Twelfth Finance Commission (2005-10)

2.34 The Twelfth Finance Commission (TFC) was appointed on November 1, 2002 to make recommendations regarding the distribution between the Union and the States of net proceeds of shareable taxes, the principles which should govern the grants-in-aid of the revenues of States from the Consolidated Fund of India and the measures needed to augment the Consolidated Fund of a State to supplement the resources of local bodies in the State on the basis of the recommendations made by the Finance Commission of the State. The terms of reference mandated the Commission to review the state of the finances of the Union and the States and suggest a Plan by which the Governments, collectively and severally, restore budgetary balance, achieve macroeconomic stability and debt reduction along with equitable growth. Furthermore, the Commission was also asked to suggest corrective measures for debt sustainability and to review the Fiscal Reform Facility introduced by the Central Government.

2.35 The Commission submitted its report on November 30, 2004 covering the period 2005-10. The recommendations of the Commission include a plan for restructuring of public finances of the Centre and the States through improvement in revenue mobilization and bringing down debt levels, and through enactment of fiscal responsibility legislation by States (Box 2.6). The Commission recommended debt relief to States linked to fiscal reforms, doing away with the present system of Central assistance to State plans in the form of grants and loans and transfer of external assistance to States on the same terms and conditions as attached to such assistance by external funding agencies. The TFC raised the share of States in shareable Central taxes from 29.5 per cent to 30.5 per cent. Total transfers to States recommended by the TFC amount to Rs.7,55,752 crore over the five year period 2005-10. Of this, transfers by way of share in Central taxes and grants-in-aid amount to Rs.6,13,112 crore and Rs.1,42,640 crore, respectively. The total transfers recommended by the TFC are higher by 73.8 per cent over those recommended by the Eleventh Finance Commission (EFC). Within the total transfers, while the share in Central taxes is higher by 62.9 per cent, grants-in-aid recommended by the TFC are higher by 143.5 per cent over those recommended by the EFC.

Box 2.6 : Recommendations of the Twelfth Finance Commission

Restructuring public finances

- Centre and States to improve the combined tax-GDP ratio to 17.6 per cent by 2009-10.
- Combined debt-GDP ratio, with external debt measured at historical exchange rates, to be brought down to 75 per cent by 2009-10.
- Fiscal deficit to GDP targets for the Centre and States to be fixed at 3 per cent.
- Revenue deficit of the Centre and States to be brought down to zero by 2008-09.
- Interest payments relative to revenue receipts to be brought down to 28 per cent and 15 per cent in the case of the Centre and States, respectively.
- States to follow a recruitment policy in a manner so that the total salary bill, relative to revenue expenditure, net of interest payments, does not exceed 35 per cent.
- Each State to enact a fiscal responsibility legislation providing for elimination of revenue deficit by 2008-09 and reducing fiscal deficit to 3 per cent of State Domestic Product.
- The system of on-lending to be brought to an end over time. The long term goal should be to bring down debt-GDP ratio to 28 per cent each for the Centre and the States.

Sharing of Union tax revenues

- The share of States in the net proceeds of shareable Central taxes fixed at 30.5 per cent, treating additional excise duties in lieu of sales tax as part of the general pool of Central taxes. Share of States to come down to 29.5 per cent, when States are allowed to levy sales tax on sugar, textiles and tobacco.
- In case of any legislation enacted in respect of service tax, after the notification of the eighty eighth amendment to the Constitution, revenue accruing to a State 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 indicative amount of overall transfers to States to be fixed at 38 per cent of the Centre's gross revenue receipts.

Local bodies

- A grant of Rs.20,000 crore for the Panchayati Raj institutions and Rs.5,000 crore for urban local bodies to be given to States for the period 2005-10.
- Priority to be given to expenditure on operation and maintenance (O&M) costs of water supply and sanitation, while utilizing the grants for the Panchayats. At least 50 per cent of the grants recommended for urban local bodies to be earmarked for the scheme of solid waste management through public-private partnership.

Calamity relief

- The scheme of Calamity Relief Fund (CRF) to continue in its present form with contributions from the Centre and States in the ratio of 75:25. The size of the Fund worked out at Rs.21,333 crore for the period 2005-10.
- The outgo from the Fund to be replenished by way of collection of National Calamity Contingent Duty and levy of special surcharges.
- The definition of natural calamity to include landslides, avalanches, cloud burst and pest attacks.
- Provision for disaster preparedness and mitigation to be part of State Plans and not calamity relief.

Grants-in-aid to States

- The present system of Central assistance for State Plans, comprising grant and loan components, to be done away with, and the Centre should confine itself to extending plan grants and leaving it to States to decide their borrowings.
- Non-plan revenue deficit grant of Rs.56,856 crore recommended to 15 States for the period 2005-10. Grants amounting to Rs.10,172 crore recommended for the education sector to eight States. Grants amounting to Rs.5,887 crore recommended for the health sector for seven States. Grants to education and health sectors are additionalities over and above the normal expenditure to be incurred by States.
- A grant of Rs.15,000 crore recommended for roads and bridges, which is in addition to the normal expenditure of States.
- Grants recommended for maintenance of public buildings, forests, heritage conservation and specific needs of States are Rs. 500 crore, Rs.1,000 crore, Rs.625 crore, and Rs.7,100 crore, respectively.

Fiscal reform facility

- With the recommended scheme of debt relief in place, fiscal reform facility not to continue over the period 2005-10.

Debt relief and corrective measures

- Central loans to States contracted till March,2004 and outstanding on March 31, 2005 amounting to Rs.1,28,795 crore to be consolidated and rescheduled for a fresh term of 20 years, and an interest rate of 7.5 per cent to be charged on them. This is subject to enactment of fiscal responsibility legislation by a State.
- A debt write-off scheme linked to reduction of revenue deficit of States to be introduced. Under this scheme, repayments due from 2005-06 to 2009-10 on Central loans contracted up to March 31,2004 will be eligible for write-off.
- Central Government not to act as an intermediary for future lending to States, except in the case of weak States, which are unable to raise funds from the market.
- External assistance to be transferred to States on the same terms and conditions as attached to such assistance by external funding agencies.
- All the States to set up sinking funds for amortization of all loans.
- States to set up guarantee redemption funds through earmarked guarantee fees.

Others

- The Centre should share 'profit petroleum' from New Exploration and Licensing Policy (NELP) areas in the ratio of 50:50 with States where mineral oil and natural gas are produced. No sharing of profits in respect of nomination fields and non-NELP blocks.
- Every State to set up a high level committee to monitor the utilization of grants recommended by the TFC.
- Centre to gradually move towards accrual basis of accounting.