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Implications of Finance Commission and State Finance Commissions Recommendation on Local Bodies in Odisha, India

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Abstract - *India is a federal set up its States is ridden by the problems of vertical and horizontal imbalance. There is the provision of two types of finance commission- one at the union level known as finance commission (FC) and the other one at state level known as state finance commission (SFC). The FC and SFC recommendations not only impacts the state finances but also have a wide range of implication on local bodies. Based on the previous FC and SFC recommendations, the study explores the implication of the recommendation on revenue & expenditure of local bodies, utilization of money & creation of basic civic services of local bodies, and on financial accountability and management by local bodies. Understanding the implication of FC and SFC recommendations for the local bodies is useful for policy frameworks at the center, state, and local levels.*

Keywords - *Finance Commission, Local Bodies, Panchayat, Grant-in-Aid.*

I. INTRODUCTION

In the context of a modern dynamic economy, decentralization of power between center, state, and local government is important for the sustainable development of an economy. India is a federal set up its States is ridden by the problems of vertical and horizontal imbalance. Recognizing these two imbalances, the Indian Constitution provides an institutional framework to bridge the gap under which the Finance Commission (FC) came into existence in 1951 under Article 280 of the Indian Constitution. The role of the finance commission widened after the 73rd and 74th Constitutional amendments in 1992 and 1993. These amendments recognized the rural and urban local bodies as the three tiers of government, and the constitution of India mandates the FC to recommend measures to augment the Consolidated Fund of a State to supplement the resources of Local Bodies based on the recommendations of the State Finance Commissions (SFCs). Accordingly, there is the provision of two types of finance commission- one at the union level known as finance commission (FC) and the other one at the state level known as state finance commission (SFC). Article 243I and 243Y of the Indian constitution provides the mandate for the provision of SFCs. The mandate of SFCs is to recommend the principles of distribution resources between State and LBs, generation of resources by LBs, and grant-in-aid to LBs, and the SFC is also empowered to suggest the measures to improve the financial position of the LBs.

As of now, fourteen FCs are constituted at the union government level in India, and four SFCs are constituted at the state level in Odisha. The latest FC (14th FC) constituted by Union Government was headed by Y.V. Reddy, and its recommendation is valid for the period 2015- 2020. Similarly, the 4th SFC is the latest state finance commission for the state of Odisha, whose recommendation is valid for the period 2015-2020. For the local bodies to perform the assigned roles, the state and union governments transfer money to the local bodies as per the recommendation of respective finance commissions. Thus, FC and SFC recommendations not only impacts the state finances but also have a wide range of implication on local bodies.

Based on the 14th FC and 4th SFC recommendation, the study explores the implication of the recommendation on revenue & expenditure of local bodies, utilization of money & creation of basic civic services of local bodies, and on financial accountability and management by local bodies. Understanding the implication of FC and SFC recommendations for the local bodies is useful for policy frameworks at the center, state, and local levels.

II. REVIEW OF LITERATURE

Before exploring the implications of FC and SFC, some important existing literature is outlined here for a better understanding of the different dimensions of FC recommendations. Babu (2009), analyzing the fiscal position of panchayat raj institutions (PRIs) in Indian, observed that 29 broad subjects or functions are assigned to PRIs for which state and central government transfers money. But the transferred funds are not sufficient for performing the assigned functions. Due to a shortage of funds, PRIs are not able to utilize the received funds properly and efficiently. Further, there are lacks of autonomy with PRIs to borrow money from other sources. Oommen (2010) studied the impact of 13th FC on PRIs for 15 states, and the study reveals that the own source revenue of PRIs has dramatically declined over the study periods, but public sector expenditure increased during the periods. Further, the study also reveals that the per-capita own source revenue and per-capita own tax revenue decreased, but the per-capita expenditure of PRI increased during the study period. Bandyopadya (2008) studied the recommendation of the 12th FC and found that the fund provided by the central government to the state government has not been utilized fully as far as local bodies are concerned. Poor performance of state government disrespected the SFC in the implementation of recommendations for PRIs. Bohl et al. (2008) studied that SFCs have less impact on the formulation of intergovernmental fiscal policy at the state level, and the majority (94%) of the total revenue of the PRIs comes from the federal and state government. Alok (2009) suggested the potential corrective measures that the FC can take for building the fiscal capacity of local governments in India. He argued that a considerable gap between own resources and the requirements of LBs exists. To achieve inclusive growth, it is important to have inclusive governance by restructuring the fiscal architecture for PRIs and ULBs in a more equitable and efficient manner. The limited fiscal space available to the states and the perceived low capacity of PRIs and ULBs has prevented the states from strengthening these institutions. The above literature suggests that there is a wide range of variability of implications of various FC recommendations. The implication varies from state to state and FC to FC. Therefore, this study tries to explore the implication of the recommendation of the recent FC and SFC on local bodies in Odisha.

