

As desired by the DG, IIPA, Executive summary of the following report is placed below:

State-Local Fiscal Transfers in India and Select Other Federations – An Analysis for the Sixth State Finance Commission of Odisha

1. Context and Objectives

This study, commissioned by the Sixth State Finance Commission (SFC) of Odisha and undertaken by the Indian Institute of Public Administration (IIPA), aims to analyze the framework and effectiveness of fiscal decentralization in India -particularly Odisha - and draw comparative lessons from select federations globally. Rooted in Articles 243I and 243Y of the Constitution, the SFCs are entrusted with recommending principles for tax sharing, revenue assignments, and grants to Panchayats and Municipalities. The Sixth SFC has been tasked with assessing fiscal needs, resource gaps, and suggesting strategies for improved service delivery from 2026 to 2031.

2. Genesis of Articles 243-I and 243-Y

The report details the origins of Articles 243 I and 243 Y of the Constitution, which mandate the establishment of SFCs to recommend principles for distributing financial resources between the state and its local governments. It explores the intent of the 73rd and 74th Constitutional Amendments, emphasizing the role of these provisions in enhancing fiscal autonomy and accountability of *Panchayats* and Municipalities.

3. Evolution of Fiscal Decentralization in Odisha

Odisha's journey in fiscal decentralization began with the Odisha Panchayati Raj Finance Commission Act, 1993, focusing solely on *Panchayats*. In 1996, the Act was amended to include Municipalities, aligning with Articles 243I and 243Y of the Constitution. The renamed Odisha Finance Commission was tasked with recommending principles for revenue sharing, grants-in-aid, tax assignments, and financial strengthening of local government.

Successive SFCs have steadily evolved in their treatment of Panchayats and Municipalities, across key areas:

- **Global Sharing:** From individual tax shares (1st SFC) to a 3% share of Net Own Tax Revenue (NOTR) (4th & 5th SFCs), with a 75:25 split favoring *Panchayats*. Later SFCs adopted composite criteria like poverty, SC/ST population, and density, marking a shift from population-only formulas to multidimensional equity-based allocation.
- **Allocation:** Evolved from basic population-area-based criteria to include factors like rural connectivity, landholdings, and revenue effort. *Panchayats* increasingly received allocations based on number of units (GPs/PSs), while Municipalities mostly used population.

- Tax Sharing: Transitioned from fragmented taxes (Kendu Leaf, MVT, entertainment surcharge) to formula-based shares of SGST and MVT. The 5th SFC recommended 7.46% of net SGST and 8.03% of MVT to local government.
- Tax/Non-Tax Assignments: Initially broad (e.g., building tax, tolls, license fees), later assignments included vacant land tax, ecological fees, and sewerage surcharges, reflecting a response to urban-environmental needs.
- Grants-in-Aid: Expanded from salary support to sectoral, performance-based, and infrastructure-focused grants. The 5th SFC covered rural roads, solar lighting, school maintenance, data centers, and drainage systems, promoting local innovation and accountability.
- Powers and Functions: Gradual functional devolution of services (sanitation, water, roads) was matched by staffing reforms - creation of Panchayati Raj cadres, accounting staff, and integration of technical personnel. Municipalities saw parallel empowerment, with enhanced planning units and urban development training institutes.
- Other Measures: SFCs emphasized timely fund release, synchronized SFC and UFC cycles, accrual accounting, District Monitoring Committees, and enforcement of the Odisha Municipal Act, 2015.
- Methodologies: SFCs progressed from questionnaires and public consultations (1st SFC) to empirical fieldwork, expert studies, divisional-level interactions, and state benchmarking (4th & 5th SFCs).

4. Indicators for Designing Intergovernmental Fiscal Transfers (IGFT)

SFCs design fiscal transfers using certain indicators that reflect fiscal needs, capacity, effort, and disability factors. IGFTs are not just funding tools - they are policy instruments that aim to strengthen local governments' capacity, promote equity, and ensure accountability.

Four key attributes guide IGFT design:

- **Fiscal Needs**: Resources required to deliver services (e.g., population, area, poverty incidence).
- **Fiscal Capacity**: Ability to generate revenue (e.g., district GDP, Own Revenue Mobilization).
- **Fiscal Effort**: Actual revenue generation compared to capacity (e.g., tax effort, fiscal discipline).
- **Disability Factors**: Structural disadvantages like remoteness, hilly terrain, or high service demand.

