have persistently flagged structural weaknesses in SFCs' functioning.

XI FC

- Noted that SFC reports exhibited highly uneven approaches, quality and coverage, compounded by frequent delays in Action Taken Reports (ATRs)

XII FC

- Recommended state governments to prescribe clear qualification norms, full-time appointments, and domain expertise for SFC Chairpersons and members

XIII FC

- Noted that SFC functioning is undermined by data gaps, limited capacity, and weak state ownership
- Recommended a draft structure for the organisation and scope of SFC reports

XIV FC

- Recommended the State Governments to strengthen SFCs through timely constitution and adequate resources to ensure timely placement of the SFC report before State legislature

XV FC

- Noted that the importance of data availability for SFCs' effective functioning
- Linked release of FC grants to timely formation of SFCs

What are the challenges that constrain the effective functioning of SFCs?

SFC lifecycle analysis:
A study of 22 states

The study takes a lifecycle approach to examine the functioning of SFCs

Stages

1. Timely constitution of SFCs

1. Delayed formation
2. Lack of a fixed term
3. Gaps in appointment process
4. Terms of References (ToRs) have not evolved to reflect emerging needs

2. Institutional support: Building a fully functional SFC

1. Physical and operational deficiencies
2. The human resource challenge
3. The data desert

3. State government's response to SFC recommendations

1. Deficiencies in Action Taken Report (ATR)
2. Weak uptake of SFC recommendations

Challenges

4. Enabling ecosystem for strengthened SFCs

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Study Approach

Objectives

- The study diagnoses ten systemic challenges that constrain the effective functioning of State Finance Commissions, across their lifecycle, and proposes reform priorities.
- It offers a starting point for active deliberations aimed at strengthening SFCs.

Approach

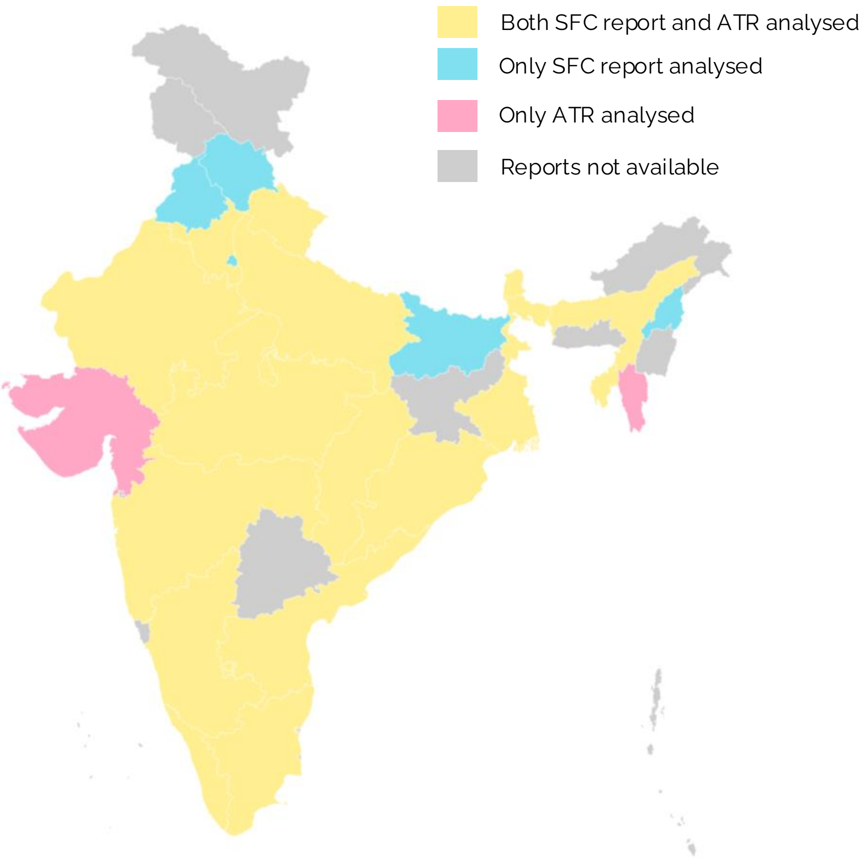
1. Quantitative assessment was undertaken for analysis of objective parameters such as:
    - timing of SFC constitution,
    - number of members in the Commission,
    - time taken to table Action Taken Reports (ATRs).

- **The quantitative assessment initially considered 22 states**. However, the analysis of specific issues is based on a smaller sample, determined by the public availability of SFC reports and Action Taken Reports (ATRs).
- **Further, for issues requiring deeper examination, a narrower sub-sample was used**. For instance, comparisons of Terms of Reference (ToRs) were undertaken for a limited set of states.

2. Qualitative insights are based on discussions with state government officials and SFC members/offices.
3. Use of existing literature and prior work

- The study builds on prior work at NIPFP and work of Prof. V.N. Alok.

States included in the study of SFCs



Reports studied:

- SFC reports of 20 states for at least one SFC term,
- Action Taken Reports (ATRs) on SFC recommendations for 18 states for at least of one SFC term
- Relevant literature (listed in annexure)

What are the challenges that constrain the effective functioning of SFCs?

1. Timely constitution of SFCs

- Delayed formation
- Lack of a fixed term
- Absence of standards in SFCs' composition
- ToRs have not evolved to reflect emerging needs

2. Institutional support: Building a fully functioning SFC
3. State government's response to SFC recommendations
4. Enabling ecosystem for strengthened SFCs

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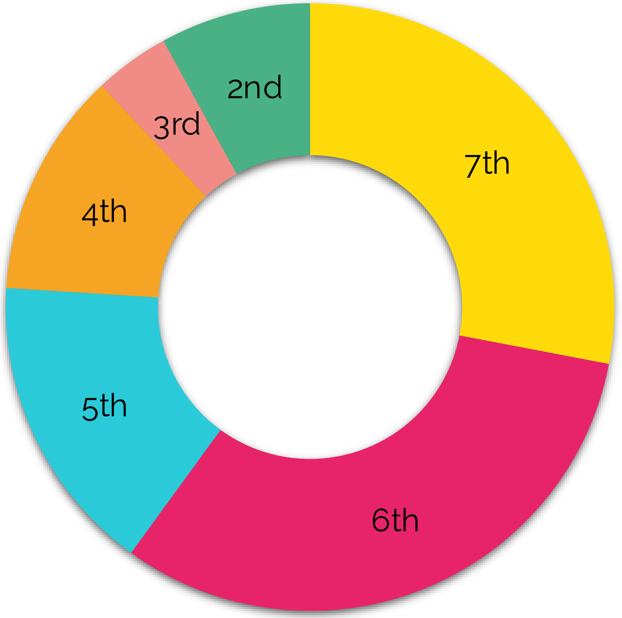
Delays in setting up State Finance Commissions result in its disempowerment from the start (1/2)

