

# Thirteenth Finance Commission

2010–2015

Volume I: Report



December 2009

# CHAPTER 1

## Summary of Recommendations

### Finances of Union and States

1. The Ministry of Finance (MoF) should ensure that the finance accounts fully reflect the collections under cesses and surcharges as per the relevant heads, so that there are no inconsistencies between the amounts released to states in any year and the respective percentage shares in net central taxes recommended by the Finance Commission for that year.  
(Para 4.33)
2. The states need to address the problem of losses in the power sector in a time-bound manner.  
(Para 4.38)
3. Initiatives should be taken to reduce the number of Centrally Sponsored Schemes (CSS) and to restore the predominance of formula-based plan transfers.  
(Para 4.56)
4. A calibrated exit strategy from the expansionary fiscal stance of 2008-09 and 2009-10 should be the main agenda of the Centre.  
(Para 4.62)

### Goods and Services Tax

5. Both the Centre and the states should conclude a 'Grand Bargain' to implement the Model GST. The Grand Bargain comprises six elements:
  - i) The design of the Model GST is suggested in paras 5.25 to 5.35.

- ii) The operational modalities are outlined in paras 5.36 to 5.41.
  - iii) The proposed agreement between the Centre and states, with contingencies for changes, is in paras 5.49 to 5.51.
  - iv) The disincentives for non-compliance are described in Para 5.52.
  - v) The implementation schedule is described in paras 5.57 to 5.59.
  - vi) The procedure for claiming compensation is in Para 5.60.  
(Para 5.48)
6. Any GST model adopted must be consistent with all the elements of the Grand Bargain. To incentivise implementation of the Grand Bargain, this Commission recommends sanction of a grant of Rs. 50,000 crore. The grant would be used to meet the compensation claims of State Governments for revenue losses on account of implementation of GST between 2010-11 and 2014-15, consistent with the Grand Bargain. Unspent balances in this pool would be distributed amongst all the states, as per the devolution formula, on 1 January 2015.  
(paras 5.54 and 5.55)
7. The Empowered Committee of State Finance Ministers (EC) should be transformed into a statutory council. The compensation should be disbursed in quarterly instalments on the basis of the recommendations by a three-member Compensation Committee comprising of the Secretary, Department of

Revenue, Government of India; Secretary to the EC and chaired by an eminent person with experience in public finance.

(Para 5.60)

8. In the unlikely event that a consensus with regard to implementing all the elements of the Grand Bargain cannot be achieved and the GST mechanism finally adopted is different from the Model GST suggested by us, this Commission recommends that this amount of Rs. 50,000 crore shall not be disbursed.

(Para 5.62)

9. The states should take steps to reduce the transit time of cargo vehicles crossing their borders by combining checkpoints with adjoining states and adopting user-friendly options like electronically issued passes for transit traffic.

(Para 5.47)

### Union Finances

10. The policy regarding use of proceeds from disinvestment needs to be liberalised to also include capital expenditure on critical infrastructure and the environment.

(Para 6.46)

11. Records of landholdings of PSUs need to be properly maintained to ensure that this scarce resource is put to productive use, or made available for other public projects, or else, sold.

(Para 6.48)

### State Finances

12. The practice of diverting plan assistance to meet non-plan needs of special category states should be discontinued.

(Para 7.79)

13. With reference to public sector undertakings:

- i) All states should endeavour to ensure clearance of the accounts of all their Public Sector Undertakings (PSUs).

(Para 7.95)

- ii) The states should use the flexibility provided by the Comptroller and Auditor General (C&AG) to clear the backlog of PSU accounts.

(Para 7.95)

- iii) All states need to draw up a roadmap for closure of non-working PSUs by March 2011. Divestment and privatisation of PSUs should be considered and actively pursued.

(paras 7.95 and 7.97)

- iv) The Ministry of Corporate Affairs should closely monitor the compliance of state and central PSUs with their statutory obligations.

(Para 7.95)

- v) A task force may be constituted to design a suitable strategy for disinvestment/privatisation and oversee the process. A Standing Committee on restructuring may be constituted under the chairmanship of the Chief Secretary to operationalise the recommendations of the task force. An independent technical secretariat may be set up to advise the finance departments in states on restructuring/disinvestment proposals.

(Para 7.98)

14. With reference to the power sector:

- i) Reduction of Transmission and Distribution (T&D) losses should be attempted through metering, feeder separation, introduction of High Voltage Distribution Systems (HVDS), metering of distribution transformers and strict anti-theft measures. Distribution franchising and Electricity Services Company (ESCO)-based structures should be considered for efficiency improvement.

(Para 7.114)

- ii) Unbundling needs to be carried out on priority basis and open access to transmission strengthened. Governance should be improved through State Load

- Dispatch Centres (SLDCs) and this function should eventually be made autonomous.  
(Para 7.116)
- iii) Proper systems should be put in place to avoid delays in completion of hydro projects.  
(Para 7.117)
- iv) Instead of putting up thermal power plants in locations remote from sources of coal, states should consider joint ventures (JVs) in or near the coal-rich states.  
(Para 7.119)
- v) Case 1 bid process should be extensively used to avoid vulnerability to high-cost purchases during peak demand periods.  
(Para 7.120)
- vi) Regulatory institutions should be strengthened through capacity building, consumer education and tariff reforms like Multi Year Tariff (MYT). Best practices of corporate governance should be introduced in power utilities.  
(Para 7.121)
15. Migration to the New Pension Scheme needs to be completed at the earliest.  
(Para 7.122)
16. States with large cash balances should make efforts towards utilising these before resorting to fresh borrowings.  
(Para 7.127)
17. With reference to accounting reforms:
- i) The Government of India (GoI) should ensure uniformity in the budgetary classification code across all states. The list of appendices to the finance accounts of states also needs to be standardised.  
(paras 7.129 and 7.134)
- ii) Details of contra-entries as well as the summary of transactions between the public account and the consolidated fund should be provided as a separate annex to the finance accounts of the states.  
(Para 7.131)
- iii) Public expenditure through creation of funds outside the consolidated fund of the states needs to be discouraged. Expenditure through such funds and from civil deposits should be brought under the audit jurisdiction of the C&AG.  
(paras 7.132 and 7.133)
- iv) The following statements need to be provided with the finance accounts of states:
- a) Comprehensive data on all subsidies.  
(Para 7.135)
- b) Consolidated information on the number of employees at each level, along with the commitment on salary. This statement should also include information on employees and their salary where such expenditure is shown as grants or booked under other expenditure.  
(Para 7.136 & 7.137)
- c) Details of maintenance expenditure.  
(Para 7.138)

### Sharing of Union Tax Revenues

18. The share of states in net proceeds of shareable central taxes shall be 32 per cent in each of the financial years from 2010-11 to 2014-15. Under the Additional Duties of Excise (Goods of Special Importance) Act, 1957, all goods were exempted from payment of duty from 1 March 2006. Following this, the Centre had adjusted the basic duties of excise on sugar and tobacco products. In view of these developments, the states' share in the net proceeds of shareable central taxes shall remain unchanged at 32 per cent, even in the event of states levying sales tax (or

Value Added Tax (VAT)) on these commodities.

(paras 8.17 and 8.18)

19. In the event of notification of the 88<sup>th</sup> Amendment to the Constitution and enactment of any legislation following such notification, it should 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 been part of the shareable pool of central taxes.

(Para 8.19)

20. The Central Government should review the levy of cesses and surcharges with a view to reducing their share in its gross tax revenue.

(Para 8.20)

21. The indicative ceiling on overall transfers to states on the revenue account may be set at 39.5 per cent of gross revenue receipts of the Centre.

(Para 8.21)

22. The share of each state in the net proceeds of all shareable central taxes in each of the financial years from 2010-11 to 2014-15 shall be as specified in Table 1.1:

(paras 8.38 and 8.39)

### Revised Roadmap for Fiscal Consolidation

23. The revenue deficit of the Centre needs to be progressively reduced and eliminated, followed by emergence of a revenue surplus by 2014-15.

(paras 9.18 and 9.31)

24. A target of 68 per cent of GDP for the combined debt of the Centre and states should be achieved by 2014-15. The fiscal consolidation path embodies steady reduction in the augmented debt stock of the Centre to 45 per cent of GDP by 2014-15, and of the states to

Table 1.1: *Inter se* Shares of States

States	Share of all Shareable Taxes Excluding Service Tax(per cent)	Share of Service Tax (per cent)
Andhra Pradesh	6.937	7.047
Arunachal Pradesh	0.328	0.332
Assam	3.628	3.685
Bihar	10.917	11.089
Chhattisgarh	2.470	2.509
Goa	0.266	0.270
Gujarat	3.041	3.089
Haryana	1.048	1.064
Himachal Pradesh	0.781	0.793
Jammu & Kashmir	1.551	nil
Jharkhand	2.802	2.846
Karnataka	4.328	4.397
Kerala	2.341	2.378
Madhya Pradesh	7.120	7.232
Maharashtra	5.199	5.281
Manipur	0.451	0.458
Meghalaya	0.408	0.415
Mizoram	0.269	0.273
Nagaland	0.314	0.318
Orissa	4.779	4.855
Punjab	1.389	1.411
Rajasthan	5.853	5.945
Sikkim	0.239	0.243
Tamil Nadu	4.969	5.047
Tripura	0.511	0.519
Uttar Pradesh	19.677	19.987
Uttarakhand	1.120	1.138
West Bengal	7.264	7.379
<b>All States</b>	<b>100.000</b>	<b>100.000</b>

less than 25 per cent of GDP, by 2014-15.

(paras 9.29 and 9.69, Table 9.7)

25. The Medium Term Fiscal Plan (MTFP) should be reformed and made a statement of commitment rather than a statement of intent. Tighter integration is required between the multi-year framework provided by MTFP and the annual budget exercise.

(Para 9.38)

26. The following disclosures should be made along with the annual Central Budget/MTFP:

- i) Detailed breakup of grants to states under the overall category of non-plan and plan grants.

(Para 9.41)

- ii) Statement on tax expenditure to be systematised and the methodology to be made explicit. (Para 9.42)
  - iii) Compliance costs of major tax proposals to be reported. (Para 9.43)
  - iv) Revenue Consequences of Capital Expenditure (RCCE) to be projected in MTFP. (Para 9.45)
  - v) Fiscal impact of major policy changes to be incorporated in MTFP. (Para 9.46)
  - vi) Public Private Partnership (PPP) liabilities to be reported along with MTFP. (paras 9.48 and 9.49)
  - vii) MTFP to make explicit the values of parameters underlying projections for receipts and expenditure and the band within which they can vary while remaining consistent with targets. (Para 9.61)
27. Transfer of disinvestment receipts to the public account to be discontinued and all disinvestment receipts be maintained in the consolidated fund. (Para 9.52)
28. GoI should list all public sector enterprises that yield a lower rate of return on assets than a norm to be decided by an expert committee. (Para 9.52)
29. The FRBM Act needs to specify the nature of shocks that would require a relaxation of FRBM targets. (Para 9.62)
30. In case of macroeconomic shocks, instead of relaxing the states' borrowing limits and letting them borrow more, the Centre should borrow and devolve the resources using the Finance Commission tax devolution formula for *inter se* distribution between states. (Para 9.63)
31. Structural shocks such as arrears arising out of Pay Commission awards should be avoided by, in the case of arrears, making the pay award commence from the date on which it is accepted. (Para 9.64)
32. An independent review mechanism should be set-up by the Centre to evaluate its fiscal reform process. The independent review mechanism should evolve into a fiscal council with legislative backing over time. (paras 9.65 and 9.66)
33. Given the exceptional circumstances of 2008-09 and 2009-10, the fiscal consolidation process of the states was disrupted. It is expected that states would be able to get back to their fiscal correction path by 2011-12, allowing for a year of adjustment in 2010-11.
- i) States that incurred zero revenue deficit or achieved revenue surplus in 2007-08 should eliminate revenue deficit by 2011-12 and maintain revenue balance or attain a surplus thereafter. Other states should eliminate revenue deficit by 2014-15. (paras 9.69 to 9.72)
  - ii) The General Category States that attained a zero revenue deficit or a revenue surplus in 2007-08 should achieve a fiscal deficit of 3 per cent of Gross State Domestic Product (GSDP) by 2011-12 and maintain such thereafter. Other general category states need to achieve 3 per cent fiscal deficit by 2013-14. (paras 9.74 to 9.76, Table 9.5)
  - iii) All special category states with base fiscal deficit of less than 3 per cent of GSDP in 2007-08 could incur a fiscal deficit of 3 per cent in 2011-12 and

maintain it thereafter. Manipur, Nagaland, Sikkim and Uttarakhand to reduce their fiscal deficit to 3 per cent of GSDP by 2013-14.

(paras 9.79 and 9.81)

iv) Jammu & Kashmir and Mizoram should limit their fiscal deficit to 3 per cent of GSDP by 2014-15.

(Para 9.80)

34. States should amend/enact FRBM Acts to build in the fiscal reform path worked out. State-specific grants recommended for a state should be released upon compliance.

(Para 9.82)

35. Independent review/monitoring mechanism under the FRBM Acts should be set up by states.

(Para 9.84)

36. Borrowing limits for states to be worked out by MoF using the fiscal reform path, thus acting as an enforcement mechanism for fiscal correction by states.

(Para 9.85)

37. Loans to states from National Small Savings Fund (NSSF) contracted till 2006-07 and outstanding at the end of 2009-10 to be reset at 9 per cent rate of interest, subject to conditions prescribed.

(Para 9.106)

38. National Small Savings Scheme to be reformed into a market-aligned scheme. State Governments are also required to undertake relevant reforms at their level.

(paras 9.111 and 9.112)

39. Loans from GoI to states and administered by ministries/departments other than MoF, outstanding as at the end of 2009-10, to be written off, subject to conditions prescribed.

(Para 9.114)

40. A window for borrowing from the Central Government needs to be available for fiscally

weak states that are unable to raise loans from the market.

(Para 9.114)

41. For states that have not availed the benefit of consolidation under the Debt Consolidation and Relief Facility (DCRF), the facility, limited to consolidation and interest rate reduction, should be extended, subject to enactment of the FRBM Act.

(Para 9.115)

42. The benefit of interest relief on NSSF and the write-off should be made available to states only if they bring about the necessary amendments/enactments of FRBM.

(Para 9.116)

### Local Bodies

43. Article 280 (3) (bb) & (c) of the Constitution should be amended such that the words 'on the basis of the recommendations of the Finance Commission of the State' are changed to 'after taking into consideration the recommendations of the Finance Commission of the State'.

(Para 10.130)

44. Article 243(I) of the Constitution should be amended to include the phrase 'or earlier' after the words 'every fifth year'.

(Para 10.125)

45. The quantum of local body grants should be provided as per Table 10.4. The general basic grant as well as the special areas basic grant should be allocated amongst states as specified. The state-wise eligibility for these grants is placed in annexes 10.15a and 10.15c.

(Para 10.159)

46. State Governments will be eligible for the general performance grant and the special areas performance grant only if they comply with the prescribed stipulations. These grants will be disbursed in the manner specified. The

- state-wise eligibility for these grants is placed in annexes 10.15b and 10.15d.  
(paras 10.161 to 10.164)
47. The states should appropriately allocate a portion of their share of the general basic grant and general performance grant, to the special areas in proportion to the population of these areas. This allocation will be in addition to the special area basic grant and special area performance grant recommended by us.  
(Para 10.170)
48. State Governments should appropriately strengthen their local fund audit departments through capacity building as well as personnel augmentation.  
(Para 10.167)
49. The State Governments should incentivise revenue collection by local bodies through methods such as mandating some or all local taxes as obligatory at non-zero rates of levy, by deducting deemed own revenue collection from transfer entitlements of local bodies, or through a system of matching grants.  
(Para 10.173)
50. To buttress the accounting system, the finance accounts should include a separate statement indicating head-wise details of actual expenditures under the same heads as used in the budget for both Panchayati Raj Institutions (PRIs) and Urban Local Bodies (ULBs). We recommend that these changes be brought into effect from 31 March 2012.  
(Para 10.177)
51. The Government of India and the State Governments should issue executive instructions so that their respective departments pay appropriate service charges to local bodies.  
(Para 10.178)
52. Given the increasing income of State Governments from royalties, they should
- share a portion of this income with those local bodies in whose jurisdiction such income arises.  
(Para 10.179)
53. State Governments should ensure that the recommendations of State Finance Commissions (SFCs) are implemented without delay and that the Action Taken Report (ATR) is promptly placed before the legislature.  
(Para 10.129)
54. SFCs should consider adopting the template suggested in Annex 10.5 as the basis for their reports.  
(Para 10.127)
55. Bodies similar to the SFC should be set up in states which are not covered by Part IX of the Constitution.  
(Para 10.180)
56. Local bodies should consider implementing the identified best practices.  
(Para 10.79)
57. A portion of the grants provided by us to urban local bodies be used to revamp the fire services within their jurisdiction.  
(Para 10.172)
58. Local Bodies should be associated with city planning functions wherever other development authorities are mandated this function. These authorities should also share their revenues with local bodies.  
(Para 10.168)
59. The development plans for civilian areas within the cantonment areas (excluding areas under the active control of the forces) should be brought before the district planning committees.  
(Para 10.169)
60. State Governments should lay down guidelines for the constitution of nagar panchayats.  
(Para 10.133)

## Disaster Relief

61. The National Calamity Contingency Fund (NCCF) should be merged into the National Disaster Response Fund (NDRF) and the Calamity Relief Fund (CRF) into the State Disaster Response Funds (SDRFs) of the respective states. Contribution to the SDRFs should be shared between the Centre and states in the ratio of 75:25 for general category states and 90:10 for special category states.

(paras 11.78, 11.79 and 11.82)

62. Balances as on 31 March 2010 under state CRFs and the NCCF should be transferred to the respective SDRFs and NDRF.

(paras 11.78 and 11.93)

63. Budgetary provisions for the NDRF need to be linked to expenditure of the previous year from the fund. With cesses being subsumed on introduction of the GST; alternative sources of financing need to be identified.

(Para 11.78)

64. The total size of the SDRF has been worked out as Rs. 33,581 crore, to be shared in the ratio given above, with an additional grant of Rs. 525 crore for capacity building.

(paras 11.92 and 11.102)

65. Assistance of Rs. 250 crore to be given to the National Disaster Response Force to maintain an inventory of items required for immediate relief.

(Para 11.103)

66. Provisions relating to the District Disaster Response Fund (DDRF) in the Disaster Management (DM) Act may be reviewed and setting up of these funds left to the discretion of the individual states.

(Para 11.96)

67. Mitigation and reconstruction activities should be kept out of the schemes funded through FC grants and met out of overall development plan funds of the Centre and the states.

(Para 11.83)

68. The list of disasters to be covered under the scheme financed through FC grants should remain as it exists today. However, man-made disasters of high-intensity may be considered for NDRF funding, once norms have been stipulated and the requisite additional allocations made to the NDRF.

(Para 11.100)

69. The administrative mechanism for disaster relief to be as prescribed under the DM Act, i.e., the National Disaster Management Authority (NDMA)/National Executive Council (NEC) at the Centre and the State Disaster Management Agency (SDMA)/State Executive Council (SEC) at the state level. Financial matters to be dealt with by the Ministry of Finance as per the existing practice.

(paras 11.105 and 106)

70. Prescribed accounting norms should be adhered to for the continuance of central assistance to the SDRFs.

(Para 11. 95)

## Grants-in-aid to States

### NPRD and Performance Incentive

71. Total non-plan revenue grant of Rs. 51,800 crore is recommended over the award period for eight states (Table 12.4).

(Para 12.12)

72. A performance grant of Rs. 1500 crore is recommended for three special category states who have graduated from a Non-plan Revenue Deficit (NPRD) situation.

(Para 12.13)

### Elementary Education

73. A grant of Rs. 24,068 crore is recommended for elementary education over the award period.

(Para 12.23)

74. The education grant will be an additionality to the normal expenditure of the states for elementary education. The expenditure

(plan + non-plan) under elementary education, i.e., major head-2202, sub-major head-01, exclusive of grants recommended, should grow by at least 8 per cent annually during 2010-15.

(Para 12.23)

### Environment

75. An amount of Rs. 5000 crore is recommended as forest grant for the award period.

(Para 12.46)

76. Grants for the first two years are untied but priority should be given to the preparation of working plans. Release of grants for the last three years is linked to progress in the number of approved working plans.

(Para 12.47)

77. Twenty five per cent of the grants in the last three years are for preservation of forest wealth. These grants are over and above the non-plan revenue expenditure on forestry and wildlife (major head-2406) and shall be subject to the conditionalities given in Annex 12.3. Seventy five per cent of the grants in the last three years can be used by states for development purposes.

(Para 12.47)

78. An incentive grant of Rs. 5000 crore is recommended for grid-connected renewable energy based on the states' achievement in renewable energy capacity addition from 1 April 2010 to 31 March 2014. The performance of states in this regard needs to be reviewed on the basis of data published by GoI on capacity addition by states.

(paras 12.52 and 12.53)

79. An amount of Rs. 5000 crore is recommended as water sector management grant for four years, i.e., 2011-12 to 2014-15 of the award period.

(Para 12.57)

80. Release of water sector grants would be subject to setting up of a Water Regulatory Authority

and achieving the normatively assessed state-specific recovery of water charges.

(Para 12.58)

81. Water sector grants should be an additionality to the normal maintenance expenditure to be undertaken by the states and shall be released and monitored in accordance with the conditionalities in Annex 12.8.

(Para 12.58)

### Improving Outcomes

82. States should be incentivised to enroll such of their residents who participate in welfare schemes within the Unique Identification (UID) programme. A grant of Rs. 2989 crore is proposed to be given to State Governments in this regard, as indicated in Annex 12.9.

(Para 12.70)

83. States should be incentivised to reduce their Infant Mortality Rates (IMR) based upon their performance beyond 31 December 2009. A grant of Rs 5000 crore is recommended for this purpose.

(Para 12.75)

84. A grant of Rs. 5000 crore is proposed to support improvement in a number of facets in the administration of justice. These include operation of morning/evening courts, promotion of Alternate Dispute Resolution (ADR) mechanisms, enhancing support to Lok Adalats, as well as legal aid and training.

(Para 12.79)

85. A grant of Rs 20 crore is recommended for promotion of innovation by setting up a Centre for Innovation in Public Systems (CIPS) to identify, document and promote innovations in public services across states. The second grant of Rs. 1 crore per district is for the creation of a District Innovation Fund (DIF) aimed at increasing the efficiency of the capital assets already created.

(paras 12.92 and 12.96)

86. To enhance the quality of statistical systems, we recommend a grant of Rs. 616 crore for State Governments at the rate of Rs. 1 crore for every district to fill in statistical infrastructure gaps in areas not addressed by the India Statistical Project (ISP).

(Para 12.101)

87. A grant of Rs. 10 crore will be provided to each general category state and Rs. 5 crore to each special category state to set up an employees' and pensioners' data base. We also urge GoI to initiate a parallel effort for preparing a data base for its own employees and pensioners.

(Para 12.108)

### Maintenance of Roads and Bridges

88. An amount of Rs. 19,930 crore has been recommended as grant for maintenance of roads and bridges for four years (2011-12 to 2014-15) of our award period.

(Para 12.114)

89. The maintenance grants for roads and bridges will be an additionality to the normal maintenance expenditure to be incurred by the states. Release of this grant and expenditure will be subject to the conditionalities indicated in Annex 12.17.

(Para 12.114)

### State-specific Needs

90. A total grant of Rs. 27,945 crore is recommended for state-specific needs (Table 12.6)

91. In addition to the stipulations described in paras 5.52 and 9.82, state-specific grants are subject to the following conditionalities:

i) No funds from any of the state-specific grants may be used for land acquisition by the states. Wherever land is required for a project/construction, such land may be made available by the State Government.

ii) The phasing of the state-specific grants given in Table 12.6 is only indicative; states may communicate their required phasing to the Central Government. The grant may be released in a maximum of two instalments per year.

iii) Accounts shall be maintained and Utilisation Certificates (UCs)/ Statements of Expenditure (SOEs) provided as per General Finance Rules (GFR) 2005.

(Para 12.324)

### Monitoring

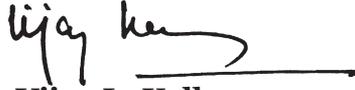
92. The High Level Monitoring Committee headed by the Chief Secretary to review the utilisation of grants and to take corrective measures, set up as per the recommendation of FC-XII, should continue.

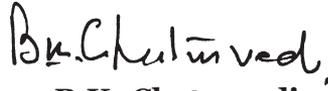
(Para 12.326)

93. The total grants-in-aid recommended for the states over the award period are given in Table 1.2.

**Table 1.2: Grants-in-Aid to States**

		(Rs. crore)
I	Local Bodies	87519
II	Disaster Relief (including for capacity building)	26373
III	Post-devolution Non-plan Revenue Deficit	51800
IV	Performance Incentive	1500
V	Elementary Education	24068
VI	Environment	15000
	(a) Protection of Forests	5000
	(b) Renewable Energy	5000
	(c) Water Sector Management	5000
VII	Improving Outcomes	14446
	(a) Reduction in Infant Mortality Rates	5000
	(b) Improvement in Supply of Justice	5000
	(c) Incentive for Issuing UIDs	2989
	(d) District Innovation Fund	616
	(e) Improvement of Statistical Systems at State and District Level	616
	(f) Employee and Pension Data base	225
VIII	Maintenance of Roads and Bridges	19930
IX	State-specific	27945
X	Implementation of model GST	50000
	<b>Total</b>	<b>318581</b>

  
**Vijay L. Kelkar**  
Chairman

  
**B.K. Chaturvedi**  
Member

  
**Indira Rajaraman**  
Member

  
**Atul Sarma**  
Member

  
**Sanjiv Misra**  
Member

New Delhi  
29, December 2009

I wish to record my deep appreciation of the outstanding support and cooperation provided by all Members of the Commission. This report is a joint endeavour, with each Member contributing immensely with their profound knowledge and deep professional commitment. I also want to put on record the Commission's appreciation of the services rendered by Shri Sumit Bose, Secretary to the Commission. He has been a friend, philosopher and guide to this Commission. The Commission greatly owes to him for its high efficiency and meticulous work. He has been an outstanding leader of a talented team of professionals which assisted the Commission.

  
**Vijay L. Kelkar**  
Chairman

New Delhi  
29, December 2009

## CHAPTER 2

# Introduction

2.1 The Thirteenth Finance Commission (FC-XIII) was constituted by the President under Article 280 of the Constitution on 13 November 2007 to make recommendations for the period 2010-15. Dr. Vijay Kelkar was appointed the Chairman of the Commission. Dr. Indira Rajaraman, Professor Emeritus, National Institute of Public Finance & Policy (NIPFP), Dr. Abusaleh Shariff, Chief Economist, National Council of Applied Economic Research (NCAER), and Professor Atul Sarma, Former Vice-Chancellor, Rajiv Gandhi University (formerly Arunachal University) were appointed full time Members. Shri B.K. Chaturvedi, Member, Planning Commission was appointed as a part-time Member. Shri Sumit Bose was appointed as Secretary to the Commission (Annex 2.1). Subsequently, the President appointed Dr. Sanjiv Misra, Former Secretary (Expenditure), Ministry of Finance as Member of the Commission in place of Dr. Abusaleh Shariff, who was unable to join (Annex 2.2).

### Terms of Reference

2.2 The Terms of Reference (ToR) of the Commission included the following:

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

- 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 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 provisos 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, keeping in view, in particular, the operation of the States' Debt Consolidation and Relief Facility 2005-2010 introduced by the Central Government on the basis of the recommendations of the Twelfth Finance Commission, and suggest measures for maintaining a stable and sustainable fiscal environment consistent 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 2010, on*

- the basis of levels of taxation and non-tax revenues likely to be reached at the end of 2008-09;*
- (ii) *the demands on the resources of the Central Government, in particular, on account of the projected Gross Budgetary Support to the Central and State Plan, 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 2010, on the basis of levels of taxation and non-tax revenues likely to be reached at the end of 2008-09;*
  - (iv) *the objective of not only balancing the receipts and expenditure on revenue account of all the States and the Union, but also generating surpluses for capital investment;*
  - (v) *the taxation efforts of the Central Government and each State Government and the potential for additional resource mobilisation to improve the tax-Gross Domestic Product ratio in the case of the Union and tax-Gross State Domestic Product ratio in the case of the States;*
  - (vi) *the impact of the proposed implementation of Goods and Services Tax with effect from 1st April, 2010, including its impact on the country's foreign trade;*
  - (vii) *the need to improve the quality of public expenditure to obtain better outputs and outcomes;*
  - (viii) *the need to manage ecology, environment and climate change consistent with sustainable development;*
  - (ix) *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 31st March, 2010 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;*
  - (x) *the need for ensuring the commercial viability of irrigation projects, power projects, departmental undertakings and public sector enterprises through various means, including levy of user charges and adoption of measures to promote efficiency.*
7. *In making its recommendations on various matters, the Commission shall 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 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 the funds envisaged in the Disaster Management Act, 2005 (53 of 2005), and make appropriate recommendations thereon.*
  9. *The Commission shall indicate the basis on which it has arrived at its findings and make available the estimates of receipts and expenditure of the Union and each of the States."*
- 2.3 The following additional item was added to the terms of reference of the Commission vide President's Order published under S.O. No. 2107 dated 25 August 2008 (Annex 2.3).
- "8.A. Having regard to the need to bring the liabilities of the Central Government on account*

*of oil, food and fertilizer bonds into the fiscal accounting, and the impact of various other obligations of the Central Government on the deficit targets, the Commission may review the roadmap for fiscal adjustment and suggest a suitably revised roadmap with a view to maintaining the gains of fiscal consolidation through 2010 to 2015.”*

2.4 The Commission was initially required to submit its report by 31 October 2009 covering the five-year period between 1 April 2010 and 31 March 2015. The conduct of elections to the Fifteenth Lok Sabha and certain State Legislative Assemblies in April-May 2009 warranted a postponement of visits by the Commission to some states. The conduct of elections also led to the delay in the presentation of the regular Budget of the Union as well as of some State Governments for the year 2009-10. Consequently, information from the Centre and some of the states on their fiscal position and projections for 2010-15 could not become available to the Commission till August 2009. In view of the above developments, the Commission was granted an extension by the President till 31 January 2010 with the condition that its report be submitted by 31 December 2009 (Annex 2.4).

### **Administrative Arrangements**

2.5 As has been the experience of previous Commissions, this Commission also faced a number of teething problems relating to infrastructure availability, including office space and staff. These difficulties constrained its initial operational effectiveness.

2.6 The Commission could initiate its preliminary tasks only in January 2008 when it was able to acquire some temporary office space at Jeevan Bharati Building, Connaught Place, New Delhi. The Commission could finally move into its regular office space at the Hindustan Times House only by May 2008. A special effort was made to get Central and State Government officers on deputation to the Commission. The process for appointing suitable staff on deputation continued till late 2008. The lists of sanctioned posts and functionaries are given in annexes 2.5 and 2.6. The

routine house-keeping functions were outsourced so that expenditure was minimised.

2.7 Considering the importance of ensuring that future Finance Commissions are able to commence their work as quickly as possible, it is necessary that these problems, faced by successive past Commissions, are effectively resolved.

### **Key Activities**

2.8 The Commission was delegated the powers of a department of the Central Government (Annex 2.7). The Commission's budget was assigned a separate head of account. This enabled the Commission to function independently.

2.9 Our recommendations have been based on a detailed assessment of the financial position of the Central and the State Governments, as well as substantial information and economic data gathered through consultations, submissions and research studies. A public notice was issued in all leading newspapers of India in December 2007 (Annex 2.8) inviting views/comments from all interested individuals, knowledgeable persons, organisations and other sources on various issues related to the terms of reference of the Commission. The request for suggestions was also posted on the Commission's website.

2.10 The Commission held its first meeting on 3 January 2008 after the Chairman and three Members had assumed charge. The fourth Member assumed office on 31 March 2008. In addition to adopting the Rules of Procedure of the Commission (Annex 2.9), the tasks before the Commission were reviewed in this meeting. The Commission held 123 meetings on the dates indicated in Annex 2.10. These meetings were held at HT House in the K.C. Neogy Room, which was designated the Committee Room of the Finance Commission and named after Shri K.C. Neogy, the distinguished Chairman of the First Finance Commission. The list of meetings excludes the meetings held with the State Government representatives at state capitals during the visits by the Commission.

