
Chapter 1

Introduction

Appointment of the Twelfth Finance Commission

1.1 The appointment of a finance commission by the President is provided for under article 280 of the Constitution of India. The first such commission was constituted on November 19, 1951. The eleven finance commissions, which have preceded the present one, have, through their recommendations, given a definitive shape to fiscal federalism in our country. The present finance commission, which is the twelfth, was appointed by the President of India on 1st November, 2002 under the chairmanship of Dr. C. Rangarajan, the then Governor of Andhra Pradesh. The President also appointed two full-time members, namely, Shri T. R. Prasad, IAS (retd.), former Cabinet Secretary, Government of India and Prof. D. K. Srivastava of National Institute of Public Finance & Policy (NIPFP) and one part-time member, namely, Shri Som Pal, Member, Planning Commission. Dr. G.C. Srivastava, IAS was appointed as the Secretary to the Commission. Later on, he was appointed as Member Secretary, against the vacancy of the fourth Member with effect from July 1, 2003. Consequent upon the resignation of Shri Som Pal from the Commission, Dr. Shankar N. Acharya was appointed as a

part-time member with effect from 1st July 2004. The relevant notifications are at annexures 1.1, 1.2 and 1.3.

1.2 The Commission was originally asked to make its report available by the 31st July 2004 covering a period of five years commencing on the 1st April 2005. Subsequently, due to disruption of normal activities on account of preponement of parliamentary election, the President, through his order dated 1st July 2004, extended the tenure of the Commission up to 31st December 2004, but required the report to be made available by 30th November 2004 (notification at annexure 1.4).

Terms of Reference (TOR)

1.3 The President *vide* the notification dated 1st November, 2002 (annexure 1.1) mandated the Commission to do the following:

“4. The Commission shall make recommendations as to the following matters:-

- (i) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I Part XII

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- of the Constitution and the allocation between the States of the respective shares of such proceeds;
- (ii) the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues under article 275 of the Constitution for purposes other than those specified in the provisions to clause (1) of that article; and
- (iii) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.
5. The Commission shall review the state of the finances of the Union and the States and suggest a plan by which the governments, collectively and severally, may bring about a restructuring of the public finances restoring budgetary balance, achieving macro-economic stability and debt reduction along with equitable growth.
6. In making its recommendations, the Commission shall have regard, among other considerations, to: -
- (i) the resources, of the Central Government for five years commencing on 1st April 2005,
- on the basis of levels of taxation and non-tax revenues likely to be reached at the end of 2003-04;
- (ii) the demands on the resources of the Central Government, in particular, on account of expenditure on civil administration, defence, internal and border security, debt-servicing and other committed expenditure and liabilities;
- (iii) the resources of the State Governments, for the five years commencing on 1st April 2005, on the basis of levels of taxation and non-tax revenues likely to be reached at the end of 2003-04;
- (iv) the objective of not only balancing the receipts and expenditure on revenue account of all the States and the Centre, but also generating surpluses for capital investment and reducing fiscal deficit;
- (v) taxation efforts of the Central Government and each State Government as against targets, if any, and the potential for additional resource mobilization in order to improve the tax-Gross Domestic Product (GDP) and tax-Gross State Domestic Product (GSDP) ratio, as the case may be;
- (vi) the expenditure on the non-salary component of maintenance and upkeep of

- capital assets and the non-wage related maintenance expenditure on plan schemes to be completed by the 31st March 2005 and the norms on the basis of which specific amounts are recommended for the maintenance of the capital assets and the manner of monitoring such expenditure;
- (vii) the need for ensuring the commercial viability of irrigation projects, power projects, departmental undertakings, public sector enterprises etc. in the States through various means including adjustment of user charges and relinquishing of non-priority enterprises through privatisation or disinvestment.
7. In making its recommendations on various matters, the Commission will take the base of population figures as of 1971, in all such cases where population is a factor for determination of devolution of taxes and duties and grants-in-aid.
8. The Commission shall review the Fiscal Reform Facility introduced by the Central Government on the basis of the recommendations of the Eleventh Finance Commission, and suggest measures for effective achievement of its objectives.
9. The Commission may, after making an assessment of the debt position of the States as on the 31st March 2004, suggest such corrective measures, as are deemed necessary, consistent with macro-economic stability and debt sustainability. Such measures recommended will give weightage to the performance of the States in the fields of human development and investment climate.
10. The Commission may review the present arrangements as regards financing of Disaster Management with reference to the National Calamity Contingency Fund and the Calamity Relief Fund and make appropriate recommendations thereon.
11. The Commission shall indicate the basis on which it has arrived at its findings and make available the State-wise estimates of receipts and expenditure.”
- 1.4 In addition to the above, through a subsequent notification dated 31st October, 2003 (*vide* annexure 1.5), the Commission was asked to make recommendations on the following matters:
- “(i) whether non-tax income of profit petroleum to the Union, arising out of contractual provisions, should be shared with the States from where the mineral oils are produced; and
- (ii) if so, to what extent.”