1. **Even at inception, not all states constituted SFCs right after the Amendment:**

- 13 of the 20 states examined had constituted their first SFCs, as prescribed, i.e., within a year of the 73rd and 74th Constitutional Amendments coming into place..
- While three states delayed the formation marginally (by 1.5 years), a few states exceeded the mandate by two years (Assam, Sikkim), three years (West Bengal), and as long as six years (Goa), signalling early lapses in institutional prioritisation.
- These early delays foreshadowed a persistent pattern of delayed SFC formation.
- As of now, only seven states have constituted all seven SFCs since the amendments came into force.

States show wide variations in status of constitution of SFCs

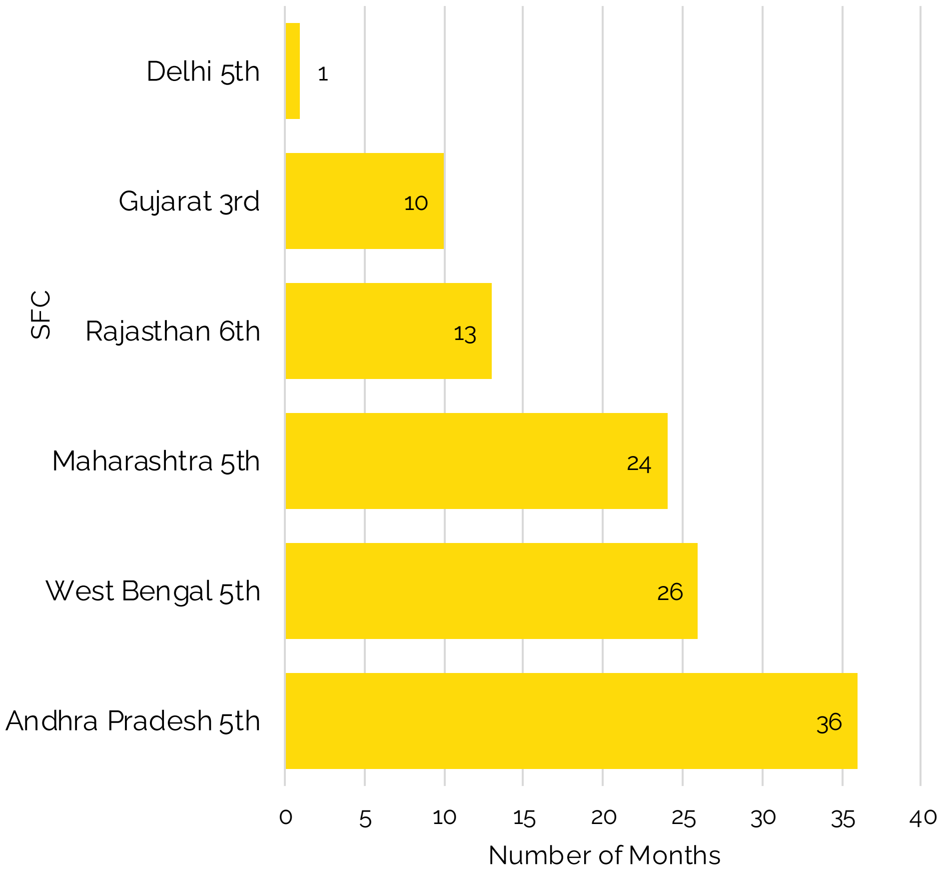


- Rajasthan, Haryana, Tamil Nadu, Bihar, Kerala, Assam, Himachal Pradesh
- Maharashtra, Odisha, Uttarakhand, West Bengal, Tripura, Uttar Pradesh, Sikkim, Punjab
- Jharkhand, Karnataka, Andhra Pradesh, Madhya Pradesh
- Gujarat, Chhattisgarh, Manipur
- Goa
- Arunachal Pradesh, Telangana

Delays in setting up State Finance Commissions result in its disempowerment from the start (2/2)

2. **Subsequently, states have often delayed SFC constitution when it was due, resulting in prolonged periods without active SFC recommendations:**
   - None of the state Acts provide a timeline for establishment of SFCs.
   - The interval between the expiry of an SFC's award period and the constitution of the next SFC ranges from **1 month to 36 months** across states.
   - In this scenario, states such as Karnataka and Chattisgarh continued devolution as per recommendations of previous award period. But, in states such as U.P and Goa, the lack of a G.O in public domain makes it difficult to gauge the principles that determined grant devolution during the gap years.

Many states set up successive SFCs several months after the previous award period ends



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Lack of a fixed term for SFCs affects fundamental functions

1. **SFCs are constituted with truncated tenures, affecting their ability to deliver on their mandate:**
   - Unlike UFCs, which typically have a fixed two-year term, SFCs have been constituted for periods as short as six months, limiting their rigour and effectiveness.
   - Where SFCs are initially given tenures of less than one year, states routinely grant one or two extensions, which effectively stretch the SFC's term to 1.5–2 years.

A key driver for delays and uncertainties in SFC formation is the absence of adequate incentives for timely state action. Further, the lack of legislative backing weakens accountability.

SFCs with short tenures end up running on serial extensions

SFC	Original Tenure, as mentioned in the ToR (in months)	No. of extensions	Total Tenure, post-extension (in months)
4th Karnataka	6	3	30
5th Odisha	6	2	15
5th Maharashtra	10	1	13
3rd Chattisgarh	12	3	32
6th Haryana	12	1	16
6th Tamil Nadu	16	2	23
6th Rajasthan	18	1	29
6th Kerala	24	0	NA

The absence of standards in SFCs' composition and service conditions affects their mandate (1/3)

1. **Given the technical nature of matters that SFCs deal with, the lack of standard practice on the Commission's expertise and size requires deliberation:**
   - The SFC requires a mix of expertise in public finance, economics, state finances, local government finances and administration.
   - A diverse SFC composition of 3-4 members and a Chairperson ensures a blend of perspectives in the synthesis of its final recommendations.
   - But only a few states require the Chairperson to have expertise in public finance or economics. Many others allow appointments based on broad "public affairs" criteria.
   - Further, state laws prescribe widely varying SFC sizes. In some instances, practically, a one-member Commission is also noted.