States and SFCs use a wide range of 21 indicators and 7 composite indices, such as:

- Population & Area: Universal, transparent, and reflect cost/service delivery scale.
- Poverty, SE Backwardness, IMR, Girl Education: Reflect development and need disabilities.
- Tax Effort, ORM, Fiscal Discipline: Capture revenue mobilization and governance quality.
- Remoteness, DDPPc, IGVAOpp: Adjust for location-based or sectoral disparities.
- Indices like UDI, IDBI, Index of Deprivation: Composite tools to assess multi-dimensional backwardness.
- Devolution & Decentralization Indices: Measure State support for local autonomy.

The use of these indicators ensures equity, objectivity, and efficiency in fiscal devolution. Odisha's future SFCs can draw on this evolving toolkit to build a context-sensitive, performance-based, and need-responsive IGFT framework.

5. Comparative Analysis of Recent SFC Recommendations

SFCs play a vital role in bridging the gap between assigned responsibilities and financial resources through revenue-sharing recommendations and institutional reforms. An analysis of 27 recent SFCs considers six key areas of commonality in recommendations:

1. Global Sharing of State Revenue: Most SFCs base devolution on a percentage of State Own Tax Revenue (SOTR) or broader fiscal pools. Some include GST compensation and Union tax shares, while others restrict the divisible pool to net own tax revenue. Sharing structures vary widely - from Gujarat and Karnataka (own tax and non-tax revenue) to Himachal Pradesh (gap-filling grants) and Kerala (differentiated development/maintenance funds). *Panchayats* usually receive a higher share in rural-dominated states, while urban-heavy states prioritize Municipalities.

2. Allocations and Equity: Most SFCs use population and area as primary criteria for allocating funds within *Panchayats* and Municipalities. Several also incorporate backwardness, fiscal effort, SC/ST population, environmental vulnerability, and per capita revenue distance to promote equity. Kerala, Rajasthan, and Mizoram used SECC deprivation indices; Odisha and Andhra Pradesh developed class-based and population-based GP classifications to tailor allocations.

3. Individual Tax Sharing: States assign varying shares of taxes like motor vehicle tax, profession tax, stamp duty, etc., to local governments. Some prefer grants instead of tax sharing

to simplify administration. A few, like Kerala and Andhra Pradesh, provide compensation for lost tax powers post-GST, maintaining fiscal stability for local governments.

4. Assignment of Tax and Non-Tax Handles: SFCs recommend expanding local fiscal powers - e.g., vacant land tax, building permit fees, parking fees, service charges, etc. - but highlight the absence of enabling by-laws as a barrier. Tamil Nadu and Sikkim promote broader tax autonomy, while other states call for strengthening user charges and streamlining collection processes.

5. Grants-in-Aid: SFCs provide both untied (general-purpose) and tied (special-purpose) grants, with growing emphasis on:

- Performance grants (based on sanitation, revenue effort, digital compliance),
- O&M grants (linked to asset maintenance),
- Capacity-building funds, and
- Development grants (sectoral, matching share, or project-based). Kerala, Sikkim, and Haryana stand out for innovation in performance-linked and environmental grants.

6. Powers and Functions: Despite legal devolution, most States continue to retain control over core functions (roads, sanitation, water) *via* line departments. SFCs recommend clearer functional assignment and resource-backed devolution. Odisha, Andhra Pradesh, and Tamil Nadu emphasize the need to empower GPs and Municipalities with staff, finances, and operational autonomy.

7. Other Measures: SFCs across states recommend:

- E-governance tools (e-Panchayat/IFMS),
- Digital audits, social audits, and performance-linked grants,
- Institutional coordination for peri-urban areas, especially in Tamil Nadu and Uttarakhand,
- Special treatment for small GPs to ensure basic service viability, e.g., Odisha's population-based GP categories.