Administrative Arrangements

1.5 The process of setting up of the administration of the Commission started with the appointment of Dr. V.K. Agnihotri as Officer on Special Duty in the Department of Economic Affairs on 30.06.2002. It took considerable time before the full complement of officers and staff could be put in place. The lists of sanctioned

posts and functionaries are at annexures 1.6 and 1.7. It also took a long time for the office accommodation at Jawahar Vyapar Bhavan to be made ready for use.

Golden Jubilee of Finance Commissions of India

1.6 The constitution of the Twelfth Finance Commission coincided with the completion of fifty years of the creation of this institution. In order to have an overview of the efforts made by the earlier commissions in ensuring stability and usefulness of the system of fiscal federalism in the country, a golden jubilee function was organized. It was inaugurated by the President of India, Dr. A.P.J. Abdul Kalam at Vigyan Bhawan in the forenoon of April 9, 2003. The inaugural function was presided over by the then Union Minister of Finance, Shri Jaswant Singh. The occasion was also graced by Shri K.C. Pant, the then Deputy Chairman of Planning Commission as chief guest. Chief ministers and finance ministers of states, secretaries and other officers of the Union and state governments and eminent economists were also present.

1.7 The inaugural function was followed by a conference of the finance ministers of the states and the launching of the official website www.fincomindia.nic.in of the Twelfth Finance Commission by Dr. C. Rangarajan. The website is interactive, dynamic, user friendly and rich in terms of data related to federal finance. Provision has been made to receive suggestions from the public online. A virtual secretariat comprising intranet (FincomNet) for select functionaries has been created and maintained to serve the requirements of the present and future finance commissions. The

website is maintained and updated in-house with the technical assistance of the National Informatics Centre.

1.8 On this occasion, the Commission brought out a commemorative volume titled, 'Fifty Years of Fiscal Federalism: Finance Commissions of India', which was released by the Chairman. The commemorative volume has turned out to be a useful compendium of excerpts relating to the composition, terms of reference, approach, recommendations and action taken reports in respect of all the eleven finance commissions. The collection, in one volume, of an otherwise scattered material has served as an authentic document, providing a comprehensive account of how the issues relating to fiscal federalism were handled from time to time.

1.9 In order to draw lessons from the experience of the previous commissions, a brain storming session was organized on 10th April 2003 wherein the chairman and members of previous finance commissions were invited to share their experiences and perception with respect to the intricacies of resource transfers from the Union to the states (list of participants at annexure 1.8).

Major Activities

1.10 Notwithstanding lack of adequately furnished accommodation and dearth of suitable personnel, the Commission started its work immediately after it was formally constituted and the Chairman and the members assumed office. The first formal meeting of the Commission took place on the 16th January 2003 in which the Commission approved the rules of procedure (copy at annexure 1.9).

1.11 The consultation process began with

a meeting of economists and economic administrators on 18.02.2003 at New Delhi. Similar meetings were held at Chennai, Mumbai and Kolkata on 10th March 2003, 17th April 2003 and 8th May 2003, respectively (list of participants at annexure 1.10).

1.12 To benefit from the suggestions of people at large, the Commission issued a press note (annexure 1.11) inviting views from the general public, institutions and organizations on issues related to its TOR. People at large responded to the press note. The list of the respondents is at annexure 1.12.

1.13 To elicit views/suggestions from the states on the TOR of the Commission, the Chairman wrote letters to chief ministers of the states and to eminent economists. The Member Secretary wrote letters to chief secretaries of the states with a request to furnish the views on TOR and on any issue of concern to them (a copy each of the letters issued are at annexures 1.13 and 1.14). The Commission received memoranda and representations from all the states.

1.14 With a view to getting acquainted with the perspective of the Union ministries on the TOR, the Chairman sought the views/suggestions of cabinet ministers. The Member Secretary also wrote to the secretaries of departments/ ministries of central government to forward their observations on TOR of the Commission (a copy each of the letters are at annexures 1.15 and 1.16). The Commission received views/suggestions from many departments/ ministries of central government (list at annexure 1.17).

1.15 Detailed information, data and other

inputs relating to Union, state and local body finances were collected from the central and state governments through schedules and write-ups. For this purpose, 57 proformae were designed and 75 topics were selected. A finance commission cell, headed by a dedicated officer, was set up by every state, so as to facilitate smooth flow of information. The Commission was, thus, able to collect a wealth of information, which enabled it to create a sound database for each state. All the information has been stored in the virtual secretariat to ensure its availability to finance commissions in the future.

1.16 In order to gauge the perception of the states relating to their financial requirements and to acquire first hand information about their fiscal performance as also to assess the socio-economic and other infrastructural needs of sub national governments, the Commission undertook visits to states commencing from 25th July, 2003. The schedule of the state visits was interrupted in the beginning of 2004 due to the nation going to polls (Lok Sabha and some of the state assemblies) during February to May 2004. The visits were resumed on 31st May, 2004 and got concluded in the month of July, 2004 (list of participants and itinerary of the state visits are at annexures 1.18 and 1.19). The Commission was warmly received by all the states and the meetings resulted in useful exchange of ideas. The local visits, which formed a part of the overall state visits, gave an opportunity to see and assess the intensity and gravity of the pressing needs of the rural and urban bodies. During the visits, the Commission also interacted with the representatives of local bodies, leaders of various political parties and representatives

of trade and industry.