III. APPROACH OF PREVIOUS FINANCE COMMISSION FOR LOCAL BODIES

It has been observed that there are some remarkable difference exists between the 14th FC recommendation and the approaches of previous FCs. So it is imperative to analyze the approaches of previous FCs before analyzing the recommendations of the 14th FC. So far as the role of the FC is concerned, it is widened after the 73rd and 74th Constitutional amendments, which mandated FC to recommend measures to augment the Consolidated Fund of a State to supplement the resources of Local Bodies based on the recommendations of the State Finance Commissions (SFCs). Starting from the 10th FC till 13th FC, we observed the following.

- Though the 10th FC did not have any terms of reference for local bodies, it still recommended the transfer of funds to panchayats and municipalities to discharge the new role assigned to them under the 73rd and 74th Constitutional amendments. Subsequently, starting with 11th FC, the FC got terms of reference to recommend on panchayats and municipalities.

- As per the terms of reference, FC has to recommend Local Bodies based on the recommendations of the State Finance Commissions (SFCs). But due to various reasons, the previous Finance Commissions could not base their recommendations entirely on the SFC reports. The reasons are variations in the approaches adopted by the SFCs, the difference in the periods covered by individual SFCs, non-synchronization of the SFC report periods with that of the Finance Commission report, and the quality of the SFC report. Accordingly, the previous FCs recommended ad-hoc grants and suggested the steps for State Governments to augment the consolidated fund of States to supplement the resources of local bodies.

- So far as the quantum of recommendation is concerned, the 10th FC recommended a grant of Rs. 4,380.93 crore for panchayats, and Rs. 1,000 crore for municipalities. The 11th FC recommended a grant of Rs. 8,000 crore for panchayats and Rs. 2,000 crore for municipalities. The 12th FC allocated a grant of Rs. 20,000 crore for panchayats and Rs. 5,000 for municipalities. The 13th FC recommended a sum of Rs. 87,519 crore, out of which panchayats were awarded Rs. 63,051 crore, municipalities Rs. 23,111 crore and a special area grant of Rs. 1,357 crore.

- So far as the performances and audit of the recommended funds are concerned, it has been observed that there is a lack of reliable financial data on panchayats and municipalities. So, previous FCs have noted for improvement of accounts, the heads of account under which funds flow to local bodies should be streamlined, exercising control and supervision over the maintenance of accounts and audit of all tiers of rural and urban local bodies and that the C&AG's audit report should be placed before a committee of the state legislature.

- Previous FCs have also recommended measures for augmenting the consolidated fund of the state governments to supplement the resources of the local bodies. The 10th FC suggested imposition of taxes on land and farm incomes, surcharge or cess on state taxes, levy of professions tax, improving the efficiency of collection of property tax, assignment of a buoyant tax in lieu of octroi when it is abolished, levy of service charges and periodic revision therein. Similarly, the 11th FC identified fourteen best practices, which included the following: (i) measures for augmenting resources of panchayats such as compulsory levy of major taxes and exploring all non-tax revenue sources; (ii) obligatory levy of user charges; (iii) insistence on the collection of minimum revenue and providing incentive grants for collections beyond this prescribed minimum amount; (iv) identifying revenue-generating common property resources and ensuring adequate income from them; and (v) giving powers to intermediate or district panchayats to levy tax or cess or surcharge on agricultural holdings. S far as the 13th FC is concerned, it suggested that the States could do the following: (a) mandate some or all local taxes as obligatory at non-zero rates of levy; (b) provide matching grants for revenues raised; (c) explore market-based financing through the issue of municipal bonds; and (d) share mining royalties with the local body in whose jurisdiction the income originates.