SFC composition varies across State Acts

One Chairman and five other members

Tamil Nadu

One Chairman and four other members

Andhra Pradesh, Assam, Haryana, Maharashtra, Odisha, Punjab, Rajasthan, West Bengal

One Chairman and two other members

Bihar, Himachal Pradesh, Karnataka, Madhya Pradesh

No. of members not mentioned

Goa

The absence of standards in SFCs' composition and service conditions affects their mandate (2/3)

2. **State Acts also differ widely on service conditions, despite SFCs' similar mandate:**
   - In several states, Acts do not specify whether the Chairperson and Members serve full-time or part-time. This includes Tamil Nadu, Karnataka, Bihar, Himachal Pradesh, and Odisha.
   - As such, SFCs are episodic in nature with a short tenure. The lack of an explicit full-time tenure dilutes their effectiveness.

The absence of standards in SFCs' composition and service conditions affects their mandate (3/3)

3. **The appointment of serving bureaucrats to SFCs has advantages but merits deliberation:**
   - At least in four states – Tamil Nadu, Odisha, Maharashtra, West Bengal – this practice is permitted.
   - In Tamil Nadu, the 5th SFC was headed by a serving IAS, who was also in office as Principal Secretary of the state's Planning, Development and Special Initiatives Department.
   - This brings clear benefits to the SFCs' functioning through synergies and efficiencies in hiring technical expertise, access to data and past records.
   - Moreover, this helps SFCs to build early consensus for proposed reforms.
   - However, it could potentially affect SFCs independence as state officials may prioritise state government considerations over those of local governments, raising the question if one model is more preferred over the other.

In summary, the relatively uniform constitutional mandate of SFCs makes a strong case for standardising their expertise, size, tenure, and service conditions, on lines comparable to the Union Finance Commission. While the XII Finance Commission articulated similar recommendations, these have seen limited translation into state-level practice.

SFC ToRs have not evolved to adequately reflect emerging needs of local governments (1/2)

1. **In some states, ToRs remain a replica of Constitutional provisions with minimal meaningful additions in the last 30 years:**

   - Constitutional provisions outline SFCs' basic mandate. It makes an explicit provision for states to add terms targeted to improving LG finances. In doing so, the Constitution recognised that there will be emerging needs.

2. **A detailed review of ToRs across SFCs in 6 states revealed that:**

- In states such as Karnataka and Haryana, the ToRs have undergone minimal changes from one SFC to another.
- In Karnataka, ToRs remain the same across 3rd, 4th and 5th SFC. Similarly in Haryana, ToRs remain the same across 5th, 6th and 7th SFC.
- In the absence of adequate evolution, critical elements appear missing in ToRs of such states. This includes an assessment of:
  - The impact of state finances on LG finances
  - LGs' existing public finance systems and processes to deliver services effectively
  - Status of fiscal decentralisation in the state
- However, in states such as Tamil Nadu, Kerala, Rajasthan and Odisha, a clear evolution is noticed.

SFC ToRs have not evolved to adequately reflect emerging needs of local governments (2/2)

Some states have taken a more holistic approach

1. **TN: ToRs of the 4th and 5th SFC TORs were similar to the Constitutional provisions, whereas ToRs of the 6th SFC reflects a shift.**

   It calls attention to critical matters affecting state and LG finances (e.g power dues) and a focus on improving service delivery of ULGs.

(b) the measures needed to improve the financial position of the local bodies and identifying new avenues for resources mobilization in rural and urban local bodies keeping in mind the local body tax structure in other States.

(c) suggesting ways to avoid mounting of unpaid bills of electricity charges to Tamilnadu Generation and Distribution Corporation (TANGEDCO) and water charges to Tamil Nadu Water Supply & Drainage Board (TWAD)/ Chennai Metropolitan Water Supply and Sewerage Board (CMWSSB) and other bulk water providers and to ensure prompt and timely settlement of charges to these utilities.

(d) suggesting ways for strengthening the service delivery capacities of Local body administration to enable them to effectively discharge the roles and responsibilities entrusted to them in the Constitution of India and the State Legislations.

(e) examining the possibility of providing devolution to Cantonment Boards from out of the Consolidated Fund of the State.

2. **Kerala: ToRs of the 6th SFC mandates the SFC to assess LGs' public finance processes and systems.**

   Such a holistic view features in ToRs of very few states.

"The FC shall make recommendations to:
(i) streamline flow of funds including carryover of funds;
(iii) improve the processes and systems with respect to budgeting, accounting and auditing;
(iv) create a database for local level planning including spatial and fiscal aspects and its systematic use;
(v) improve the quality of planning by Local Governments including regular upkeep of assets;
(vi) enhance the quality of assets created by Local Governments including the use of appropriate construction technologies;
(ix) enhance accountability including social accountability of Local Governments
(x) improve the monitoring of performance of Local Governments;
(viii) enable Local Governments to contribute effectively to disaster"

What are the challenges that constrain the effective functioning of SFCs?

1. Timely constitution of SFCs

2. **Institutional support: Building a fully functioning SFC**
   - **Physical and operational deficiencies**
   - **The human resource challenge**
   - **The data desert**

3. State government's response to SFC recommendations
4. Enabling ecosystem for strengthened SFCs

Physical and operational deficiencies, including poor preservation of institutional memory, affect SFCs' efficiency

1. **SFCs are not always provided with timely institutional support. This includes:**

- The lack of office space and equipment:
  - The 4th Uttarakhand SFC was allotted office space four months after its constitution.
  - The 4th SFC Maharashtra moved office space 4-5 times.
- The most crippling challenge is the near loss of institutional knowledge, especially on the rationale behind decision-making by previous SFCs. When an SFC dissolves, its files are often stored away and forgotten. The next SFC, constituted years later, tends to start all over by:
  - Re-visiting methodological questions
  - A fresh assessment of fiscal devolution principles, rationale and trends
  - Recreating templates for stakeholder consultation and engagement with external organisations and/or consultants
  - Stumbling upon the same data challenges in analysing state and LG finances.

Why does this problem arise?

- State Acts and Rules are silent; creating lack of clarity on 'what' 'when' and 'how' support should be provided. This includes support on office equipment and human resource recruitment, among others.
- Subsequently, detailed SOPs are missing altogether resulting in delayed bureaucratic action.
- Where institutional mechanisms exist, it can be attributed to specific officers taking action.
- Few states (e.g. TN, Kerala) have invested in preserving institutional memory through the formation of SFC cells or through the deputation of senior FD staff in SFCs.
- A toolkit or playbook that automates such decision-making, across all states, is missing.