2.11 All the State Governments were requested to submit their memoranda, along with detailed

information on their fiscal and financial performance in the prescribed proforma, by 1 May 2008. An interactive online discussion with the State Finance Departments/State Finance Commission Cells was organised through video-conferencing on 11 and 12 February 2008 to enable them to seek clarifications on the information sought by the Finance Commission on the various topics. All states were provided the facility to upload the data directly on to the Commission's website. This ensured minimisation of data entry errors.

2.12 Detailed information/data on assessment of the resources and expenditure of the Union Government for the period 2002-03 to 2014-15 in 22 formats and on 43 issues/topics, as well as their views on ToR of the Commission, were sought from the Ministry of Finance vide letter dated 31 March 2008 with a request to furnish the information by 31 May 2008. These formats were also sent to 16 ministries/departments of the Central Government for providing information related to their respective subjects.

## Consultations

2.13 The Chairman wrote letters to all Chief Ministers, Union Ministers, heads of national and regional political parties, the country's Executive Directors in IMF, World Bank and ADB and other eminent persons in various walks of life, seeking their views on the issues before the Finance Commission.

2.14 Similar letters were addressed by the Secretary to all Union Secretaries, Chief Secretaries/Finance Secretaries of the states, a number of universities, including IIMs and IITs, soliciting their inputs on issues related to the ToR of the Commission.

2.15 Five regional meetings of economists and economic administrators were organised for detailed consultation and exchange of views on the issues before the Commission. These were held on 23 January 2008 at New Delhi; on 25 February 2008 at Chennai; on 10 March 2008 at Kolkata; on 26 March 2008 at Pune and on 10 April 2008 at

Shillong. A list of participants is placed in Annex 2.11.

2.16 A meeting with Chairmen/Members of previous Finance Commissions was held on 2 May 2008 at the India International Centre, New Delhi. A number of previous Chairmen and Members participated. This meeting provided very useful guidance to the Commission. A list of participants is placed in Annex 2.12.

2.17 Before undertaking visits to the states, meetings were held with the respective Accountants General of each of the 28 states. This enabled the Commission to obtain an overview of the states' fiscal and financial position with reference to key indicators including growth rates of Gross State Domestic Product (GSDP), efficiency in expenditure, physical and financial performance of various sectors, financial health of Public Sector Undertakings—particularly those related to transport and power sectors—and the status of finalisation of accounts of the state-owned companies. The schedule of meetings held is listed in Annex 2.13.

2.18 We greatly appreciate the support and inputs provided by the Comptroller and Auditor General (C&AG) of India in facilitating our interaction with the Accountants General and for the detailed views on the ToR of the Commission, including information regarding on-going reform efforts in the direction of migration to accrual-based accounting system by the Union and State Governments, management of backlog of accounts and audit of state PSUs and the state of accounts and audit of local bodies. Detailed discussions on various issues were also held with the CA&G on 16 June 2009.

2.19 We would like to thank the Reserve Bank of India (RBI) for making available data and analysis on various fiscal issues, particularly on post-FRBMA (Fiscal Responsibility and Budget Management Act) fiscal architecture and the RBI Staff Study Report on 'Fiscal Consolidation by Central and State Governments: The Medium Term Outlook'. The RBI also took the initiative in conducting a number of other studies which

provided very useful information and analytical data on various issues related to the Finance Commission.

### **Workshops and Seminars**

2.20 A number of workshops/seminars were organised, each focused on significant issues before the Commission, as follows:

- i) A workshop to discuss issues relating to 'Local Self Government' was held at Bengaluru on 26 February 2008. A list of participants is placed in Annex 2.14.
- ii) A meeting on 'Priorities Before the Thirteenth Finance Commission' was held at the Y.B. Chavan Centre, Mumbai on 27 March 2008. A list of participants is placed in Annex 2.15.
- iii) A conference was held by the Centre for Research in Rural and Industrial Development (CRRID), Chandigarh to consider the 'Special Problems and Prospects of Development of Border Areas' on 5 April 2008. A list of participants is placed in Annex 2.16.
- iv) An international seminar on 'Challenges Before the Thirteenth Finance Commission' was organised by The Foundation for Public Economics and Policy Research (FPEPR) at India Habitat Centre, New Delhi on 17 May 2008. A list of participants is placed in Annex 2.17.
- v) A seminar was organised by the National Institute of Public Finance and Policy (NIPFP) on 'Issues Before the Finance Commission' on 23-24 May 2008. A list of participants is placed in Annex 2.18.
- vi) Another seminar was organised by the NIPFP on 'Issues Related to India's Fiscal System' on 15 November 2008. A list of participants is placed in Annex 2.19.
- vii) A workshop on 'Inter-state and Intra-state Economic Disparities in India: Implications for the Thirteenth Finance Commission' was

held on 13 December 2008 at Asian Development Research Institute (ADRI), Patna. A list of participants is placed in Annex 2.20.

- viii) A workshop on 'Empowering the Panchayati Raj Institutions (PRIs)' was held at the Institute of Rural Management, Anand (IRMA), Gujarat on 22-23 December 2008. A list of participants is placed in Annex 2.21.
- ix) A workshop on 'Development of Good Governance Index for the States in India' was organised by the National Institute of Administrative Research, Mussoorie at the India International Centre, New Delhi on 14 November 2008. A list of participants is placed in Annex 2.22.
- x) A conference on India's medium-term macroeconomic and fiscal outlook was held at New Delhi on 2 June 2009. A list of participants is placed in Annex 2.23.
- xi) Expenditure on employees' salaries and pension benefits forms a major part of the public expenditure of states. A study was commissioned in May 2009 to work out the approach and roadmap through which states can build reliable employee and pensioner data bases as well as a data management systems. This will enable them to ensure effective fiscal planning as well as simulate the fiscal impact of recommendations by future Pay Commissions and Finance Commissions. A conference was held on 30 July 2009 at the India International Centre, New Delhi to discuss various options on this issue.

2.21 These seminars, addressed by prominent economists, financial sector administrators, policy makers and practitioners provided significant inputs to the Commission's work.

2.22 A meeting with the state Finance Ministers was held on 16 September 2008. A number of issues on Centre-state fiscal relations covering the common problems of all states as well as special problems of groups of states were discussed during

this meeting. The state Finance Ministers, for the first time, presented a collective memorandum to the Commission which greatly facilitated our work. A list of participants is placed in Annex 2.24.

2.23 A meeting between the Finance Commission and the Planning Commission was held on 23 October 2009. The Chairman of the Finance Commission, Deputy Chairman of the Planning Commission and Members of both the Commissions discussed a number of issues related to the Centre and the states as well as arising from the ToR. These included the fiscal position of the Centre and states, the requirements of GBS, additional funding requirements for implementing flagship programmes and options for fiscal adjustments by the Centre and states. The list of participants is given in Annex 2.25.

2.24 A large number of central ministries/ departments had sent their comments on the Terms of Reference of the Commission with reference to their respective subject matter. Detailed discussions were held with the various ministries/departments on the issues concerning them as per the schedule indicated in Annex 2.26.

### Visits of the Commission

2.25 The Commission visited all the 28 states between June 2008 and July 2009 as part of consultations with the State Governments and other key stakeholders. The State Governments sent their memoranda in advance. The visits to states were briefly suspended during April and May 2009 due to elections for the Lok Sabha and some state legislative assemblies. During state visits, discussions were held with the Chief Ministers, their cabinet colleagues, and other senior officials of the State Governments on the fiscal and financial situation of the states their funding priorities and requirements. In each state, during the course of the visit, separate meetings were held with representatives of recognised political parties, representatives of urban and rural local bodies and representatives of trade and industry. The Commission also undertook field visits which enabled it to get first hand experience of important developmental issues. The itinerary of the state visits is placed in Annex 2.27. A list of participants who attended the discussions during these visits is placed in Annex 2.28. We are thankful to the State Governments for making extensive arrangements to ensure fruitful discussions and field visits by the Commission.

#### Box 2.1: Research Studies

FC-XIII commissioned 29 external and two in-house studies. The basic motivation has been to obtain an in-depth understanding of various issues that have implications on the Terms of Reference of FC-XIII. These studies have addressed issues ranging from inter-regional implications of redistribution of fiscal transfers in a computable general equilibrium framework; forecasting and policy simulations in a macrofiscal modelling framework; growth and trade impact of GST; integrating environment, ecology and climate concerns in Indian fiscal federalism; inter-state distribution of central subsidies to strengthening justice delivery systems; increasing cost-effectiveness of defence expenditure and index of governance. These studies have been conducted by scholars based in universities and leading research institutions located in different parts of the country. One study, viz. 'Problems and Prospects in Border Areas of Northeast India', has been conducted by a team of scholars drawn from all the universities in the North-East and IIT, Guwahati. These studies, many of which have been pioneering in terms of analytical techniques or empirical analysis, have brought out new insights, validated intuitive perceptions, widened perspectives of Indian Fiscal Federalism and evaluated possible implications of issues such as GST. Just to illustrate, one study has highlighted that equivalent variation of transfers from the high income region to middle and poor income regions not only raises income and welfare in the latter, but also positively impact the former. Similarly, another study shows that various subsidies and tax expenditure by the Government of India benefit the high income states more than proportionately. Again, evaluating the possible impact of GST in a computable general equilibrium integrating both I-O and B (capital) matrix, it is observed that GST induces huge positive trade and income effects. Insights obtained from these invaluable studies have, directly or indirectly, influenced the thinking and deliberations of FC-XIII. Additionally, these studies would be a valuable addition to the existing literature on Indian Fiscal Federalism.

2.26 With a view to keeping abreast of the latest international developments in fiscal federalism, measures to improve the quality of public expenditure, environmental issues and Goods and Services Tax (GST), the Commission visited the US and Canada during 14-24 October 2008. During the US visit, in addition to various meetings with international experts, the Commission attended a workshop and a seminar at Washington DC. The workshop was organised jointly by the World Bank and IMF and the seminar was organised by the Centre for Advanced Studies of India (CASI), University of Pennsylvania, Philadelphia. Both reviewed the issues before the Commission. In Canada, the Commission met officials of the Federal Government as well as officials of the provinces of Quebec and Ontario. The Commission also participated in a seminar organised by the International Development Research Centre (IDRC), Ottawa. Annex 2.29 provides details of the visits.

### **Studies Commissioned and Other Inputs**

2.27 Our task covered a very broad spectrum of issues. Hence, in addition to the data/information collected from the states and the consultative process followed to elicit views and suggestions on various aspects, a number of research studies were sponsored by the Commission. These studies, undertaken by premier research institutions, contributed to the knowledge base of the Commission, enhancing its analytical ability in making its recommendations. We recommend that once our report is tabled in Parliament, the study reports, as listed in Annex 2.30, be made available on the Commission's website for use and reference by students, researchers, academicians and all others interested in these issues. Our programme of research and studies was made easier by the delegation of financial powers by the Ministry of Finance for this purpose.

2.28 The Commission recognises the role of innovation in enhancing outcomes and better managing the environment. At the request of the

Chairman, the National Innovation Foundation compiled state-wise booklets which included:

- i) Innovations developed within the particular state and relevant nationally.
- ii) Innovations from the rest of the country relevant to the particular state.
- iii) Relevant herbal practices and products of the state.

These state-specific booklets were shared with the states during the Commission's visits. These booklets were also put up on the Commission's website to enable public access. We are thankful to the National Innovation Foundation and its Chairman, Dr.R.A. Mashelkar and Vice-Chairman Prof. Anil K. Gupta for preparing these very useful volumes, one for each state, at very short notice.

2.29 The Commission called for information on innovations introduced by State Governments to improve service delivery and administrative systems. A number of significant innovations were highlighted by the states. There is clearly a need to create a climate and nurture a culture for diffusing innovations in public systems.

2.30 The reports of earlier Finance Commissions provided extremely useful inputs to our work. We also consulted extensively reports of other commissions and committees, such as the Second Administrative Reforms Commission (SARC), as well as other government commissions, committees and expert groups.

### **Working Groups and Task Forces**

2.31 A technical group chaired by Dr. Indira Rajaraman, Member of the Commission and Shri Ramesh Kolli, Additional Director General, Ministry of Statistics and Programme Implementation and comprising Dr. R.C. Sethi, Additional Registrar General of India; Shri R. Sridharan, Adviser (FR), Planning Commission; Dr. Laveesh Bhandari, Director, Indicus Analytics Pvt. Ltd., New Delhi and Dr. Rathin Roy, Economic Adviser of the Commission as Members, examined the feasibility of utilising district level indicators for measuring the intra-state disparities.

2.32 A working group was constituted under the chairmanship of Shri T.N. Srivastava, Member Secretary, FC-XI and Dr. Pradeep Apte, from the Department of Economics, Fergusson College, Pune and Member, State Finance Commission (SFC), Maharashtra; Prof. Nripendra Nath Bandyopadhyay, Member, Third SFC, West Bengal; Dr. Tapas Sen, Senior Fellow, National Institute of Public Finance & Policy; Prof. M.A. Oommen from the Institute of Social Sciences and Shri Dharmendra Shukla, Member Secretary, Third SFC Madhya Pradesh, as Members to draw up a common template for the use of SFCs.

2.33 A task force comprising Shri Arbind Modi, Joint Secretary, Department of Revenue as the Chairman and officers of FC-XIII, namely, Shri V. Bhaskar and Shri B.S. Bhullar, Joint Secretaries; Dr. Rathin Roy, Economic Adviser; and Shri Ritvik Pandey, Deputy Secretary, as Members, was set up to assist the Commission on issues related to the proposed implementation of GST from 1 April 2010.

2.34 Another technical working group was constituted to review the Debt Consolidation and Relief Facility (DCRF) 2005-10. This was headed by Dr. Rathin Roy, Economic Adviser, FC-XIII with Mrs. Anuradha Prasad, Finance Manager (Maritime Systems), Ministry of Defence; Shri B.M. Misra, Adviser, Central Office, Reserve Bank of India, Mumbai and Shri Vijay Singh Chauhan, Additional Director, Directorate of Revenue Intelligence, New Delhi, as Members.

2.35 We wish to place on record our appreciation of the contribution made by these groups.

### Other Meetings

2.36 A high level Ethiopian delegation led by Mr. Dagfe Bula, Speaker of the House of Federal Democratic Republic of Ethiopia visited the Commission on 7 May 2008. Another delegation from Ethiopia led by HE Mr. Mesfin Mengistu, Chairperson of Expenditure Management & Control Standing Committee of the House of Peoples' Representatives of the Federal Republic of Ethiopia visited the Finance Commission on 5 November 2008 to keep abreast of the system of fiscal

federalism in India. A group of 23 officials from Bhutan, Indonesia, Philippines and Thailand visiting India under the Colombo Plan as a part of the Capacity Building Programme to share Indian Governing Practices also visited the Finance Commission on 21 August 2009 to familiarise themselves with the financial devolution practices in India.

2.37 The Commission had the benefit of receiving views on various issues relating to its terms of reference from a large number of eminent personalities from various walks of life, who met the Chairman, Members and Secretary of the Commission. The list of visitors who met the Chairman is placed in Annex 2.31.

2.38 A two-month internship programme was introduced in the Commission for providing exposure to postgraduate students in Economics/Public Finance/Financial Management, on the working of the Finance Commission. There was an overwhelming response from the candidates seeking a chance to work as interns in the Commission. Seven interns worked in the Commission on short term projects.

2.39 We inherited an excellent website from FC-XII. The Commission's website was re-designed around four objectives. The first was to be a permanent storehouse of information on this Finance Commission and previous Finance Commissions for all stakeholders and to provide continuity between Commissions. The second was to provide a status of its ongoing work including a summary of the discussions it held with all State Governments. The third was to seek suggestions on issues before the Commission, both in response to specific discussion papers posted on the website as well as *suo moto* suggestions from interested parties. The fourth was to act as a medium for exchange of information between State Governments and the Commission. Data exchange was web-enabled, ensuring quicker and more accurate transmission of information. The site which was designed to ensure easy access to data received nearly 1,50,000 hits between January 2008 and December 2009. We expect that the National Informatics Centre (NIC) Unit in the

Ministry of Finance will maintain this website till the next Commission takes it over.

### **Acknowledgements**

2.40 We would like to place on record our appreciation of the valuable and wide ranging contribution of the officers in the Commission. Their untiring work and diligent analysis of all the material received by the Commission was extremely useful for us in formulating our views on various issues arising from our Terms of Reference. We are deeply thankful to Shri V.Bhaskar and Shri B.S. Bhullar, Joint Secretaries; Dr. Rathin Roy, Economic Adviser; Shri Rajib Kumar Sen, Shri P.K.Verma and Shri S.K.Bansal, Directors; and Shri Ritvik Pandey, Deputy Secretary. We were also fortunate to have benefited from the services of Shri G.R Reddy as Adviser, who joined us in October 2009, after Dr. Roy left to take up his assignment with UNDP,

Brazil. Shri Sanjeev Joshi, Dr. R.N.Sharma, Shri Subhra Ray, Smt. Neeru Shad Sharma, Joint Directors and Shri Harish Pokhriyal, Dr. Manish Gupta, Shri J.K. Rathee, Shri A.S.Parmar, Shri D. Brahma Reddy, Shri Upendra Sharma, Deputy Directors and all the other officers and members of the staff, are listed in Annex 2.6, contributed significantly to our work. Smooth running of housekeeping by the support staff, including those on contract, ensured the efficient functioning of the office. Our special thanks are due to Shri S. Ravi, PS to Chairman and our personal staff who put in their best efforts throughout the past two years. We would like to thank the team from the National Informatics Centre, in particular, Shri Nagesh Shastri, Senior Technical Director and Shri P.K. Garg, Technical Director, for managing the IT requirements of the Commission, as well as the Government of India Printing Press for printing this report on time.

## CHAPTER 3

# Issues and Approach

### Introduction

3.1 The overall task of the Finance Commission is to discharge the mandate laid down in articles 270, 275 and 280 of the Constitution, consistent with the principles of federal finance, taking into account the current and likely future macroeconomic and fiscal scenarios, so as to secure fiscal stability and adequate resource availability for the Centre, the states and the local bodies.

3.2 The Presidential orders that provide the Terms of Reference (ToR) for the Thirteenth Finance Commission can be viewed as setting the Commission three different types of tasks. The first or 'core' task of the Commission is to recommend distribution, between the Union and the states, of the net proceeds of taxes to be divided between them under Chapter I, Part XII of the Constitution of India, commonly termed as the 'divisible pool'. Second, the Commission has also to recommend the allocation between the states of such proceeds. Under Article 275 of the Constitution the Commission may provide general purpose grants to states which are 'in need of assistance' and other specific purpose grants. Third, the Commission has been asked to recommend measures to supplement the resources of the panchayats and municipalities in different states by augmenting the consolidated funds of individual states, taking into account the recommendations of the respective State Finance Commissions (SFCs).

3.3 Every Commission is required by its Terms of Reference to keep specific policy

considerations in mind while undertaking its core task. Thus, the Thirteenth Finance Commission has to take account of:

- i) The need to balance the receipts and expenditure on revenue account of all the states and the Union and generating surpluses for capital investment.
- ii) The impact of the proposed implementation of the Goods and Services Tax (GST) from 1 April 2010, including its impact on the country's foreign trade.
- iii) The need to improve the quality of public expenditure.
- iv) The need to manage ecology, environment and climate change consistent with sustainable development.
- v) The need to ensure commercial viability of public sector and departmental undertakings, as also of irrigation and power projects.
- vi) The taxation efforts of the Central Government and each State Government and the potential for additional resource mobilisation to improve the tax-Gross State Domestic Product/Gross Domestic Product ratio.

3.4 These specific considerations are taken account of by the Commission in the assessment of the financial needs of the Centre and the states and in the design of specific purpose grants.

3.5 The ToR assign FC-XIII a specific 'macro policy task', which is to review the state of the

finances of the Union and the states and the operation of the states' Debt Consolidation and Relief Facility (DCRF) 2005-10 and suggest measures to maintain a stable fiscal environment, consonant with equitable growth. A subsequent addition to our ToR mandates us to review the roadmap for fiscal adjustment and suggest a suitably revised roadmap that would maintain the gains of fiscal consolidation through 2010-15.

3.6 The issues that we have to consider, therefore, directly emanate from the ToR of this Commission. In this chapter we will outline the broad considerations that inform the Commission's approach to its core and policy tasks. We also discuss the main issues and our proposed approach.

3.7 The overall approach of the Commission is to foster 'inclusive and green growth promoting fiscal federalism'. This is the vision underlying the Commission's recommendations on inter-governmental fiscal arrangements and on the roadmap for fiscal adjustment. This vision has to be given effect within the overall structure of inter-governmental fiscal arrangements, whose contours are Constitutionally specified.

3.8 The federalist development State is a domain for evolutionary policymaking, responsive to internal and external policy imperatives such as political integration and globalisation, with sovereign powers to fulfil its mandate. These powers are, however, not absolute. The development project of the state is enabled by evolutionary policy making, while circumscribed by the laws that mandate the exercise of its sovereignty in the formulation and implementation of policy.

3.9 Kautilya argued for a social contract defined by laws, principles and doctrines in *Dharmasastra* and *Arthasastra*, delimiting the Constitutional metes and bounds of Monarch and State. The Indian Constitution can, thus, be seen from a variety of perspectives, as providing a regulatory framework within which the developmental federalist State undertakes its project. The structure of the inter-governmental

fiscal framework has to serve the purposes of the contemporary development project, while at the same time, ensuring that it functions within the regulatory framework defined, in our time, by the Constitution of India.

3.10 Inclusive growth is the cornerstone of India's development project. India's recent economic growth performance has, indeed, been creditable. However, such growth must make a demonstrable difference to the lives of the poorest and most vulnerable citizens. On this, as reflected in the Millennium Development Goals (MDGs) there is global consensus, of which our nation is a part. India has the potential and the means to secure such a future for its citizens. The stress laid on inclusive growth in the Eleventh Plan has meant that such growth has been accompanied by a concerted effort, by all levels of government, to invest in the delivery of public services, particularly those which promote progress in achievement of the MDGs. But, to achieve this potential, it is necessary that resources be mobilised and deployed in such a manner that the recent high rates of growth are maintained and even increased. Thus, sustainable and inclusive growth are prerequisites for achieving the MDGs.

3.11 Inclusivity informs our recommendations in every sphere. In our formula for horizontal devolution, the highest weightage amongst all the variables is for correcting the fiscal disability of a state vis-a-vis those of the top-ranked states. Further, we also recognise the fiscal disability of the special category states by computing their fiscal distance from the top-ranked states after setting their tax effort at the average for the special category alone, in place of an all-state average. Inclusivity is justified, not merely to ensure equal treatment of citizens by governments, but also for long term economic efficiency reasons, so as to minimise the burden of fiscally-induced migration on high-income states. It also underlies our attempt to prescribe a fiscal roadmap targeting elimination of the revenue deficit so that net new borrowing is directed towards creation of public

infrastructure which would benefit all. It also underlies many of our grant provisions, for instance, maintenance for the new village connectivity roads financed under Pradhan Mantri Gram Sadak Yojana (PMGSY). And finally, inclusivity underlies our substantially enhanced grant for local bodies, including those of the Schedule V and VI areas, so as to enable provision of sanitation and other public goods.

3.12 Fiscal consolidation promotes growth. By fiscal consolidation we do not mean a reduction in the role of the State. In a complex and developing economy like India, the government will continue to mobilise and deploy a significant proportion of resources to promote public welfare. Rather, fiscal consolidation refers to measures to improve the quality and effectiveness of the processes of public expenditure and resource mobilisation. We are of the view that there are feasible pathways for fiscal consolidation with high growth, as a study by the NIPFP for this Commission shows analytically. In the present context, this also means providing the fiscal space to promote both public and private investment, so as to secure the highest possible sustainable, green and inclusive rate of growth for the Indian economy. For the Commission, this involves proposing ways to incentivise such consolidation within the mandate and instruments at our disposal. We have been particularly mindful of this challenge in our recommendations with respect to the future fiscal roadmap.

3.13 For achieving a greener and more inclusive growth path we need a fiscally strong Centre, fiscally strong states and fiscally strong local bodies, or the third tier of government. Therefore, we are proposing the strategy of 'expansionary fiscal consolidation' with no compression of development expenditures. Such a fiscal strategy will provide a more propitious environment for increasing both public and private investments, as well as for better handling of adverse economic shocks that we may face due to external developments. In other words, the proposed fiscal strategy will also improve our country's economic security.

3.14 A high growth economy minimises the risk of 'crowding out' of the private sector, by allowing the government to increase fiscal space for public investment consistent with fiscal prudence. In fact, in such an environment, the private sector becomes a valuable actor. Better targeted public good delivery systems can be used to engage the private sector in the provision of key public goods, particularly infrastructure. Effective fiscal consolidation ensures that the government gets the best value for money from such engagement. In assessing the resources available for overall transfers the Commission has also taken into account the total resources available, including potential inflows from disinvestment.

3.15 Green growth involves rethinking growth strategies with regard to their impact on environmental sustainability and the environmental resources available to poor and vulnerable groups. It is significant to note that many stimulus packages announced globally to combat recession incorporated a green component. International experience is that green growth promotes inclusivity. Further, the renewable energy sector is relatively labour intensive, with the potential for generating more jobs than the oil and gas industries.

3.16 Securing the environment is critical for India's future generations and not just a matter of international commitment. A degraded environment reduces the quality of life for all citizens, but the impact is particularly pronounced on the poor and vulnerable groups, as it is they who suffer the most from degraded access to clean water, air and sanitation, as well as from climate shocks. It is for this reason that, despite the fact that India's per capita greenhouse gas emissions are much below the world average and far lower than the average of developed countries, we have pursued policies which complement efforts towards mitigation of climate change. It is, therefore, important to incentivise fiscal policies that promote measures for energy conservation, renewable energy, soil conservation, afforestation and more effective and affordable access to clean water at different levels of government. This would

impact all levels of government, including local bodies, which face mounting challenges in delivering better access to clean water, better solid waste management and enhanced, but green local infrastructure. Our grant proposals are supportive of such an approach.

3.17 In India, Finance Commissions have had to face three important challenges. First, there has been a historically high degree of vertical imbalance between the Centre and the states, as will be shown in Chapter 4. Recently, there has also been an increase in the size of the non-shareable portion of central revenue receipts. Second, there is spatial inequality in the fiscal capacity and fiscal needs of different states. The reasons underlying this spatial inequality vary considerably, depending on the state in question. Further, different states are at different stages of the development transformation, so their fiscal needs also vary over time. The Constitution provides general guidance on addressing the needs of the states and the Centre as well as taking account of state-specific needs, but does not provide the prescriptive framework for Finance Commissions. Third, it is a fact that recent decentralisation initiatives and the increasing pace of urbanisation have considerably increased the fiscal obligations of the third tier of government, but not the devolution of human and financial resources to discharge these obligations. This has increasingly become an important dimension of the work of every Finance Commission. Thus, the work of every Commission is multi-dimensional in nature.

3.18 Added to this are the new domestic challenges that have emerged. The imperatives of urbanisation, empowerment of India's villages and improved information flows have collectively increased the expectation and demand for public and merit goods. In meeting this demand the challenge of sustainable development has to be kept firmly in mind, so that present generations do not diminish the lives and capabilities of future generations. Further, India has one of the world's youngest populations.

This is a one-time demographic dividend which needs to be harnessed through appropriate investments in human development, particularly in education and public health, so that the country, having undertaken its long term development transformation, is then able to cater to the long term challenge that this dividend poses—that of an ageing population. In making its awards the Commission has to be mindful of the short and long term implications that these challenges pose for the public finances of India and the need to foster the appropriate fiscal incentives to address these challenges.

3.19 An important challenge faced by our Commission was that the assessment of the resource position of the Centre and the states has had to be made in the face of more than normal uncertainties, given the developments in the global economy and the consequent need for resources to be devoted to stabilisation and countercyclical measures by the Centre as well as the states. The Commission's recommendations for vertical and horizontal devolution have to be consistent with the requirement that the Commission '... suggest a suitably revised roadmap with a view to maintaining the gains of fiscal consolidation through 2010 to 2015'. The impact of countercyclical measures on the absolute and relative finances of Central and State Governments will affect the future fiscal roadmap. This, in turn, has to be taken into account in preparing the forecasts necessary to calculate consistent and appropriate vertical and horizontal devolutions.

3.20 All Commissions have to approach their tasks, recognising that the data base for many important economic variables (e.g., taxable capacity) is less than perfect and may require approximations and normative corrections. We are well aware that it is desirable to make the fiscal awards more incentive-compatible and better targeted to securing the different objectives enjoined on the Commission in its terms of reference. This requires the Commission to identify and use reliable and widely acceptable data which is regularly available, easily understood and does not require interpretation

or normative assessment by any agency during the Commissions' award period. Data limitations, thus, act as a reality check on our aspirations in this direction, as does the fact that Finance Commissions have to take account of the limits and constraints of political economy that any country faces in working out inter-governmental/jurisdictional fiscal transfers.

3.21 As mentioned in Chapter 2, we commissioned several external and in-house studies to inform deliberations and assist in developing our approach. The Commission was very keen that its work be knowledge based and, to this end, interacted continuously with the scholars and institutions commissioned to carry out applied research. These studies, as well as our consultations with the national and international professional and policy community, have greatly contributed to our endeavour to present evidence and research based arguments in support of our recommendations.

### **Approach to Fiscal Consolidation**

3.22 Despite the commendable correction achieved by the Centre and states through implementation of the Fiscal Responsibility and Budget Management (FRBM) legislation across the 2005-10 period, the closing debt-GDP ratio for 2009-10 is estimated at 82 per cent, well above the FC-XII target of 75 per cent. Our starting point was to determine the feasible target for the debt-GDP ratio, consolidated across the Centre and the states, by 2014-15. A major task, then, before this Commission was to determine the extent to which fiscal consolidation could reduce the medium term combined debt-GDP ratio over the time horizon 2010-15, based on our projection of the medium term macro-economic situation. We are proposing a target of 68 per cent for a combined Centre and state debt to GDP ratio to be achieved by the year 2014-15 and 45 per cent for the Central Government debt-GDP ratio. We then specified a time path, whereby the Centre and states would be able to return to the process of fiscal adjustment, in the aftermath of the

deviation necessitated by the events of 2008-09. These developments also signalled the need to specify more closely the circumstances under which such deviations were to be triggered and a more desirable distribution of the burden of incidence of stabilisation and counter-recessionary measures.

3.23 We have taken elimination of the revenue deficit as the long term and permanent target for both the Centre and the states. We are of the view that there is a general consensus on this issue and further, that such a target is enjoined on us by our Terms of Reference, given the need to generate surpluses for public investment. Our prescribed fiscal consolidation path for the Central Government entails a decline in the revenue deficit from 4.8 per cent of GDP as projected for the fiscal year 2009-10, to a revenue surplus of 0.5 per cent of GDP by 2014-15. This allows for acceleration in capital expenditure to 3.5 per cent of GDP; more if there are disinvestment receipts. This projected scenario would be one that places Central Government finances on a sound footing in the long term, consistent with the requirements of inclusive growth.

3.24 The second round of Fiscal Responsibility Legislation (FRL) by states, prescribed by us in accordance with our additional term of reference, takes up from where FC-XII left off. The fiscal consolidation path promotes growth-expansive fiscal consolidation, by incentivising elimination of revenue deficit thereby ensuring that net public borrowing is directed exclusively towards growth-enhancing public investment. At the same time, we recognise the adjustment period required for exit from the fiscal loosening permitted to states in 2008-09 and 2009-10, as part of the national fiscal stimulus to contain the adverse impact of the international growth meltdown. Accordingly, we allow 2010-11 as a year of adjustment and begin our fiscal consolidation path only from 2011-12. For those states which begin the process from a more adverse fiscal situation than others, a longer period is granted for conforming to the mainstream. Thus, our prescriptions explicitly recognise that one size does not fit all. Although

public investment is growth-promoting, its quantum in any single year has to be subjected to an overall fiscal deficit cap. This ensures that public claims on financial savings do not crowd out private investment. It also ensures avoidance of the kind of bunching of repayment obligations that can happen when public borrowing is not paced uniformly across years and permits the kind of pre-planning and judicious choice of projects necessary if public investment is to have maximal impact. These are the multiple considerations that have gone into our configuration of the roadmap for fiscal adjustment over the horizon 2010-15.