- It is observed that the previous FCs have adopted different approaches for the transfer of funds to the local bodies. The major concerns for all the previous FCs were the management and audit of the funds by the local bodies. Therefore, a proper accounting practice is required at the local level to fulfill the goals of federal governments.

IV. RECOMMENDATION OF 14TH FINANCE COMMISSION FOR LOCAL BODIES

The 14th Finance Commission was mandated to recommend measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State. Accordingly, the 14th FC tries to find out the resource gap of the local bodies, but the FC has expressed its helplessness to depend on the data collected because of variation in the quality of the data across all states. Therefore, 14th FC has recommended the transfer of funds after careful examination of the SFCs reports of different states. The 14th FC has focused on basic services and recommended that the local bodies should be required to spend the grants only on the basic services within the functions assigned to them under relevant legislations. Further, it is audit and accounts should be maintained properly, and the accounts should distinctly capture income on account of own taxes and non-taxes, assigned taxes, devolution and grants from the State, grants from the Finance Commission, and grants for any agency functions assigned by the Union and State Governments. Technical guidance and support arrangements by the C&AG should be provided.

A. Criteria and Quantum of grants to local bodies

The 14th FC has not used any index or indices of devolution transfer of resources to States for panchayats and municipalities. However, it has recommended the distribution of grants to the States using 2011 population data with the weight of 90 percent and area with the weight of 10 percent. The total grant to each state is divided into two such as a grant to gram panchayats and a grant to municipalities. Giving stress on the provision of basic services to the people and recognizing the importance of stability and predictable resource flow to the local bodies, the 14th FC has recommended a total grant of Rs. 2,87,436 crore for the period 2015-20. The total grant to panchayats worked out to be Rs. 2,00,292.2 crore, and that to municipalities are Rs. 87,143.8 crore, which consists of assistance of Rs. 488 per capita per annum at an aggregate level. Accordingly, the grant for each State for each year is fixed. This has been done by 14th FC to ensure a stable flow of resources at predictable intervals. The grants recommended by 14th FC consist of two parts such as a basic grant and a performance grant for gram panchayats and municipalities. In the case of gram panchayats, 90 percent of the grant is the basic grant, and 10 percent is the performance grant, whereas, for municipalities, the division between basic and performance grant is on an 80:20 basis. The grants recommended by 14th FC are to be released in two installments each year in June and October. In addition to the grants, 14th FC has also recommended augmenting the resources of local bodies. It suggested that the levy of vacant land tax by peri-urban panchayats be considered, and a part of land conversion charges can be shared by State Governments with municipalities and panchayats. States are advised to take steps to empower local bodies to impose advertisement tax and improve their own revenues from this source and also recommended that states should review the structure of entertainment tax. The 14th FC recommends raising the ceiling of professions tax from Rs. 2,500 to Rs. 12,000 per annum.

B. The 14th FC and Odisha

The 14th FC has recommended a Basic Grant of Rs. 7965.28 crores and a performance grant of Rs. 885.03 crores to the panchayats of Odisha, which is worked out to be a total of Rs. 8850.31 crores. Similarly, for municipalities, a total grant of Rs. 1772 crores are recommended, which consists of Rs. 1417.98 crores as basic grants and Rs. 354.50 crores as the performance grant. The grant receivable by the state government of Odisha will be transferred to the local bodies as per the recommendation of the state finance commission (SFC) reports. Therefore, now it is imperative to analyze the SFC reports of Odisha to understand the implications of the 14th FC recommendations. The following sections deal with the recommendations of the SFC.

V. RECOMMENDATION OF STATE FINANCE COMMISSION IN ODISHA

Since the recommendation of 14th FC is linked to the SFC reports, it is imperative to analyze the SFC reports of Odisha to analyze the implication of FC recommendations. As of now, four SFC has been constituted by the state government of Odisha. Here we have discussed the implementation status of the 2nd and 3rd SFC, and the subsequent section deals with the recommendation 4th SFC on local bodies.

A. Implementation Status of the 2nd SFC

The 2nd SFC was constituted in 2004 and submitted its report in 2005. The 2nd SFC recommended the transfer of 10% of the State's average gross tax revenue to the local bodies during the period from 2005 to 2010. But to a stark contrast, the government has not released the recommended money to the local bodies. Table 1 shows the 2nd SFC recommendation and the actual money released by the government to PRIs.