The Human Resource challenge (1/2)

Another equally critical gap is SFC's access to requisite human resource

1. **The absence of clear standards on the skill-sets, composition, and deployment of the SFC secretariat results in its delayed operationalisation:**
   - SFCs need a secretariat of data scientists, practicing public finance specialists and administrative staff, all of whom must be recruited, onboarded, and managed for a short, intense period.
   - However, clear provisions for timely deputation and/or recruitment are missing.
   - None of the state Acts (reviewed) have explicit provisions on the composition of secretariat.

2. **SFC's inevitable dependence on state government for staff deployment or recruitment has led to inadequacies:**
   - The 4th Himachal Pradesh SFC became fully functional only a year after constitution due to non-availability of surplus staff with other departments. There were further delays in receiving approvals from the state government for alternative modes of staff recruitment.
   - The 4th Uttarakhand SFC was notified in Feb 2015 but the commission started work approximately 6 months after. In addition to lack of office space, the staff of Finance Department (who were also deputed to the Finance Commission), could not spare much time as they had other responsibilities as well.
   - 55% of the sanctioned staffing posts remained vacant throughout the tenure of the 4th Maharashtra SFC.

The Human Resource challenge (2/2)

3. SFCs face a technical capacity crunch:

- There is an inadequate focus on hiring technical expertise.
    - In Haryana 5th SFC, of the 26 positions sanctioned for the secretariat, 21 were administrative in nature, compared to 5 technical positions. In practice, the SFC functioned with just 12–13 staff throughout its tenure, and administrative staff constituted the majority of it.
    - Across three recent SFCs (4th Karnataka, 6th Tamil Nadu, and 6th Assam), only about 25% of sanctioned or filled posts were technical, compared to nearly 42% in the XV FC, highlighting a significant technical capacity gap in SFCs
- As a result, SFCs are constrained from undertaking in-depth analysis required to credibly assess local governments' expenditure needs.

Sparsely available data hinders accurate assessment of LGs' financial needs and their performance

Fragmented and unreliable data sources makes it difficult to construct a reliable narrative. SFCs require fiscal, socio-economic, and service delivery data to assess local government performance. But, in many states, the following challenges have been observed to varying degrees

1. **Existing national surveys (e.g., NFHS, NSS) do not capture data at the local government level,** forcing SFCs to rely on multiple sources which may not provide a comprehensive picture.

2. **Digitalised datasets on municipal finances, service delivery, and grant performance, from previous SFCs, are often unavailable,** making longitudinal analysis difficult.

3. **Limited Access to Standardised Fiscal Data:**
   - Where fiscal data exists, it is mostly available as non-standardised PDF documents that are hard to decipher.
   - Further, absence of functional classification of fiscal information restricts meaningful analysis.

4. **In the absence of established sources, SFCs end up relying on uneven and manually entered submissions from LGs,** resulting in compromised decision-making.
   - Many local governments delay responses despite reminders from their parent departments.
   - Information shared by local governments can be incomplete, and/or error-ridden, requiring extensive verification and repeated follow-ups.

What are the challenges that constrain the effective functioning of SFCs?

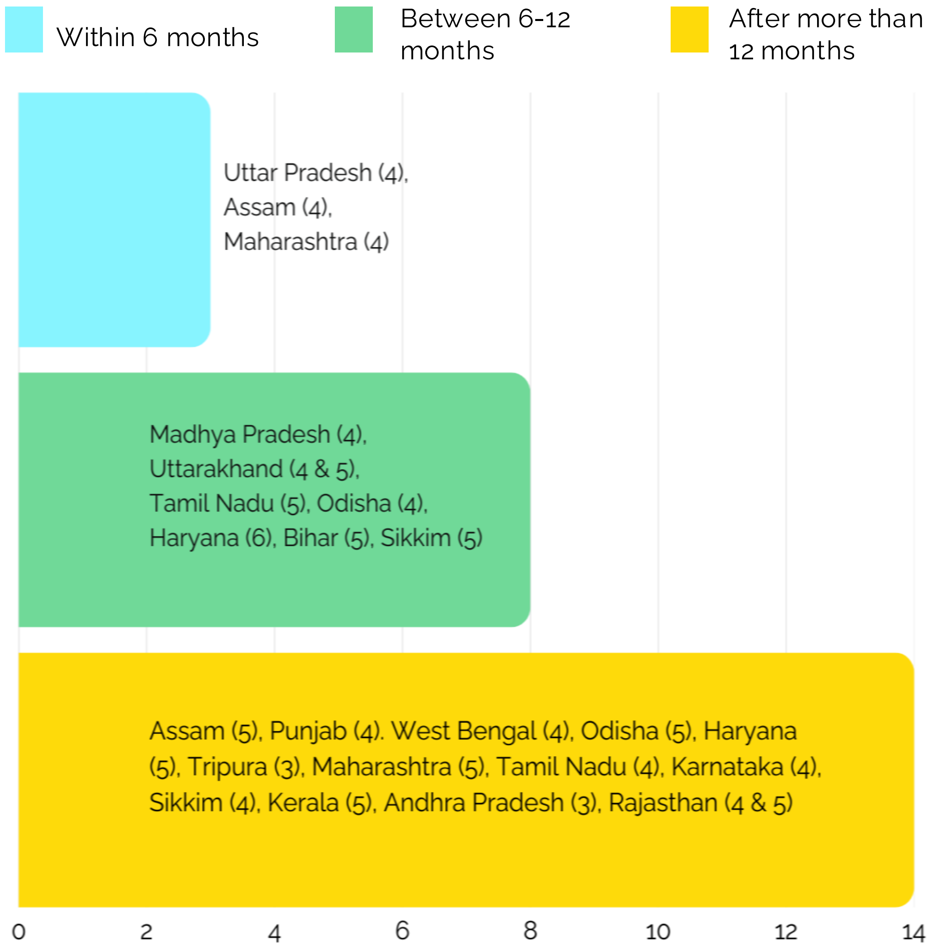
1. Timely constitution of SFCs
2. Institutional support: Building a fully functioning SFC
3. **State government's response to SFC recommendations**
   - **Deficiencies in ATRs**
   - **Weak uptake of SFC recommendations**
4. Enabling ecosystem for strengthened SFCs

Deficiencies in ATRs (Action Taken Reports) weaken accountability of the state government (1/2)

1. **ATRs are tabled with a delay, or not at all, rendering them ineffective as instruments of legislative oversight**
   - In 14 of 25 Commissions studied across 17 states, ATR was tabled with more than 12 months delay.
   - In some cases, such as the first three Karnataka SFCs, ATRs have been never placed before the Legislature, despite provision in the Constitution and State Act.