3.25 We have also carried forward the practice, introduced by FC-XII, of incentivising fiscal consolidation by states. The intent is not to restrict the discretionary latitude of states with respect to their fiscal domain, but to secure commitment by all states to the national fiscal consolidation required for achievement of macroeconomic stability. Our projections of revenues of states into 2010-15 enjoin greater tax effort on the part of states with a poor revenue collection record, thus implicitly rewarding states with higher levels of past achievement. Our projections of state expenditures are based on norms by type of expenditure, thus indicating the directions open to states for expenditure reform. Equally, the proposed expansionary fiscal consolidation path for the Union will promote inclusive growth.

3.26 We have sought to design grants with a view to incentivising improvements in accountability of, transparency in and innovation at, the cutting edge of the public goods delivery process. Thus, the Commission's approach is geared to advancing the fiscal reforms agenda in all these three dimensions.

3.27 Expenditure reforms are an important driver of the Commission's approach to the fiscal roadmap for the future. Two game-changing tax reforms, namely GST and the new Direct Tax Code, will give considerable impetus to revenue growth. Expenditure reforms

at all levels of the government have a strategic role in the Commission's approach towards fiscal consolidation. A major thrust of the proposed expenditure reforms is to improve the supply of public goods which is also inclusive by reducing existing untargeted and regressive subsidies. Other reforms are aimed at improving the productivity of public expenditure. These include: (i) performance-linked incentives to states and local bodies; (ii) measures to improve transparency and accountability, e.g., stricter audit procedures; (iii) 'institutional deepening' for better expenditure management, e.g., creation of the local body ombudsman, fiscal council and independent evaluation organisations; (iv) promotion of innovations and their diffusion so as to reduce cost as well as to improve quality of public services and (v) larger fiscal transfers to the local bodies, to encourage speedier implementation of the 73<sup>rd</sup> and 74<sup>th</sup> Constitutional amendments regarding the transfer of functions and functionaries in consonance with the subsidiarity principle.

### **Considerations in Recommending the Design of Fiscal Transfers**

3.28 The approach to designing fiscal transfers by this Commission is, in its basics, consistent with the approach of recent Commissions. The availability of resources and expenditure requirements of the Centre and the states has been assessed on the basis of certain norms. Having estimated these, the vertical and horizontal devolution of taxes is determined. Grants are then allocated to states, based on certain criteria. However, these are not to be understood as linear stages in the Commission's working. A calibrated normative approach, is followed, where the assessment of resources available and expenditure commitments forecast by different government entities is undertaken, bearing in mind the overall resource envelope available to the general government, viz. gross revenue receipts of the Government of India and the State Governments, as well as the desired roadmap

for fiscal consolidation. An iterative process with application of careful judgment and appreciation of the evolutionary nature of past trends helped us to determine the vertical sharing of resources between the Union and the states. Our endeavour has been to make this process transparent in our explanation of the logic underlying the Commission's recommendations on vertical and horizontal devolution and the principles governing the award of grants-in-aid to the states and local bodies.

3.29 Table 3.1 gives the share of each state in total FC transfers and the deviation from the mean share across Commissions. This analysis has been carried out for all Commissions. We have, as far as possible, tried to keep the boundaries of the states across two consecutive FCs same, so as to enable proper comparison. For example, in the case of FC-XII the share of Jharkhand has been added to that of divided Bihar to get the share of undivided Bihar for comparison with the Bihar of FC-XI. Our analysis indicates that differences exceeding 1 per cent are very rare; the largest difference, of 3.31 per cent, happening but once in the case of the Eleventh Commission, relative to the Tenth Commission, for Bihar. By and large, *inter se* changes in tax devolution shares tend not to exceed half a percentage point. Differences tend to be larger in the case of grants; and even so, differences exceeding 3 per cent are fairly rare. In some cases, (e.g., Nagaland and Jammu & Kashmir in the case of the last two Commissions), the large differences reflect the provision or expiry of a major specific purpose grant. It can, therefore, be concluded that, in general, the *inter se* shares of Finance Commission transfers have not varied widely over the various Commissions. This is an important feature of the political economy of India's fiscal federalism.

3.30 This remarkable stability across time and over a variety of circumstances, (for instance, covering the years of fiscal squeeze as well as the relative fiscal abundance of recent years) has meant that the structure of inter-governmental fiscal relations has not been 'shocked' by changes

in macro-fiscal circumstances and has, in turn, not caused structural shocks to the macro-fiscal situation in the Indian economy. Thus, there is a marked tendency towards stability in the relative share of the Centre and states in respect of aggregate transfers.

3.31 The overall approach of the Commission has taken account of the following issues in the design of fiscal transfers:

i) *Symmetry between the Centre and states:* It is commonly understood that the intent of setting up a Constitutional body such as the Finance Commission is to ensure that all levels of government are accorded similar treatment. In making projections of revenue and expenditure we have applied a normative discipline for both the Centre and states.

ii) *Equal treatment:* There are two contexts in which this proposition may be understood. First, there is no automatic priority accorded to any level of government, or to any two units at the same level of government within the framework of inter-governmental relations, in the Commission's award. Second, the Commission is concerned with equalisation, not equity. This proposition needs to be understood in a citizen-centered, rather than government-centric fashion, namely, that all citizens of India should expect to receive a comparable standard of public services, irrespective of where they reside within the Republic of India. The intent is to ensure that the states and local bodies have the fiscal potential to provide comparable levels of public services, at reasonably comparable levels of taxation. Clearly, this does not mean that per capita expenditure on such provision will be even across the country; conversely, it means that one of the requirements of equal treatment is to address differences in fiscal needs and cost disabilities for providing a similar level of public services, which may be higher or lower than the average. Thus, the principle does not guarantee uniformity in public services across the country, but addresses the fiscal requirements of each jurisdiction to enable such uniformity.

**Table 3.1: State-wise Share in Total Transfers (Tax devolution + Grants) as Recommended by Different FCs and its Deviation from the Mean Share**

State	(per cent)													
	First	Second	Third	Fourth	Fifth	Sixth	Seventh	Eighth	Ninth (1)	Ninth (2)	Tenth	Eleventh	Twelfth	Mean
Andhra Pradesh	4.16 (-3.21)	8.58 (1.21)	9.31 (1.95)	8.05 (0.68)	7.77 (0.4)	8.08 (0.71)	7.30 (-0.07)	7.34 (-0.03)	6.60 (-0.77)	6.83 (-0.54)	7.98 (0.61)	7.13 (-0.24)	6.66 (-0.71)	7.37
Arunachal Pradesh									1.11 (0.37)	0.79 (0.05)	0.78 (0.05)	0.53 (-0.2)	0.47 (-0.27)	<b>0.73</b>
Assam	4.60 (0.67)	4.33 (0.4)	4.47 (0.55)	5.04 (1.12)	3.65 (-0.27)	4.58 (0.65)	2.49 (-1.44)	4.07 (0.15)	4.12 (0.19)	3.73 (-0.19)	3.67 (-0.25)	3.05 (-0.87)	3.22 (-0.71)	<b>3.92</b>
Bihar	11.78 (1.51)	9.09 (-1.18)	7.83 (-2.44)	6.91 (-3.36)	9.57 (-0.7)	8.79 (-1.48)	10.62 (0.35)	10.70 (0.43)	10.65 (0.38)	10.54 (0.27)	10.88 (0.61)	13.04 (2.77)	13.14 (2.87)	<b>10.27</b>
Chhattisgarh													2.42	
Goa									0.34 (0.04)	0.48 (0.18)	0.27 (-0.03)	0.19 (-0.11)	0.23 (-0.07)	<b>0.30</b>
Gujarat		3.41 (-0.54)	6.50 (2.54)	4.23 (0.27)	4.34 (0.39)	3.84 (-0.12)	4.62 (0.67)	3.77 (-0.18)	3.19 (-0.76)	3.50 (-0.45)	3.92 (-0.04)	2.76 (-1.2)	3.39 (-0.57)	<b>3.96</b>
Haryana				1.19 (-0.01)	1.42 (0.21)	1.26 (0.05)	1.48 (0.28)	1.11 (-0.09)	1.21 (0)	1.13 (-0.08)	1.23 (0.03)	0.97 (-0.24)	1.06 (-0.14)	<b>1.21</b>
Himachal Pradesh					0.94 (-0.83)	2.12 (0.35)	1.56 (-0.21)	1.96 (0.19)	1.86 (0.09)	1.75 (-0.02)	2.10 (0.33)	1.72 (-0.06)	1.91 (0.14)	<b>1.77</b>
Jammu & Kashmir		2.34 (-0.32)	1.66 (-1)	2.27 (-0.39)	2.17 (-0.49)	2.42 (-0.24)	1.81 (-0.85)	2.84 (0.18)	3.48 (0.82)	3.17 (0.51)	3.23 (0.57)	3.78 (1.12)	2.76 (0.1)	<b>2.66</b>
Jharkhand												0.00	3.13	
Karnataka	1.42 (-3.3)	7.01 (2.29)	6.19 (1.48)	7.48 (2.77)	4.65 (-0.07)	3.99 (-0.72)	4.82 (0.1)	4.38 (-0.34)	4.22 (-0.5)	3.83 (-0.89)	4.64 (-0.08)	4.53 (-0.19)	4.16 (-0.56)	<b>4.72</b>
Kerala	0.85 (-2.81)	3.62 (-0.04)	5.23 (1.56)	6.51 (2.85)	4.38 (0.71)	4.99 (1.33)	3.70 (0.03)	3.27 (-0.4)	3.01 (-0.66)	3.25 (-0.41)	3.41 (-0.26)	2.83 (-0.83)	2.59 (-1.07)	<b>3.66</b>
Madhya Pradesh	5.84 (-1.1)	6.81 (-0.13)	6.62 (-0.32)	5.60 (-1.34)	6.45 (-0.49)	5.66 (-1.28)	7.66 (0.72)	7.50 (0.56)	6.99 (0.04)	7.40 (0.46)	7.10 (0.16)	8.05 (1.11)	8.55 (1.61)	<b>6.94</b>
Maharashtra	16.35 (8.33)	10.47 (2.45)	9.12 (1.1)	9.01 (0.99)	9.16 (1.14)	7.40 (-0.62)	8.22 (0.2)	6.68 (-1.34)	6.71 (-1.31)	5.85 (-2.17)	6.05 (-1.97)	4.46 (-3.56)	4.79 (-3.23)	<b>8.02</b>

State	First	Second	Third	Fourth	Fifth	Sixth	Seventh	Eighth	Ninth (1)	Ninth (2)	Tenth	Eleventh	Twelfth	Mean
Manipur					0.50 (-0.46)	1.33 (0.37)	0.93 (-0.03)	1.19 (0.23)	1.09 (0.13)	1.02 (0.06)	0.94 (-0.02)	0.74 (-0.22)	0.91 (-0.05)	<b>0.96</b>
Meghalaya					0.35 (-0.38)	0.91 (0.18)	0.64 (-0.09)	0.97 (0.24)	0.82 (0.09)	0.78 (0.05)	0.83 (0.1)	0.68 (-0.05)	0.58 (-0.15)	<b>0.73</b>
Mizoram									1.25 (0.41)	0.96 (0.12)	0.80 (-0.05)	0.58 (-0.26)	0.62 (-0.22)	<b>0.84</b>
Nagaland			0.05 (-1.14)	2.01 (0.81)	1.53 (0.34)	1.41 (0.21)	1.15 (-0.04)	1.34 (0.14)	1.25 (0.06)	1.17 (-0.02)	1.23 (0.04)	1.02 (-0.17)	0.99 (-0.21)	<b>1.20</b>
Orissa	5.06 (-0.32)	4.51 (-0.87)	7.72 (2.34)	8.03 (2.65)	5.41 (0.02)	6.01 (0.62)	4.72 (-0.66)	4.84 (-0.54)	4.53 (-0.85)	5.21 (-0.17)	4.28 (-1.1)	4.77 (-0.61)	4.89 (-0.49)	<b>5.38</b>
Punjab	5.09 (2.59)	4.95 (2.45)	4.50 (2)	2.22 (-0.27)	2.13 (-0.37)	1.76 (-0.74)	2.01 (-0.48)	1.64 (-0.86)	2.04 (-0.46)	1.58 (-0.92)	1.58 (-0.91)	1.25 (-1.25)	1.70 (-0.79)	<b>2.50</b>
Rajasthan	5.35 (0.29)	4.57 (-0.48)	5.36 (0.3)	4.52 (-0.54)	4.99 (-0.07)	5.87 (0.81)	4.33 (-0.73)	4.25 (-0.81)	4.77 (-0.29)	6.15 (1.09)	5.03 (-0.03)	5.42 (0.36)	5.17 (0.11)	<b>5.06</b>
Sikkim							0.18 (-0.09)	0.26 (0)	0.23 (-0.03)	0.24 (-0.02)	0.31 (0.05)	0.38 (0.11)	0.24 (-0.02)	<b>0.26</b>
Tamil Nadu	9.87 (3.33)	6.95 (0.41)	7.00 (0.47)	7.17 (0.63)	6.98 (0.44)	5.60 (-0.93)	7.21 (0.68)	6.25 (-0.29)	6.38 (-0.15)	5.85 (-0.69)	5.89 (-0.64)	4.97 (-1.57)	4.85 (-1.68)	<b>6.54</b>
Tripura					0.63 (-0.53)	1.38 (0.21)	0.96 (-0.2)	1.42 (0.26)	1.34 (0.18)	1.35 (0.19)	1.27 (0.1)	1.00 (-0.16)	1.11 (-0.05)	<b>1.16</b>
Uttar Pradesh	16.30 (0.94)	13.51 (-1.85)	11.29 (-4.06)	12.96 (-2.39)	14.53 (-0.82)	14.04 (-1.31)	15.90 (0.55)	15.47 (0.12)	15.83 (0.48)	16.46 (1.1)	15.95 (0.6)	18.05 (2.7)	19.27 (3.92)	<b>15.35</b>
Uttarakhand													1.61	
West Bengal	13.35 (5.2)	9.85 (1.69)	7.15 (-1)	6.78 (-1.37)	8.44 (0.29)	8.57 (0.41)	7.66 (-0.49)	8.74 (0.59)	6.99 (-1.16)	6.99 (-1.16)	6.61 (-1.54)	8.10 (-0.05)	6.73 (-1.42)	<b>8.15</b>

Note: Figures in parentheses indicate deviation from the mean across Commissions.

The FC-XII figures of UP, MP and Bihar are for the undivided state (i.e., it includes respectively figures of Uttarakhnad, Chhattisgarh & Jharkhand).

iii) *Predictability*: The ability of governments to provide timely and need-based public services should not be negatively impacted by uncertainties and/or volatilities regarding resource flows. In the Indian context, where resource flows across inter-governmental units are sizeable in magnitude, close attention needs to be paid to this aspect in the design of the fiscal framework. In India the Centre collects important sources of revenue, which are then devolved to the states. The Centre, states and local authorities, all have a role to play in financing the delivery of key public services within their respective jurisdictions. It is important to ensure that the medium term framework for inter-governmental resource allocation allows all tiers of government to be reasonably certain about the resources at their disposal, in order to undertake their respective expenditure assignments.<sup>1</sup>

iv) *Incentives*: Finance Commission awards are but one part of the complex set of institutions that constitute the framework of inter-governmental arrangements in India. On the fiscal side, institutions like the Planning Commission, the finance departments and planning boards of different states, state Finance Commissions, the judiciary and the legislature, all play a role in determining the mobilisation and allocation of public resources. In this context the Finance Commission can play an important role in incentivising different tiers of government to undertake fiscal measures. A sterling example of this was the fiscal consolidation process undertaken in the period 2005-10. The role played by the previous Finance Commission was not that of leading or implementing the process; instead, it was that of incentivising the Central and State Governments to act on their resolve to reform the public finances of India, by recommending appropriate fiscal and other policy measures that could serve as a roadmap, together with a framework of positive incentives for its

implementation. In our view the facilitating role of the Finance Commission in designing such incentives is as critical as, if not more critical than, the process of determining the criteria for inter-governmental awards. Our Commission has, therefore, tried to play its part in designing incentives consistent with the Terms of Reference. We have sought to maintain the incentive component within the devolution formula, while also seeking to provide grants to incentivise improvements in governance and the environment. We have, further, maintained time consistency of incentives across recent Commissions in order to improve the impact of such incentives.

3-32 Like our predecessors, this Commission's recommended award has to take a very large number of variables into consideration, given the terms of reference and the multi dimensional balancing required to arrive at consistent vertical and horizontal transfers. In our approach we have tried to ensure that:

- i) The normative annual needs of the Centre and the states are addressed at a level that is largely acceptable to both, consistent with the requirements of fiscal consolidation.
- ii) The requirements of different elements in the terms of reference of the Commissions are addressed in a manner that is fully compatible with the Constitutional requirement to recommend an award that takes account of the needs of the Centre as well as those of the states.
- iii) The design of vertical and horizontal devolution as well as that of grants-in-aid supports, rather than detracts from, efforts to maintain a 'hard budget constraint'.
- iv) The design enables individual states to access resources for their overall development needs, through appropriate *inter se* formulae for tax devolution, by a

<sup>1</sup>Indira Rajaraman (2008), 'The Political Economy of the Indian Fiscal Federation' in Barry Bosworth, Suman Bery and Arvind Panagariya (ed.), *India Policy Forum 2007-08* (Brookings and NCAER), Volume 4; 1-35

normatively forecasted non-plan revenue deficit for those states that continue to display a forecasted fiscal gap following the Commission's normative assessment of their fiscal position for the 2010-15 period, and through the provision of general and state-specific grants.

- v) Adequate attention is paid to the low resource base and the cost disabilities of special category states due to their physical geography, sparse terrain, remoteness and historical circumstances.

3.33. We are required to consider the impact of the proposed implementation of the goods and services tax with effect from 1 April 2010, including its impact on the country's foreign trade. GST, with its revenue and growth effects, influences three other items in our ToR. These include the reference to estimation of the resources of the Central and State Governments, the reference to the potential to improve the tax-GDP ratio of the Centre and the states, the reference to the need to balance the receipts and expenditure on the revenue account and to generate surpluses for investment. We have, therefore, attempted to be holistic in our consideration of GST as this is, indeed, a 'game-changing' reform to create India as a vibrant common market. Our approach seeks to define the contours of the present debate on GST and outline the framework for a Model GST. A National Council of Applied Economic Research (NCAER) study sponsored by the Commission explains why implementation of such a Model GST will be a positive sum game and will bring considerable economic benefits for the whole country, with reduced transaction costs, revenue neutrality and substantially lower tax rates. This study also suggests that implementation of the model GST will lead to better environmental outcomes. We seek to propose a 'Grand Bargain' through which such a GST can be implemented and which incorporates assurances on compliance by all parties. We have also addressed the concerns voiced by some states on possible negative impacts.

3.34. There has been significant advancement since the Government of India announced its intention, in February 2007, to move to a GST by April 2010. The Empowered Committee of state Finance Ministers has released two significant documents—'The Model and Road Map for Goods and Services Tax in India' in April 2008 and the 'First Discussion Paper on Goods and Services Tax in India' in November 2009. These documents, while reflecting the commitment of the State Governments to implement GST, indicate the present stage of the agreement reached on the GST model and its implementation modalities. The Discussion Paper suggests the possibility of different rates for goods and services and different tax thresholds for the Central GST and the State GST, while exempting a number of items. It has yet to take a final view on the Revenue Neutral Rate to be adopted and the treatment of some goods. A number of State Governments and industry associations have independently expressed their concerns to the Commission on the framework of the GST. We have, therefore, attempted to move this debate forward by defining the contours of a Model GST and incentivising State Governments to adopt it.

### **Vertical Devolution: Issues and Approach**

3.35 A key economic feature of a nation State is the existence of an internal common market. An important objective of economic policy should be to make sure that this market functions as efficiently as possible. This happens when resources and commodities move from one region to another without impediments or distortions caused by policy. While differences in local cost conditions may exist, their mitigation is a legitimate objective of policy making. However, distortions caused by faulty policy design are undesirable. In a decentralised tax system differences in tax structures across jurisdictions can cause undesirable distortions. In addition, there are fixed administrative costs associated with collecting different taxes which can be mitigated by a joint collection mechanism. Thus, according to our Constitution, many direct

taxes like Income Tax are levied and collected by the Centre, but the proceeds are shared with the states. Similarly, the principle of equal treatment, irrespective of jurisdiction, is an important part of the political settlement in India. Thus, the principle that underpins both vertical and horizontal devolution is that equality of access should be enabled, but cannot ensure that common standards in quality or outcomes in public services are actually achieved. For that to happen it is necessary that the average cross-state level of tax effort assumed actually prevails in the states and that efficiency of delivery is not below the cross-state average. At the same time, we recognise that the Central Government can play a role in incentivising improved levels of public service delivery across the country.

3.36 Vertical transfers can be justified on four principal grounds. First, transfers may be responses to the extant asymmetric decentralisation of expenditure responsibility and revenue-raising authority. Second, they may be used to equalise the fiscal capacity of the regions to avoid inefficient migration of persons and businesses among regions and to foster horizontal equity across the country. Third, these may also be used in conditional forms to neutralise fiscal externalities imposed by regional governments on other regions, as well as to achieve national standards in social programmes and to induce efficiency in the internal economic union. Finally, these may be used as instruments for insuring regions against shocks to their fiscal capacities (though this is mainly done through grants-in-aid). Each of these reasons informs our assessment of vertical devolution. Given the background of the ongoing economic recession it is clear that it is both efficient and desirable for the Centre to institute countercyclical measures to fulfil the key function of economic stabilisation. At the same time, the symmetric decentralisation of expenditure commitments and resource mobilisation powers requires redressal through vertical devolution. In

addition, devolution must be adequate with regard to the requirements of fiscal consolidation and reform that the Commission recommends.

3.37 The Constitution specifies the taxing powers of the Centre and states with respect to different sources of tax revenue. It can be argued that there is a vertical imbalance in the distribution of these taxing powers which has worsened over time, as pointed out in Para 3.17. While in the total revenue expenditure there has been long term stability in the relative shares of the Centre and the states after implementation of the transfers recommended by the Finance Commission, the buoyancy of central taxes has been higher than those of the states and such a trend is expected to continue, given the nature of tax assignment to the Centre and states. Rangarajan & Srivastava (2008)<sup>2</sup> have shown that to maintain constancy in the share of states in post-devolution total tax revenue, this share would need to increase by the margin by which the buoyancy of central tax revenue exceeds the buoyancy of combined tax revenue. The argument for using post-devolution tax shares to maintain consistency, as against altering tax assignments, is based on the premise that most schemes of assigning resources in different country settings tend to be biased in favour of the Centre in assignment of tax collection powers on efficiency grounds.

3.38 On the expenditure side it can also be argued that the states have higher 'fixed costs' than the Centre, as reflected in their higher share of committed expenditure in total non-plan expenditure relative to the Centre. In addition, states have restrictions placed on their borrowing powers. These features exacerbate the fiscal pressure on the states when, as is the case at present, an economic slowdown occurs. The discretionary fiscal space available to states to maintain fiscal prudence in the face of falling revenue buoyancy is less than that of the Centre. In addition, over the period

<sup>2</sup> C. Rangarajan & D.K. Srivastava (2008) : 'Reforming India's Fiscal Transfer System : Resolving Vertical & Horizontal Imbalances' : EPW Volume 43.

2010-15, there is the added fiscal burden posed by the states' pay awards, following that of the Sixth Central Pay Commission (CPC). The fiscal burden of the latest round of pay awards is much higher for the states in absolute as well as relative terms. Another issue that has been kept in mind is the increased tendency to expand the share of the non-divisible pool of resources available to the Centre, including cesses and surcharges, relative to the divisible pool. These important issues have informed the Commission's reflections on the appropriate vertical devolution.

3.39 The Commission has explicitly recognised the risks and uncertainties inherent in the current macroeconomic situation. We have been mindful that our economy will continue to face such, particularly due to external shocks. Keeping this in mind, we have been somewhat cautious in projecting growth rates, for both GDP and for revenues. In the case of GDP, our projected growth rates are lower than those given to us by the Planning Commission. For projecting revenues of the Centre, the revenue buoyancy estimate that we have adopted is lower than that of the Ministry of Finance. Similarly, for the states' revenue projections, we have adopted relatively more cautious revenue buoyancy parameters. Equally, whether for the Union or for the states, our fiscal correction targets are not overly ambitious, and are more likely to lead to a situation where performance is better than the promise. Such a development will only enhance the confidence of the markets, particularly the capital markets. This is, perhaps, a better way to build the country's reputational capital and will, thus, bring many long term benefits to the Central as well as State Governments.

3.40 In the case of the Centre, as well as of the states, we have viewed the first year of the award period, namely 2010-11, as a year for adjustment and recovery. We recognise the impact of exogenous price shocks on key fiscal parameters. These shocks make predictability difficult. Thus, the proposed Central FRBM legislation incorporates a terms of trade band, beyond which

the targets may be readjusted in a transparent manner. Similarly, we recommend a mechanism whereby, in such cases, the states are absolved from the task of taking on macro-economic adjustment and stabilisation. This task of macroeconomic stabilisation is a function which should be entirely assumed by the Central Government. This is reflected in our recommended design of the future fiscal roadmap.

3.41 In the design of a prudent fiscal regime there is a choice between delivery of public goods and services and provision of subsidies for private goods. While it is undoubtedly true that well directed subsidies can improve the access of target groups to merit goods, the extent to which this is true depends on what is subsidised and how. From the academic and policy literature on the subject and based on studies prepared for the Finance Commission, we are of the view that the impact of many central subsidies—including tax expenditures—is, on balance, regressive. Per capita subsidies flowing to the poorer states from the three major subsidies, viz. food, fertiliser and petroleum, were found to be far lower than the national average. The reasons for this may vary across the subsidies. Food subsidies are determined *inter alia* by efficiency of administrative arrangements in the respective states, as well as by their fiscal capacity to provide additional subsidies. The use of fertilisers is directly linked to irrigation facilities created and the size of land holdings. Consumption of petroleum products is directly proportional to the purchasing power of citizens. We have no persuasive evidence that price subsidies on foodgrains, power and irrigation—constituting the bulk of subsidies at the state level—are effective. In fact, in our consultations and state visits we found several examples of regressive incidence of these subsidies, largely on account of leakages and highly imperfect targeting systems. This is a cause for concern.

3.42 Given that inclusive growth is the overriding objective of public policy, regressive untargeted subsidies that reduce fiscal space for key growth-promoting public investments and

delivery of public goods to enhance inclusiveness are, today, a fiscal obstacle to the acceleration of India's development transformation. We have also noted that the preceding Finance Commissions took a very similar view in their normative assessments of central and state finances. Hence, this Commission, in its normative approach and recommendations with respect to the future fiscal roadmap, has recommended a fiscal path wherein subsidies are closely targeted. We have sought to discourage public spending on subsidies that detract from inclusive growth and, so, reduce fiscal space.

### **Horizontal Devolution: Issues and Approach**

3.43 In determining horizontal devolution, the reports of previous Commissions and the professional literature identify four issues that need to be addressed:

*i) Fiscal need:* In a diverse country like India it is common for the fiscal needs of different states to vary. The drivers of such differences also vary. The Commission has to balance the need for equal treatment with the need to be sensitive to the requirements of states in different stages of the development transformation. It is in this context that purpose- and state-specific grants assume great importance. This is particularly the case since, as represented to us by many states, fiscal need is not adequately captured by state level development indicators. There are also important intra-state disparities which, quite legitimately, require deployment of resources to address their fiscal needs. While lack of adequate district level data has not allowed the Commission to address this issue as directly as we would have liked, we have been mindful that differences in fiscal need cannot be addressed simplistically.

*ii) Fiscal capacity:* The core task of all states in the Union of India is to provide those public goods and services that their Constitutional responsibility mandates. However, the fiscal capacity—measured by the revenue base available

to each state—varies. The considerations that determine the *inter se* share of an individual state in the divisible pool need to factor in a state's fiscal capacity. If all states had equal fiscal capacity, then this would be done simply by dividing such a pool on the basis of fiscal need. However, recognising the differences in the tax base of different states, this is not an approach that has historically been followed.

*iii) Costs of providing similar levels of public goods and services:* Such differences arise due to feature-based or historical circumstances, adverse physical geography, sparse terrain, or geopolitical constraints to development. To some extent, the definition of some states as 'special category states' addresses this issue. However, adequate attention will need to be paid to such factors, given the Commission's terms of reference with respect to disaster management and the attention we seek to give to green growth.

*iv) Rewarding efficiency in public management, fiscal effort and outcomes:* The adoption of fiscal responsibility legislation and the general improvement in the fiscal health of many states has been one of the most positive features of the period following the report of FC-XII. We are mindful of the need to sustain and build upon this effort and this requires incentivising improved efficiency in public expenditure management and revenue effort.

3.44 We commissioned a joint study by the Institute of Economic Growth (IEG) and India Development Foundation (IDF) to evaluate the impact of fiscal transfers. The IEG-IDF study constructed a multi-regional Computable General Equilibrium (CGE) model where the Indian economy was stylised as an economy comprising three regions, viz. high income, middle income and low income regions. The IEG-IDF study has provided valuable insights. This shows that well-designed fiscal transfers from high income to low income regions of India have net positive welfare implications for all three regions. This is essentially due to the deep economic interdependence of the three regions and this impact will be even higher if such transfers are

utilised for increased expenditure on basic needs and on capital formation. We have taken this into account in our approach to both horizontal devolution and grant design.

3.45 With regard to the criteria and weights for horizontal devolution, it is difficult to map a one-to-one correspondence between individual criteria and one or more of the issues raised above. For instance, higher population and/or area indicate the need to spend more in absolute terms to provide the same level of public goods and services. Equally, for similar levels of Gross State Domestic Product (GSDP), a state with higher population would, *ceteris paribus*, have greater fiscal capacity. A larger area, *ceteris paribus*, implies larger factor endowment and therefore, positively impacts fiscal capacity. For this reason, this Commission has not attempted to explicitly assign specific criteria as measures of fiscal capacity or fiscal need. In the case of cost disabilities, the distinction between the general and special category states provides a macro-level recognition of this factor in the normative assessment as well as in the allocation of general and state-specific grants.

3.46 Since the Commission is concerned with equalisation, not equity, it is both feasible and possible to address efficiency and fiscal equalisation, using both instruments available to the Commission, viz. grants and devolution. In the case of efficiency and performance, we have made a special effort to address the concerns of some states regarding the possibility of perverse incentives. The lack of adequate data to design forward-looking indicators has, perhaps, been the greatest challenge in this endeavour. Despite this constraint the Commission has sought to explicitly recognise and give due weight to considerations of efficiency and performance in its overall design. It should be pointed out that the wider the differences over time in the response to incentives to secure fiscal discipline, the less likely will be the stability in *inter se* shares of the different states. Equally, states that respond to incentives to maintain and enhance

fiscal discipline will, *ceteris paribus*, have the possibility of improving their *inter se* shares.

### Principles Governing the Design of Grants

3.47 Generally, the amount of grants-in-aid provided to the states by different Finance Commissions since the First Finance Commission have been under the Constitutional obligation of the Union Government as per articles 273 (1) and 275 (1). In addition, other kinds of grants have been given to the states to: (i) reduce disparities in the availability of various administrative and social services across states; (ii) allow particular states to meet special financial burdens emerging as a result of their peculiar circumstances; and (iii) to provide resources for specific activities considered to be national priorities. Further, grants such as the Debt Consolidation and Relief Facility of the Twelfth Finance Commission mean foregone revenues for the Centre.