Table 1. Second SFC Recommendation and Released amount to PRI (in Crore)

Type of Transfer	Recommendation	Released	Difference
Devolution	847.32	0	-847.32
Compensation & Assignment	0	120.93	120.93
Grants-in-aid	610.98	178.51	-432
Total	1458.30	299.44	-1158

Table .1 shows that no fund was released to the PRIs under devolution head though the recommended amount was Rs.847.32 crore. Similarly, in the case of grants-in-aid to PRIs, the released amount was Rs.178.51 crore against the recommendation of Rs.610.98 crore. So far as compensation and assignment to PRIs are concerned, the 2nd SFC was silent, and however, the government has released Rs.120.93 crores under this head. In total, the 2nd SFC has recommended Rs. 1458.30 crore for PRIs, but the state government had released only Rs. 299.44 crore. This shows a huge difference between a recommendation and released amount under different heads. So far as urban local bodies (ULBs) are concerned, the scenario is completely different. Table 2 shows 2nd SFC recommendation and the actual money released by the government to ULBs.

Table 2. Second SFC Recommendation and Released amount to ULBs (in Crore)

Type of transfer	**Recommendation**	**Released**	**Difference**
Devolution	211.83	0	-211.83
Compensation & assignment	0	1074.26	1074.26
Grant –in-aid	246.37	106.98	-139.39
Total	458.2	1181.24	723.04

Sources: Compiled from 3rd and 4th SFC report of Odisha

This is clear from the above that the 2nd SFC recommended Rs.211.83 crore to the urban local body (ULB) on devolution head, but the state government has released no amount under this head. But under the compensation & assignment, the government has released Rs.1074.26 crores against the zero recommendation. So far as the total amount is concerned, the government has released Rs.723.04 crores over and above the recommended amount. Thus there is a differential approach adopted by the state government towards PRIs and ULBs. This differential approach needs to be streamlined. The 2nd SFC recommended Rs.847.32 & Rs.211.83 crore to the PRI and ULB on the devolution head. But there was no response from the government on this head. Though the SFC has given more priority to PRIs, the state government has released more money to ULBs.

B. Implementation status of the 3rd SFC

The 3rd SFC was constituted in the year 2008 under the provision of Article-243-I and 243- Y of the Constitution of India, Orissa Finance Commission Act 1993. The 3rd SFC had a provision that 15 percent of state tax revenue transferred to the local bodies on the ground of devolution, grant-in-aid, and assignment. Table3 and 4 show the recommended and released amount under different heads to PRIs and ULBs.

Table 3. Third SFC Recommendation and Released amount to PRI (in Crore)

Type of transfer	Recommendation	Released	Difference
Devolution	3360.64	906.45	-2453.95
Compensation & Assignment	0	175.04	175.04
Grants-in-aid	2224.45	836.66	-1387.79
Total	5585.19	1918.15	-3667.04

Sources: Compiled 4th SFC report of Odisha

Table .3 shows that the state government has not released the required fund recommended by SFC. The SFC recommended 3360.64 crore funds to PRIs under devolution, but the state government has released only Rs.906.45 crores. In the case of grant-in-aid, SFC recommended Rs. 2224.45 crores, but the government has released only Rs836.66 crores to PRIs. So far as the total recommendation is concerned, SFC had recommended Rs. 5585.19 crores, but the state government had released only Rs.1918.15 crores. So there is a huge gap of 3667.04 crores between the released amount and recommended amount.

Table 4. Third SFC Recommendation and Released amount to ULBs (in Crore)

Type of transfer	Recommendation	Released	Difference
Devolution	1120.21	241.84	-878.37
Compensation & assignment	0	2022.22	2022.22
Grant –in-aid	421.10	116.04	-305.06
Total	1541.31	2380.10	838.79

Sources: Compiled and 4th SFC report of Odisha

Table 4 shows 3rd SFC recommendation and amount released by the government to ULBs. Here the scenario is again different, like 2nd SFC. The state government has released more money to the ULBs than the recommended amount. During the 3rd SFC period, the state government has also adopted a different approach between PRIs and ULBs. The 3rd SFC basically focuses on devolution head of local bodies, but the government actually release more fund assignment and compensation sector. During the 2nd and 3rd SFC, the state government has not released the recommended amount of the PRIs. This calls for serious introspection in the ongoing 4th SFC.