2. **Further, they are not available in public domain, exacerbating the information asymmetry around the state's response to SFC recommendations**
   - In 7 of these 25 Commissions, ATRs have not been made publicly available.
   - These include the 5th SFCs of Bihar and Maharashtra, the 4th SFCs of Uttar Pradesh, Punjab, and Karnataka, and the 3rd SFCs of Tripura and Andhra Pradesh.

ATR submission timelines vary widely, with delays prevailing



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Deficiencies in ATRs (Action Taken Reports) weaken accountability of the state government (2/2)

3. **Where ATRs are available, ambiguous reporting make it difficult for stakeholders (Legislature, LGs, and the public) to make an informed assessment of the status of acceptance of recommendations.**

- Only a summary of accepted and rejected recommendations presented (Maharashtra)
- Detailed response to recommendations but no mention of responsible department or timelines (Kerala & Tamil Nadu)
- ATR focuses only on devolution-related recommendations; omitting responses on accounting, fiscal databases, institutional reforms etc. (Rajasthan, Haryana & West Bengal)
- ATR offers detailed explanations, but these are not always aligned with SFC recommendations, making it difficult to assess acceptance or rejection (Odisha)

ATR on 4th Maharashtra SFC's recommendations

Only serial no. of recommendations have been mentioned, with no reasons stated for acceptance or rejection

3.2) Recommendations having Indirect Financial Burden - 38

3.2.1) Accepted recommendations - Nil

3.2.2) Partially Accepted recommendations - 14.10A.II.28

3.2.3) Rejected recommendations-14.8.4,14.8.12,14.10A.II.4,14.10A.II.5, 14.10A.II.8,14.10A.II.9,14.10A.II.11,14.10A.II.12,14.10A.II.15, 14.10A.II.16,14.10A.II.17, 14.10A.II.19, 14.10A.II.20, 14.10A.II.33,14.10A.II.34, 14.10A.II.38, 14.10B.II.3, 14.10D.II.1,14.10 D.II.4, 14.10 D.II.9, 14.10 D.II.10, 14.10 D.II.11, 14.10 D.II.16,14.10D.II.21,14.11.II.1, 14.11.II.2, 14.11.II.3,14.11.II.4, 14.11.II.7, 14.11.II.8, 14.11.II.9, 14.11.II.10, 14.11.II.13.o1,14.11.II.13.o2, 14.11.II.13.o3, 14.11.II.14, 14.11.II.15

3.3) Administrative Reforms etc.Recommendations - 57

3.3.1) Accepted recommendations- Nil

3.3.2) Partially Accepted recommendations - 14.8.1,14.9.2

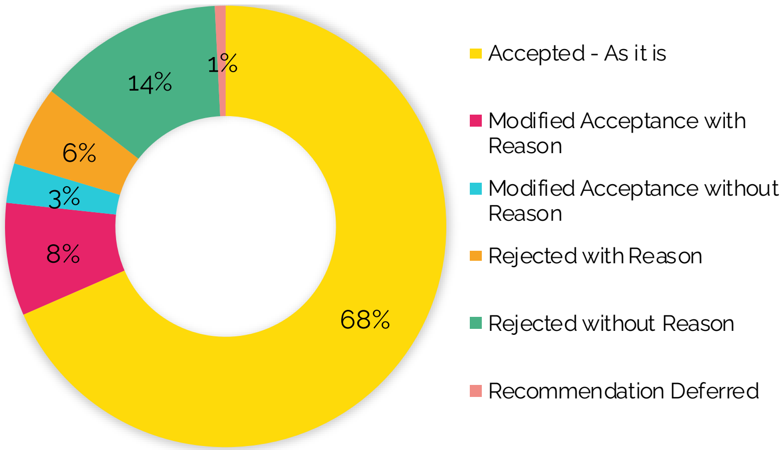
3.3.3) Rejected recommendations –14.8.2,14.8.3,14.8.5, 14.8.7,14.8.9,14.8.10,14.8.1 14.8.13,14.8.15,14.9.3,14.9.4,14.9.5,14.9.6,14.9.7,14.9.9, 14.9.10,14.9.11,14.9.12,14.10A.II.1,14.10A.II.2,14.10A.II.3, 14.10A.II.6.ii,14.10A.II.10,14.10A.II.13,14.10A.II.14, 14.10A.II.18,14.10A.II.21,14.10A.II.27,14.10A.II.29,14.10A.II.30,14.10A.II. 14.10A.II.32,14.10A.II.35,14.10A.II.36,14.10A.II.37,14.10A.II.39, 14.10A.II.40,14.10A.II.41,14.10B.II.1,14.10B.II.5.o1,14.10B.II.5.o3, 14.10 C.II.2,14.10 C.II.3,14.10 D.II.2,14.10 D.II.3,14.10 D.II.7, 14D.II.8,14.10 D.II.14, 14.10D.II.15,14.10 D.II 17, 14.10D.II.18, 14.D.II.22, 14.10D.II.23,14.11.II.12, 14.11.II.13

Limited acceptance and minimal scrutiny dilute the impact of SFC recommendations (1/3)

Of the 1,138 recommendations reviewed from 9 states, 68% of recommendations were accepted as is. This appears promising but certain core issues remain unresolved.

1. **Recommendations maybe rejected without any or adequate reasoning:**
   - Taken together, the 4th and 5th Maharashtra SFCs issued 287 recommendations, nearly half of which were rejected without justification.
   - In Chhattisgarh, the state government rejected the 3rd SFC's proposed formulae for inter-se devolution to PRIs and ULGs without adequate justification, by merely stating that the 2nd SFC's formulae would continue. Similar trends are noticed across different states. An example from TN is provided beside.

Considerable share of SFC recommendations face rejection, modification, or weak follow-through



6th TN SFC's recommendation rejected without adequate justification

Sl. No.	Chapter No.	Para No.	Gist of Recommendations	Decision taken by the State Government
146	III	4.184	Pooling of Assigned Revenue and its tie-up with State-level schemes should be stopped, and the entire revenue should be assigned to the Local Bodies concerned without any interception.	As it is necessary to provide infrastructure to local bodies through implementation of schemes at state level, the recommendation is not accepted.

