GOVERNMENT OF INDIA
MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS

EXPLANATORY MEMORANDUM AS TO THE ACTION TAKEN ON THE RECOMMENDATIONS MADE BY THE TWELFTH FINANCE COMMISSION IN ITS REPORT SUBMITED TO THE PRESIDENT ON DECEMBER 17, 2004

1. The Twelfth Finance Commission was constituted by the President on November 1, 2002 to give recommendations on specified aspects of Center State fiscal relations during 2005-10. The Commission submitted its Report covering all aspects of its mandate on December 17, 2004.

2. The Finance Commissions are constituted by the President after every five years or earlier under Article 280 of the Constitution to give recommendations on specified aspects of Centre-State fiscal relation. The recommendations of these Commissions are based on detailed assessment of the financial position of the Central and State government and wide consultations with stakeholders. The Commissions usually visit the States, sponsor studies, hold consultations with experts and their recommendations are backed up by detailed reasons disclosing the methodology adopted by them.

3. The Report of the Twelfth Finance Commission (hereinafter referred to as the Commission) covering the five years period commencing from April 1, 2005 together with the Explanatory Memorandum on the action taken on the recommendations of the Commission is being laid on the table of the House, in pursuance of Article 281 of the Constitution. A summary of the Commission's main recommendations relating to devolution of taxes and duties to the State, grants-in-aid under Article 275 of the Constitution, financing of relief expenditure and debt relief to the States and other matters is contained in Chapter 16 of the Report of the Commission.

4. The Government has carefully considered the main recommendations contained in the Report of the Commission and the action proposed to be taken on these recommendations is detailed below.

DEVOLUTION OF SHARE IN CENTRAL TAXES AND DUTIES TO STATES

5. Under Article 270 of the Constitution, as amended w.e.f. 1st April, 1996 by the Constitution (Eightieth Amendment) Act, 2000, a prescribed percentage of the net proceeds of all Central taxes (except Union surcharge, cess levied for specific purpose under any law made by Parliament and the duties and taxes referred to in Articles 268 and 269) is to be assigned to the States within which that tax is leviable in that year and distributed among those States in terms of Orders issued by the President on the recommendations of the Finance Commission.

For the period of five years commencing from April 1, 2005, the Commission has recommended that 30.5 per cent of the net proceeds of shareable Central taxes may be distributed amongst all such States where any such Central tax is leviable. If in any year during 2005-10, a particular Central tax is not leviable in a State, the share of that State in that tax should be put to zero and the entire proceeds be distributed among the remaining State by proportionately adjusting their shares. For this purpose, additional excise duties in lieu of sales tax on textiles, tobacco and sugar are treated as part of the shareable pool of central taxes. If this tax rental arrangement is terminated and the States are allowed to levy sales tax (or VAT) on these commodities without any prescribed limit, the share of the State in the net proceeds of shareable central taxes shall be reduced to 29.5 percent. If any legislation is enacted in respect of service tax after the Eighty Eight Constitutional amendment is notified, it must be ensured that the revenue accruing to a State under the legislation should not be less than the share that would accrue to it, had the entire service tax proceeds been part of the shareable pool. The percentage share of each State in Union taxes and duties and the criteria for devolution and relative weights assigned to different factors is indicated in Chapter 7 of the Report.

The Government has accepted the above recommendations of the Commission.

GRANTS-IN-AID OF THE REVENUES OF STATE UNDER THE SUBSTANTIVE PROVISIONS OF ARTICLE 275 OF THE CONSTITUTION

Non-plan Revenue Deficit Grant

6. The Commission has recommended grant-in-aid to be given under Article 275(1) of the Constitution, other than those under the proviso to Article 275(1), equal to the amount of deficits assessed for each year during the period 2005-10. A total non-plan revenue deficit grant of Rs.56855.87 crore is recommended during the award period for fifteen States. The amount of the grant for each State having non-plan deficits is indicated in Chapter 10 of the Report for each of the 5 years starting from the financial year 2005-06.

The Government has accepted this recommendation.

Grant for education

7. The Commission has recommended grants for eight States amounting to Rs.10171.65 crore over the award period for the education sector, with a minimum of Rs.20 crore in a year for any eligible State. The year-wise allocation for each State is given in Chapter 10 of the Report. The grant for the education sector is an additionality, over and above the normal expenditure to be incurred by the States in this sector. Conditionalities governing the release and utilization of this grant have been specified in Annexures 10.1 to 10.3 of the Commission's Report.