3.48 It has been argued that Non-Plan Revenue Deficit (NPRD) grants risk moral hazard by providing an incentive to states to run non-plan revenue deficits. Our analysis of the incidence of such grants does not seem to indicate that this is true in the case of general category states. Only one state has received an NPRD grant from each and every Finance Commission, which, however, has been declining absolutely and sharply in real terms since the award of FC-IX. While it is true that some states have received significant grants from specific Commissions, there is no pattern showing increased inter-temporal recourse to such grants by general category states. In the case of special category states, cost disabilities are such as to require the use of this instrument to address fiscal equalisation, on a case-by-case basis, much as envisaged by the Constitution, with the need for such consideration diminishing as the development payback from special attention to these states kicks in over time. In this Commission's award there has been a significant reduction in the volume and state-wise incidence of NPRD grants, which is to be expected, given the structural improvements in the fiscal position

of many states, including special category states. In the latter case, in recognition of the effort made to exit NPRD, we have, in fact, deemed it appropriate to acknowledge such achievement with a performance incentive. In our view, therefore, the need for NPRD grants diminishes as structural fiscal reforms are implemented and economic performance improves and we expect this welcome trend to continue.

3.49 An important issue that arises when considering the appropriate design of horizontal distribution is whether to reward states for past performance or incentivise states to improve performance during the award period. It pertains more to criteria that seek to capture fiscal discipline and fiscal effort. Of course, if criteria that reward are more or less consistent over time, then these serve as incentives. For example, if it is known that fiscal discipline will be: (i) given due weight and (ii) measured roughly in the same way over the next three Commission award periods, then this acts as a built-in incentive to states to design policies so as to accord with such incentives.

3.50 The major constraint in designing forward-looking incentives is the availability of real time data on which to judge performance. The other constraint is the lack of an institutional 'home' within which assessments of improvements in performance can be judged and awards accordingly made. In the case of FRBM this task was performed by the Ministry of Finance, Government of India. The task was relatively simple, given that the data on adherence to benchmarks was fiscal in nature and available expeditiously from the annual budgetary process. Milestones often involved discrete actions, such as passing a specific legislation or setting up a specific fund. We have retained the forward-looking element in our design of grants and have sought to extend such, where feasible, to areas beyond the FRBM.

3.51 Our recommendations regarding the principles for disbursement of different grants have a conditionality element. We have taken the utmost care not to have intrusive conditionalities;

i.e., not be intrusive in the domain of decision making by the State Governments and local bodies. Our approach to setting conditionalities is informed by three objectives:

*i) To ensure additionality of resources:* Mindful of the fungibility of resources, our objective is to discourage the use of grants to substitute what a State Government is already spending on the purpose for which the grant is being given. Thus, the overall result of the grant should be to reduce the deficit in resources to provide public goods.

*ii) To improve transparency and accountability, thus enabling a 'feedback' route in improving policy formulation and implementation:* If grants were to incentivise greater transparency and accountability in public spending, then they would improve the effectiveness of public expenditure and targeting of public goods. Thus, the conditionalities should be viewed as incentives to act and to improve the effectiveness of public expenditure. There is a general consensus in policy literature on Indian public expenditure that there exists huge scope for doing this. Our approach, by improving accountability and outcome delivery consistent with our Terms of Reference, will empower citizens as well as their elected representatives, including those at the municipal and panchayat levels.

*iii) To assist in better monitoring of expenditure:* In designing the conditionalities/performance-based incentives for various grants we have taken sufficient care to not to be intrusive vis-à-vis the administrative domain of the State Governments. As these grants flow from the public exchequer, the touchstone for the proposed performance-based incentives/conditionalities is their potential for contributing towards better prudential monitoring of these expenditures.

3.52 We have sought to incentivise different levels of government to adopt and undertake green policy actions. Our approach has been to use the grant instrument to foster such incentives. In addition, we have also sought to discourage policy actions that distract from

sustainable development, such as the fertiliser subsidy in the case of the Centre and power subsidies in the case of the states.

3.53 Our environmental grants both reward past actions and incentivise future actions. The forest grant that we recommend is essentially a reward for contributing to the ecology and bio-diversity of India, as well as a compensation to states for the opportunity loss on account of keeping areas under forest.

3.54 A quantum increase in the supply of electricity is a critical requirement for future sustainable growth. It is desirable that this growth takes place in the greenest possible fashion, with the maximum reduction in carbon intensity. We have, therefore, provided forward looking grants as an incentive to increase the share of electricity generated from renewable sources.

3.55 During our visits to the states and to local bodies it became apparent to us that improved management of India's water resources was an imperative for sustainable, inclusive development. With this in mind, another of our environmental grants incentivises the states to establish an independent regulatory framework for the water sector. We also expect a substantial increase in our grants to local bodies to be used by them to mitigate their environmental challenges in areas such as water and solid waste management.

3.56 There is a general consensus that India's main development challenge is to improve governance and effectiveness of public institutions. In responding to considerations in this area specified by the ToR, we have used grants to incentivise state and local governments to demonstrably improve outcomes. We have focused on specific areas where such results might be achieved, with the hope that the demonstration effect will lead to all-round improvements across the public service delivering mechanism. Thus, we have proposed a forward looking grant that would reward states for their public health efforts towards reduced infant mortality rates—one of the most important MDGs.

3.57 Monitoring and evaluation to improve the link between outputs and outcomes requires adequate data and statistical systems that allow such monitoring and evaluation to be evidence based. We have, therefore, recommended a grant for improving statistical systems at the district and state level, that complements national level initiatives to improve the quality, richness and reliability of national statistical systems.

3.58 In addition, we have consulted with the Department of Justice and State Governments on appropriate fiscal incentives to assist the judicial system to improve the speed and effectiveness of delivery of this critical public good and have recommended a grant for the purpose. Likewise, we have made state-specific grants to expand and improve the training of police personnel.

3.59 Looking forward, we recognise that improvement in governance is as much, if not more, about emulating historic best practice as about innovating to deliver better. The President of India has declared the next ten years as the 'decade of innovation', but innovation happens not just in the laboratories, universities and cutting edge research institutions of our nation; it also happens, as we have seen in our visits to the states, in the districts, villages and towns of India, where people innovate to perform and deliver better in their day-to-day activities. We are of the view that these innovations are the essence of the continual effort to improve governance and, therefore, need to be recognised, rewarded and shared. To this end, we have recommended the creation of a district innovation fund to incentivise and recognise these processes, at the levels of government closest to the ordinary citizen as well as a grant for the establishment of a national Centre for Innovations in Public Systems (CIPS).

3.60 Thus, our approach to governance has been to incentivise innovations, improvements and outcomes in a selected number of areas in which such improvements can be easily designed and recognised. We believe that this would spur a virtuous cycle of improvements in governance in

every sphere of public activity by demonstrating that such improvements are within the power of every civil servant and public agent, irrespective of their location and the challenges and constraints within which they work.

### **State-specific Grants: Approach**

3.61 The Commission has recommended the award of state-specific grants following two broad principles.

- i) Our field visits and discussions led us to believe that even relatively small grants have shown discernible results, provided that these were directed towards felt needs. This was particularly true of sectors which do not benefit from centrally sponsored programmes or where there are significant funding gaps.
- ii) There is also a rationale for state-specific grants where these address deprivation, generate significant externalities (especially environmental externalities), meet the needs of the marginal groups or areas and encourage policy innovations.

### **Assignment of Resources to Local Bodies: Issues**

3.62 We consulted extensively with representatives of both urban and rural local bodies as well as representatives of autonomous district councils during our visits to all the states. One issue raised uniformly by public representatives was lack of funds to provide adequate levels of even basic services such as drinking water, sewerage, solid waste management and street lighting to their citizens. This problem is intensified by the increasing pace of urbanisation as well as the rising cost of providing such services in rural areas.

3.63 The transfer of funds, functions and functionaries to local bodies consistent with the XI and XII Schedules of the Constitution has met with limited success so far. The traditional theology that funds and functionaries will follow functions does not appear to have worked. A

number of states have notified transfer of functions, but this has not been followed by transfer of funds and functionaries. Only some states have significantly empowered local bodies by transferring expenditure obligations, taxation powers and staff resources to them. It has been contended that decentralisation is not fiscally neutral as it will generate increased demands in the scope, scale and quality of services provided by the local bodies. Thus, more funds devolved to local bodies would encourage State Governments to accelerate their decentralisation efforts. Transfer of functions and functionaries may then follow transfer of funds.

3.64 We have also noted that in recent times the local bodies have been entrusted with funds, often directly through Centrally Sponsored Schemes (CSS) such as the National Rural Employment Guarantee Scheme (NREGS) and Jawaharlal Nehru National Urban Renewal Mission (JNNURM), which have stretched their already limited planning implementation and accounting capacities. There is a felt need and demand for untied funds to augment local capacities, which was communicated to us almost universally across states during our visits.

3.65 While the issue of providing additional funding support to local bodies is significant, all the building blocks of the third tier structure deserve attention. These include: (i) entrusting local bodies with implementation and expenditure responsibilities consistent with their mandate; (ii) enhancing their capacity to meet these obligations through assigning necessary revenue raising powers as well as providing adequate transfers; (iii) making them accountable for their performance, including delivery of services as per previously notified standards; (iv) strengthening the functioning of the State Finance Commissions; and (v) providing focussed support to the scheduled and excluded areas. The Eleventh and Twelfth Finance Commissions made a number of recommendations in this regard. Some of these recommendations, though important, have not been implemented so far. More needs to be done to promote decentralisation. We also need to put

in place a stronger incentive mechanism aimed at persuading State Governments to decentralise further. Our analysis develops on the work already done while attempting to identify and address major challenges in achieving these objectives.

3.66 Based upon our consultations, as well as the studies sponsored, the issues to be addressed by us were classified into four broad categories:

*i) Issues related to devolution:* These include: (a) The volume of support to local bodies and the parameters that should be used for deciding interstate allocations; (b) the basis on which grants are distributed between rural and urban areas; (c) whether local bodies can be provided a share of the divisible pool instead of a grant; (d) possibilities for using a devolution index; (e) how to prevent delays in transmission of funds to local bodies and (f) whether the use of conditionalities is advantageous.

*ii) Issues relating to preparation of accounts and audit:* The generation of credible data on the performance of local bodies is essential for any meaningful analysis of their financial and operational performance. Presently, the lack of audited comparable data across local bodies limits their effective utilisation by State Finance Commissions and prevents comparability across states. The issues which we examine include: (a) uniformity and consistency in the accounts of urban and rural local bodies; (b) a uniform audit procedure for all states in the country to ensure comparability and (c) accountability of local bodies through appropriate mechanisms.

*iii) Issues relating to the functioning of State Finance Commissions:* The State Finance Commissions, which buttress the functioning of local bodies, need to be strengthened, their functioning made more predictable and the process of implementing their recommendations made more transparent. To enable this, the issues to be addressed include: (a) the need to ensure that SFC reports across states are adequately analytical and similar in approach; (b) the need to ensure that State Governments take prompt

action on the SFC recommendations; (c) the need to ensure that SFC reports are synchronous with the report of the National Finance Commission; (d) basis on which the grants would be divided between rural and urban local bodies and (e) whether the Finance Commission's recommendations for augmenting the consolidated funds of the states should be made after considering the SFC reports, rather than on the basis of these reports.

*iv) Other related issues:* (a) The role of development authorities and how their functioning can be made consistent with schedules XI and XII; (b) treatment of 'excluded' areas where parts IX and IX A of the Constitution do not apply; (c) measures needed to enhance the collection of property tax; (d) revamping of fire services and (e) treatment of nagar panchayats.

### **Assignment of Resources to Local Bodies: Approach**

3.67 In the light of past experience, we have adopted a platform-based incentive approach to determine the volume of local body grants to be provided to each state. Following previous Commissions, we will continue to provide for a grant to all the states for meeting the needs of the local bodies for the period 2010-15. In addition, we have sought to incentivise devolution and performance through the introduction of a performance-based component which will be available only to those states which meet the stipulations related to the issues identified above by 2011-12. The year 2010-11 will be available for states to meet these stipulations. In our view, this time is adequate. States which are unable to do so, but meet these stipulations in subsequent years, will be eligible for grants prospectively.

3.68 We have kept the performance grant at an appropriately high level so as to strongly motivate states to meet these conditionalities. The conditionalities imposed by us are not novel. They have been examined and recommended by a number of bodies including earlier Finance

Commissions, the Second Administrative Reforms Commission (SARC), the Comptroller and Auditor General (C&AG) and the respective ministries of the Government of India. They are aimed at inducing change to improve the functioning of

local bodies, ensuring predictability and transparency in transfer of funds and enhancing the functioning of State Finance Commissions. A number of states are already in compliance with some of these conditionalities.

## CHAPTER 4

# Review of Union and State Finances

### Introduction

4.1 The post-2003-04 period witnessed a number of important developments which had a bearing on the public finances of the Centre as well as the states. The country entered a higher growth trajectory, marking a distinct break from the past. There was considerable improvement in revenue growth following the higher growth in the economy. The operationalisation of the Fiscal Responsibility and Budget Management Act (FRBMA) by the Centre in 2004-05 ushered in an era of rule-based management of public finances. The introduction of Value Added Tax (VAT) by most states in 2005-06 considerably enhanced their tax base. Revenue augmentation by states was supplemented by the recommendations of the Twelfth Finance Commission (FC-XII), whereby the share of states in the net tax revenues of the Centre was raised from 29.5 per cent to 30.5 per cent. The Commission also recommended higher specific purpose grants to states. The benefit of the Debt Consolidation and Relief Facility (DCRF) recommended by the Commission was conditional on the states enacting Fiscal Responsibility Legislation (FRL). All states, with the exception of West Bengal and Sikkim, responded by enacting FRL. The DCRF, by linking the debt waiver to reduction of revenue deficit and containing fiscal deficit at least at the level of 2004-05, incentivised the states to undertake fiscal correction. The DCRF resulted in considerable relief to the states in terms of debt write-off and savings in interest payments on outstanding central loans.

4.2 Following these developments, there was considerable improvement in the finances of both the Centre and the states till 2007-08. The revenue

deficit of the Centre declined from 3.57 per cent of Gross Domestic Product (GDP) in 2003-04 to 1.11 per cent in 2007-08. The Centre's fiscal deficit declined by 1.79 percentage points, to 2.69 per cent of GDP in the same period. The revenue account of the states recorded a surplus of 0.94 per cent of GDP in 2007-08 as compared to a deficit of 1.25 per cent of GDP in 2004-05. The aggregate fiscal deficits of the states declined by 1.89 percentage points, to 1.51 per cent of GDP over the same period. At the level of both the Centre and the states, fiscal consolidation was, to a considerable degree, enabled by enhanced tax effort and tax reforms.

4.3 The global downturn caused a sharp decline in GDP growth in 2008-09 and is likely to adversely affect growth prospects in 2009-10. GDP growth declined sharply to 6.7 per cent in 2008-09, from an average of 9.4 per cent in the preceding three years. Apart from the impact of international developments, the deficient south-west monsoon in 2009-10 has also been an adverse factor for growth. The Economic Advisory Council (EAC) to the Prime Minister puts the likely GDP growth in 2009-10 at about 6.5 per cent. The Reserve Bank of India (RBI) has forecast GDP growth in 2009-10 at 6 per cent, with an upward bias. The sharp decline in growth of the economy has triggered an expansionary fiscal stance by the Centre as a countercyclical measure. The Centre has put in place three fiscal stimulus packages in quick succession (December 2008, January 2009 and February 2009) comprising reduction in tax rates, enhancement of drawback rates for exports, extension of tax exemptions and additional allocations under the plan for Centrally Sponsored Schemes (CSS) like the National Rural

Employment Guarantee Scheme (NREGS). Implementation of the recommendations of the Sixth Central Pay Commission (CPC) by the Centre, farm debt waiver and additional provision of funds for food and fertiliser subsidies have added to the fiscal burden. These additional commitments, though not a part of the stimulus, have, nevertheless, served as fiscal stimulus to the economy. Collectively, these have meant a 'pause' in the implementation of the FRBMA by the Centre. The states, too, have been allowed a relaxation in their fiscal and revenue deficit targets.

4.4 The current expansionary fiscal stance must also be seen against the requirement in our Terms of Reference (ToR) that we consider the need to improve the quality of public expenditure to obtain better outputs and outcomes while formulating our recommendations. Increased expenditure by the government must also lead to superior outcomes through higher productivity, enhanced efficiency and greater effectiveness. While equity considerations have dominated the devolution debate in the past, recent Finance Commissions have also incorporated the efficiency criterion in their recommendations. This has, however, mostly been linked to raising of revenue and the extent of fiscal correction undertaken. Taking this initiative forward, linking efficiency and effectiveness of public expenditures to the quality of service delivery and achievement of desirable outcomes remains a major challenge.

4.5 Against the above backdrop, we analyze and examine below the trends in the finances of the Centre and states as a prelude to the formulation of our views on the vertical and horizontal distribution of resources.

### Review of Central Finances

4.6 In the first instance, aggregate trends in central finances are analyzed in terms of deficit indicators. These are revenue, fiscal and primary deficits. Deficits matter as they signal the impact of changes in public finances on debt sustainability. As the fiscal indicators will be analyzed in relation to the targets set under the FRBMA, a brief description of the FRBMA is in order. Faced with persistent fiscal problems, manifested in the form of increasing

revenue and fiscal deficits, the Central Government enacted the FRBMA in 2003, which was brought into force from 5 July 2004. In addition to stipulating ceilings on fiscal indicators, the legislation laid down fiscal management principles combining fiscal transparency, budget integrity and accountability. The main obligations of the Centre under the FRBMA 2003 and FRBM Rules 2004, as amended through the Finance Act, 2004 are as follows:

- i) Eliminating revenue deficit by 2008-09 by ensuring a minimum annual reduction of 0.5 per cent of GDP every year from 2004-05.
- ii) Reducing fiscal deficit by at least 0.3 per cent of GDP annually from 2004-05, so that fiscal deficit is reduced to no more than 3 per cent of GDP at the end of 2008-09.
- iii) Limiting government guarantees to 0.5 per cent of GDP in any financial year and limiting additional liabilities to 9 per cent of GDP in 2004-05 and thereafter reducing the limit of 9 per cent by one percentage point of GDP in each subsequent year.
- iv) Central Government not to borrow from the Reserve Bank of India from 2006-07.
- v) Disclosing specified information, such as arrears of revenue, government assets and guarantees, latest from 2006-07.
- vi) Undertaking quarterly review of receipts and expenditure.

4.7 Table 4.1 presents a profile of the fiscal indicators of the Central Government from 2003-04 onwards. Originally, the FRBMA mandated that the revenue deficit should be eliminated and fiscal deficit contained at 3 per cent of GDP by March 2008. In 2004, the target was shifted to March 2009 by an amendment of the Act. The annual deficit reduction targets could not be adhered to in 2005-06 as the Centre pressed the 'pause button' to accommodate the higher transfers recommended by FC-XII. The revenue deficit of the Centre declined to 1.11 per cent of GDP in 2007-08, its lowest level since 1990-91. In 2008-09, there was a total reversal of fiscal correction with the revenue deficit reaching a level of 4.53 per cent of GDP. The Union Budget for

**Table 4.1: Centre: Profile of Fiscal Indicators***(per cent of GDP)*

Year	Fiscal Deficit	Revenue Deficit	Primary Deficit	Ratio of Revenue to Fiscal Deficit (%)
2003-04	4.48	3.57	-0.03	79.71
2004-05	3.98	2.49	-0.05	62.57
2005-06	4.08	2.57	0.38	63.03
2006-07	3.45	1.94	-0.19	56.27
2007-08	2.69	1.11	-0.93	41.42
2008-09 (RE)	6.14	4.53	2.51	73.89
2009-10 (BE)	6.85	4.83	3.00	70.51

Note: Minus (-) sign indicates 'surplus'.

Source: Basic data from Central Budget documents

2009-10, which was formulated against the backdrop of the global downturn and subdued domestic demand, envisaged a revenue deficit of 4.83 per cent of GDP.

4.8 The fiscal deficit of the Centre declined from 4.48 per cent of GDP in 2003-04 to 2.69 per cent in 2007-08, the lowest since 1990-91. There was a reversal of the declining trend in 2008-09, with the fiscal deficit ballooning to 6.14 per cent of GDP. For 2009-10, it has been budgeted at 6.85 per cent of GDP. The reasons for the reversal of fiscal correction in 2008-09 have been alluded to in Para 4.3. The reversal of fiscal correction was not entirely on account of the fiscal stimulus measures. Pay revision, farm debt waiver and additional expenditure on food and fertiliser subsidies have added substantially to the fiscal burden. Much of the deterioration in fiscal indicators observed in 2008-09 was on account of these additional expenditure commitments. The EAC, in its Economic Outlook for 2009/10, has placed the deficit on account of reduction in tax revenue due to economic slowdown as well as the tax cuts in excise and service taxes effected as part of the fiscal stimulus at about 1 per cent of GDP. The fiscal deficit figures presented in Table 4.1 do not take into account the off-budget bonds issued to the oil marketing and fertiliser companies amounting to Rs. 95,942 crore or 1.8 per cent of GDP in 2008-09.

4.9 The primary balance which turned into a marginal surplus in 2003-04 continued to remain in surplus till 2007-08 with the exception of 2005-06. The year 2008-09 witnessed a sharp increase in primary deficit to 2.51 per cent of GDP. It is budgeted at 3 per cent of GDP in 2009-10, the

highest in the post-reform period. Primary deficits add to the debt-GDP ratio unless GDP growth is higher than the interest rate on public debt.

4.10 The ratio of revenue deficit to fiscal deficit, which indicates the extent to which borrowings are used to meet current expenditure, declined from nearly 80 per cent in 2003-04 to 41.42 per cent by 2007-08. However, this proportion went back to nearly 74 per cent in 2008-09 (RE). Thus, a review of the fiscal situation reveals that all fiscal indicators, after registering an improvement in the years following the enactment of the FRBMA, have witnessed sharp deterioration in 2008-09 and 2009-10. The Union Government has expressed its intention to return to the FRBM path of fiscal correction at the earliest, as soon as the negative effects of the global crisis on the Indian economy have been overcome. We have been asked to revisit the roadmap of fiscal adjustment and suggest a suitably revised roadmap factoring in the need to bring the liabilities of the Central Government on account of oil, food and fertiliser bonds into fiscal accounting as well as the impact of various other obligations on deficit targets with a view to maintaining the gains of fiscal consolidation through 2010-15.

4.11 Table 4.2 shows the sources of correction in central finances between 2003-04 and 2007-08. Between 2003-04 and 2007-08, the revenue deficit of the Centre declined by 2.46 percentage points of GDP. Much of this decline came from an improvement in tax revenues. The marginal decline in revenue expenditure of the Centre was entirely on account of the decline in interest payments following softer interest rates. What also contributed to the reduction

**Table 4.2: Fiscal Correction at the Centre: 2003-04 to 2007-08**

(per cent of GDP)

	2003-04	2004-05	2005-06	2006-07	2007-08	Change 2007-08 over 2003-04	2008-09 (RE)	2009-10 (BE)
I Total Revenue Receipts (a+b)	9.58	9.72	9.69	10.52	11.47	1.89	10.56	10.49
a) Net Tax Revenue	6.79	7.14	7.54	8.50	9.31	2.52	8.76	8.10
b) Non Tax Revenue	2.79	2.58	2.15	2.02	2.17	-0.62	1.81	2.40
II Revenue Expenditure	13.14	12.20	12.26	12.46	12.58	-0.56	15.10	15.32
<i>Of which: Interest Payments</i>	4.50	4.03	3.70	3.64	3.62	-0.88	3.62	3.85
III Capital Expenditure	3.96	3.62	1.85	1.67	2.50	-1.46	1.83	2.11
IV Total Expenditure (II+III)	17.11	15.82	14.11	14.13	15.09	-2.02	16.93	17.43
V Revenue Deficit (II-I)	3.57	2.49	2.57	1.94	1.11	-2.46	4.53	4.83
VI Fiscal Deficit	4.48	3.98	4.08	3.45	2.69	-1.79	6.14	6.85
Memo Item: Non-debt Capital Receipts	3.05	2.11	0.34	0.16	0.93	-2.12	0.23	0.09

Source: Basic data from Central Budget documents

in fiscal deficit was compression of capital expenditure. Thus, the fiscal correction at the Centre was largely on account of revenue augmentation and partly on account of capital expenditure compression.

4.12 The outstanding liabilities of the Central Government, after reaching 63.33 per cent of GDP in 2004-05, started declining consistently (Table 4.3). This is because an economy can maintain a stable debt-GDP ratio and incur a primary deficit as long as the average nominal interest rate on debt is lower than the nominal GDP growth rate. This decline occurred even though a new component had been added to internal debt in 2004-05, which is not reflected in the fiscal deficit. The Government of India

introduced the Market Stabilisation Scheme (MSS) in consultation with the RBI in April 2004. Under the scheme, the Government of India raises money through the issue of dated securities/treasury bills to absorb excess liquidity in the market on account of foreign inflows. The amount so raised was to be kept in a separate account with the RBI and was not meant to meet the expenditure needs of the government. Despite a sharp increase in the fiscal deficit in the years 2008-09 and 2009-10, a marginal decline in the ratio of outstanding debt to GDP is projected even in these two years.

4.13 Among the components of outstanding debt, there is an increase in the share of internal debt.

**Table 4.3: Outstanding Liabilities of the Central Government**

(per cent of GDP)

	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09 (RE)	2009-10 (BE)
I. Public Debt	39.58	41.37	43.20	44.01	43.12	42.45	41.45	39.74	40.66	40.14	42.60
<i>Of which:</i>											
a) Internal Debt	36.59	38.23	40.06	41.58	41.45	40.51	38.82	37.27	38.29	37.85	40.24
b) External Debt	2.99	3.14	3.14	2.43	1.67	1.93	2.63	2.48	2.37	2.29	2.35
II. Other Liabilities	12.72	14.22	16.75	19.51	19.92	20.88	21.68	21.49	19.41	18.79	17.09
<i>Of which:</i>											
Reserve Funds and Deposits	2.43	2.78	3.21	3.26	3.35	2.95	3.06	3.17	2.69	2.31	2.11
<b>Total Liabilities (I+II)</b>	<b>52.31</b>	<b>55.58</b>	<b>59.96</b>	<b>63.52</b>	<b>63.05</b>	<b>63.33</b>	<b>63.13</b>	<b>61.23</b>	<b>60.07</b>	<b>58.93</b>	<b>59.68</b>

Notes: 1. Balances of external debt are according to book value.

2. Other Liabilities include National Small Savings Funds, State Provident Funds, other accounts such as Special Deposits of Non-Government Provident Funds and Reserve Funds and Deposits.

Source: Basic data from Central Budget documents

Because of the developments unfolding since the global crisis, the Centre increased its net market borrowings sharply, from Rs. 1,31,768 crore in 2007-08 to Rs. 2,61,972 crore in 2008-09 and further to Rs. 3,97,957 crore in the budget estimates for 2009-10. Following the global downturn, the Memorandum of Understanding (MoU) signed with the RBI was amended in February 2009 to allow a part of the amount in the MSS account to be transferred to the Consolidated Fund of India as part of the government's normal market borrowing programme. Following this, an amount of Rs. 12,000 crore was transferred from the MSS account to the Consolidated Fund of the Centre in March 2009. A further amount of Rs. 28,000 crore raised through MSS was de-sequestered in May 2009.

#### Gross Tax Revenues of the Centre

4.14 Higher GDP growth coupled with better tax administration and introduction of new taxes such as the 'fringe benefit tax', has resulted in higher growth of tax revenues, particularly from 2004-05. The high buoyancy of direct tax revenues may

be attributed substantially to improvement in tax compliance following the institution of the Tax Information Network (TIN) and its implementation by the National Securities Depository Ltd (NSDL). According to the report of the Comptroller and Auditor General of India (C&AG), in 2002-03 almost 80 per cent of the assesseees for tax deduction at source (TDS) did not file returns. With the setting up of the TIN in January 2004, tax compliance has gone up significantly.

4.15 The gross tax-GDP ratio went up by over three percentage points in a span of four years, from 9.23 per cent in 2003-04 to 12.56 per cent in 2007-08 (Table 4.4). The entire improvement came from the buoyancy of direct taxes, more particularly from corporation tax, reflecting the increasing profitability of the Indian corporate sector. In fact, indirect tax-GDP ratio has remained stagnant between 5 and 6 per cent since the late nineties.

4.16 As a result of the higher growth of direct taxes, there has also been a shift in the composition of gross tax revenues of the Centre. For the first time in the history of public finances of the

**Table 4.4: Major Taxes of the Centre: Performance since 2003-04**

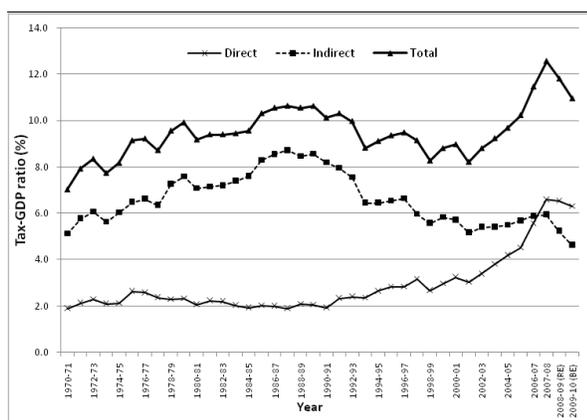
Year	Corporation Tax	Income Tax	Total Direct Taxes	Customs Duties	Union Excise Duties	Service Tax	Total Indirect Taxes	Total Central Tax Revenues (Gross)
<i>per cent of GDP</i>								
2003-04	2.31	1.50	3.81	1.77	3.30	0.29	5.42	9.23
2004-05	2.63	1.56	4.22	1.83	3.15	0.45	5.47	9.68
2005-06	2.82	1.56	4.61	1.81	3.10	0.64	5.60	10.21
2006-07	3.50	1.82	5.57	2.09	2.85	0.91	5.89	11.47
2007-08	4.08	2.17	6.61	2.20	2.62	1.09	5.95	12.56
2008-09 (RE)	4.17	2.03	6.55	2.03	2.04	1.22	5.25	11.80
2009-10 (BE)	4.38	1.82	6.32	1.67	1.82	1.11	4.63	10.95
<i>per cent of Centre's Gross Tax Revenue</i>								
2003-04	24.99	16.27	41.31	19.12	35.69	3.10	58.69	
2004-05	27.11	16.15	43.53	18.89	32.50	4.66	56.47	
2005-06	27.66	15.29	45.12	17.77	30.38	6.30	54.88	
2006-07	30.48	15.86	48.61	18.23	24.84	7.94	51.39	
2007-08	32.52	17.30	52.63	17.55	20.84	8.65	47.37	
2008-09 (RE)	35.35	17.20	55.48	17.20	17.26	10.35	44.52	
2009-10 (BE)	40.05	16.66	57.72	15.29	16.61	10.14	42.28	

Note: Total Direct Taxes and Total Indirect Taxes include Other Taxes.  
Source : Basic data from Central Budget documents

country, direct taxes have overtaken indirect tax collections in the year 2007-08. This is a healthy development as direct taxes are more progressive than indirect taxes. From less than 20 per cent share in total tax revenues in 1990-91, the share of direct taxes has increased to over 55 per cent in 2008-09. Figure 4.1 shows the trends in growth of direct and indirect taxes as a proportion of GDP.

4.17 Within direct taxes, the share of corporation tax has increased from 24.99 per cent of gross tax revenue in 2003-04 to 35.35 per cent in 2008-09, an increase of over 10 percentage points. The share of income tax in gross tax revenue of the Centre witnessed a marginal increase from 16.27 per cent to 17.20 per cent in the same period. In the case of indirect taxes, while the share of custom duties in gross tax revenue declined marginally by nearly two percentage points between 2003-04 and 2008-09, the share of Union excise duties witnessed a sharp decline of over 18 percentage points. The sharp decline in the share of Union excise duties was largely on account of rate cuts, and in recent years, on account of the slowdown in the growth of the manufacturing sector. The share of indirect taxes would have fallen further but for the buoyant revenue from service tax. Service tax improved its share from 3.10 per cent in 2003-04 to 10.35 per cent in 2008-09. The increase in the share of service tax was on account of an increase in both coverage as well as tax rates.