1.17 Meetings with Accountants General of the states preceded the state visits of the Commission. These meetings (list at annexure 1.20) gave an incisive feed back on intricate issues concerning the respective states. The discussions primarily delved on issues relating to revenue and expenditure, vertical and horizontal imbalances at the level of local governments, measures taken for resource mobilization and reforms initiated to inculcate fiscal discipline.

1.18 In order to get inputs from noted economists and administrators in a structured manner, the Commission asked the National Institute of Public Finance & Policy (NIPFP) to organize a seminar on 'Issues before the Twelfth Finance Commission' on 29-30 September, 2003. At the seminar (list of participants at annexure 1.21), several papers were presented which focused on the key concerns in fiscal federalism in India. Some of the papers later appeared in the Economic and Political Weekly (Vol.39, No.26, June 26 – July 2, 2004, pp. 2707-2794). Subsequently, a compilation of all the papers along with experts' comments thereon was published in a volume titled, 'The Dynamics of Fiscal Federalism: Challenges before the Twelfth Finance Commission'.

1.19 The urban municipal bodies form an integral part of the structure of governance at the state-level. Their efficient functioning to meet the requirements of the local residents is crucial and its relevance cannot be relegated. To identify the emerging requirements of the municipalities, the Indian Institute of Public Administration (IIPA), at the behest of the Commission, organized a national seminar on municipal

finance on 29-30 December 2003 in New Delhi (list of participants at annexure 1.22). The technical sessions of the seminar highlighted the role of the Twelfth Finance Commission in fiscal decentralisation and brought out the contemporary issues pertaining to municipal finances. The papers presented in the seminar were published by the IIPA in a volume titled, 'Municipal Finance in India: Role of Twelfth Finance Commission'.

1.20 The Commission also took up the initiative to get the National Institute of Rural Development (NIRD), Hyderabad organize a national seminar on panchayati raj finance on 23rd January 2004 (list of participants at annexure 1.23). The discussions threw light on various issues concerning the finances of rural local bodies and outlined the feasible approaches to make the bodies self-sustainable. The proceedings of the seminar have been published by the NIRD.

1.21 With a view to benefit from the insight and research findings of economists, academia and administrators, the Commission awarded 26 studies on a variety of issues related to the terms of reference of the Commission. These included debt sustainability/ debt relief, expenditure management, commercial viability of state electricity boards, revenue implications of value added tax (VAT), tax efforts by the centre and the states and financial status of the irrigation sector, to name a few (complete list of studies commissioned is at annexure 1.24).

1.22 To gain from international experience, the Commission visited USA, Canada and Australia (itinerary at annexure 1.25). The discussions held with national

and selected sub-national governments covered issues such as the criteria for inter-governmental transfers, the implementation of the principle of equalization, the sales tax system in Canada, goods and services tax in Australia and Australian reform programme to implement the agreement of centre-state financial relations. During the course of its visit, the Commission interacted with experts from different countries in a workshop organized in Washington (programme of the workshop is at annexure 1.26).

1.23 Workshops on management of solid waste and cost of provision of sewerage, waste water treatment and drainage in urban centers in India were organized by the Infrastructure Professionals Enterprise (P) Ltd. on 2nd July 2004 at India International Centre, New Delhi under the aegis of the Commission. The workshops encompassed brain-storming sessions and presentation of papers on sustainability and viability of waste-to-energy initiatives in India, decentralized waste water treatment in small communities and community waste segregation and composting (list of participants at annexure 1.27).

1.24 In order to assess and evaluate the requirements of central ministries, the Commission held meetings with the Planning Commission and the ministries of finance (departments of economic affairs, expenditure and revenue), railways, defence (departments of defence and defence production & supplies), home affairs (departments of home and border management), health & family welfare (departments of health and family welfare), power, petroleum & natural gas, coal, mines, rural development, urban development & poverty alleviation (department of urban

development), chemicals & fertilizers (department of fertilizers), communication & information technology (department of posts), tribal affairs, human resource development (department of elementary education & literacy), law & justice (department of justice), consumer affairs, food & public distribution (department of food & public distribution) and agriculture (department of agriculture & cooperation). A complete list of meetings is at annexure 1.28.

1.25 Eminent personalities from various walks of life met the Chairman, members and Member Secretary at the Commission's office on various occasions and shared their views on different issues. This list of dignitaries, who called on the Chairman is at annexure 1.29.

1.26 A delegation of the Tanzanian Joint Finance Commission, headed by the Chairman, Shri William Shellukindo met the Chairman and Member Secretary and held discussions with a view to learn from Indian experience (composition of delegation at annexure 1.30).

1.27 The Commission held 56 formal meetings in which various issues were deliberated upon. Details are at annexure 1.31. On the suggestion of the Commission, amendments were made in the Finance Commission (Salary and Allowances) Rules, 1951 to make the salary, allowances and perquisites of the members of the Commission at par with those of the members of the Planning Commission. The relevant notification is at annexure 1.32.

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