VI. RECOMMENDATION OF 4TH SFC FOR LOCAL BODIES

After scrutinizing the implementation status of the previous SFCs, in this section, we analyze the recommendation of the 4th SFC. According to the 4th SFC report, the 'constitutional provisions fairly assumed that the financial sustainability of the rural and urban local bodies could not be ensured only by assigning taxes, duties, tolls, and fees. Indeed, these are less buoyant in nature, and the local bodies have not been able to exploit the assigned sources of revenue. To supplement the resources of the local bodies, transfer from the State's own revenue as well as grants-in-aid thus plays a pivotal role. The role of the State Finance Commission in determining the principles governing these transfers and for activities of the local bodies assumes significance. Addressing the vertical and horizontal imbalances is also a pertinent issue for the State Finance Commission.' Recognizing the fiscal constraints of the state, the current SFC tries to strengthen the fiscal domain of the PRIs and Municipalities so as to enable them to function effectively. The 4th SFC identified eight thrust or basic areas where the local bodies have to focus on delivering services. These basic or thrust areas area water supply, solid waste management, stormwater drainage, sanitation, street light, repairing of living quarters for functionaries, maintenance of assets, and revenue generation.

To perform the assigned duties, the local bodies will get resources from two sources such as (a) own revenue and (b) transfer receipts. To generate their own revenues, the PRIs, particularly gram panchayats, are empowered to levy and collect taxes, fees, and duties like a cycle, rickshaw, cart tax, etc. taxation of latrine, drainage, and water, if provided; fees from the lease of public properties, markets, etc. The commission recommends that the rate of taxation be revised by the PRIs themselves. However, the 4th SFC has suggested three new taxes for PRIs such as (1) Fees for approval of construction, (2) Advertisement Tax, and (3) Property Tax.

So far as transfer receipts are concerned, the 4th SFC has recommended for transfer of funds under three broad heads: (a) Devolution, (b) Assignment taxes, and (c) Grants-in-Aid, which are discussed below in detail.

A. Schemes of Devolution

The quantum of devolution under the 4th SFC is earmarked with Rs. 3291.85 crores which is 3% of the State's net shareable pool of taxes (excluding Entry Tax, Entertainment Tax, and Motor Vehicle Tax). The devolution money is generally to be spent on meeting the infrastructural gap and welfare needs of the community. The 4th SFC has recommended that the devolution amount is to be untied and is to be divided between rural and urban local bodies in the proportion of 75:25. The inter-se-distribution amongst three tiers of PRIs and categories of ULBs is based on population, category number of units like number of GPs, Panchayat Samit's, etc. The formula used for the devolution of money between PRIS and ULBs is shown in table 5.

Table 5. Criteria for fund allocation among PRIs and ULBs

Criteria	Data Reference	Rural	Urban	Ratio with Criteria		Weight to criteria	Ratio after weight is assigned to criteria	
				Rural	Urban		Rural	Urban
Population	2011	83.31	16.69	4.99	1	30	1.50	0.3
Density of Population		228.48	2636.63	0.09	1	30	0.03	0.3
% age of persons below poverty line	2011-12 68th Round NSSO	35.69	17.29	2.06	1	20	0.41	0.2
Literacy Rate	2011	70.2	90.7	0.77	1	10	0.08	0.1
SC and ST concentration	2011	90.66	9.34	9.71	1	10	0.97	0.1
Total Weight							2.98	1
Rural Urban Divide (in Percentage)							75	25

Sources: 4th SFC Report, Odisha

As per the criteria, PRIs will get 75% of the total devolution, which worked out to be Rs.2468.85 crores out of which Rs.1852.95 crore is meant for Gram Panchayats, Rs.498.15 crore for Panchayat Samitis, and Rs.117.75 crore for Zilla Parishads during the award period 2015-2020. Further, ULBs will get 25% of the total devolution, which worked out to be Rs. 823 crores, out of which municipal corporations will get Rs.258.90 crores, municipalities will get Rs.430.45 crores, and NACs will get Rs.133.65 crores over the five years 2015-2020.