Limited acceptance and minimal scrutiny dilute the impact of SFC recommendations (2/3)

2. **Select critical recommendations relating to grant devolution or strengthening of LG finances maybe rejected:**
   For instance, in Maharashtra, the state government rejected key recommendations of the 4th SFC with no justification:

- Devolve at least 40% of state revenue from tax & non-tax revenue to LGs. (14.4)
- Publish detailed allocations for PRIs & ULGs as appendices and annexures in regular state budget. (14.4)
- Creating a data cell in Rural Development (14.10A.II.34) and Urban Development departments (14.10D.II.21)
- Transferring shares of stamp duty and RTO tax at 22% and 50%, respectively (14.11.II.11)
- Transitioning villages with high population into municipal bodies (14.11.II.13)

3. **Despite acceptance, there are questions around implementation of the recommendations. Two case studies.**
   The following two examples illustrate this:

- **Uttarakhand SFC**: The 3rd SFC stated in their report "Unfortunately, in most of the cases the acceptance of the (2nd SFC's)recommendations did not lead to their implementation".
- Further, the 4th SFC was unable to receive responses on the 'status of implementation' from respective departments. They had to base their observations on discussions with officials and available government documents.
- **Karnataka SFC**: The Karnataka state government decided to devolve 10-10.5% of the divisible pool, based on the recommendations of the 3rd SFC. However, the funds released to ULGs (including the amount released to parastatals) was short of the mandated devolution by an extent of 20% in FY 2017-18 to 53% in FY 2014-15 (CAG, 2020).

Limited acceptance and minimal scrutiny dilute the impact of SFC recommendations (3/3)

4. **Lastly, the lack of annual review mechanisms or periodic reporting requirements to the legislature leads to complete ambiguity over progress during the award period.:**
   - As a result, there are barely any discussions in the Legislature (or public discourse) on the status of financial devolution or other recommendations.
   - The lack of transparency also makes it difficult for press, researchers and civil society organisations to provide independent commentaries on the status of implementation.

What are the challenges that constrain the effective functioning of SFCs?

1. Timely constitution of SFCs
2. Institutional support: Building a fully functioning SFC
3. State government's response to SFC recommendations
4. **Enabling ecosystem for strengthened SFCs**

Lastly, there is a definite absence of platforms for exchange of perspectives and collaboration, inhibiting effective peer learning amongst SFCs, as well as with the ecosystem

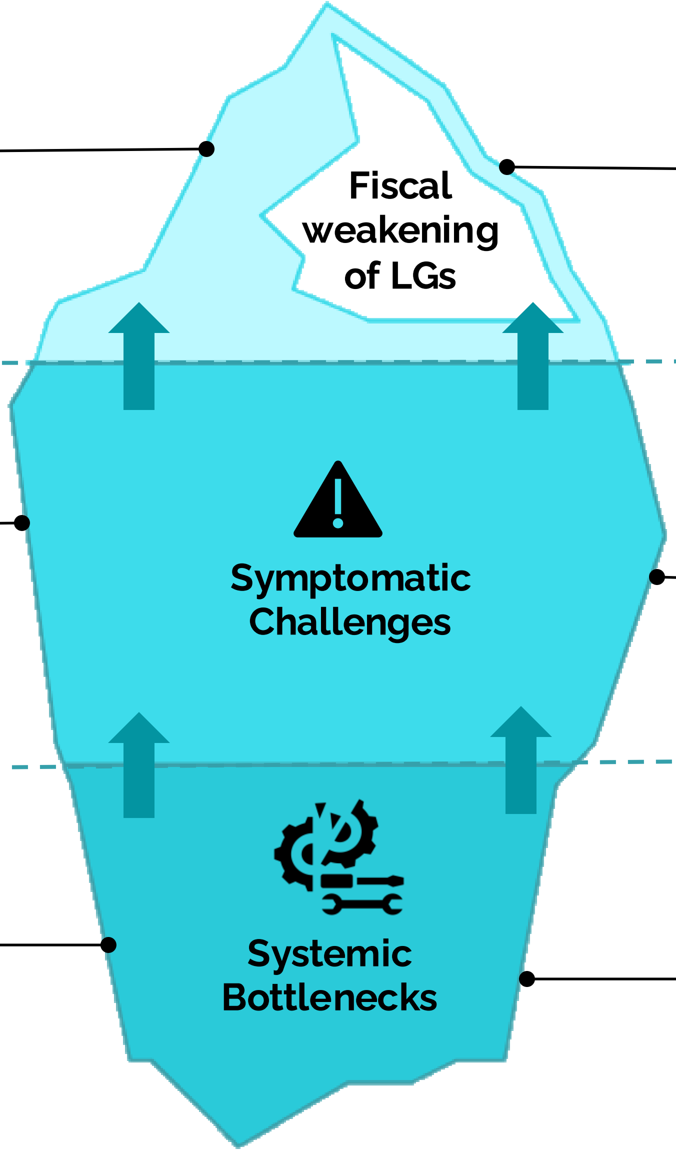
1. **A key instance is the limited discourse on 'good practices' of financial devolution.** The table outlines a few indicative questions, around which there are limited deliberations and research.
2. **Similarly, there is limited public attention** (media, elected representatives, etc) affecting the accountability of both SFCs and the state governments. This is in contrast to the functioning of the UFC and uptake of its recommendations, both of which receive relatively higher public scrutiny.
3. **Limited public goods** in the ecosystem that can support SFCs functioning. This includes (not exhaustive):
   - Publicly available datasets
   - Analysis on fiscal devolution trends across states
   - Methods to estimate LGs' expenditure needs.

Potential questions that require deliberation in the ecosystem

To determine ↓	Ask ↓
The divisible pool of state finances	• What should be the State's total divisible pool of finances from which resources are devolved to rural and urban local governments? • Should there be revenue sources that are commonly considered across all states?
The grant architecture	• What are the purposes for which SFC grants should be devolved to local governments? • What should be the proportionate share of different components? • For every grant component, how should the grant quantum be determined?