**Figure 4.1: Centre's Tax-GDP Ratio: Direct, Indirect and Total (1970-71 to 2009-10 (BE))**



### Trends in Non-tax Revenues

4.18 Non-tax revenue of the Centre mainly comprises interest receipts, dividends and profits from public sector undertakings including banks, and receipts from economic services. Non-tax revenues as a percentage of GDP have declined from 2.79 per cent in 2003-04 to 1.81 per cent in 2008-09 (Table 4.2). The decline is mainly on account of lower interest receipts from the states due to termination of the practice of on-lending to states, and interest relief as a result of the DCRF following the recommendations of FC-XII. The debt swap scheme under which the states swapped their high-cost outstanding debt to the Centre with low-cost market borrowings during 2002-05 also partly resulted in lower interest payments by the states. The share of interest receipts in the non-tax revenues of the Centre declined from over 50 per cent in 2003-04 to less than 20 per cent in 2008-09. Now the predominant share in non-tax revenues is accounted for by dividends and profits and economic services. The non-tax revenue-GDP ratio is budgeted to increase to 2.40 per cent in 2009-10. The bulk of improvement in this ratio is expected from the communication sector through the sale of 3-G spectrum. Exploitation of offshore oil and gas reserves is likely to further contribute to improvement in the non-tax revenues of the Centre.

### Trends in the Centre's Expenditure

4.19 After registering a significant fall from 17.11 per cent of GDP in 2003-04 to 14.13 per cent of GDP in 2006-07, total expenditure of the Central Government rose to a level of 16.93 per cent of GDP in 2008-09. The fall in the ratio of total expenditure to GDP came mostly from a reduction in capital expenditure. Capital expenditure of the Centre, which declined from 3.96 per cent of GDP in 2003-04 to 1.67 per cent of GDP in 2006-07, rose to 2.50 per cent of GDP in 2007-08 (Table 4.5). This improvement was mainly the result of an increase in the non-plan capital outlay to acquire RBI's stake in the State Bank of India. Thereafter, capital expenditure declined to about 2 per cent of GDP in 2008-09.

**Table 4.5: Trends in Central Government Expenditure***(per cent of GDP)*

Year	Revenue Expenditure	Interest Payments	Defence	Pay and Allowances	Pensions	Subsidies	Capital Expenditure	Total Expenditure
2003-04	13.14	4.50	2.18	1.21	0.58	1.61	3.96	17.11
2004-05	12.20	4.03	2.41	1.16	0.58	1.46	3.62	15.82
2005-06	12.25	3.70	2.25	1.08	0.56	1.32	1.85	14.10
2006-07	12.46	3.64	2.07	1.00	0.54	1.38	1.67	14.13
2007-08	12.58	3.62	1.94	0.97	0.51	1.50	2.50	15.09
2008-09 (RE)	15.10	3.62	2.15	1.33	0.61	2.43	1.83	16.93
2009-10 (BE)	15.32	3.85	2.42	1.50	0.60	1.90	2.11	17.43

Source : Basic data from Central Budget documents

4.20 Expenditure on interest payments, defence, pay and allowances and subsidies are the main components of the Centre's revenue expenditure, accounting for about 63 per cent of the total. While the proportion of expenditure on interest payments to GDP has shown a marginal decline because of the low interest rate regime, expenditure on defence has remained at more than 2 per cent of GDP in almost all the years since 2003-04. Expenditure on pay and allowances of Central Government employees excluding defence personnel, after moderating from 1.21 per cent of GDP in 2003-04 to 0.97 per cent of GDP in 2007-08, jumped to 1.33 per cent of GDP in 2008-09 and is estimated to go up even further to 1.50 per cent in 2009-10, the highest since 2000-01. The increase in the ratio of pay and allowances is mainly due to the implementation of the recommendations of the Sixth CPC and payment of 40 per cent of the arrears in 2008-09 and 60 per cent in 2009-10. Expenditure on pay and allowances may moderate in the coming years with the tapering off of the effect of payment of arrears.

4.21 Expenditure on explicit subsidies is the third largest item of revenue expenditure after interest payments and defence. Food and fertiliser subsidies are the main explicit subsidies provided by the Centre. Though the administered price mechanism for petroleum products was dismantled, explicit subsidies are provided in the Central Budget for kerosene and cooking gas. Explicit subsidies as a proportion GDP, after moderating from 2004-05 to 2007-08, have been rising since then due to the firming up of commodity prices, particularly those of food, fuel and fertiliser.

4.22 Table 4.6 presents trends in major explicit subsidies as a proportion of the Centre's revenue

receipts. Food subsidy is the difference between the procurement prices and carrying costs of food grains and the issue price for the public distribution system. Expenditure on food subsidy as a proportion of total revenue receipts of the Centre witnessed some moderation between 2004-05 and 2006-07. However, thereafter there was a steep rise in the food subsidy to Rs. 43,627 crore in 2008-09 from the previous year's level of Rs. 31,328 crore. This increase was on account of the increase in the minimum support prices of food grains as well as the quantum of food grains procured. Procurement of rice went up from 26.3 million tonnes in 2007-08 to 32.8 million tonnes in 2008-09, while that of wheat more than doubled from 11.1 million tonnes to 22.7 million tonnes in the corresponding period. Further, procurement and carrying costs have increased, but the issue price has remained unchanged since 1 July 2002. These developments were reflected in the increase in expenditure on food subsidy from 5.78 per cent of total revenue receipts of the Centre in 2007-08 to 7.76 per cent in 2008-09. It is budgeted to go up further to 8.54 per cent of revenue receipts in 2009-10. Andhra

**Table 4.6: Explicit Subsidies Relative to the Centre's Revenue Receipts***(per cent)*

Year	Food	Fertiliser	Others	Total
2003-04	9.55	4.49	2.77	16.80
2004-05	8.43	5.19	1.40	15.02
2005-06	6.67	5.34	1.73	13.74
2006-07	5.53	6.04	1.59	13.15
2007-08	5.78	6.00	1.31	13.09
2008-09 (RE)	7.76	13.49	1.74	22.99
2009-10 (BE)	8.54	8.13	1.43	18.11

Source : Basic data from Central Budget documents

Pradesh, Haryana, Punjab and Uttar Pradesh together accounted for 69.5 per cent of the rice procured in the Kharif season 2007-08, while Haryana and Punjab alone accounted for 91.1 per cent of wheat procured in the Rabi season of 2007-08.

4.23 The second largest explicit subsidy is that on fertilisers, which was in the range of 5-6 per cent of revenue receipts between 2004-05 and 2007-08, but shot up to 13.49 per cent in 2008-09. In absolute terms, fertiliser subsidy increased from Rs. 32,490 crore in 2007-08 to Rs. 75,849 crore in 2008-09. The subsidy is designed to provide fertilisers to farmers at a fixed maximum retail price (MRP), a price that is administratively set, and varies by the type of fertiliser. This dispensation has completely discouraged fresh investment in indigenous production of fertilisers, and the cost-plus formula carries little incentive for improved production efficiency. Stagnant domestic production has resulted in increasing import dependence over time. India, as a major importer with a commitment to providing subsidised fertiliser at a fixed price, has in turn, been at the mercy of an international fertiliser oligopoly. The subsidy has risen explosively because the subsidised price has not been revised since 2001, whereas the prices of inputs into fertiliser production as also of fertiliser imports, have risen substantially, exacerbated by the adverse international market structure. Further, despite the rising subsidy bill, use of fertilisers has not brought about a commensurate increase in agricultural productivity. On the contrary, the price pattern has had a distortionary impact on the pattern of nutrient application, resulting in declining fertiliser response ratios.

4.24 The explicit subsidies reported in the budget of the Central Government do not include off-budget bonds issued to oil marketing and fertiliser companies. Though the administered price mechanism for petroleum products was discontinued, there is still no deregulation of petroleum product prices. International price of crude increased from an average of US \$38 per barrel in 2004 to US \$54 per barrel in 2005, and further to US \$70 per barrel in April-June, 2006.

This was followed by a sharp increase in the price of crude to US \$147 per barrel in July 2008. Linked with this increase in crude prices there was also a significant increase in the prices of fertiliser imports. In order to partly compensate the oil marketing companies selling petroleum products at government determined prices, the Centre has started issuing bonds to oil companies. The value of oil bonds, which amounted to about 0.50 per cent of GDP in the years 2005-06 to 2007-08, has shot up to 1.43 per cent of GDP in 2008-09. Oil bonds do not fully reflect the extent of subsidy on petroleum products. Upstream oil companies and oil marketing companies share a part of the under-recoveries on petroleum products. The practice of issuing off-budget bonds to fertiliser companies started in 2007-08. Fertiliser bonds as a percentage of GDP increased from 0.16 per cent of GDP in 2007-08 to 0.38 per cent of GDP in 2008-09. Taking into account the off-budget bonds issued to oil marketing and fertiliser companies and to other institutions, the augmented revenue and fiscal deficit would work out to 6.34 and 7.99 per cent of GDP, respectively, in 2008-09.

4.25 A study sponsored by us and carried out by the National Institute of Public Finance and Policy (NIPFP) shows the regressive nature of all major explicit subsidies on food, fertiliser and petroleum products. Per capita explicit subsidies received in the poorer states of Bihar, Jharkhand, Madhya Pradesh, Orissa and Uttar Pradesh are found to be much lower as compared to the average for all states. Despite inherent defects in the subsidy regime, reforms have remained a major policy challenge. Subsidies differ from other components of public expenditure, which target provision of public goods like defence. Subsidies variously support private consumption and/or production inputs in a manner such that their incidence is difficult to quantify. Unless the subsidies are pruned and better targeted, investment in public infrastructure will suffer. As regards oil subsidy, continuation of the present system of insulating domestic consumers against rising international prices will be a drag on the fiscal situation of the country and goes against the tenets of conservation.

Oil subsidy, besides disproportionately benefiting the more developed states, has negative effects on the environment.

### Summary

4.26 To sum up, the following are the main trends in the Centre's finances in recent years:

- i) The fiscal correction path, following the enactment of FRBMA was more or less on track till 2007-08, after a pause in 2005-06. A number of developments, particularly the slowdown of the economy and its adverse impact on revenue growth, increasing commodity prices, anti-recessionary measures, farm loan waiver and implementation of the recommendations of the Sixth CPC, have resulted in a worsening, going beyond the reversal of the fiscal correction achieved till 2007-08.
- ii) Despite deterioration in all fiscal indicators in 2008-09 and 2009-10, the debt-GDP ratio remained stable, or even declined marginally. This was because of the growth of nominal GDP remaining higher than the average nominal interest rate.
- iii) Though the tax-GDP ratio has come down in 2008-09, it is still higher than the level reached in 2004-05. The fall in the aggregate tax-GDP ratio in 2008-09 would have been sharper but for buoyant revenues from corporation tax and service tax. There has been a continuous increase in the tax-GDP ratios of these taxes till 2008-09. While the tax-GDP ratio in respect of corporation tax is expected to be maintained even in 2009-10, that of service tax is expected to witness a marginal fall. With buoyant revenues from corporation tax, revenue from direct taxes has, for the first time, overtaken that from indirect taxes in 2007-08.
- iv) Total expenditure of the Centre relative to GDP witnessed a significant contraction between 2003-04 and 2006-07, after which it started rising again, despite moderation in capital expenditure. Rising revenue

expenditure, particularly in 2008-09 and 2009-10, contributed to growth in total expenditure. Within revenue expenditure there was sharp increase in expenditure on pay and allowances, as well as subsidies.

- v) Resumption of the path of fiscal correction is crucial to achieving a sustainable fiscal situation at the Centre. Though softening of international oil prices has provided some relief, reverting to the high growth path and a strategy to exit from the expansionary fiscal stance put in place as a countercyclical measure will hold the key to fiscal correction. In recent years, off-budget liabilities of the Centre have assumed alarming proportions. In 2008-09, off-budget bonds issued to oil marketing and fertiliser companies amounted to Rs. 95,942 crore or 1.80 per cent of GDP.

### Review of State Finances

4.27 Improvement in state finances started around 2004-05, aided by a higher rate of growth of the economy and the resultant increase in buoyancy of the states' own tax revenues as well as central transfers. This improvement further received a boost with the FC-XII recommending an increase in the states' share in net central taxes from 29.5 per cent to 30.5 per cent. FC-XII also recommended the Debt Consolidation and Relief Facility (DCRF) comprising consolidation of central loans contracted till March 2004 and outstanding on 31 March 2005, along with debt write-offs, linked to reduction of the revenue deficits of states and containment of fiscal deficit at the 2004-05 level. Enactment of fiscal responsibility and budget management legislations was made a pre-condition for states to avail the benefits under DCRF. FC-XII recommended that each state enact FRL which should, at the minimum, provide for elimination of revenue deficit by 2008-09 and reduction of fiscal deficit to 3 per cent of GSDP. Following this pre-condition stipulated by FC-XII, 21 states put in place FRL beginning 2005-06. Karnataka, Kerala, Tamil Nadu, Punjab and Uttar Pradesh had already enacted fiscal responsibility legislation even before

**Table 4.7: Aggregate State Finances: Fiscal Indicators***(per cent of GDP)*

Year	Revenue Deficit	Fiscal Deficit	Primary Deficit	Revenue Deficit/ Fiscal Deficit	Debt/GDP
2004-05	1.25	3.40	0.65	36.77	32.49
2005-06	0.19	2.56	0.20	7.52	31.81
2006-07	-0.71	1.69	-0.60	-41.98	29.73
2007-08	-0.94	1.51	-0.61	-62.46	27.59

Note: Minus (-) sign indicates surplus.

Source: Basic data from State Finance Accounts

this condition was imposed by FC-XII. West Bengal and Sikkim are the only states which are yet to do so. The enactment of FRL brought an element of discipline into budget-making by the states. Another major development having a considerable bearing on improvement of state finances was the introduction of VAT by most states in 2005-06. This has improved the tax base of the states by replacing the single point sales tax previously in place.

#### Trends in Aggregate Fiscal Indicators

4.28 Aided by buoyant own revenues and central transfers following the higher growth of the economy, there was consistent improvement in almost all fiscal indicators of states from 2004-05 to 2007-08 (Table 4.7). The revenue account of states turned surplus in 2006-07 from a deficit of 1.25 per cent of GDP in

2004-05. The fiscal deficit declined significantly from 3.40 per cent in 2004-05 to 1.51 per cent of GDP in 2007-08. The primary balance also turned surplus in 2006-07 from a deficit of 0.65 per cent of GDP in 2004-05. The surplus on the revenue account provided more fiscal space to states to enhance their capital spending. In line with other fiscal indicators, the debt-GDP ratio too exhibited a declining trend.

4.29 Factors contributing to the fiscal correction by states are presented in Table 4.8. There was significant improvement in total revenue receipts of states by 1.71 percentage points of GDP, between 2004-05 and 2007-08. While all the components of revenue receipts contributed to this improvement, the primary contributors are transfers from the Centre followed by own tax

**Table 4.8: State Finances: Sources of Fiscal Correction***(per cent of GDP)*

	2004-05	2005-06	2006-07	2007-08	Change 2007-08/ 2004-05	2008-09 (RE)	2009-10 (BE)
I. Total Revenue (A+B)	11.49	11.99	12.92	13.20	1.71	13.87	13.60
A. Own Revenue	7.25	7.24	7.73	7.70	0.45	7.70	7.60
i) Tax Revenue	5.78	5.91	6.11	6.07	0.29	6.21	6.27
ii) Non-tax Revenue	1.47	1.33	1.62	1.63	0.16	1.50	1.33
B. Transfers from Centre	4.24	4.75	5.18	5.50	1.26	6.16	6.00
i) Tax Share	2.49	2.65	2.92	3.22	0.73	3.26	3.17
ii) Grants	1.75	2.10	2.27	2.29	0.54	2.90	2.83
II. Revenue Expenditure	12.73	12.18	12.21	12.26	-0.47	13.59	14.09
Of which: Interest Payments	2.75	2.36	2.29	2.12	-0.63	1.96	1.95
III. Total Expenditure	14.62	14.33	14.53	14.73	0.11	16.53	16.73
IV. Revenue Deficit	1.25	0.19	-0.71	-0.94	-2.19	-0.27	0.50
V. Fiscal Deficit	3.40	2.56	1.69	1.51	-1.89	2.64	3.23
VI. Primary Deficit	0.65	0.20	-0.60	-0.61	-1.26	0.68	1.28
Memo: Non-debt capital receipts	0.26	0.25	0.18	0.17	-0.09	0.31	0.12

Source: Basic Data from State Finance Accounts

revenues. During this period, revenue expenditure declined by 0.47 per cent of GDP largely on account of decline in interest payments by 0.63 per cent of GDP. Thus, as in the case of the Centre, aggregate fiscal improvement at the level of the states was mainly revenue-led, particularly through transfers from the Centre. Central transfers to states will be much higher than those reported in Table 4.8 if the benefit of the DCRF recommended by FC-XII is taken into account. Under the DCRF, central loans amounting to Rs. 1,13,601 crore have been consolidated and an amount of Rs. 18,717 crore has been written off by the end of 2008-09. Interest relief obtained by states amounted to Rs. 15,689 crore in the four-year period 2005-09.

4.30 As part of its countercyclical measures in the wake of the global economic downturn, the Centre had raised the market borrowing limit of states by Rs. 30,000 crore in 2008-09 and allowed them to exceed their fiscal deficit target by 0.50 percentage points, to 3.5 per cent of GSDP in 2008-09. The fiscal deficit target was further raised to 4 per cent of GSDP in 2009-10. The target for elimination of the revenue deficit was shifted by a year to 2009-10. The revised estimates of 2008-09 and budget estimates for 2009-10 indicate deterioration in the aggregate finances of states owing to lower growth of own revenues and transfers from the Centre on one hand, and increase in revenue expenditure on the other. The revenue surplus of states declined from 0.94 per cent of GDP in 2007-08 to 0.27 per cent in 2008-09 (RE). Fiscal deficit increased by 1.13 per cent to 2.64 per cent of GDP in 2008-09. The revenue account of states is estimated to turn into a deficit of 0.50 per cent of GDP in 2009-10 (BE) after

registering a surplus in the preceding three years. The aggregate fiscal deficit of states is budgeted to increase further to 3.23 per cent of GDP in 2009-10, close to the level obtaining in 2004-05. The primary balance of states, which remained in surplus in 2006-07 and 2007-08, turned into a deficit of 0.68 and 1.28 per cent of GDP in 2008-09 (RE) and 2009-10 (BE), respectively.

### Trends in Aggregate Revenues of States

4.31 There was improvement in all the components of revenue receipts of states between 2004-05 and 2007-08. Own tax revenues as a proportion of GDP improved from 5.78 per cent in 2004-05 to 6.07 per cent in 2007-08, the highest so far (Table 4.9). Non-tax revenues improved, albeit sluggishly, from 1.47 per cent to 1.63 per cent in the same period. Share in central taxes, which had improved considerably following the recommendations of FC-XI, further improved in the award period of FC-XII. Share in central taxes as a percentage of GDP went up from 2.49 per cent in 2004-05 to 3.22 per cent in 2007-08.

4.32 An area of concern for states in the sharing of net central tax revenue is the sharp increase in the proportion of cesses and surcharges in the gross tax revenue of the Centre, from 3.51 per cent in 2001-02 to 13.63 per cent in 2009-10 (BE). This has considerably reduced the proportion in gross tax revenue of the Centre of net tax revenues shareable with states.

4.33 The second issue with regard to sharing of central taxes relates to the actual share in the net tax revenue of the Centre devolved to states. Following the 80<sup>th</sup> Amendment of the Constitution facilitating sharing of the net proceeds of all central

**Table 4.9: Trends in Aggregate State Revenue Receipts**

(per cent of GDP)

Year	Own Tax Revenues	Own Non-tax Revenues	Share in Central Taxes	Plan Grants	Non-plan Grants	Total Revenue
2004-05	5.78	1.47	2.49	1.31	0.44	11.49
2005-06	5.91	1.33	2.65	1.21	0.89	11.99
2006-07	6.11	1.62	2.92	1.44	0.82	12.92
2007-08	6.07	1.63	3.22	1.57	0.72	13.20

Source: Basic data from State Finance Accounts

taxes, FC-XI and FC-XII recommended that the share of states in the net proceeds of central taxes be fixed at 29.5 per cent and 30.5 per cent, respectively. However, the actual shares devolved to states as per the finance accounts have been lower than the percentages recommended by these Commissions. The actual shares devolved to states in 2005-06, 2006-07 and 2007-08, the first three years of FC-XII award for which finance accounts are available, amounted to 29.36, 28.95 and 29.64 per cent of net shareable tax revenues of the Centre, respectively. The Ministry of Finance has explained that the amounts reported in the Union finance accounts do not fully cover the actual collections under cesses and surcharges and that after accounting for these, the releases to states are in alignment with their share in net central taxes as recommended by the Finance Commissions. We are of the view that there is a need for more transparency in the current procedure. We, therefore, recommend that this matter be looked into by the Ministry of Finance with a view to ensuring that finance accounts fully reflect the collections under cesses and surcharges under relevant heads, so that there are no inconsistencies between the amounts released to states in any year and the respective percentage shares in net central taxes recommended by Finance Commission for that year.

4.34 Another area of concern is the tax concessions extended by the Centre. In the interests of transparency, the Central Budget reports figures of

revenue foregone as a result of tax concessions. Loss of revenue on account of tax concessions in respect of both direct and indirect taxes is estimated at Rs. 4,18,095<sup>1</sup> crore for the year 2008-09. The National Institute of Public Finance and Policy (NIPFP) study for the Commission has allocated revenue foregone on account of select exemptions and tax preferences, accounting for 65 per cent of tax expenditures in direct taxes and about 18 per cent of those reported in the receipts budget for excise duty across states, based on the estimated shares of individual states. The study shows that Himachal Pradesh and Uttarakhand are far ahead of other states in terms of per capita gain from tax expenditures because of area exemptions. Excluding area-based exemptions, Karnataka emerges at the top with a per capita gain of Rs. 922, followed by Haryana and Goa with a per capita benefit of Rs. 700 each. The per capita benefit is much lower for the poorer states. This raises the question about the rationale for continuing with tax exemptions involving huge revenue losses and disproportionate benefit derived by the relatively developed states. There is a strong case for phasing out many of the tax exemptions. This should happen in the normal course with the proposed introduction of Goods and Services Tax (GST).

4.35 Among the other components of revenue receipts, improvement in plan and non-plan grants was 0.26 and 0.28 percentage points of GDP, respectively between 2004-05 and 2007-08. Taking all the components together, the revenue receipts of all states increased from 11.49 per cent in 2004-05 to 13.20 per cent of GDP in 2007-08.

**Table 4.10: Aggregate State Finances: Expenditure Indicators**

(per cent of GDP)

Year	Total Revenue Expenditure	Interest Payments	Pension	Plan Revenue Expenditure	Non-plan Revenue Expenditure	Capital Expenditure
2004-05	12.74	2.75	1.18	1.89	10.85	1.88
2005-06	12.18	2.36	1.14	1.94	10.24	2.14
2006-07	12.21	2.29	1.13	2.17	10.04	2.32
2007-08	12.26	2.12	1.19	2.39	9.88	2.47

Source : Basic data from State Finance Accounts

<sup>1</sup>The estimates of tax expenditures are based on short term impact analysis assuming that the underlying tax base would not be affected by the removal of tax exemptions and that all other tax provisions would remain unchanged. These assumptions may not hold good in all cases. Thus, the estimates of tax expenditure are subject to a number of limitations and can only be taken as indicative. Furthermore, in the case of customs, the duty foregone is estimated as the difference between the collection rate and the enacted rate, even when the latter might have been substantially reduced by an administrative notification.

### Trends in Aggregate Expenditure of States

4.36 In contrast to growth in revenue receipts, all the components of revenue expenditure, with the exception of plan revenue expenditure, have exhibited a declining trend in the period 2004-05 to 2007-08 (Table 4.10). Total revenue expenditure as a percentage of GDP declined from 12.74 per cent in 2004-05 to 12.26 per cent in 2007-08. Within total revenue expenditure, while non-plan expenditure witnessed a sharp decline from 10.85 per cent to 9.88 per cent, plan expenditure increased from 1.89 per cent to 2.39 per cent in the same period. Interest payments moderated from 2.75 per cent of GDP in 2004-05 to 2.12 per cent in 2007-08. This decline can be attributed to the interest relief obtained by states from the DCRF, amounting to Rs. 15,689 crore over the period 2005-09. The debt swap scheme, which was operational during 2002-05 also contributed to the reduction in interest payments. An amount of Rs. 1,02,034 crore of high-cost debt was swapped under the scheme, resulting in savings in interest payments for states. It may, however, be difficult to sustain the reduction in revenue expenditure because of the pay revisions. A number of states have revised pay scales of employees in the light of the recommendations of the Sixth CPC. Karnataka and Kerala revised their pay scales in 2007 and 2004, respectively. The increase in plan revenue expenditure of states is on account of increased transfers through Centrally Sponsored Schemes.

4.37 Aggregate capital expenditure of states registered improvement in the period 2004-05 to 2007-08 following reduction in revenue expenditure and the surplus on revenue account in the years 2006-07 and 2007-08. Between 2004-05 and 2007-08, the aggregate capital expenditure of states went up by 0.59 percentage points of GDP.

### Power and Irrigation Subsidies

4.38 Subsidy for the power sector is the largest component of State Government subsidies. Most of the State Power Utilities (SPUs) have negative financial flows. As SPUs are fully owned by State Governments, the financial performance of these entities has a direct bearing on state finances. State Governments' support to SPUs mainly consists of

direct subsidies, subventions, contribution to equity, direct loans and extending guarantees to loans raised. According to a study sponsored by the Commission, the aggregate impact of the support to SPUs on state finances amounted to about Rs. 30,000 crore in 2007-08. Out of this, direct subsidy provided by State Governments amounted to about Rs. 18,000 crore. Guarantees extended on loans raised by the power sector constituted 36 per cent of the total guarantees extended by State Governments in 2007-08. The power sector in most states is beset with high technical and commercial losses, irrational power tariffs and inefficient distribution and transmission infrastructure, resulting in huge losses. Losses in the power sector are expected to be a major drag on the finances of State Governments, and therefore, the problems confronting this sector need to be addressed in a time-bound manner.

4.39 Subsidies to the irrigation sector are mostly implicit in nature, arising from gross under-recovery of user charges. Cumulative public investment in the irrigation sector amounted to over Rs. 2,50,000 crore at the end of the Tenth Five-Year Plan (2006-07). Ideally, these investments should generate a net return. The distressing fact is that receipts from the sector do not even cover the expenditure on operation and maintenance of irrigation projects. In 2006-07, revenue receipts of all states from the irrigation sector aggregated to Rs. 1666 crore, accounting for only 16 per cent of the non-plan revenue expenditure of states on irrigation. The main problems of the sector are very low water rates, poor collection efficiency, high establishment cost and lack of maintenance of irrigation projects.

### State Level Public Sector Undertakings

4.40 State level public sector undertakings (PSUs) continue to remain a drag on the finances of State Governments. Cumulative financial support by way of contribution to equity, loans and subsidies to state PSUs stood at Rs. 91,947 crore, Rs. 1,70,492 crore and Rs. 25,026 crore, respectively at the end of March 2008. Outstanding guarantees extended by states on the loans raised by PSUs amounted to

Rs. 1,12,723 crore and constituted 60 per cent of the total outstanding guarantees of all states at the end of March 2008. As per the information received from states, dividend and interest payments by PSUs amounted to Rs. 167.41 crore and Rs. 1684.97 crore, respectively in 2007-08. While dividend amounted to 0.18 per cent of equity, interest payments amounted to 0.99 per cent of the outstanding loans. These percentages are abysmally low and nowhere near the desired levels of 5 per cent return on equity and 7 per cent interest on outstanding loans suggested by FC-XII.

### Summary

4.41 The main trends in the aggregate position of state finances can be summarised as follows:

- i) There was considerable improvement in the aggregate finances of states following higher growth of own tax revenues and increased transfers from the Centre. The revenue account of states turned surplus in 2006-07 and continued to remain in surplus in 2007-08. This is ahead of the target date of 2008-09 recommended by FC-XII. The process of fiscal consolidation in states was helped in no small measure by the enactment of FRBMA by most states by bringing in rule based management of public finances.
- ii) There was only a marginal reduction in the revenue expenditure of states. Reduction in interest payments as a proportion of GDP was higher than reduction in revenue expenditure.
- iii) Subsidies by states to power and irrigation sectors, both explicit and implicit, are a big drag on the finances of states. The performance of state level PSUs continues to remain poor.
- iv) One noteworthy development was the increase in the aggregate capital expenditure of states following reduction in revenue expenditure and the surplus on the revenue account.
- v) The expected reduction in the growth of own revenue receipts and central transfers,

along with increasing expenditure commitments on account of pay revisions are likely to pose a threat to the fiscal correction achieved so far.

### State Finances: A Comparative Perspective

4.42 Improvement in the various fiscal indicators has not been uniform across states (Table 4.11). In 2004-05, among the general category states, revenue accounts of only four states—Bihar, Chhattisgarh, Karnataka and Madhya Pradesh—were in surplus. By 2007-08, revenue accounts of all states, with the exception of Kerala, Punjab and West Bengal, turned surplus. Thus, in all but three general category states, elimination of the revenue deficit was achieved one year ahead of the target year of 2008-09 prescribed by FC-XII. In the special category, five states were in revenue deficit in 2004-05, but by 2006-07, the revenue accounts of all turned surplus and remained so in 2007-08. The revenue surplus in many of the special category states was of a higher magnitude relative to their respective GSDPs as compared to those in the general category. The higher revenue surplus in these states is indicative of the higher revenue account transfers to these states. Central transfers account for over 70 per cent of the revenue receipts of special category states.

4.43 With surpluses on the revenue account, the fiscal deficits of states went into financing capital expenditure. This marks the qualitative dimension in the fiscal correction achieved by states. There was also significant quantum correction. Eleven of the 17 general category states had fiscal deficits exceeding 3 per cent of GSDP in 2004-05. This number came down to just five in 2007-08. These five states were Goa, Kerala, Punjab, Uttar Pradesh and West Bengal. Of these, two had a revenue surplus in 2007-08. Thus, fiscal correction was largely achieved much before 2008-09, the target year for containing the fiscal deficit at 3 per cent of GSDP.