B. Assignment of Taxes

The Commission considered the recent development of meeting the establishment expenses of local bodies from grants or assignments out of recommendations of the State Finance Commissions. The total assignments worked out to be Rs. 6530.50 crores, out of which Rs3001.70 crores are meant for PRIs and Rs.3528.80 crores for ULBs. The assignment money is generally spent on salaries and establishments head of the PRIs and ULBs.

C. Grant-in-Aid

One of the mandates of the Commission was to lay down norms for providing grants-in-aid to the units of local self-government from the consolidated fund of the State. The grant-in-aid is provided for some specific sector development. Institutions of local governance are expected to look after the sectors of development and services as specified in the Eleventh and Twelfth Schedules of the Constitution. Having recommended funds to be devolved and assigned to the local bodies, the Commission proceeds to identify specific services and infrastructure needs that should be met in the ensuing five years of the award period. Sectors needing thrust are drinking water supply, solid waste management, stormwater discharge, sanitation, street lighting, drainage & roads, staff quarters, maintenance of assets, creation of revenue generation avenues, capacity building, incentive structure, etc. The funds recommended under grand in aid to PRI and ULB are given in table 6.

Table 6. Sector Specific Funding

Local Bodies		Component	Fund Requirement (2015-2020)
PRIs		Water Supply	
	1	Mega water Supply to Acute Affected Villages	1010.97
		Installation of tube well	775.46
		O & M for Rural Water Supply	2515.00
	2	Street Lighting	259.38
	3	Drainage System	2972.00
	4	Staff Quarters Construction in GPs	215.14
	5	Staff Quarter Construction in Panchayat Samiti	140.18
	6	Capital Assets Maintenance	330.94
	7	Creation of Capital Assets for Revenue generation	622.70
	8	Incentive	75.36
	9	Engagement of CAs and Database Management	120.54
		Total	**9037.67**
ULBs		**Water Supply**	
	1	New Installation	2703.00
		O & M	1754.00
	2	Solid waste management	882.80
	3	Strom water drainage	802.00
	4	Street light	92.00
	5	Maintenance of Capital Assets	45.75
	6	Urban sanitation	52.46
	7	Creation of capital assets and revenue generation	84.00
	8	Incentive	34.00
	9	Capacity building and database management	15.00
		Total	**6465.01**
Grand Total			**15502.66**
Sources: 4th SFC Report, Odisha			

A total sum of Rs.15502.68 crores is recommended under grant-in-aid, out of which 9037.67 crores are recommended for PRs and Rs. 6465.01 crores recommended for ULBs. For PRIs, major thrusts are given to drainage systems and rural water supply. For ULBs, major thrusts are given to water supply and solid waste management.

VII. IMPLICATIONS OF THE ECOMMENDATION ON LOCAL BODIES

The above recommendations of 14th FC and 4th SFC of Odisha have a wide range of implications on local bodies. The major implications are outlined below

- The grants are linked to performance requirements, and thus the local bodies have to show their performance in terms of revenue generation and expenditure.
- The local bodies have to maintain proper Accounts and Audits to get performance grants. But still, there is a trust deficit between the state and local bodies that needs to be bridged.
- The recommendation has stressed the priority of basic services, and thus the local bodies should be required to spend the grants only on the basic services within the functions assigned to them under relevant legislations.
- The 4th SFC recommendation will augment the revenue and expenditure of the local bodies, but it may create doubtful expenditure for which proper monitoring is required.
- Money will be directly transferred to GPs, which will reduce the complexity of fund transfer. This will speed up the process.
- Though the revenue and expenditure of the PRIs will increase, they are still needing a focused approach to increase their own revenue.
- The current recommendation will increase direct accountability, and local-level planning will be very effective. However, to bridge the trust deficit, some monitoring agency is required.
- The thrust areas like water supply, solid waste management, stormwater drainage, sanitation, street light, etc., will be upgraded, but local influence needs to be managed in a positive manner.

VIII. CONCLUSION

To sum, it can be said that the FCs have given more priority to accountability and focus on basic services. Further, the FC has given more choices in the hands of the local bodies to increase their revenues. However, effective monitoring, a Fund Management system, maintenance of local assets, and creation of assets must be supervised under a surveillance system to make the local bodies function more effectively. Further PRIs level planning requires professional help, and government should make provision for this.

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