SFCs are disempowered by systemic bottlenecks, impacting fiscal predictability for Local Governments

1. Lack of a predictable and robust fiscal transfer architecture
2. Inadequate devolution from state finances (compared to LG needs)



3. Inequitable distribution across LGs
4. Delays in fund release

A) Timely constitution of SFCs:

- Delayed formation
- Lack of a fixed term
- Absence of standards in SFCs' composition and service conditions
- ToRs have not evolved to reflect emerging needs

B) Institutional support: Building a fully functioning SFC

- Physical and operational deficiencies
- The human resource challenge
- The data desert

C) State government's response to SFC recommendations

- Deficiencies in ATRs
- Weak uptake of SFC recommendations

1. **Inadequacies in the Statutory Framework**
2. **Weak Administrative Responsiveness**
3. **Political Economy Constraints**
4. **Accountability & Oversight Weaknesses**

What reforms & reform pathways are necessary to reinvigorate SFCs?

What reforms & reform pathways are necessary to reinvigorate SFCs?

Our Vision:

SFCs must be accorded the same stature, strength, and sanctity as the UFC, in its constitution, competence, operational autonomy, and the weight given to their recommendations

Based on the challenges discussed, reforms across following areas have been identified:

Timely constitution of SFCs	Institutional support: Building a fully functioning SFC
Improved accountability in implementation of SFC recommendations	Fostering an active ecosystem that strengthens SFCs' role

Timely constitution of SFCs

Recommendation 1.1:

States should constitute SFCs **at least two years** before the start of the next award period and require **submission of SFC reports by October** of the FY preceding the next award period.

- This provides SFCs an effective working term of approximately 18 months.
- This also ensures that SFC recommendations inform budget preparation for Year 1 of the upcoming award period

Further, SFC recommendation period should be synchronous with the Union Finance Commission's award period to improve predictability and coherence of fiscal transfers to ULGs. States should constitute SFCs early enough for their recommendations to feed into the consideration of the UFC.

Recommendation 1.2:

Notification of SFC constitution should be available in the **public domain.**

Institutional support: Building a fully functioning SFC

Recommendation 2.1:

- State Finance Departments must develop **clear SOPs** that ensure **provision of budget, office space and staff deployment** before the constitution of a new SFC.
- **Staff strength, its composition and job descriptions** should be defined in consultation with the Chairperson of the SFC and of the Member Secretary, within **30 days** of the appointment of the SFC Chairperson.

Recommendation 2.2:

States, particularly those with high digital maturity, should establish **continuous, automated data systems** that serve SFCs and state departments; rather than creating one-time data collection exercises for each SFC cycle. These data systems should have the following features, largely:

- Single source of data (financial/works/service delivery/HR)
- Avoid any layers of manual entry to avoid errors and administrative burden
- Real-time or close to real-time updating of data
- Use of open-source IT platforms
- Public disclosure of the data for transparency and accountability

Improved accountability in implementation of SFC recommendations

Recommendation 3.1:

State govt should **prepare and table** the ATR in the Assembly within **6 months** of SFC report submission or along with the **State Budgets** in line with the practice followed by the Union government with respect to UFC's recommendations.

Recommendation 3.2:

ATRs must include state's response **related to all SFC recommendations** i.e. financial, non-financial **using a standard template** covering:

- Reporting on uptake of every recommendation along with justification (accepted/rejected/accepted with modification(s)),
- Timeline for implementation,
- Responsible department,
- Details of planned grant devolution (planned fund allocation to LGs for 5 years)

Improved accountability in implementation of SFC recommendations

Recommendation 3.3:

In case certain SFC recommendations are not accepted for implementation, **detailed reasons** must be provided as part of the **ATR** submitted to the Legislative Assembly. This will promote transparency and accountability regarding such decisions.

Recommendation 3.4:

Once tabled before the state legislature, **ATRs must be uploaded** in state and national web portals in **machine readable formats**.

Recommendation 3.5:

- At the beginning of the FY, **State Finance department** must ensure mandatory **disclosure** by **publishing ULG-wise annual allocation of SFC grant amount**.
- This can be published along with budget documents (similar to the practice followed by Government of Karnataka).
- Further, details of **ULG-wise SFC grant release and expenditure of the previous FY** should also be published, along with the Budget Documents.

Fostering an active ecosystem that strengthens SFCs' role

Recommendation 4.1:

www.cityfinance.in, hosted by the Ministry of Housing and Urban Affairs (MoHUA), or an equivalent **digital repository**, can be expanded to serve as a **public good** for SFCs. This can include:

- **A data repository:** the platform should host key SFC-related datasets from across states—including SFC reports, Action Taken Reports (ATRs), devolution formulae, types of grants, and ULG-wise per capita grant data, along with other relevant fiscal, economic and demographic indicators.

- **SFC toolkit**: A toolkit with frameworks, guiding principles, and analytical tools to support institutional strengthening, devolution, including model templates for data analysis, devolution formula design, and evaluation of trends in fiscal transfers.

Fostering an active ecosystem that strengthens SFCs' role

Recommendation 4.2:

An **Annual National Conference or Forum of SFCs** should be convened with participation from State Finance Departments, relevant Line Departments, SFC Chairpersons, members and partner institutions.

- The forum should serve as a platform to share experiences, deliberate on methodologies, approach to fiscal devolution, and build a trusted community of collaborators focused on strengthening SFCs and ultimately, empowering local governments.

- Such an annual engagement would foster peer learning and harmonisation of approaches across states.

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Fostering an active ecosystem that strengthens SFCs' role

Recommendation 4.3:

Develop a two-pronged approach for improved accountability of both state governments and SFCs:

1. A **systematic monitoring system** where the entire lifecycle of SFCs, across states, is monitored.
    - 'Systematic' implies monitoring of objective, pre-defined parameters for every stage of SFC lifecycle. For instance, time take to set up and operationalise SFCs, time taken for submission of SFC reports and ATRs, and status of implementation of accepted recommendations.
    - Such a monitoring system should be institutionalised within a Union Ministry or with credible organisations such as NIRDPR (for rural) and NIPFP (for urban).
    - An annual report card can be generated and provided to necessary stakeholders, including Standing Committees and elected representatives at every level of the Government.
2. Research institutions should be commissioned to prepare an **Annual SFC Effectiveness Report**. .
    - The report should compile SFC recommendations across states, assess their quality and consistency, and track state governments' actions on implementation.

Fostering an active ecosystem that strengthens SFCs' role

Recommendation 4.4:

- **Activate pathways to pursue Constitutional Amendments** and revisions to State Acts essential to bring to effect recommendations 1.1-3.5.
- At the Union level, develop model legislative and procedural provisions that can guide amendments to State Acts and rules.