4.44 Among the 11 special category states, only four (Jammu & Kashmir, Mizoram, Nagaland and Uttarakhand) had fiscal deficits exceeding 3 per cent

Table 4.11: Comparative Performances of States: Revenue and Fiscal Deficits

(per cent of GSDP)

States	Revenue Account (Surplus(-))					Fiscal Account Deficit (Surplus(-))				
	2004-05	2005-06	2006-07	2007-08	Difference	2004-05	2005-06	2006-07	2007-08	Difference
					(5-2)					(10-7)
1	2	3	4	5	6	7	8	9	10	11
Andhra Pradesh	1.22	0.03	-1.04	-0.05	-1.27	3.89	3.52	2.10	2.81	-1.08
Bihar	-1.47	-0.10	-2.52	-4.42	-2.95	1.70	4.62	3.05	1.62	-0.08
Chhattisgarh	-0.33	-2.51	-4.13	-3.97	-3.64	2.75	0.79	-0.06	0.17	-2.58
Goa	1.07	0.16	-0.97	-1.01	-2.08	4.80	4.51	3.36	3.29	-1.51
Gujarat	2.13	0.18	-0.70	-0.70	-2.84	4.60	2.85	2.22	1.56	-3.04
Haryana	0.28	-1.14	-1.26	-1.51	-1.78	1.29	0.27	-0.93	0.86	-0.43
Jharkhand	0.61	0.05	-1.51	-1.72	-2.33	4.32	10.18	1.45	2.79	-1.53
Karnataka	-1.09	-1.38	-2.21	-1.75	-0.66	2.40	2.19	2.49	2.48	0.07
Kerala	3.33	2.52	1.85	2.33	-1.00	4.04	3.36	2.68	3.76	-0.28
Madhya Pradesh	-1.60	-0.03	-2.60	-3.57	-1.97	6.05	3.93	2.15	1.95	-4.10
Maharashtra	2.59	0.88	-0.16	-2.56	-5.15	4.81	4.02	2.27	-0.49	-5.29
Orissa	0.73	-0.61	-2.48	-4.11	-4.84	1.91	0.35	-0.90	-1.31	-3.22
Punjab	3.48	1.13	-1.64	2.78	-0.70	4.22	2.42	0.50	3.35	-0.87
Rajasthan	1.83	0.51	-0.43	-0.99	-2.82	5.24	3.98	2.67	2.05	-3.20
Tamil Nadu	0.35	-0.85	-1.01	-1.57	-1.91	2.75	0.98	1.51	1.27	-1.48
Uttar Pradesh	2.84	0.45	-1.57	-1.00	-3.84	5.27	3.60	3.08	4.01	-1.26
West Bengal	3.94	3.15	3.06	2.63	-1.31	5.11	4.09	4.19	3.69	-1.42
<b>Total: GCS</b>	<b>1.62</b>	<b>0.40</b>	<b>-0.72</b>	<b>-1.02</b>	<b>-2.63</b>	<b>4.10</b>	<b>3.19</b>	<b>2.15</b>	<b>1.90</b>	<b>-2.21</b>
Arunachal Pradesh	0.27	-6.23	-20.44	-18.57	-18.84	13.54	8.80	-3.14	0.24	-13.29
Assam	0.56	-2.61	-3.47	-3.66	-4.22	3.92	-0.62	-1.12	-1.12	-5.04
Himachal Pradesh	5.02	-0.36	-0.67	-2.66	-7.68	7.85	2.83	3.25	1.73	-6.12
Jammu & Kashmir	-2.32	-1.49	-1.96	-3.42	-1.10	6.86	9.96	6.65	8.38	1.52
Manipur	-2.00	-7.98	-8.39	-21.31	-19.31	9.84	5.36	8.89	-1.79	-11.63
Meghalaya	0.86	-1.15	-3.37	-2.47	-3.33	5.39	2.83	1.07	2.82	-2.58
Mizoram	-4.33	-2.43	-8.43	-3.99	0.34	9.59	14.71	6.40	11.91	2.32
Nagaland	-2.90	-3.65	-8.62	-5.89	-2.99	4.08	5.41	2.44	5.52	1.44
Sikkim	-10.54	-10.75	-11.06	-14.91	-4.37	11.58	8.13	4.68	2.73	-8.85
Tripura	-4.75	-6.74	-8.27	-8.04	-3.29	2.90	1.17	-1.28	0.14	-2.75
Uttarakhand	4.01	0.28	-3.02	-1.87	-5.88	9.19	7.18	2.98	5.12	-4.07
<b>Total: SCS</b>	<b>0.63</b>	<b>-2.17</b>	<b>-3.78</b>	<b>-4.35</b>	<b>-4.98</b>	<b>6.30</b>	<b>3.86</b>	<b>2.01</b>	<b>2.46</b>	<b>-3.84</b>
<b>All States</b>	<b>1.56</b>	<b>0.24</b>	<b>-0.90</b>	<b>-1.20</b>	<b>-2.76</b>	<b>4.24</b>	<b>3.23</b>	<b>2.14</b>	<b>1.93</b>	<b>-2.31</b>

Notes: 1. The fiscal indicators presented in Tables 4.11 to 4.14 are based on non-comparable estimates of GSDP and do not tally with those given in Chapter 9 which are based on comparable estimates of GSDP.

2. The ratios presented in Tables 4.11 to 4.14 are relative to GSDP of states and therefore do not match with those in Tables 4.7 and 4.8, which are relative to GDP. The aggregate ratios given in Tables 4.11 to 4.14 can be converted into ratios with reference to GDP by multiplying them with the conversion factors of 0.8024, 0.7930, 0.7889 and 0.7821 for the years 2004-05, 2005-06, 2006-07 and 2007-08, respectively.

3. GCS: General Category States; SCS: Special Category States.

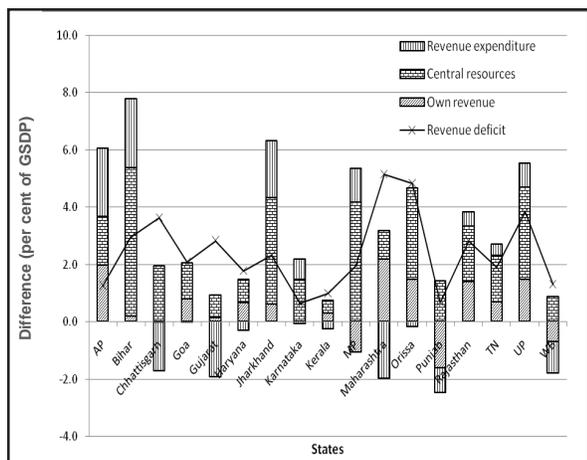
Source: Basic data from State Finance Accounts

of GSDP in 2007-08, as compared to 10 in 2004-05. Fiscal correction in special category states is characterised by large year-to-year variations, both within and across states, because of the low and fluctuating nature of GSDP in these states.

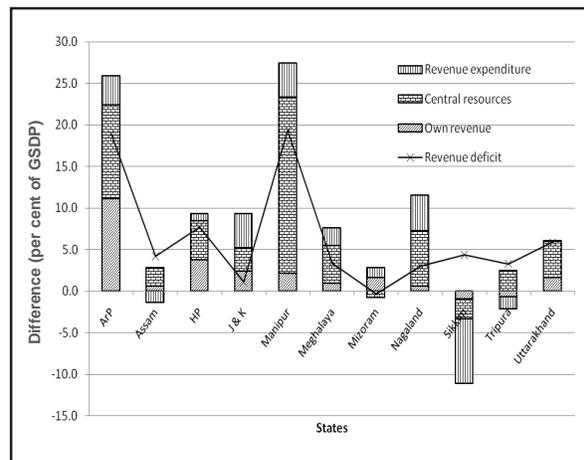
4.45 Figures 4.2 and 4.3 decompose the correction in the revenue deficit-GSDP ratios of general category and special category states, respectively. Correction is decomposed into

increase in own revenue, increase in central transfers, and decrease in revenue expenditure. In the general category there are wide variations across states in the extent of correction achieved through improvement in own revenue and compression of revenue expenditure. However, in the majority of states, the correction is revenue-led, with major corrections coming from central transfers. There was no revenue expenditure compression in special category states, with the exception of Assam, Sikkim

**Figure 4.2: Reduction (+) in Revenue Deficits in General Category States : 2007-08 over 2004-05**



**Figure 4.3: Reduction (+) in Revenue Deficit in Special Category States: 2007-08 over 2004-05**



**Table 4.12: Outstanding Debt Relative to GSDP: State-wise Position**

(per cent of GSDP)

States	2004-05	2005-06	2006-07	2007-08	Difference (5-2)
1	2	3	4	5	6
Andhra Pradesh	35.30	33.70	32.18	31.16	-4.14
Bihar	58.02	58.01	49.61	48.49	-9.53
Chhattisgarh	27.31	24.11	22.00	18.95	-8.37
Goa	37.89	37.58	39.21	38.27	0.38
Gujarat	37.59	37.02	34.56	31.44	-6.15
Haryana	25.91	25.40	22.63	19.73	-6.18
Jharkhand	26.33	31.55	30.98	31.10	4.77
Karnataka	31.32	31.10	30.64	27.94	-3.39
Kerala	39.63	38.45	36.61	35.78	-3.85
Madhya Pradesh	41.23	42.27	41.56	38.81	-2.42
Maharashtra	30.91	32.11	30.34	26.70	-4.21
Orissa	50.53	48.98	43.30	37.29	-13.24
Punjab	46.89	45.25	39.97	39.47	-7.41
Rajasthan	51.28	51.28	47.93	46.29	-4.98
Tamil Nadu	27.25	27.15	25.25	22.14	-5.11
Uttar Pradesh	53.28	53.21	51.96	50.60	-2.68
West Bengal	50.01	47.88	44.35	42.82	-7.19
<b>Total: GCS</b>	<b>39.18</b>	<b>38.82</b>	<b>36.44</b>	<b>34.01</b>	<b>-5.17</b>
Arunachal Pradesh	62.29	80.09	69.73	68.13	5.84
Assam	33.40	32.22	31.13	29.87	-3.53
Himachal Pradesh	71.68	68.44	63.73	60.73	-10.94
Jammu and Kashmir	58.47	63.27	64.04	67.17	8.70
Manipur	67.48	77.09	78.37	79.40	11.92
Meghalaya	37.43	40.61	39.68	41.30	3.87
Mizoram	110.44	109.48	103.70	102.74	-7.69
Nagaland	52.62	56.30	55.71	54.00	1.38
Sikkim	69.10	73.82	71.70	76.33	7.24
Tripura	50.40	47.06	44.79	42.08	-8.31
Uttarakhand	115.79	112.11	103.21	94.13	-21.66
<b>Total: SCS</b>	<b>60.56</b>	<b>60.58</b>	<b>58.02</b>	<b>56.30</b>	<b>-4.26</b>
<b>All States</b>	<b>40.49</b>	<b>40.12</b>	<b>37.69</b>	<b>35.28</b>	<b>-5.21</b>

Note: GCS: General Category States; SCS: Special Category States.

Source: Basic data from State Finance Accounts

and Tripura. As in the case of the general category states, transfers from the Centre have played a major role in fiscal correction.

4.46 The debt-GSDP ratio represents the final outcome of all the budgetary transactions, particularly the borrowings contracted to finance fiscal deficits over the years, and is an important indicator of fiscal correction. In consonance with the reduction in fiscal deficits there was reduction in the debt-GSDP ratio of the general category states by over 5 percentage points of GSDP in 2007-08 over 2004-05 (Table 4.12). In seven out of the 17 general category states, debt-GSDP ratio exceeded 40 per cent in 2004-05 as compared to the group average of 39.18 per cent. By 2007-08, the number of such states had come down to four,

viz., Bihar, Rajasthan, Uttar Pradesh and West Bengal. Among these, Uttar Pradesh, and West Bengal have fiscal deficits exceeding 3 per cent of GSDP. Bihar, though a revenue surplus state, had the highest debt-GSDP ratio in 2004-05. All the states except Goa and Jharkhand managed to bring about reduction in their debt-GSDP ratio. FC-XII recommended that the debt-GSDP ratio be brought down to 28 per cent over a period of time so as to be consistent with the fiscal deficit target.

4.47 Though the aggregate debt-GSDP ratio of the special category states in 2007-08 was lower as compared to the 2004-05 level, the debt position of six of the 11 states, which had registered a revenue

**Table 4.13: Own Tax Revenues: Comparative Performance of States**

States	Average OTR/ GSDP				( per cent )	Buoyancy
	2004-05	2005-06	2006-07	2007-08	Difference (5-2)	
1	2	3	4	5	6	7
Andhra Pradesh	7.72	8.14	8.89	9.21	1.49	1.327
Bihar	4.57	4.44	4.08	4.84	0.27	0.685
Chhattisgarh	7.20	7.36	7.85	7.34	0.13	1.128
Goa	7.46	8.21	8.89	8.27	0.81	1.348
Gujarat	6.85	7.14	7.25	7.13	0.28	0.944
Haryana	7.95	8.53	8.64	7.87	-0.07	1.199
Jharkhand	4.64	5.01	5.09	5.00	0.35	1.76
Karnataka	10.73	11.09	12.38	12.07	1.35	1.593
Kerala	8.13	7.86	8.38	8.42	0.29	1.097
Madhya Pradesh	7.25	7.84	8.17	8.43	1.19	1.321
Maharashtra	7.90	7.66	7.87	8.22	0.32	1.168
Orissa	5.85	6.37	6.65	6.64	0.79	1.608
Punjab	7.13	8.19	7.31	7.20	0.07	1.455
Rajasthan	7.18	7.63	7.82	7.97	0.79	1.571
Tamil Nadu	9.57	10.16	10.57	10.20	0.64	1.376
Uttar Pradesh	6.36	6.74	7.37	7.25	0.89	1.534
West Bengal	4.76	4.43	4.29	4.24	-0.51	1.145
<b>Total: GCS</b>	<b>7.35</b>	<b>7.59</b>	<b>7.88</b>	<b>7.89</b>	<b>0.53</b>	<b>1.322</b>
Arunachal Pradesh	1.76	2.13	2.30	2.45	0.69	2.398
Assam	5.16	5.59	5.46	4.77	-0.40	1.628
Himachal Pradesh	5.43	5.88	5.84	6.12	0.70	1.362
Jammu & Kashmir	5.57	6.13	6.20	8.05	2.48	1.952
Manipur	1.78	1.88	2.28	2.59	0.80	1.991
Meghalaya	3.58	4.00	4.38	4.20	0.62	1.591
Mizoram	1.61	2.04	2.27	2.36	0.75	2.779
Nagaland	1.46	1.86	1.86	1.83	0.36	1.441
Sikkim	5.48	5.43	6.12	6.36	0.88	1.542
Tripura	2.89	3.15	3.32	3.29	0.41	1.572
Uttarakhand	6.09	6.82	8.46	8.05	1.96	2.316
<b>Total: SCS</b>	<b>4.88</b>	<b>5.36</b>	<b>5.64</b>	<b>5.68</b>	<b>0.80</b>	<b>1.916</b>
<b>All States</b>	<b>7.20</b>	<b>7.46</b>	<b>7.75</b>	<b>7.76</b>	<b>0.56</b>	<b>1.343</b>

Note: GCS: General Category States; SCS: Special Category States.

Source: Basic data from State Finance Accounts

surplus in all three years since 2005-06, worsened by 2007-08. The debt-GSDP ratio of special category states continues to remain at a much higher level than that of the general category states. Low levels and fluctuating nature of GSDP growth partly explains the high debt-GSDP ratios in some of these states.

### Own Tax Revenues

4.48 There was an improvement in own tax revenues of all general category states with the exception of Haryana and West Bengal between 2004-05 and 2007-08 (Table 4.13). The improvement in tax-GSDP ratio was highest in

Andhra Pradesh followed by Karnataka, Madhya Pradesh and Uttar Pradesh. The tax-GSDP ratios in the first two states were relatively higher in 2004-05 as compared to the average for general category states. Karnataka stands out with the highest tax-GSDP ratio of 12.07 in 2007-08 as compared to the average of 7.89 for the general category states as a whole. The improvement in states with low tax-GSDP ratios has been relatively less. While Bihar, with the lowest tax-GSDP ratio of 4.57 in 2004-05, improved its ratio marginally in 2007-08, the ratio in respect of West Bengal slipped by 0.51 percentage points to 4.24 in the same period.

**Table 4.14: States: Comparative Trends in Expenditure**

(per cent of GSDP)

States	Revenue Expenditure					Capital Expenditure				
	2004-05	2005-06	2006-07	2007-08	Difference (5-2)	2004-05	2005-06	2006-07	2007-08	Difference (10-7)
1	2	3	4	5	6	7	8	9	10	11
Andhra Pradesh	14.88	14.79	15.39	17.27	2.40	2.57	3.25	3.68	4.09	1.51
Bihar	19.99	22.15	20.80	22.41	2.42	1.65	2.60	5.27	5.80	4.16
Chhattisgarh	15.85	13.54	13.70	14.15	-1.70	2.85	2.72	3.42	4.09	1.23
Goa	16.92	16.40	17.00	16.90	-0.02	3.71	4.35	4.31	4.19	0.48
Gujarat	12.85	11.59	11.48	10.93	-1.92	2.17	3.17	3.08	2.22	0.05
Haryana	12.18	11.88	12.94	11.88	-0.31	0.96	1.52	1.92	2.32	1.36
Jharkhand	13.59	15.43	14.46	15.58	1.99	2.60	3.34	2.33	3.72	1.12
Karnataka	16.64	16.69	17.76	17.36	0.72	3.12	3.47	4.54	4.02	0.90
Kerala	15.57	14.81	14.62	15.33	-0.25	0.62	0.66	0.63	0.91	0.29
Madhya Pradesh	16.80	17.68	17.44	17.97	1.16	4.61	5.69	4.03	4.79	0.18
Maharashtra	13.18	11.93	12.05	11.20	-1.98	2.03	2.30	1.98	1.99	-0.05
Orissa	17.32	17.32	17.30	17.16	-0.17	1.48	1.32	1.59	2.73	1.25
Punjab	17.65	16.59	15.03	16.77	-0.87	0.78	1.38	2.10	1.59	0.81
Rajasthan	16.97	16.60	16.81	17.48	0.51	2.97	3.32	3.24	3.93	0.96
Tamil Nadu	14.41	13.94	14.57	14.80	0.40	2.26	1.77	2.27	2.57	0.32
Uttar Pradesh	18.09	16.66	17.85	18.94	0.85	2.29	3.11	4.48	4.92	2.63
West Bengal	13.49	13.26	12.53	12.39	-1.11	0.88	0.70	0.74	0.87	-0.01
<b>Total: GCS</b>	<b>15.18</b>	<b>14.63</b>	<b>14.77</b>	<b>14.98</b>	<b>-0.20</b>	<b>2.12</b>	<b>2.50</b>	<b>2.78</b>	<b>2.94</b>	<b>0.83</b>
Arunachal Pradesh	52.91	57.15	55.79	56.43	3.52	13.14	15.00	17.22	18.81	5.67
Assam	19.47	18.22	17.97	18.09	-1.38	4.15	1.88	2.28	2.40	-1.75
Himachal Pradesh	25.11	25.39	26.96	25.93	0.82	2.84	3.22	3.91	4.42	1.59
Jammu and Kashmir	34.22	37.38	36.56	38.34	4.12	8.99	11.38	8.46	11.69	2.71
Manipur	36.15	39.57	45.19	40.19	4.04	11.41	12.16	16.23	19.42	8.01
Meghalaya	27.50	26.50	27.41	29.63	2.14	4.23	4.10	4.60	5.15	0.92
Mizoram	56.85	58.87	57.53	58.04	1.19	13.43	16.73	15.63	16.55	3.13
Nagaland	31.51	36.36	34.81	35.76	4.25	7.10	9.14	11.13	11.42	4.32
Sikkim	107.57	96.59	91.20	99.83	-7.74	22.07	18.89	15.77	17.66	-4.41
Tripura	26.31	25.48	24.14	24.83	-1.48	7.67	7.92	7.03	8.21	0.54
Uttarakhand	21.23	21.44	21.80	21.33	0.10	4.79	6.52	5.72	6.57	1.78
<b>Total: SCS</b>	<b>26.60</b>	<b>26.89</b>	<b>26.94</b>	<b>27.15</b>	<b>0.54</b>	<b>5.82</b>	<b>5.89</b>	<b>5.69</b>	<b>6.68</b>	<b>0.86</b>
<b>Total All States</b>	<b>15.88</b>	<b>15.36</b>	<b>15.47</b>	<b>15.67</b>	<b>-0.21</b>	<b>2.34</b>	<b>2.70</b>	<b>2.94</b>	<b>3.16</b>	<b>0.81</b>

Note: GCS: General Category States; SCS: Special Category States.

Source: Basic data from State Finance Accounts

4.49 All special category states improved their tax-GSDP ratios in 2007-08 relative to 2004-05, with the exception of Assam. There was considerable improvement in Own Tax Revenues in the states of Jammu & Kashmir and Uttarakhand. States in the special category improved their overall tax-GSDP ratio by 0.8 percentage point of GSDP in 2007-08 over 2004-05, which was higher than the aggregate improvement of 0.53 per cent of GSDP achieved by general category states.

### Expenditure of States

4.50 Expenditure trends for states are presented in Table 4.14. The general category states witnessed a marginal reduction of 0.20 per cent of GSDP in their revenue expenditure in 2007-08 over the 2004-05 level. Reduction in revenue expenditure as a percentage of GSDP was observed in nine of the 17 states. Andhra Pradesh, Bihar and Jharkhand stand out for witnessing a significant increase in their revenue expenditure, ranging from 1.99 to 2.42 per cent of GSDP between 2004-05 and 2007-08. Reduction in interest burden following the DCRF seems to have aided the states in their effort to reduce revenue expenditure. In contrast, there was a marginal increase in the revenue expenditure of special category states during 2004-08. Revenue expenditure-GSDP ratio is much higher at 27.15 per cent in special category states as compared to 14.98 per cent in general category states in 2007-08. Assam, Sikkim and Tripura are the only three states in the special category to have reduced their revenue expenditure-GSDP ratios in 2007-08 compared to the 2004-05 levels.

4.51 Aided by improvement on the revenue account, there was overall improvement in the capital expenditure of general category states from 2.12 per cent of GSDP in 2004-05 to 2.94 per cent of GSDP in 2007-08. Only Maharashtra and West Bengal witnessed a marginal reduction in their capital expenditure-GSDP ratios between 2004-05 and 2007-08. The improvement was significant in the poorer states of Bihar and Uttar Pradesh. With the exception of Assam and Sikkim, all the special category states witnessed improvement in their

capital expenditures. The improvement was significant in Arunachal Pradesh, Manipur, Mizoram and Nagaland. The capital expenditure-GSDP ratio in special category states is much higher than that in the general category states because of higher revenue surpluses in the former.

### Summary

4.52 The comparative performance of states during 2004-08 may be summarised as below:

- i) There was significant improvement on the revenue account, with the number of revenue-surplus general category states going up from four in 2004-05 to 14 in 2007-08. The only three states with revenue deficits in 2007-08 were Kerala, Punjab and West Bengal. Thus, in most general category states, elimination of the revenue deficit was achieved one year ahead of the target date. All special category states were in revenue surplus in 2007-08.
- ii) Elimination of revenue deficit in all states (barring three) by 2007-08, meant that fiscal deficits were now incurred on account of capital expenditure. This marks the quality of fiscal correction achieved.
- iii) Only five of the 17 general category states had fiscal deficits exceeding 3 per cent of GSDP in 2007-08, as compared to 11 in 2004-05. Among the 11 special category states, only four (Jammu & Kashmir, Mizoram, Nagaland and Uttarakhand) had fiscal deficits exceeding 3 per cent of GSDP in 2007-08, as compared to 10 in 2004-05.
- iv) In six of the 17 general category states, fiscal deficit was less than 2 per cent of GSDP, and in Maharashtra and Orissa, the fiscal account turned surplus in 2007-08. The borrowing limits prescribed for states in accordance with the correction path stipulated by FC-XII, were with reference to the GSDP paths as projected by FC-XII. States with higher GSDP growth than projected would, thereby, exhibit lower fiscal deficits as a percentage of their actual GSDP.

- v) Corresponding to the declining path of fiscal deficits, the debt-GSDP ratios of states also declined over the period. There were only four general category states with debt-GSDP ratios exceeding 40 per cent in 2007-08, as compared to seven in 2004-05. However, the debt position of six of the 11 special category states worsened by 2007-08.
- vi) With a few exceptions, the tax-GSDP ratios of all states improved over 2004-08, both in the general category and the special category, the exceptions being Haryana and West Bengal in the general category and Assam in the special category. The tax-GSDP ratio is the highest in Karnataka, followed by Tamil Nadu and Andhra Pradesh. Bihar and West Bengal are at the bottom of the list of general category states in terms of tax-GSDP ratios.
- vii) There was only a marginal decline of 0.20 per centage points of GSDP in the aggregate revenue expenditures of general category states in 2004-08, with eight states witnessing an increase and nine states registering a decline. There was significant increase in revenue expenditure in Andhra Pradesh, Bihar and Jharkhand. Further, significant reduction in revenue expenditure took place in Chhattisgarh, Gujarat, Maharashtra and West Bengal. There was a marginal increase in revenue expenditure of special category states during 2004-08, with the exception of Assam, Sikkim, and Tripura, which saw a reduction in their revenue expenditure-GSDP ratios.

### **Trends in Inter-governmental Transfers**

4.53 In India, resource transfers from the Centre to states, comprising statutory and non-statutory transfers take place through a multiplicity of channels. Statutory transfers in the form of share in central taxes and non-plan grants are based on the recommendations of the Finance Commissions. Non-statutory revenue transfers are in the form of plan grants from the Planning Commission, as well as plan and non-plan grants from the central ministries. The relative shares of these revenue transfers are presented in Annex 4.1.

4.54 Transfers through the Finance Commissions are predominant, accounting for over 68 per cent of total transfers in recent years. There has been an increase in the share of Finance Commission transfers from 60.13 per cent in the award period of FC-VIII to 68.03 per cent in the period covered by FC-XII. Within the Finance Commission transfers, there has been an increase in the share of grants, particularly in the periods covered by FC-XI and FC-XII. FC-XII felt that grants could be targeted better and that cost disabilities and distributive considerations could be addressed more effectively through grants than through tax devolutions. The Commission, accordingly, increased the share of grants in the transfers recommended by it.

4.55 The share of plan grants has been increasing since 2006-07 and the increase is more pronounced from 2007-08 onwards. This is on account of a shift in the composition of plan grants as well as higher transfers through CSS. Now, a substantial portion of plan grants dispensed to states is scheme-specific, and as a result, the share of formula-based normal central assistance in total plan grants has come down significantly. There has been an increase in the number of Centrally Sponsored Schemes, some of which are funded by the proceeds of cesses levied by the Union Government.

4.56 In recent years, plan grants have become more scheme-oriented, reverting in a way to the pre-1969 position of scheme-based transfers. There is a general consensus on reducing the number of CSS and moving towards predominance of formula-based transfers, but there has been no significant movement in this direction. It is our considered view that initiatives should be taken in this direction.

4.57 Multiplicity of transfer channels makes it necessary for the Finance Commission to look at overall transfers. For the first time FC-XI recommended an indicative ceiling of 37.5 per cent of Centre's gross revenue receipts as transfers to states from all channels. This was raised to 38 per cent by FC-XII. Trends in transfers to states as a proportion of the Centre's gross revenue receipts are presented in Annex 4.2.

**Table 4.15: Share of the Centre in Combined Revenue Receipts Before and After Transfers**

(per cent)

Commission	Share of the Centre in Combined Revenue Receipts			FC Transfers to States/ Combined Revenue Receipts	Total Transfers to States/ Combined Revenue Receipts
	Before Transfers	After FC Transfers	After Total Transfers		
FC-VIII	65.4	49.1	38.7	16.3	26.7
FC-IX	62.8	45.6	35.3	17.2	27.5
FC-X	60.8	44.1	36.3	16.7	24.5
FC-XI	58.5	40.4	33.3	18.1	25.2
FC-XII	62.6	42.4	35.7	20.2	26.9
2005-06	61.9	41.6	35.3	20.3	26.6
2006-07	62.5	41.9	35.4	20.6	27.1
2007-08	63.5	43.6	36.5	19.9	27.0

Notes: 1. For FC-XII the average is for three years (2005-08).

2. FC transfers to states include both tax devolution and grants.

3. Total transfers to states include tax devolution and grants by the Finance Commissions and other plan and non-plan grants from the Centre. These do not include transfers outside the state budget.

Source: Basic data from Indian Public Finance Statistics and Union Finance Accounts (various years).

4.58 After the peak level of 40.33 per cent of gross revenue receipts of the Centre during the award period of FC-IX, central transfers dipped to around 35 per cent in the periods covered by FC-X and FC-XI. During the period covered by FC-XII, central transfers are estimated to be over 38 per cent of the Centre's gross revenue receipts. In 2008-09 and 2009-10, there is more than two percentage point increase in central transfers to states. Both Finance Commission grants and plan grants account for the variations in central transfers as a percentage of gross revenue receipts.

### Vertical Imbalance

#### Revenue Receipts

4.59 The relative shares of the Centre and states in the combined revenue receipts as well as combined expenditure show the vertical imbalances in the Indian federation. The total transfers as a proportion of combined revenue receipts have remained stable since FC-VIII. There has been a slight upward drift in the share of Finance Commission transfers in combined revenue receipts over the period as a whole, because of an increase in the recommended share of the states in net central taxes by successive Finance Commissions (Table 4.15).

#### Expenditure

4.60 Table 4.16 presents the relative shares of the Centre and states in the combined revenue and total expenditures. The Centre's share in the combined revenue expenditure varied from 40.0 per cent to 46.1 per cent through the period covered by FC-I to FC-XII. Since the period covered by FC-VIII, there has been a remarkable stability in the relative shares of the the Centre and the states in the combined revenue expenditure with the share of the Centre fluctuating in the narrow range of 43 to 44 per cent. As far as combined total expenditure is concerned, the share of the Centre varied from 43.14 per cent to 50.51 per cent through the award periods of all the twelve Finance Commissions. The share of the Centre remained stable at around 43 per cent since the award period of FC-X.

4.61 Figure 4.4 shows the year-wise variations in the shares of states in combined revenue and total expenditure.

### Policy Implications

4.62 Putting fiscal correction back on track should be the priority of both the Centre and the states. With the moderation in international oil prices, commitments on account of arrears of pay following the recommendations of the Sixth CPC and farm loan

waiver having been met and the economy showing signs of recovery, it should be possible to return to the path of fiscal correction at the earliest. There is improvement in the global economic outlook with a number of major economies coming out of recession. There are also indications of the global economic situation improving in the last quarter of 2009 and the improvement continuing through 2010. A calibrated exit strategy from the fiscal expansionary stance of 2008-09 and 2009-10 should be the main agenda for the government in 2010-11. The proposed introduction of GST is expected to reverse the temporary reduction in revenue following rate cuts effected as part of the fiscal stimulus. We are recommending a revised roadmap of fiscal correction for both the Centre and the states. The revised roadmap prescribes a combined debt-GDP ratio of 68 per cent for 2014-15. With the target of debt-GDP ratio for the Central Government set at 45 per cent in 2014-15, the target envisaged for all the states by implication is 25 per cent (the state and central ratios do not add up to the combined ratio because of the netting out of central loans to states). The roadmap

**4.16: Relative Shares of Centre and States in Revenue and Total Expenditures**

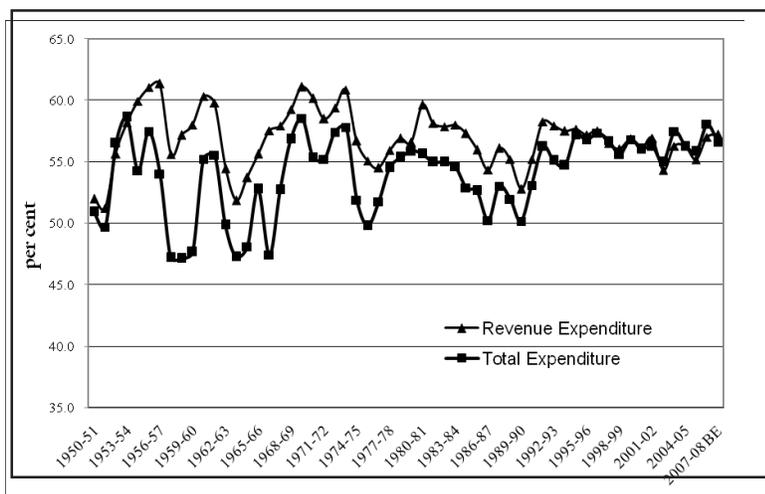
Average for Finance Commission Periods	Relative Shares			
	Total Expenditure		Revenue Expenditure	
	Centre	States	Centre	States
FC-I	43.83	56.17	40.77	59.23
FC-II	49.47	50.53	41.83	58.17
FC-III	50.51	49.49	46.10	53.90
FC-IV	47.69	52.31	41.77	58.23
FC-V	43.14	56.86	40.00	60.00
FC-VI	47.35	52.65	44.19	55.81
FC-VII	44.79	55.21	41.98	58.02
FC-VIII	47.86	52.14	44.22	55.78
FC-IX	45.58	54.42	43.45	56.55
FC-X	43.35	56.65	43.18	56.82
FC-XI	43.77	56.23	44.03	55.97
FC-XII*	43.74	56.26	44.45	55.55
<b>Overall</b>				
<b>Average</b>	<b>45.92</b>	<b>54.08</b>	<b>43.00</b>	<b>57.00</b>

Note: \* Average of three years (2005-08).

Source: Basic Data from Indian Public Finance Statistics (various years).

also targets elimination of revenue deficit by the Centre and all the states individually by 2014-15 as detailed in Chapter 9.

**Figure 4.4: Relative Shares of States in Combined Revenue and Total Expenditure**



## CHAPTER 5

# Goods and Services Tax

### Introduction

5.1. This Commission is required to consider ‘the impact of the proposed implementation of Goods and Services Tax with effect from 1<sup>st</sup> April 2010 including its impact on the country’s foreign trade’, while formulating its recommendations. The changeover to the Goods and Service Tax (GST) will be a game-changing tax reform measure which will significantly contribute to the buoyancy of tax revenues and acceleration of growth, as well as generate many positive externalities. Three other items of consideration in our Terms of Reference (ToR), viz. (i) ‘...estimation of the resources of the Central and State Governments’; (ii) ‘... the objective of not only balancing the receipts and expenditure on the revenue account but also to generate surpluses in the capital account’; and (iii) ‘... to improve the tax- gross domestic product ratio of the Center and the States’ will also be influenced by the GST. This Commission therefore recognised the need to holistically examine all the issues relating to the implementation of GST.