6. Methodologies Adopted by Latest SFCs Across States

Recent SFCs across states have adopted diverse yet increasingly sophisticated methodologies to fulfill their mandates. These include structured data collection through questionnaires, consultations with government departments, field visits, and use of digital tools such as web portals and dashboards. States like Kerala, Tamil Nadu, Telangana, and Karnataka demonstrated

robust, evidence-based approaches, partnering with academic institutions for research and analysis. However, states like Nagaland and Arunachal Pradesh followed minimal or continuity-based models due to data or institutional limitations. COVID-19 influenced SFCs (Punjab, Tripura, Uttarakhand) relied more on secondary data and virtual consultations. Overall, a shift toward more inclusive, data-driven, and participatory methodologies is evident, though capacity and technological disparities persist across states.

7. Comparative Analysis from Other Federations

The report draws insights from federal countries - Argentina, Australia, Brazil, Canada, Germany, and South Africa- to inform Odisha's fiscal decentralization strategy:

- Australia and Canada: Emphasize vertical balance and performance-linked grants.
- Germany: Strong intergovernmental coordination with a focus on equalization.
- Brazil and South Africa: Highlight constitutionally mandated local tax powers and transparent transfer systems.

These models underscore the importance of predictable, rule-based, and transparent fiscal arrangements.

8. Select Practices Relevant for the Sixth SFC of Odisha

This chapter outlines relevant SFC practices from across India that the Sixth SFC of Odisha can adopt to enhance equitable and efficient fiscal devolution. Key themes are structured under fiscal needs, capacity, effort, and disability factors, in line with global IGFT norms.

1. Fiscal Needs: Odisha, being disaster-prone and developmentally diverse, should adopt delay compensation mechanisms, provide support for new/upgraded ULBs, and use backwardness indices and ecological vulnerability (as in Kerala) to allocate funds. Distinct norms for PESA and non-PESA Gram Panchayats are vital.

2. Fiscal Capacity: To improve local resource generation, Odisha should operationalize District/Metro Planning Committees, adopt a Local Fiscal Responsibility Act (as in Karnataka), and rationalize tax rates regularly. Outsourcing tax collection to SHGs/third parties and establishing a State Property Tax Board would enhance revenue efficiency. Revising the professional tax ceiling is also overdue.

3. Fiscal Effort: The state should tap into Value Capture Finance (VCF) for urban growth, prioritize arrear recovery, and strengthen SFC monitoring cells. These will improve financial discipline and local accountability.

4. Other Key Practices: Odisha can adopt dedicated fund streams (GPF, Dev, Maintenance), introduce service-level benchmarks for Panchayats, and explore municipal green bonds. Additionally, capacity building in digital skills, fund management, and disaster resilience is critical. Integrating CSR, SHGs, renewable energy, and localized data systems will strengthen decentralized governance.

Overall, these practices align with Odisha's needs in terms of disaster preparedness, fiscal decentralization, capacity constraints, and service delivery challenges - making them both feasible and impactful for the Sixth SFC's recommendations.

7. Fiscal Decentralization and the Mandate of the Sixth State Finance Commission of Odisha

The chapter outlines a forward-looking roadmap for the Sixth SFC of Odisha to deepen fiscal decentralisation and empower local governments. It suggests a balanced approach combining continuity with innovation, anchored in a data-driven, performance-oriented and normative framework. On vertical devolution, it proposes a structured, formula-based system that accounts for both expenditure needs and revenue capacity, ensuring equitable and predictable transfers. For horizontal allocation, it advocates moving beyond population-based criteria to include factors like deprivation, fiscal effort, disaster vulnerability, and special attention to tribal and aspirational districts. Strengthening local revenues through sharing specific taxes like profession tax and Motor Vehicle Tax and assigning more tax and non-tax handles such as market fees and user charges is also advised.

The chapter emphasizes the importance of untied, tied, and performance-based grants-in-aid with transparent eligibility and monitoring systems. It calls for aligning local revenue powers with expenditure responsibilities through activity mapping and linking them to the Eleventh and Twelfth Schedule functions. A normative approach for estimating local revenue and expenditure needs is suggested, including service-level benchmarks and adoption of cost-effective delivery models like PPPs and digital tools. It also stresses the need to review the implementation of the Fifth SFC's recommendations to identify bottlenecks and improve future execution.

Institutional reforms such as stronger audits, transparent accounting, digital systems, and regular capacity building for local officials are seen as essential. Additional best practices suggested include structured Action Taken Reports (ATRs) to the legislature and clear definitions for peri-urban areas.