The Government has accepted this recommendation of the Commission.

Grant for health

8. The Commission has recommended grants for seven States amounting to Rs.5887.08 crore over the award period for the health sector, with a minimum of Rs.10 crore in a year for any eligible State. The year-wise allocation for each State is given in Chapter 10 of the Report. The grant for the health sector is additionality, over and above the normal expenditure to be incurred by the States in this sector. Conditionalities governing the release and utilization of this grant have been specified in Annexures 10.1 to 10.3 of the Commission's Report.

The Government has accepted this recommendation of the Commission.

Grants for maintenance of roads and bridges and public buildings

9. The Commission has recommended grants amounting to Rs.15000 crore for maintenance of roads and bridges and Rs. 5000 crore for maintenance of public buildings over the award period. The State-wise year-wise allocations are given in Chapter 10 of the Report. These grants are an additionality, over and above the normal expenditure to be incurred by the States. Conditionalities governing the release and utilization of these grants have been specified in Annexures 10.4 to 10.6 of the Commission's Report.

The Government has accepted the above recommendations of the Commission.

Grant for maintenance of forests

10. The Commission has recommended grants amounting to Rs.1000 crore over the award period for maintenance of forests. The State-wise, year-wise allocation is given in Chapter 10 of the Report. This grant is an additionality, over and above the normal expenditure to be incurred by the State for this purpose.

The Government has accepted this recommendation of the Commission.

Grant for heritage conservation

11. The Commission has recommended grants amounting to Rs.625 crore over the award period for heritage conservation. This grant is to be used for preservation and protection of historical monuments, archaeological sites, public libraries, museums and archives, and also for improving the tourist infrastructure to facilitate visits to these sites. The State-wise, year-wise allocation is given in Chapter 10 of the Report. This grant is an additionality, over and above the normal expenditure to be incurred by the States for this purpose.

The Government has accepted this recommendation of the Commission.

Grant for State specific needs

12. The Commission has recommended grants amounting to Rs.7100 crore over the award period for State specific needs. The State-wise, purpose-wise details of these grants are given in Chapter 10 of the Report.

The Government has accepted this recommendation of the Commission subject to the condition that the grants would be released based on the level of preparedness of the States to utilize the grants for the specific purpose for which they have been recommended.

Grants for local bodies

13. The Commission has recommended grants amounting to Rs.25000 crore over the award period for local bodies. Of this Rs.20000 crore is for Panchayats and Rs.5000 crore is for urban local bodies. The inter-State distribution and the criterion adopted in arriving at the proposed distribution are given in Chapter 8 of the Report. The Commission has emphasized that of the grants allocated to panchyats, priority should be given to expenditure on the O&M costs of water supply and sanitation and that at least 50% of the grants provided to each State for the urban local bodies should be earmarked for the schemes of solid waste management. Besides expenditure on O&M costs of water supply and sanitation in rural areas and on the schemes of solid waste management in urban areas, panchayats and urban local bodies should, out of the grants allocated, give high priority to expenditure on creation of data base and maintenance of accounts.

The Government has accepted this recommendation of the Commission as per the provisos to recommendation summarized in paras 8.52 to 8.55 of the Report.

Financing of calamity Relief expenditure

14. The Commission has recommended the continuance of the scheme of Calamity Relief Fund in its present form with contribution from the Centre and the States in the ration of 75:25. The size of the CRF for the period 2005-10 is worked out at Rs.21333.33 crore. This includes the Centre's share of Rs.16000 crore, and the State's share of Rs5333.33 crore. The State-wise distribution of CRF giving the Centre and State's share is indicated at Annexure 9.1 to 9.3 of the Report. The Commission has also recommended continuance of the scheme of NCCF in its present form with core corpus of Rs.500 crore. The outgo from the fund may continue to be replenished by way of collection of National Calamity Contingent Duty and levy of special surcharges.

The Government has accepted the above recommendations of the Commission.

Sharing of Profit Petroleum

15. The Commission has recommended the sharing of the non-tax revenue of 'Profit Petroleum' arising out of contractual provisions under NELP with the States from where the mineral oil and natural gas are produced in the ratio of 50:50. The details are given in Chapter 13 of the Report.