5.2. The first phase of reform of indirect taxation occurred when the Modified Value Added Tax (MODVAT) was introduced for selected commodities at the central level in 1986, and then gradually extended to all commodities through Central Value Added Tax (CENVAT). The introduction and integration of service tax into CENVAT deepened this effort. Reform at the state level occurred through introduction of Value Added Tax (VAT) by all the states in the country in a phased manner between April 2003 and January 2008. Buoyed by the success of VAT, and mindful of the need for further improvement, the Government of

India (GoI) indicated in Feb 2007 that a roadmap for introduction of destination-based GST in the country by 1 April 2010 would be prepared in consultation with the Empowered Committee (EC) of state Finance Ministers. This commitment was reiterated in February 2008 and July 2009. The origin-based Central Sales Tax (CST) was successively reduced from 4 to 3 per cent and 2 per cent during 2007 and 2008, respectively, as part of this reform process. In November 2007, a Joint Working Group consisting of representatives of the Empowered Committee and the Government of India prepared a report on the changeover to GST. This report was discussed by the EC, which then prepared ‘A Model and Road Map for Goods and Service Tax in India’ in April 2008. The model and roadmap, while recommending that a dual GST be put in place, also provided preliminary views on the state and central taxes to be subsumed within the GST. The model detailed the operational issues which needed to be addressed, including the number of rates, the exemptions and exclusions from GST, as well as the treatment of inter-state transactions. The roadmap outlined the legal and administrative steps which needed to be taken in order to comply with the April 2010 time line. The Government of India’s response to this document formed the basis of the second round of discussions and reviews. This culminated in the release of the ‘First Discussion Paper on Goods and Service Tax in India’ in November 2009. This discussion paper provides details of the taxes to be subsumed, while at the same time, outlining the modalities of implementation of the tax. It also makes recommendations on a number of building blocks of the GST, including taxation of inter-state trade,

provision of compensation, treatment of area based schemes and the additional steps required to be taken. It, however, does not provide any guidance on the Revenue Neutral Rates (RNR) which need to be adopted at the central and state level. This discussion paper is expected to spark a public debate, leading to possible modification of the design and implementation modalities of the GST.

5.3 Commendable progress has been made over the past three years in generating a national consensus on GST. Agreement on the broad framework of this tax has now been reached. GST will be a dual tax, with both central and state GST components levied on the same tax base. All goods and services, excluding the agreed upon exemptions, will be brought into this base. No distinction between goods and services will be made, with a common legislation applying to both. However, a number of issues remain to be resolved. These need to be addressed carefully. Only if a model GST is put in place, can all its potential benefits be fully exploited. Given the large positive economic and fiscal externalities of the GST reform, putting in place an incentive structure to motivate all stakeholders to design and implement such a model GST was, therefore, a prime concern of the Commission. A number of State Governments and industry associations communicated to the Commission their concerns on the design and implementation of GST. To address these and other GST related issues including the mandate in our ToR, the Commission sponsored three independent studies. One, undertaken by the National Council for Applied Economic Research (NCAER) studied the impact of GST on international trade. The second was undertaken by a task force (TF) which examined the whole gamut of GST-related issues, from design to implementation and made suitable recommendations. Both these studies have been published on the website of the Finance Commission.<sup>1</sup> We review below their main findings and recommendations after briefly highlighting the concerns expressed by the State Governments.

## Views of State Governments

5.4 The State Governments expressed their views on the structure of GST as well as its implementation modalities to the Commission during our state visits. Nine State Governments gave their views in their respective memoranda and some expressed their views through letters to the Commission. While all the states broadly supported the introduction of GST, the major concerns expressed by them are detailed hereunder.

5.5 *Determination of the tax base:* Some State Governments pointed to the importance of accurately assessing the tax base that would be available to them under GST. They noted that with regard to service tax, figures presently available were those pertaining to the point of collection, rather than to the point of incidence. Also, the rules of supply for services have not yet been finalised. States which presently have a high tax effort apprehended that the RNR finally agreed upon would not be favourable to them. Manufacturing states would suffer additionally due to the abolition of CST. They suggested that the GST rates should, therefore, be used as a floor rate.

5.6 Low income states argued that as their consumption base was low, and they had increased their tax effort significantly after implementing VAT, there was little scope for them to increase their revenues under the proposed GST regime.

5.7 *Vertical imbalance:* It was apprehended that the GST could possibly accentuate the vertical imbalance in favour of the Centre through a proportionally larger Central Goods and Services Tax (CGST) rate and access to a larger consumption base, hitherto unavailable to the Centre.

5.8 *State autonomy:* The GST requires a commitment to a stable rate structure. This will compromise the fiscal autonomy of State Governments and deprive them of the only lever of macro-economic policy available to them.

5.9 *Single rate:* A single GST tax rate would be regressive, with the tax levied on items of common

<sup>1</sup> The final report of the third study was awaited at the time of writing. It will also be put on the FC website after receipt.

consumption increasing, while providing needless relief to the higher taxed luxury goods.

5.10 *Compensation mechanism:* Some states currently having a high tax effort noted the possibility of suffering losses upon implementation of GST. They requested that an objective compensation mechanism to support such losses be put in place. Compensation on loss of CST should also be part of this package.

5.11 *Small enterprises:* Small enterprises manufacturing specified goods with an annual turnover of less than Rs. 1.5 crore are presently exempt from excise. The GST will bring them into the tax net, rendering them uncompetitive and enhancing their compliance cost.

5.12 *Cesses and surcharges:* All cesses and surcharges levied by both the Centre and the states should be subsumed into the GST.

5.13 *Taxes to be excluded from GST:* Electricity duties; purchase tax; and taxes on crude oil, motor spirit (MS), high speed diesel (HSD), alcohol and tobacco should be excluded from the purview of GST.

5.14 *Compliance mechanism:* The GST law should be subject to rigorous compliance and deviations should not be permitted. Changes should be made only with the consent of all the states.

5.15 *Selective rollout:* States should be given the option to adopt GST at their convenience and the possibility of implementation of GST in only some states should be incorporated in the design.

5.16 *Dispute Resolution:* An independent dispute resolution mechanism should be put in place.

5.17 *Implementation modalities:* All tax returns, assessment and audit procedures should be harmonised across the country. A comprehensive information technology (IT) based infrastructure should be put in place to track inter-state transactions.

5.18 Adequate preparation for the changeover, rather than an arbitrary fixed schedule, should be the sole criterion for deciding the timing for introduction of GST.

5.19. The CST Act should be abrogated such that the provision for notifying declared goods is not available to the Centre.

5.20. The rules of supply for inter-state sales should be finalised expeditiously, in an objective manner. Further, the modalities for levying GST on imports, textiles and sugar should be agreed upon.

### Views of the Central Government

5.21. During our consultations with the Central Government, they expressed concerns about the following issues:

- i) The recommendation in the Discussion Paper that GoI maintain the CGST threshold at Rs. 1.5 crore, while the State Goods and Services Tax (SGST) composition threshold would be Rs. 40 lakh.
- ii) The importance of agreeing upon a uniform and limited list of exempted items for the Centre and for all the states.
- iii) The criticality of promoting the power sector and the importance of subsuming electricity duty into GST.
- iv) The need to subsume purchase tax into GST to ensure that it remains a consumption-based tax and is not exported across tax jurisdictions.

### Impact of GST on Foreign Trade

5.22. A NCAER study, commissioned by us, evaluates the possible impact of GST on India's international trade in a Computable General Equilibrium (CGE) framework. It notes that the differential multiple tax regimes across sectors of production are leading to distortions in the allocation of resources as well as production inefficiencies. Complete offsets of taxes are not being provided to exports, thus affecting their competitiveness. It estimates that implementation of a comprehensive GST across goods and services will enhance the nation's Gross Domestic Product (GDP) by between 0.9 and 1.7 per cent. This works out to between Rs. 52,600 crore and Rs. 99,450 crore on the basis of GDP figures for 2009-10. Such

benefits would accrue every year. It would also lead to efficient allocation of the factors of production, with a fall in the overall price level. The report identifies a number of sectors which would directly benefit from the implementation of GST. The study estimates the gain in exports to vary between 3.2 and 6.3 per cent. Imports are expected to gain between 2.4 per cent and 4.7 per cent, thus improving the trade balance.

5.23. The study estimates the revenue-neutral GST rate across goods and services to be between 6.2 and 9.2 per cent, depending upon the assumptions made. This value was conservatively arrived at, ignoring the existence of tax thresholds and composition limits. The study assumes that the GST adopted will be a truly consumption based tax which will: (i) eliminate all origin based taxes; (ii) subsume all the other presently levied indirect taxes on goods and services (excluding customs) and (iii) will not be exported across tax jurisdictions. To exploit the benefits of GST fully, we also need to ensure that tax compliance costs are low and tax credits are available seamlessly across tax jurisdictions. Apart from uniform tax rates, this will also require harmonisation of procedures for levy, assessment, appropriation and even audit, between the states and the Centre, as well as amongst the states themselves. This is best done through a model GST, the characteristics of which are outlined in Para 5.25.

### Report of the FC -XIII Task Force

5.24. The task force, appointed by this Commission, comprehensively analyzed all GST related issues and made a number of recommendations. The Task Force Report is available on the Commission's website. The key points are summarised below:

- i) Following the present VAT, the GST should be levied on consumption and computed on the basis of the invoice credit method.
- ii) All major indirect taxes (excluding customs) and all cesses and surcharges should be subsumed into the central and state GST.

Specifically, stamp duty, taxes on vehicles, taxes on goods and passengers and taxes and duties on electricity should be subsumed into the GST.

- iii) Transmission fuels, High Speed Diesel (HSD), Motor Spirit (MS) and Aviation Turbine Fuel (ATF) should be brought under a dual levy, of GST and an additional levy, with no input tax credit available on the additional levy. This would protect the existing revenues from these sources. However, all other petroleum products should be brought within the ambit of the GST, as should natural gas.
- iv) The sumptuary goods of tobacco and alcohol should be taxed through GST as well as an additional levy, with no input tax credit being provided on the additional levy.
- v) The entire transportation sector should be included in the GST base, and taxes on vehicles, goods and passengers should be subsumed into the GST. Similarly, the power sector should be included in the tax base and electricity duty subsumed.
- vi) The real estate sector (both residential and commercial) should be included in the tax base and stamp duty levied by State Governments should be subsumed into GST. A threshold of Rs. 10 lakh in this regard will permit exemption of small residential and business properties.
- vii) The entire financial services sector should be brought under the GST tax base.
- viii) Capital goods should be treated like all other goods and services, with no restrictions on avilment of input tax credit at purchase, and a corresponding liability for GST on subsequent sale.
- ix) No exemptions should be allowed, except for a common list applicable to all states as well as the Centre, which should only comprise : (a) unprocessed food items; (b) public services provided by all governments

- excluding railways, communications, public sector enterprises; (c) service transactions between an employer and employee and (d) health and education services.
- x) 'Place of supply' rules for goods and services should be based on international best practice, and be carefully framed to ensure consistency, credibility and relevance.
- xi) An exemption threshold of Rs. 10 lakh should be adopted, with a composition limit of Rs. 40 lakh, above which GST would be mandatorily applicable. The present excise exemption upto Rs. 1.5 crore should be withdrawn. However, in the case of certain high value goods comprising: (i) gold, silver and platinum ornaments; (ii) precious stones and (iii) bullion, the dealers may, subject to the threshold limit of Rs. 10 lakh but without the ceiling of Rs. 40 lakh, also be allowed to opt for the composition scheme.
- xii) Area-based exemptions should be withdrawn and the tax paid reimbursed wherever considered necessary.
- xiii) Inter-state transactions should be treated through a mechanism which permits sellers in one state to charge SGST from buyers in another state. The seller shall furnish the transaction related information and composite payment of tax in respect of both intra and inter state transactions, to nodal bank. This SGST should then be immediately credited to the consuming state by the bank where such payment is made.
- xiv) Harmonisation should be ensured in registration, return filing, assessment, and audit across states.
- xv) The GST tax base has been estimated at Rs. 31,25,325 crore. This is the average of five different estimations of the tax base obtained by following as many approaches. These estimates are given in Table 5.1.
- xvi) The consequent Revenue-Neutral Rate works out to 11 per cent (5 per cent for CGST

**Table 5.1: Estimates of the Tax Base of GST by Different Approaches**

	(Rs. crore)
1. Subtraction Method	30,73,037
2. Consumption Method	
a. Task Force Method	37,43,077
b. NCAER Method	30,77,952
3. Shome Index Method	27,82,809
4. Revenue Method	29,49,748
<b>Average</b>	<b>31,25,325</b>

and 6 per cent for SGST). This excludes the additional levies which would be imposed on petroleum and sumptuary goods. The task force has recommended that all goods and services should be subject to tax at the single positive GST rate of 12 per cent (that is, 5 per cent for CGST and 7 per cent for SGST) other than exports.

## The Model GST

### Outline of the Model GST

5.25. Keeping in mind the recommendations of the task force, we outline the design and modalities of a model GST law. Such a model GST would not distinguish between goods and services. It should be levied at a single positive rate on all goods and services. Exports should be zero-rated. Tax compliance costs should be low and tax credits should be available seamlessly across tax jurisdictions. The other design and operational modalities of a model GST are outlined below.

#### *Taxes to be Subsumed*

5.26. For the GST to be purely consumption based, all related indirect taxes and cesses should be subsumed into it. Thus, the Central GST portion would subsume the following taxes:

- i) Central excise duty and additional excise duties
- ii) Service Tax
- iii) Additional Customs Duty (Countervailing Duty)
- iv) All surcharges and cesses

5.27. The SGST portion would subsume the following taxes:

- i) Value Added Tax
- ii) Central Sales Tax
- iii) Entry Tax, whether *in lieu* of octroi or otherwise
- iv) Luxury Tax
- v) Taxes on lottery, betting and gambling
- vi) Entertainment Tax
- vii) Purchase Tax
- viii) State Excise Duties
- ix) Stamp Duty
- x) Taxes on vehicles
- xi) Tax on goods and passengers
- xii) Taxes and duties on electricity
- xiii) All state cesses and surcharges

#### *Special Provisions for Certain Goods*

5.28 The taxation of petroleum products and natural gas would be rationalised by including them in the tax base. HSD, MS, and ATF could be charged GST and an additional levy by both the Central and State Governments. No input credit would be available against either CGST or SGST on the additional levy. A similar treatment would be provided to alcohol and tobacco. Such an arrangement would ensure protection of existing revenues while taking care of environmental concerns.

#### *Exemptions*

5.29 No exemptions should be allowed other than a common list applicable to all states as well as the Centre, which should only comprise: (i) unprocessed food items; (ii) public services provided by all governments excluding railways, communications and public sector enterprises and (iii) service transactions between an employer and employee (iv) health and education services.

5.30 A threshold of Rs. 10 lakh and a composition limit of Rs. 40 lakh have been agreed upon by the EC for SGST in the first discussion draft. It is

desirable that these limits be applied to CGST as well. Sales of goods of local importance will fall within these threshold limits, thus keeping them out of the ambit of GST.

5.31 Dealers with turnover below Rs 1.5 crore were previously exempt from CENVAT. As thresholds need to be consistent across SGST and CGST, such exemptions should not continue. Under the GST regime, dealers with turnovers between Rs. 10 lakh and Rs. 40 lakh will have to pay both CGST and SGST. Their compliance burden will increase. This issue can be addressed if both CGST and SGST are levied and collected from such dealers by a single agency, viz. the State Government, which would then remit the CGST portion to the Central Government. State Government will be responsible for assessment, levy, collection and audit, with Central Government retaining it right to exercise these functions in respect of CGST in specific cases. State Governments could be reimbursed the collection charges for this effort. Wherever the additional levy is likely to cause hardship, a scheme for reimbursement to economically vulnerable dealers could be considered by the government.

5.32 The present area-based exemption schemes are not consistent across the states where they are applicable. They differ in the admissibility of CENVAT credit as well as the sunset clause. Since it would be difficult to subsume these schemes into the GST structure, it is recommended that they be terminated. The existing schemes should not be grandfathered. Alternative options like refunding taxes paid by industries in these locations could be considered.

#### *Treatment of Inter-state Sales*

5.33 All transactions across tax jurisdictions should be free from tax. While exports will be zero rated, inter-state transactions should be effectively zero-rated so as to ensure that the tax is collected by the consuming state consistent with the destination principle. Therefore, any model adopted must allow accurate determination and efficient transfer of input tax credit across tax jurisdictions. Further, the model should not impose any undue restrictions on tax credit set-off or increase in compliance costs.

*Formulation of Rules of Supply*

5.34 The 'place of supply' rules for services need to be carefully framed to ensure consistency and credibility. It should be based on international best practice.

*GST on Imports*

5.35 Imports from outside the country would be subject to GST on the destination principle. This will require that proof of consumption at a pre-determined destination state should be provided. The procedure for collection and appropriation of this tax needs to be put in place. Rules for transferring this tax burden in the case of importers who sell to a consumer in a third state after the import is made, need to be clarified.

**Operational Modalities**

5.36 To reduce compliance costs and increase collection efficiency, all state GST laws should be harmonised. All stages of the taxation chain, from levy of the tax to its assessment, collection and appropriation, should be similar across states. This would involve similar rules across states, dealing not only with assessments, audit and refunds, but also with more basic issues like registration, filing of returns, treatment of transportation of goods, etc.

5.37 While CST will be reduced to zero, the necessity of stipulating documentation for inter-state trade needs to be carefully examined. The model for taxing inter-state sales finally adopted should provide clarity on the jurisdiction of states while facilitating inter-state trade and stock transfers. Given the volume of such transactions, this system necessarily has to be IT-based. Such an IT network should enable the sharing of information between states and assist in the plugging of revenue leakages. A system to facilitate inter-state verification of dealers and transactions is also necessary. The present system, viz. Tax Information Exchange System (TINXSYS), does not appear to be fully operational across all states. There are asymmetric benefits to states in putting in place such infrastructure and this appears to be affecting their incentives to do so. A system which will

uniformly incentivise all states to participate in and contribute to the verification system needs to be put in place. Alternately, one central agency could be charged with maintaining this system. The existing TINXSYS infrastructure should be updated and strengthened.

**Dispute Resolution and Advance Ruling Mechanism**

5.38 An effective, efficient and uniform system for redressal of anomalies in the legislation should be put in place. This could be an independent and quasi-judicial authority with full powers to look into all disputes related to GST implementation, both at the Centre and state level. Such an authority could issue guidelines, administer and enforce agreement between states and the Centre, and between the states themselves. A common Advance Ruling Authority for both the Centre and the states should also be put in place.

*Refunds*

5.39 Prompt refunds form the core of an effective GST framework, especially as cross-utilisation of input tax credit across CGST and SGST, are not envisaged. Delayed payment of refunds enhances the cost of dealer operations and reduces the efficiency of the tax system. The experience with refunds under the VAT regime is not reassuring, even though VAT laws in a number of states mandate payment of interest for delay. State Governments must adopt a more effective refund system. They could consider an electronic system where refunds are directly credited to the eligible dealer's bank account.

*Selective Rollout*

5.40 VAT was introduced in a phased manner by State Governments over a period of nearly three years, between April 2003 and January 2008. VAT dealt purely with the treatment of intra-state sales and states were not explicitly disadvantaged if they did not implement VAT. Transactions between VAT and non-VAT states did not warrant special treatment. However, GST changes the rules of the game. It requires inter-state trade to be zero rated.

It empowers states by including services as well as the manufacturing stage in their tax base. It thus creates an uneven balance between states which implement GST and those which do not. Goods and services sold between complying and non-complying states would thus require to be treated differently in the wake of selective implementation of GST. If CST were to continue to apply in non-complying states, inter-state sales would become further complex. Goods passing through a non-complying state, to be finally sold in a complying state, would be burdened by a cascading tax which would adversely affect the price to the final consumer. The seamless flow of Input Tax Credit (ITC) on inter-state transactions would be interrupted. Further, rate mismatches may encourage trade diversion and cost of compliance would become extremely high for inter-state dealers. This would discourage economies of scale. We, therefore, feel that the model GST should be implemented by all states and the Centre at one time, and not be partially implemented in some states. It is for this reason that we recommend that proper preparation for the GST and generating of a consensus amongst all states is a greater priority than complying with the 2010 deadline. However, as has been suggested in some quarters, it is possible for the Centre alone to transform the CENVAT into a GST at the manufacturing stage at any time. It could unify the CENVAT rates and impose a general tax on all services, while adopting a common threshold. As mentioned earlier, a dual tax on petroleum products, tobacco and alcohol could be levied—a GST component and an additional levy component with no input credit being provided on the latter.

#### *Transition Provisions*

5.41 A number of transitional issues will arise. Provisions to address such issues must be consistent with the model GST.

#### **Benefits from Supporting the Model GST**

5.42 This Commission supports the implementation of a model GST for the following reasons:

- i) The NCAER study computed the present value of GST-reform induced gains in GDP as the present value of additional income stream based on the discount rate of 3 per cent representing the long-term real rate of interest. The present value of total gain in GDP is estimated as between Rs. 14.69 lakh crore and Rs. 28.81 lakh crore. The corresponding dollar values are US \$325 billion and \$637 billion. This represents between 25 and 50 per cent of the 2009-10 GDP gained through this major tax reform. The all-government tax revenue will also increase by about 0.20 per cent of GDP, a significant increment to revenues through implementation of the model GST.
- ii) The Task Force report estimated that such a GST would have a tax base of around Rs. 31,00,000 crore. It further estimated that this would require a revenue-neutral rate of only 12 per cent (5 per cent for the Central GST and 7 per cent for the State GST). This is a substantial decrease from the present 20.5 per cent (8 per cent for CENVAT and 12.5 per cent for VAT). This should be the target.
- iii) Adoption of such a model GST would make India a dynamic common market and also result in generation of positive externalities. Despite lower levels of taxes, the revenue of the Union and the states will be buoyant. Subsumation of all major indirect taxes will result in removal of inefficient taxes. Our manufactures will become more competitive and consequently exports will grow. Provision of seamless input tax credit across all transactions will avoid tax cascading, eliminate double taxation and improve resource allocation. It will foster a common market across the country, reorient supply chains and remove the present bias towards backward integration. Further, it will also inhibit tax induced migration of investment. It will, thus, support the growth of lagging but resource-rich regions. A single rate across all goods and services will eliminate

classification disputes and make tax assessment more predictable. The harmonisation of tax assessment, levy and collection procedures across states proposed under the GST will reduce compliance costs, limit evasion, enhance transparency and improve collection efficiency.

- iv) Successful implementation of GST also offers the possibility of strengthening the revenue base of local bodies that form the third tier of government.
- v) The inclusion of real estate in the GST tax base will constrain the parallel economy with consequent positive spillovers into governance and the development of land markets.
- vi) The NCAER model suggests that GST could lead to better environmental outcomes.

### Concerns of State Governments

5.43 We address below the principal concerns of states relating to revenue from certain products, loss of autonomy in a GST framework, possibilities of states entering GST in a phased manner and treatment of small enterprises.

#### Revenue from Certain Products

5.44 The model GST will accommodate the concerns of governments with regard to maintenance of their revenues from transmission fuels and sumptuary goods by allowing the imposition of an additional levy over and above the GST.

#### Dilution of Fiscal Autonomy of States

5.45 Concerns have been expressed by some state governments that the GST regime will constrict their fiscal autonomy and further tilt the vertical imbalance. However, this argument should be viewed in the following perspective:

- i) While the states will normally not be able to deviate from the nationally agreed model for the GST, such constraints will apply to the Centre as well. Further, the states still have

fiscal headroom available. They can impose an additional levy on transmission fuels as well as sumptuary goods and the authority to levy temporary cesses and surcharges in case of emergencies, remains. They can also continue to levy user charges for services provided to citizens. Expenditure policy will continue to remain as a powerful fiscal instrument. Further, the strengthening of their fiscal base will improve their access to capital markets, enhancing their borrowing capacity.

- ii) The tax base of State Governments will significantly increase with the inclusion of the tax on services as well as the tax on manufacture. The tax base of the Centre, on the other hand, will increase only to the extent of tax on sales. Thus, it cannot be said that the vertical imbalance will increase in favour of the Centre.
- iii) States will benefit from the abolition of the cesses and surcharges presently being levied by the Centre, as the size of the divisible pool will rise. Presently this amounts to about 15 per cent of the divisible pool.
- iv) Tax policy is tax administration, and significant scope exists for improving tax collection efficiency through implementation of GST.
- v) The GST grant recommended by this Commission compensates for the seeming limitation in fiscal autonomy by enhancing expenditure autonomy through compensation payments and additional formulaic transfers.
- vi) The GST will be a landmark effort by the states and the Union to further co-operative federalism with all stakeholders contributing to national welfare by accepting its framework.

### Compensation Mechanism

5.46 An objective compensation mechanism incorporated in the 'Grand Bargain' will provide

reassurance to both the Central and State Governments. This has been proposed in Para 5.60.

### Checkposts

5.47 Most states have put in place a system of checkposts on their border roads. There are a number of reasons for putting in place such physical barriers to trade. These include (i) enforcement of state excise, market cess, forest and vehicle fitness regulations (ii) applicability of lower taxes on inter-state trade than on intra-state trade (iii) there being no tax on stock transfers (iv) levy of entry tax on specified goods (v) levy of octroi by some municipalities and (vi) internal security. The onset of GST will not obviate all these reasons, and therefore, check posts on state borders may remain. However, it must be recognised that such checkposts, by the very nature of their operations, generate enormous delays in road traffic. The arrangement also encourages rent-seeking behaviour. It may be difficult to eliminate checkposts, given the valid concerns of State Governments. But what appears to be egregious is that the same vehicle has to pass through two checkposts—the exporting state’s checkpost and the importing state’s checkpost—while crossing one border. Both these checkposts are often located within a couple of kilometres of each other and a transport vehicle has to spend considerable time at both. Perhaps, it may be possible for both states to put up a combined checkpost. Officials of both states could sit together and conduct their verifications in a single check post. Alternately, one state could handle traffic in one direction and the other state in the other direction, essentially ensuring that there would be only one check per border for a goods vehicle. Such an arrangement would significantly reduce travel time and we recommend it for consideration. There is an overwhelming rationale for minimising delays and thus reducing transaction costs. States could be encouraged to consider user-friendly options like electronically issued passes for transit traffic in order to reduce truck transit time through their states.

### The Grand Bargain

5.48 We propose that both the Centre and the states conclude a ‘Grand Bargain’ to implement the

model GST. Keeping the experience of the implementation of VAT in mind, we suggest that the six elements of the Grand Bargain comprise: (i) the design of the GST; (ii) its operational modalities; (iii) binding agreement between Centre and states with contingencies for change in rates and procedures; (iv) disincentives for non compliance; (v) the implementation schedule and (vi) the procedure for states to claim compensation. The design of the model GST is suggested in paras 5.25 to 5.35. The operational modalities are outlined in paras 5.36 to 5.41. The proposed agreement between the Centre and states, with contingencies for changes in the agreement, is described in paras 5.49 to 5.51. The disincentives for non-compliance are described in paras 5.52. The implementation schedule is described in paras 5.57 to 5.59. The procedure for claiming compensation is at Para 5.60.

### Binding Agreement between Centre and States

5.49 Compliance of states with the previously agreed upon guidelines for VAT has not been very uniform. A number of states have deviated from the three-tier VAT rates, thus indicating the need to put in place an enforcement mechanism. States are equally apprehensive that the Centre may unilaterally raise tax rates without consulting them. The Constitution does not envisage sharing of tax bases. Taxation powers are listed either in the State List or in the Central List, but not in the Concurrent List. For the first time since the Constitution was enacted, a tax base is proposed to be shared between the Centre and the states. It is, thus, necessary that a firm arrangement be put in place for implementing the GST to prevent deviations from the agreed upon model by either the Centre or the states.

5.50 One option is the possibility of a Constitutional provision to facilitate a tax agreement between the Centre and the states on the lines of the erstwhile Article 278. One suggestion is that the new Article 278 could read: ‘Notwithstanding anything in this Constitution, the Government of a state may enter into an agreement with the government of any other state or the union

government with respect to the levy and collection of any tax or duty leviable by them, and during the period such agreement is in force, the power of such states and union as the case may be, to make laws to impose any tax shall be subject to the terms of such agreement.’ It has been argued that such a provision will eliminate the need to amend the taxing powers entrusted to the Union and the states through Schedule VII of the Constitution.

5.51 Such an agreement (between the 28 states and the Centre as parties) could specify the tax rates adopted as well as the conditions under which the agreed tax rates can be changed. The agreement can be made part of Goods and Service Tax laws which the Centre and all the states will separately enact. The agreement will, amongst other things, specify the rates to be adopted in these enactments and the implementation schedule. For amending the rates subsequently, it is proposed that all states would need to agree to a proposal to decrease rates. Only three quarters of the number of states would need to agree if the rates have to be increased. The Centre would have a veto power. All amendments to the agreement should be consistent with (i) maintaining the integrity of the GST base; (ii) providing for administrative simplicity and (c) minimising compliance costs for taxpayers. The agreement will need to be monitored by the Empowered Committee which could be transformed after the implementation of GST into a Council of Finance Ministers with statutory backing.

### Disincentives for Non Compliance

5.52 Keeping in mind the experience under VAT it may become necessary to deter violations of agreement by visiting a penalty on non-complying states. We recommend that Finance Commission’s state specific grants and the state’s share of the GST incentive grant be withheld for the period during which a state is in violation of the agreement. If a state is in violation for only part of a year, its grant should be reduced to a proportionate extent.

### Compensation/Incentive Grants

5.53 This Commission is aware that the tenor of the ongoing discussions on the GST model and

implementation modalities does not include some of the major elements of the model GST outlined above. In our view, any major deviation from the concept of the model GST would dilute its positive externalities, significantly reduce its benefits and reduce the incentive to switch over. For the reasons outlined in Para 5.42, this Commission strongly urges that any GST model adopted be consistent with the Grand Bargain described in Para 5.48. To incentivise implementation of such a Grand Bargain between the states and the Centre, this Commission recommends the sanction of a grant of Rs. 50,000 crore to be provided to all states in the aggregate, subject to the GST framework adopted being consistent with the Grand Bargain. We recognise that while GST on the whole will be revenue neutral, there may be some winners and losers during the initial years of implementation. This grant will accommodate claims for compensation from the adversely affected states and balance will be distributed amongst states as per the devolution formula.

5.54 The grant of Rs. 50,000 crore would be used for meeting the compensation claims of State Governments between 2010-11 and 2014-15. Unspent balances in this pool would be distributed amongst all the states as per the devolution formula, on 1 January 2015. To allow for the possibility of implementation of GST during 2010-11, we propose that the grant be initially allocated as given in Table 5.2:

**Table 5.2- Scheduling of GST Grant**

2010-11	Rs. 5000 crore
2011-12	Rs. 11250 crore
2012-13	Rs. 11250 crore
2013-14	Rs. 11250 crore
2014-15	Rs. 11250 crore

5.55 We see this allocation as substantial for two reasons. First, the Task Force estimation of RNR provides assurance that such a level of compensation may not be required. Second, the amount of compensation required will depend upon the year in which GST is implemented. The total amount of Rs. 50,000 crore may be earmarked for

GST compensation and incentive provided the model GST is implemented before 31.3.2013. Unspent grants at the end of a year will be carried forward to the next year if GST is implemented before 31.3.2013. If GST is implemented during 2013-14, the grant will be restricted to Rs 40, 000 crore. If GST is implemented during 2014-15, the grant will be restricted to Rs 30,000 crore.

5.56 To be eligible to draw down this grant, all the elements of the Grand Bargain outlined in Para 5.48 will need to be adopted. If the GST framework adopted is not consistent with this, then this Commission recommends that this grant of Rs. 50,000 crore not be disbursed. Thus, if the Grand Bargain is not concluded, this grant will not mean any net fiscal outgo. If a model GST is implemented and the grant is disbursed, then the resultant increase in GDP and tax revenue will fully finance it. If the Grand Bargain is not put in place, then the grant lapses. There are, thus, no fiscal risks with this grant— only advantages.