Annexures

Annexure 1: References

Studies referred:

- Alok, V.N., Fiscal Decentralization in India: An Outcome Mapping of State Finance Commissions, 2021, Pulgrave Macmillan
- Chakraborty, Pinaki et al, Overview of State Finance Commissions, October 2018, Draft Report, National Institute of Public Finance and Policy
- CAG (2020). Report No.2 of 2020 - Performance audit of Implementation of 74th Constitutional Amendment Act, Government of Karnataka.
- NIPFP Public Library

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Annexure 2: Details of SFC Reports, ToRs and ATRs analysed

Sl. No.	State/UT	SFC Report & ToR analysed	ATR analysed
1	Andhra Pradesh	3rd	3rd
2	Assam	4th, 5th, 6th	4th, 5th
3	Bihar	5th, 6th	-
4	Chhattisgarh	3rd	3rd
5	Gujarat	-	3rd
6	Haryana	5th, 6th	5th. 6th
7	Himachal Pradesh	4th, 5th	-
8	Karnataka	4th, 5th (Interim)	4th
9	Kerala	5th, 6th	5th, 6th
10	Madhya Pradesh	4th	4th
11	Maharashtra	4th, 5th	4th, 5th
12	Mizoram	-	1st

Sl. No.	State/UT	SFC Report & ToR analysed	ATR analysed
13	Nagaland	1st	-
14	Odisha	4th, 5th	4th, 5th
15	Punjab	6th	-
16	Rajasthan	5th, 6th	5th, 6th
17	Sikkim	4th, 5th	4th, 5th
18	Tamil Nadu	4th, 5th, 6th	4th, 5th, 6th
19	Tripura	3rd	3rd
20	Uttarakhand	4th, 5th	4th, 5th
21	Uttar Pradesh	4th, 5th	4th, 5th
22	West Bengal	4th	4th
	Delhi	5th	-

The choice of SFCs and ATRs was largely determined by information available in the public domain.

Annexure 3: Limitations

Overall, the study was limited by uneven public availability and accessibility of SFC reports and Action Taken Reports across states.

States/UTs whose SFC Reports and ATRs couldn't be accessed:

SFC reports
Arunachal Pradesh
Goa
Gujarat
Jharkhand
Manipur
Meghalaya
Telangana
Jammu and Kashmir

ATRs	
Arunachal Pradesh	Jammu and Kashmir
Bihar	Nagaland
Goa	Punjab
Gujarat	Telangana
Himachal Pradesh	Delhi
Karnataka	Meghalaya
Manipur	Jharkhand

States where only limited review of SFC reports was possible (due to format or language constraints, only partial review could be undertaken for):

States	Limitations
Madhya Pradesh	Reports available only as scanned copies (Hindi)
Uttar Pradesh	
Mizoram	Report available only in a regional language

Annexure 4: Sample ATRs highlighting the variations in ATR formats across states

ATR for 5th Tamil Nadu SFC
Detailed response to recommendations but no mention of responsible department or timelines

Sl. No.	Para No.	Gist of Recommendations	Decision taken by the State Government
63	5.65 (viii)	Prompt payment rebates should be offered to encourage payment before time. (para 5.41)	Not Accepted. As the property tax etc. have to be collected in full, rebate is not possible.
64	5.65 (ix)	Incentives can be given to Wards and Streets which show the best collection performance, in terms of percentage of collection by implementing small special schemes exclusively in that area. (para 5.41)	Not Accepted. As it is administratively cumbersome and such incentive may not enthuse the public.
65	5.65 (x)	Penalty should be imposed for belated payments. Tax defaulters list should be published by the ULBs soon after the close of the financial year. (para 5.41)	Accepted
66	5.65 (xi)	"Any time anywhere" remittance systems should be enabled for Property Tax in all ULBs (para 5.42)	Accepted
67	5.65 (xii)	A mechanism should be initiated by the Commissioner of Municipal Administration to ensure that department wise and local body wise demand for Property Tax are consolidated and adequate budgetary provisions sought from the Finance Department under the relevant heads of account to prevent accumulation of arrears on State Government buildings. (para 5.43)	Accepted
68	5.65 (xiii)	Government should take up necessary amendments to Article 285 of the Constitution to make Central Government buildings liable for Property Tax. In the interim, Ministry of Urban Development, Government of India must be impressed upon to make statutory provisions enabling levy of service charges to replace the current executive instructions which have proved ineffective. (para 5.44 &5.55)	Accepted

ATR for 6th Haryana SFC
ATR focuses only on devolution-related recommendations; omitting responses on other reform recommendations

3. Accordingly, the State Government has accepted the financial recommendations of the Commission as under: -

i. Financial devolution of 7 percent of the net State's Own Tax Revenue (actual basis) to Local Bodies in the ratio of 55:45 (PRIs : ULBs).

ii. Distribution criteria for Gram Panchayats and Urban Local Bodies based on weightage of 75 percent to Population (as per data of population on Parivar Pehchan Patra Portal, as on 31st December each year) and 25 percent to Per Capita Own Revenue Distance.

iii. Distribution criteria for Zila Parishad and Panchayat Samities based on Population (as per data of population on Parivar Pehchan Patra Portal, as on 31st December each year).

iv. Not more than 30 percent of the devolved funds be utilised on pavement of streets by the local bodies.

v. Actual revenue of local bodies must be minimum 85 percent of their budgeted revenue in audited accounts of the previous year (t-1), failing which, the noncompliant ULBs will face a 20 percent cut from recommended share from the SFC grant, due to those ULBs, in the current year (t).

ATR for 4th Odisha SFC
ATR offers detailed explanations, but these are not always aligned with SFC recommendations, making it difficult to assess acceptance or rejection

4th SFC's recommendation:

3.22 The Commission, recommends the State Government to constitute a committee headed by the Chief Secretary with Development Commissioner, Finance Secretary, PR Secretary and H & U.D. Secretary as members to meet quarterly to examine suitability and feasibility of implementation of SFCs' financial as well as other relevant recommendations in a time bound manner. The committee may be serviced by Finance Department. This recommendation aims at strengthening local self-governance such that it does not lie in a moribund state by default.

State's response:

5.6. There shall be a High Level Monitoring Committee headed by the Chief Secretary with Development Commissioner and Secretaries of Finance, P.R. and H & U.D Departments as Members to review the progress of utilization of grants to Local Bodies so provided as per the recommendations of 4th State Finance Commission. The Committee will be serviced by Finance Department.

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