The government has accepted the above recommendations of the Commission subject to the condition that this should be within the overall ceiling of transfers recommended by the Commission (38% of gross revenues). This would imply that once the total transfers cross 38% of gross revenues of the Centre, sharing of non-tax revenue of Profit Petroleum would not accrue in that year. Further, this should not be considered by the State as establishing a general principle of sharing of the Centre's non-tax revenues.

Debt relief to States

16. The Commission has recommended that the scheme of Fiscal Reform Facility may be replaced by a scheme of Debt Relief over the period 2005-10. The scheme of Debt Relief recommended by the Commission envisages:-

I. The rescheduling of all Central Loans contracted till 31.3.2004 and outstanding as on 31.3.2005 into fresh loans for 20 years carrying 7.5% interest w.e.f. the years a State enacts the Fiscal Responsibility Legislation.

Details of the scheme are given in Chapter 12 of the Report.

The Government has accepted the above recommendations of the Commission subject to the condition laid down by the TFC that the debt relief (re-scheduling and consolidation and lowering of interest rate) would be admissible on the State enacting the Fiscal Responsibility legislation and would take effect prospectively from the year in which such legislation is enacted. It is also expected that the States would comply with the obligations regarding reduction of Fiscal Deficit and Revenue Deficit imposed by the Fiscal Responsibility Legislation. The Centre would request the next Finance Commission to make appropriate adjustment in case the State availing of the debt relief is not able to comply with the Fiscal Responsibility Legislation.

II. A debt write-off linked to reduction in revenue deficit by a State. The quantum of write-off of repayment would be linked to the absolute amount by which the revenue deficit is reduced in each successive year during the award period. In accordance with the recommendation of the TFC, the benefit of write-off would be available only if the fiscal deficit of the State is contained to the level of 2004-2005. If in any year the fiscal deficit exceeds this level, the benefit of write-off, even if eligible otherwise, would not be given. The details of the scheme are given in Chapter 12 of the Report.

The Government has accepted the above recommendations of the Commission.

Central Assistance for State Plans

17. The Commission has recommended that the Centre should release only the grant portion of Central Assistance for State plan (CPA) and leave it to the State to raise loan portion from any source. For States unable to raise loans from market, the Centre may act as a financial intermediary but without any subsidization of cost. The details are given in Chapter 10 of the Report.

This approach has been accepted by the Government, in principle, to be implemented in phases in consultation with RBI. Form 2005-06, the States would be allowed at their discretion, not to draw the loan portion of the CPA.

External Assistance Loans

18. The Commission has recommended that the Centre should pass on external assistance on back-to-back basis to State and manage it through a separate Fund in the Public Account. The details are given in Chapter 12 of the Report.

The Government has accepted the recommendation to pass on external assistance on the same terms and conditions on which it was received subject to the condition that the service cost and exchange rate fluctuations would also be passed on to the States under this arrangement.

Accounting Procedure

19. The Commission has recommended a move by the Centre towards introduction of accrual accounting and standardization of accounting classification down to the object head for all State to improve fiscal management. The details are given in Chapter 14 of the Report.

The Government has accepted this recommendation in principle. The Government Accounting Standards Board in the office of the Comptroller and Auditor General of India would be asked to draw a detailed road map and operational frame work for its implementation.

Miscellaneous

20. The Commission has recommended that the total transfers (tax devolution and Plan/Non-Plan grants) from the centre to the States should not exceed 38% of gross revenue receipts of the Centre (both tax and non-tax). The details are given in Chapter 7 of the Report.

The Government has accepted this ceiling on total Revenue account transfers, from the Centre to the States subject to the condition that the acceptance does not imply the establishment of a principle of mandatory sharing of a fixed percentage of Centre's revenue receipts with the States.

IMPLEMENTATION

21. The Commission's recommendations fall in the following categories:

I. Those to be implemented by an Order of the President.
II. Those to be implemented by executive orders.
III. Those to be examined further.

22. The recommendations under Articles 270 and 275(1) of the Constitution relating to share in Union taxes and duties and grants-in-aid, respectively, fall in the first category and the necessary order will be submitted to the President for approval.

23. The recommendations relating to sharing of Profit Petroleum, Debt Relief, Central Assistance for State Plans and External Assistance Loans will be implemented by executive orders.

24. Other recommendations of the Commission will be considered in due course.

New Delhi **P.CHIDAMBARAM**
February 26,2005 Minister of finance