### **Implementation schedule of the Model GST**

5.57 We recognise that building consensus on implementing the model GST may be an involved process but equally appreciate that the requirement of a good design is paramount and should not be subordinated to a deadline. International experience tells us that flaws in design are extremely difficult to correct subsequently. We therefore recommend that marginal rescheduling of the timetable for implementation should be acceptable if the design adopted is consistent with the model GST.

5.58 The objective of the model GST is to optimise tax collection with minimal economic distortions. The Model GST should, inter alia, comprise of (i) a uniform rate for goods and services (ii) a uniform rate across states (iii) a zero rate for exports and (iv) for all other goods and services a single rate, excluding the rate for precious metals. There could be two possible approaches to the implementation of the Model GST: the 'big-bang' approach and the 'incremental' approach. The introduction of the GST is the last mile in the reform of the indirect tax

system of this country initiated in 1986 with the introduction of the MODVAT. All stakeholders stand to gain from a swift comprehensive changeover to the GST. To the extent the switchover is staggered, the potential gains from the comprehensive GST outlined in Para 5.42 would remain unrealised. Therefore, we recommend that all the elements of the model GST should be implemented comprehensively at one instance.

5.59 However, we are aware that two essential elements of the model have not yet been formally discussed by the states and consensus needs to be built before they are adopted. These are the inclusion of stamp duty in the GST tax base to enable the taxation of real estate and the use of a single rate in the GST framework. More time may be required for these elements to be included in the GST framework. Given that the terminal year of the period covered by our recommendations is 2014-15, we propose as follows. If found necessary, the GST may be initially implemented without these two elements provided that

- i) At the time of its implementation, the road map for their inclusion in the framework before 31 December 2014 is announced.
- ii) The GST is introduced with not more than two rates.
- iii) Properties other than individually owned residential properties are brought into the ambit of GST within two years of its implementation.

This contingency does not preclude the possibility of the Centre implementing GST at an accelerated pace.

### **Modalities for Disbursing Compensation**

5.60 As mentioned in Para 5.10, states had requested that an objective compensation mechanism to support possible revenue losses after implementing GST be put in place. We recommend the following:

- i. The present Empowered Committee be transformed into a statutory Council of Finance Ministers with representation from

the Centre and states. A GST Compensation Fund should be created under the administrative control of this Council.

- ii. The Central Government shall transfer to the GST Compensation Fund amounts as indicated in Table 5.2 and subject to the conditionalities indicated in paras 5.55 and 5.56.
- iii. The amounts in the Fund should be used for compensating states for any revenue loss on account of adoption of the model GST and the Grand Bargain as indicated above. The balance, if any, remaining on 1 January 2015, will be distributed amongst the states on the basis of the devolution formula indicated in Chapter 8 of our report, used for distributing resources in the divisible pool amongst states.
- iv. The amount will be disbursed in quarterly instalments on the basis of the recommendations made by a three-member Compensation Committee comprising of the Secretary, Department of Revenue, Government of India; Secretary to the EC and chaired by an eminent person with experience in public finance. This person would be appointed by the Union Government.

### The Way Forward

5.61 A number of legal and administrative steps need to be taken prior to the implementation of GST. These include stakeholder consultations, amendments to the Constitution and state laws, administrative reorganisation, preparation of GST registration, assessment and audit manuals, staff training and conduct of awareness campaigns amongst stakeholders. We have not touched upon these milestones in our discussion, but are aware that these processes may take substantial time. This is also a reason why we have earlier recommended that the putting in place an excellent design and operational framework for the GST should be given priority, even if this implies rescheduling the previously announced implementation timetable.

5.62 We recognise that the process of generating a consensus to implement the Grand Bargain as outlined by us may be difficult and involved. However, we believe that such a consensus can, and should be, generated to fully exploit the potential of GST and reap the benefits of its positive externalities. While we would like to support this model GST, which is fully consumption based, has provision for seamless credit and imposes low compliance cost, we must allow for the possibility that political economy considerations may will otherwise. In the unlikely event that such a consensus cannot be achieved and the GST framework finally adopted is different from the Grand Bargain suggested by us, this Commission recommends that the grant amount of Rs. 50,000 crore shall not be disbursed.

### Impact of GST on Projections made by the Finance Commission

5.63 Though GST requires that all cesses and surcharges be abolished, and this Commission recommends that GST be implemented as early as possible, we have, in our projections, assumed continuing revenue for the Central Government from cesses for the period 2010-15. This has been done for the following reasons.

- i. Ignoring the positive externalities of GST, the Commission has conservatively assumed that GST will be revenue-neutral. Thus, income from cesses and surcharges will be included in the computation of RNR. In the scenario when GST is implemented, the aggregate revenue figures in our projections will remain unchanged, though the accounting heads under which they are reported may change. Since the catalysing effect of GST on the economy has not been factored in our projections, they can be seen as conservative.
- ii. A number of critical sectors, including roads, education, and calamity relief, are being funded from the proceeds of cesses levied by the Government of India. The transition plan to the GST must ensure that budget provisions are made to support such initiatives.

5.64 The model, the modalities as well as the timing of implementation of the GST have not yet been finalised. Making projections over a five-year period, assuming the implementation of the GST during this period, would, be a hazardous exercise. This Commission has, thus, for the purpose of our financial projections, assumed that the impact of GST will be revenue-neutral and that the gross revenues of the Centre and states will not be lower than those projected even after GST is implemented.

## **Summary of Recommendations**

5.65 Both the Centre and the states should conclude a Grand Bargain to implement the model GST. The Grand Bargain comprises five elements: (i) the design of the model GST is suggested in paras 5.25 to 5.35; (ii) the operational modalities are outlined in paras 5.36 to 5.41; (iii) the proposed agreement between the Centre and states, with contingencies for changes is at paras 5.49 to 5.51; (iv) the disincentives for non-compliance are described in paras 5.52 (v) the implementation schedule is described in paras 5.57 to 5.59. (vi) the procedure for claiming compensation is at Para 5.60 (Para 5.48).

5.66 Any GST model adopted must be consistent with all the elements of the Grand Bargain. To incentivise implementation of the Grand Bargain this Commission recommends the sanction of a grant of

Rs. 50,000 crore which will taper down to Rs. 40,000 crore and Rs. 30,000 crore if GST is implemented after 1.4.2013 and 1.4.2014 respectively. The grant would be used for meeting the compensation claims of State Governments for revenue losses on account of GST implemented, consistent with the Grand Bargain, between 2010-11 and 2014-15. Unspent balances in this pool would be distributed on 1 January 2015 amongst all the states as per the devolution formula (paras 5.54 and 5.55).

5.67 The EC should be given formal authority. The compensation should be disbursed in quarterly instalments on the basis of the recommendations by a three-member Compensation Committee comprising of the Secretary, Department of Revenue, Government of India; Secretary to the EC and chaired by an eminent person with experience in public finance to be appointed by the Central Government (Para 5.60).

5.68 In the unlikely event that a consensus to implement all the elements of the Grand Bargain cannot be achieved and the GST mechanism finally adopted is different from the model GST suggested by us, this grant of Rs. 50, 000 crore shall not be disbursed. (Para 5.62).

5.69 States should take steps to reduce the transit time of cargo vehicles crossing its borders by combining checkpoints with adjoining states and adopting user friendly options like electronically issued passes for transit traffic (Para 5.47).

## CHAPTER 6

# Union Finances: Assessment of Revenue and Expenditure

### Introduction

6.1 The Central Government shoulders the primary responsibility of discharging the key functions of stabilisation and growth in the arena of public finance. Maintaining a stable macroeconomic and fiscal environment, fostering increased rates of savings and investment, ensuring current account stability and maximising growth are, thus, the main policy objectives. In addition, to ensure inclusive growth, the State must mobilise and allocate resources in a manner that allows the poor, vulnerable and disadvantaged sections of the population access to the benefits of growth. In practice, this enlarges the equity or allocative aspect in the public finances of the Central Government.

6.2 The Government of India has to maintain fiscal prudence and at the same time, make certain that adequate incentives exist for stable, sustainable and inclusive growth. It also has to ensure availability of resources for functions relating to external and internal security, maintenance of law and order; and provision of critical infrastructure in the areas of national transport and communication network. Although the main engine of growth, in an emerging economy such as India, is private sector investment, the government needs to provide for adequate supply of essential public goods and create enabling conditions for an efficient private sector to flourish. The states and the Centre have an important collaborative role to play in this endeavour. These are the general principles that inform the Commission's assessment of Union finances.

6.3 The purpose of undertaking an assessment of Union finances is to see that the Central Government has adequate fiscal space to fund the expenditure needs that stem from the above responsibilities. Since resource availability with the government is limited, this is, necessarily, an exercise in constrained optimisation. The Central Government and the states alike have expenditure responsibilities that need to be met out of a finite resource envelope. In addition, these responsibilities must be discharged in a manner that is consistent with maintaining the efficiency of public expenditure. This is an important consideration for this Commission in assessing the relative apportionment of public expenditure into competing requirements such as expenditure on provision of social and economic services, security expenditure, committed expenditure and transfers and subsidies.

### Scope of the Chapter

6.4 The Terms of Reference (ToR) require the Thirteenth Finance Commission (FC-XIII) 'to review the state of the finances of the Union and the states, keeping in view, in particular, the operation of the states' Debt Consolidation and Relief Facility (DCRF) 2005-10 introduced by the Central Government on the basis of the recommendations of the Twelfth Finance Commission'. In doing so the Commission has, among other things, been asked to take account of:

- i) 'The resources of the Central Government for five years commencing 1 April 2010, on the basis of the levels of taxation and non-tax

revenues likely to be achieved at the end of 2008-09.

- ii) The demands on the resources of the Central Government, particularly on account of the projected gross budgetary support to the central and state plan, expenditure on civil administration, defence, internal and border security, debt-servicing and other committed expenditure and liabilities.
- iii) The objective of not only balancing the receipts and expenditure on the revenue account of all the states and the Union, but also generating surpluses for capital investment.
- iv) The need to improve the quality of expenditure to obtain better outputs and outcomes.
- v) The need to ensure the commercial viability of irrigation projects, power projects, departmental undertakings and public sector enterprises through various means, including levy of user charges and adoption of measures to promote efficiency.’

6.5 With reference to the above considerations, this chapter presents our assessment of the revenue prospects and the expenditure needs of the Union Government for the award period. In undertaking this assessment, the views of the central ministries/ departments, Planning Commission, Reserve Bank of India (RBI) and the opinions of the various experts consulted have been duly taken note of.

### **The Consultative Process**

6.6 The Ministry of Finance (MoF) gave its comments on our ToR, vide a memorandum submitted on 13 March 2009, followed by projections (including assumptions made) on revenues and expenditure furnished on 8 September and 16 October 2009, respectively. The response from the Planning Commission on these issues was received on 9 January 2009 and 21 May 2009. The Planning Commission also furnished projections on revenues, expenditure (including gross budgetary support (GBS)) and the underlying

assumptions, vide their communication on 16 November 2009. Several other ministries also commented on various aspects of the ToR, either in writing and/or during the discussions held with them.

6.7 The MoF has urged the Commission to take note of the fact that due to the global events unfolding over the last two years, it may not be appropriate to treat either 2007-08 or 2008-09 as the base year for the purpose of calibrating the variables that would ultimately influence the award. It has been argued that there is a need to make the necessary adjustments in the adopted base year in order to have a more realistic estimate of the revenue and expenditure during 2010-15. It has also emphasised the need to create fiscal space for inclusive growth as envisaged in the Eleventh Plan. While doing so, the Commission has been urged to keep in mind the constraints on resource mobilisation through borrowings in view of the Fiscal Responsibility Legislation (FRL) in place, both at the Centre and in the states. The likely impact of the proposed implementation of the Goods and Services Tax (GST) has also been highlighted for consideration. Issues concerning emphasis on the quality of public expenditure; management of the ecology, environment and climate change; and shift to an accrual system of accounting, have also been mentioned in the memorandum. A detailed note on the macroeconomic framework, an overview of the central and state finances, including transfer of resources from the Centre to the states, was also presented by the MoF. In conclusion, the memorandum mentions that in view of the Constitutional roles and responsibilities of the Centre and the states remaining unchanged and the fact that the introduction of GST will augment the revenues of the states significantly, there is a scope for substantially reducing the states’ share in net central taxes and overall transfers from the Centre to the states. The other submissions in the memorandum include a review of the actual utilisation of grants by the states during the period 2005-09 and the need to ensure that the states provide for adequate maintenance expenditure for assets created under the plan schemes.

6.8 The Planning Commission in its submission on 16 November 2009 has projected an aggregate GBS requirement of Rs. 26,23,701 crore for the period 2010-15. In respect of the Centrally Sponsored Schemes (CSS), it states that according to the expressed views of the Central Government it is not desirable to transfer these funds in the form of 'Normal Central Assistance' as demanded by the states because of the fact that the transfer mechanism via the CSS ensures that central funds actually flow to the critical sectors and that there is also a matching flow of state funds into these sectors. In this context, this Commission has been asked to ensure adequate availability of funds to the states to enable them to make the matching contributions. The Planning Commission has also opined that a larger provision of earmarked grants offset by a lower tax share would have the effect of delineating the states' resources more effectively. Like the MoF, the Planning Commission has also underlined the need to earmark funds for the maintenance of assets created through plan expenditure. It has further expressed the view that given the slowdown of the economy due to global recessionary trends, the fiscal correction strategy may not only have to be state-specific, but may also need to be recalibrated. Comments have also been made on the issue of improving the quality of public expenditure to obtain better outcomes in areas such as the management of ecology, environment and climate change; the commercial viability of state level public sector enterprises and departmental undertakings, including irrigation and power projects; the roadmap for fiscal adjustment; the revenue-capital classification of budgetary expenditure; the relevance of revenue and fiscal deficit targets; cyclically adjusted budget balancing; and disaster management.

6.9 Other central ministries have also commented on the specific issues of the ToR pertaining to them. The RBI has expressed its opinion on the additional ToR about including the off-budget liabilities while setting deficit targets. The joint memorandum of the states has expressed serious concern about the inclusion of the GBS (comprising primarily of CSSs) as committed

expenditure of the Central Government in the ToR, which is without precedent in the history of Finance Commissions. They have pointed to a possible pitfall in such an approach, in that the Finance Commission's constitutionally recommended transfers in terms of devolution of the states' share of central taxes and the grants-in-aid, could then become residual. The comments of all the ministries, the Planning Commission, the RBI and the collective views of the states have been dealt with in the relevant chapters of the Report.

6.10 The MoF, on 8 September 2009, submitted statements containing item-wise projections of revenues and expenditures, along with the assumptions made therein. After a meeting with the Commission, some of the figures were revised in the light of their submission on 16 October 2009. Several major revenue earning/spending ministries also gave their assessment of the resources likely to be generated/required during the award period. The Commission considered all these estimates while making its projections of the revenue and expenditures of the Central Government.

### **Policy Considerations Informing the Assessment**

6.11 A major challenge faced by this Commission, as noted in chapters 3 and 4, was the macroeconomic situation extant since late 2007-08. The Indian economy has faced several exogenous shocks in the past years. First, sharp increases in commodity prices have impacted public finances by raising the cost of financing fuel and fertiliser subsidies. Second, the global financial crisis has led to a slowdown in Gross Domestic Product (GDP) growth, impacting the revenue base and necessitating significant incremental counter-recessionary public expenditure. While the situation has improved considerably in the last few months, it may still be some time before the world economy reverts to its pre-recession growth trajectory. The advanced economies are likely to recover rather slowly and investors worldwide are likely to evince greater discretion and caution while making fresh commitments. Added to this would be the threat

of inflationary pressures due to the increased pressure on crude oil prices in the wake of economic recovery. This could further aggravate the existing domestic inflationary pressure due to increasing food prices. Several experts in this field are of the view that there is also a risk that arises from the possibility of another setback in the world of finance, where even a small adverse event has an amplified capacity for destabilisation. These risks call for a prudent assessment of the growth prospects of the Indian economy and require the Commission to carefully calibrate its assessment of the future growth of GDP and correspondingly, of the revenue base. The judgement as to when the process of recovery would become sustained may be critical in this regard. Our consultations with leading professional economists have also underscored this point. Accordingly, the Commission has not assumed a constant GDP growth rate over its award period but has employed a calibrated approach. It has also been urged by the experts that the Commission maintain, at least, the level of adjustment envisaged in the Fiscal Responsibility and Budget Management (FRBM) Act 2003, during its award period, given that the Indian economy may quite reasonably be expected to revert to a trend nominal growth rate of at least 13.5 per cent in the medium term.

6.12 Accordingly, we have adopted nominal growth rates of 12.50 per cent in 2010-11, 13 per cent in 2011-12 and 13.5 per cent in each of the years from 2012-13 to 2014-15. The MoF projections are broadly similar, while those of the Planning Commission are higher. The inflation scenario adopted by us is in line with the RBI projections of a rate of 4.5 per cent to 5 per cent. MoF, however, has assumed a lower inflation rate of 3 per cent to 4.5 per cent over the period 2010-15.

6.13 In order to project the revenues and expenditures of the Centre for the period 2010-15, we have followed a two-step approach comprising a reassessment of the base year figures and, based on this, their projection for the award period (2010-15). The 2009-10 (BE) figures reflected in the Union Budget presented on 6 July 2009 have, by and large, been taken as the base for projections. However,

with regard to some items of revenue and expenditure, suitable adjustments have been made after careful consideration.

### **Reassessment of Base Year 2009-10**

6.14 In the case of tax revenues we have used the 2009-10 (BE) projections made by the Central Government. These reflect a decreasing buoyancy relative to the previous years, which is appropriate, given the severity of the economic downturn in 2008-09 and 2009-10 that has affected the direct as well as the indirect tax base.

6.15 For non-tax revenues we have used the 2009-10 (BE) projections made by the Central Government in all cases except receipts under economic services. In the case of economic services, using the BE figure (Rs. 60,039 crore) as the base seemed inappropriate as this figure included receipts from the auction of 3G—a one-time phenomenon which, if included in any growth projections, would significantly overestimate the future non-tax receipts under this head. In view of this consideration, the receipts under other communication services have been reassessed at Rs. 23,335 crore as against the BE figure of Rs.48,335 crore, thereby reducing the overall receipts under economic services to Rs.35,039 crore.

6.16 On the non-plan side we have reassessed some of the items of expenditure as per the rationale given in paras 6.17 to 6.20.

6.17 The MoF memorandum urged the Commission to take account of the revision of salaries and pensions due to the implementation of the Sixth Central Pay Commission's recommendations. In the 2009-10 (BE) figures, the impact of increased pay and allowances was already subsumed. Moreover, these figures also include the arrears payable. Since the arrears are a one-time payment, for the purposes of projection of the salary component, this amount was deducted from the relevant items of non-plan expenditure (viz. defence; police; other general, social and economic services and non-plan expenditure of UTs with legislature).

6.18 The expenditure estimates for debt waiver to farmers in 2009-10 (BE) are not expected to recur. Hence, these have not been included in the assessment of the base year. However, the Ministry of Finance has provided estimates of expenditure under this head for 2010-11 and 2011-12. These have been incorporated in the expenditure projections for the above years as these are policy commitments pursuant to the original decision on debt relief. No fresh commitments to such expenditure in the future have been allowed.

6.19 Budget 2009-10 has provided for Rs. 3109 crore as petroleum subsidy, even though the actual subsidy on this item is much higher—the balance amount being borne through off-budget mechanisms. In keeping with our additional ToR with regard to bringing all off-budget liabilities on government account, the 2009-10 base year figure for petroleum subsidy has been reassessed. The reassessment is based on the estimates of the High Powered Committee on Financial Health of Oil Companies headed by Shri. B.K. Chaturvedi. As per this report, the estimated annual subsidy on kerosene is Rs. 30,000 crore. This subsidy was based on the international crude price of US \$140 per barrel. With mean crude prices assumed to be around US \$70 per barrel, the subsidy would come down by at least Rs. 15,000 crore. The report also suggests a number of reform measures which, once implemented, could reduce the subsidy bill to 60 per cent of the estimated level. Accounting for such reform measures, which the Commission feels could be implemented without delay, the kerosene subsidy bill would be around Rs. 9000 crore. On Liquefied Petroleum Gas (LPG) sales, the Ministry of Petroleum has estimated an under-recovery of Rs. 17,600 crore for 2008-09 (at the prevailing crude oil prices). With mean crude prices assumed to be around US \$70 per barrel the subsidy amount would come down by at least Rs. 8800 crore. It is assumed that of this, GoI will apportion 20 per cent

(i.e. Rs. 1760 crore) for future subsidies on account of LPG so as to protect below poverty line (BPL) families transiting from superior kerosene oil to LPG, as envisaged in the Chaturvedi Committee Report. Thus, the reassessed base year figure for fuel subsidy amounts to Rs.10,760 crore (9000 + 1760). There should be no off-budget financing of such subsidy in future years and this approach would be in line with our ToR.

6.20 The non-plan, non-FC grants for states and UTs have been modified by deducting the non-plan grants given to the states and UTs as compensation for Value Added Tax (VAT)/ Central Sales Tax (CST). The reassessed amount is Rs. 5154 crore as against Rs. 14,176 crore in 2009-10 (BE).

## Projections for the Award Period

### Tax Revenues

6.21 The Commission considered various scenarios with respect to future tax revenue streams. If all taxes grow at the Trend Growth Rate (TGR) for the period 1999-2000 to 2007-08, the implied buoyancy would be 1.43. TGRs for shorter periods yield even higher buoyancies. It was felt that assuming such a high buoyancy for the projection period would be unrealistic, given that the 2004-08 period witnessed an unprecedented growth in the direct and service tax base. Thus, it was decided to moderate the buoyancy estimate and the tax revenues for the period 2010-15 have been projected by using an overall buoyancy of 1.33. This is derived by calculating the buoyancy of gross tax revenue, excluding service taxes for the period 1999-2008 (service taxes had a high outlier buoyancy of 4.54 during this period). This has been applied on the base year estimates of individual taxes to arrive at year-wise projections for revenue from each tax item. The resultant tax-GDP ratios

Table 6.1: Tax-GDP Ratio

Years	2009-10 BE	2010-11	2011-12	2012-13	2013-14	2014-15
Tax-GDP ratio	10.95	11.35	11.78	12.24	12.72	13.22

are reported in Table 6.1. Our projections are somewhat lower than the projections of the MoF.

6.22 As detailed in Chapter 5, the introduction of GST will not affect tax revenues as the rates implemented would be revenue-neutral. On the contrary, as explained, it is likely to improve revenues. This 'upside' potential of GST has not been factored into our projections and, to that extent, they are conservative.

### **Non-tax Revenues**

6.23 Under non-tax revenues, interest receipts from State and UT Governments have been projected to decline by 2 per cent each year from the base year onwards. This is to take account of the fact that the Centre's loan portfolio to states is reducing as past loans are amortised and no new loans are being issued, as per existing policy. Interest receipts from railway capital are projected to remain constant at the base year level of 0.09 per cent of GDP. Profits from RBI/banks have been assumed to grow at the same rate as that of GDP. On the basis of our consultations with the Ministry of Petroleum and Natural Gas and the Department of Telecommunication as well as various sector experts, receipts from economic services have been projected to grow at an annual rate of 18 per cent over the reassessed base year. For all other items, the TGR for the period 1999-2008 has been applied on the base year figures to get the annual projections. As a proportion of GDP, the non-tax revenue is projected to increase from 2.01 per cent in 2010-11 to 2.24 per cent in 2014-15. MoF projected a decline in this ratio from 2.00 per cent to 1.70 per cent during the same period. However, in view of the immense potential of sectors like telecommunication and petroleum, we feel that the MoF projection is an underestimation.

6.24 Our revenue projections for the Union Government for the period 2010 to 2015 have considerable upside potential. This is due to the fact that: (i) the revenue buoyancy that we have assumed is less than the MoF buoyancy estimate; (ii) our growth assumptions are conservative

compared to the projections of the Planning Commission, particularly for the latter half of the period; (iii) the game-changing tax reforms that are slated during this period, such as GST and the Direct Tax Code, will have a positive impact on revenues as these reforms will further stimulate growth and improve tax compliance and finally, (iv) our projections for the proceeds from disinvestment are less than the potential that we have identified in Para 6.44. Further, there is a possibility of additional revenues from sale of non-performing land assets. These additional revenues can comfortably finance the new expenditures arising out of implementation of the The Right of Children to Free and Compulsory Education Act (RTE), 2009 or to meet unforeseen external challenges.

### **Non-plan Expenditure**

6.25 With regard to non-plan expenditure, the memorandum of the MoF asserts that such expenditure is, to a large extent, highly inflexible in the short run. We recognise this as being true for interest payments, defence revenue expenditure, salaries, pensions and transfers to the states and UTs. As mentioned by the Ministry of Defence, we recognise that modernisation of the defence forces is a high priority. We are also of the view that there exists considerable scope to rationalise expenditures on explicit subsidies. The expenditure projections have been made with these aspects in mind and the reasoning underlying them has been outlined in paras 6.26 to 6.38.

6.26 For interest payments we have used projections consistent with the growth in adjusted debt stock allowed by the FRBM path. The details of adjustments made in the debt stock are explained in Chapter 9. We have projected interest payments using an average interest rate of 7.35 per cent for debt contracted till 2009-10 and 7.5 per cent for the subsequent years on the incremental borrowing required to finance the fiscal deficit of the previous year. This would imply that interest payments as a proportion of non-plan expenditure would range between 35.21 per cent and 39.99 per cent during the award period.

6.27 For defence expenditure, the Ministry of Finance has projected a growth rate of 7 per cent per annum for defence revenue expenditure. Capital expenditure is projected to grow at 10 per cent per annum. The Ministry of Defence has emphasised the need to provide adequately for enhanced force multipliers. We also recognise the need to provide for some real growth in defence revenue expenditure, to allow for adequate depreciation and maintenance. We are of the view that the Finance Ministry's projections address these needs and have, therefore, adopted them. The resultant projection for the overall annual growth rate of defence expenditure works out to 8.33 per cent. Further, we are of the view that there exists considerable scope to improve the quality and efficiency of defence expenditure through increased private sector engagement, import substitution and indigenisation; improvements in procedures and practices and better project management, within the parameters of Government of India's policy. Efforts in this direction will further expand the fiscal space available for defence spending.

6.28 The Commission has taken the view that long term fiscal consolidation and improvement in the quality and effectiveness of government expenditure would require realignment in the expenditure priorities of the Central Government. If the Central Government is to expand its provisioning of the much needed national public goods, it will need to streamline expenditures. This is particularly true in the case of subsidies. Without subsidy reform it will not be possible to improve the supply of national public goods and also maintain fiscal prudence. We are of the view that it is, at the present juncture, feasible to implement reforms in the administration of key subsidies pursuant to the recommendations of the various high-powered committees and other institutions that have provided valuable suggestions in this regard. We have closely consulted with the relevant line ministries on the subject to ensure that such reforms can be implemented without adversely

affecting the consumption capabilities of the target groups. This approach is also in continuity with the normative approach of the Eleventh and Twelfth Finance Commissions.

6.29 Against this backdrop, the Commission has made normative projections with regard to future expenditure on subsidies, keeping in mind the need for reform as well as the need to better target subsidies to enhance the access of target sections of the population to key merit goods. Hence, in this respect, we have digressed from the estimates of MoF which has assumed an annual growth of 5 per cent for food, fertiliser and fuel subsidies.

*i) Food:* The intention behind providing food subsidy is to improve the food security of the vulnerable sections of society. With this in mind, we have allowed for 50 per cent subsidy on the minimum support price (MSP) to BPL families and full subsidy for the beneficiaries under Antyodaya Anna Yojana (AAY). These subsidy figures have been based on the calculations of the Department of Food and Public Distribution which assume MSP to increase 10 per cent annually. On this basis the average annual growth in food subsidies for the projection period is 8.87 per cent.

*ii) Fertiliser:* The fertiliser subsidy needs to be targeted to ensure food security and self sufficiency while preventing wasteful and suboptimal use of fertilisers. In addition, we are informed that given the oligopolistic nature of the global fertiliser market, with India as a large buyer of key fertilisers, restraining inefficient fertiliser consumption would also result in price benefits in the medium term. The Department of Fertilisers, in their interaction with the Commission, also made the point that a reworking of the subsidy regime would promote optimal use of fertilisers as well as better targeting of the subsidy. With these considerations in view, we have taken as a reference point the recommendation of the PM's Economic Advisory Council (EAC) to restrict this subsidy to 120 kilograms<sup>1</sup> of fertiliser per cultivator household. On

<sup>1</sup> The report of the Economic Advisory Council (2007) states that 120 kg of fertiliser (comprising 80 kg of nitrogenous fertiliser, 30 kg of phosphatic fertiliser and 10 kg of potassic fertiliser) provide a well balanced total of 60 kg of nutrients. This will meet the full requirement of small and marginal farmers and will also meet the self-consumption food requirement of medium and large farmers. The balance requirement is to be met from the free market.

this basis, the estimated financing requirement for this subsidy was Rs. 10,980 crore in 2006-07. We consider this to be a reasonable target for 2014-15 if oil prices (which are closely aligned with the freight on board (FOB) unit price of the fertiliser basket) remain around US \$70 per barrel. To achieve this in the terminal year, the 2009-10 (BE) figure has been reduced equi-proportionately each year so that the forecasted subsidy provision in 2014-15 is equal to the target figure of Rs. 10,980 crore. We have not allowed for any inflation as we expect trend prices to be lower than those extant in 2006-07, not least due to the expected inhibition of cartel formation in international fertiliser supply during the Finance Commission award period.

*iii) Fuel:* The reassessed base year figure has been kept constant in nominal terms over the projection period, reflecting the need to control this subsidy if the parameters underlying the calculation (chiefly oil prices) do not change in this duration. Our assumption is that any real growth will be financed through efficiency savings.

*iv) Other subsidies:* For each of the projection years the number, equivalent to the figure in the base year, has been kept constant in nominal terms, reflecting the need for some real reduction in these subsidies.

6.30 Such reduction in subsidies is important to improve equity as well as growth in the economy. As shown in a study undertaken by National Institute of Public Finance and Policy (NIPFP), these subsidies are regressive, in the sense that in per capita terms, they are relatively higher for the higher income states. Further, large subsidies, such as in fertilisers and LPG, are likely to be regressive on an inter-personal basis also, as fertiliser subsidies are higher in per capita terms in irrigated areas and LPG subsidies are higher in per capita terms in urban areas. The reduction of these subsidies, by freeing up fiscal space, will facilitate increase in the supply of public goods such as schools, village roads and irrigation, which will lead to higher growth by inducing greater private investment.

6.31 For police expenditure, we have projected growth at an annual rate of 7.5 per cent per annum over the reassessed base year figure, given the need

to provide adequately for non-wage operational expenditure and taking into account the expected increase in the strength of the central police force.

6.32 Pensions have been projected to grow at an annual rate of 9 per cent during the award period. MoF had projected this to grow at 9 per cent for the first three years and 10 per cent for the two subsequent years. In view of the fact that the effect of increased outgo on pension has already been factored into the 2009-10 (BE) figures, we did not perceive any rationale for providing a differentiated growth rate for this item of expenditure.

6.33 Election expenditure has been assumed to be largely on account of the next general election to the Lok Sabha due in 2014-15. We have provided for 5 per cent of the base year expenditure in each year (except 2014-15) for by-elections. For 2014-15, however, in anticipation of the general election, the amount provided has been calculated by applying a 5 per cent compound growth rate to the election expenditure incurred in 2009-10.

6.34 Expenditure on other general services and economic services is projected to grow at an annual rate of 5 per cent over the reassessed base year, making full provision for inflation. Expenditure on social services is projected to grow at an annual rate of 7.5 per cent over the reassessed base year, reflecting the Central Government's intention to expand spending on human development. MoF had projected an annual growth rate of 7 per cent for other general services (including police), economic services and social services.

6.35 For each of the projection years, the 2009-10 base year figure for the non-plan grants and loans to public enterprises is assumed to remain constant in nominal terms. Non-plan expenditure of the UTs without legislature is projected to grow at the trend growth rate of 12.1 per cent, calculated for the period 2004-05 to 2008-09 (RE), over the reassessed base year.

6.36 As compared to the Centre, the states had to pay a higher effective rate of interest on the National Small Savings Fund (NSSF) loans taken till 2006-07. In order to correct this, the Commission has recommended interest relief on the NSSF loans

contracted by the states till 2006-07, with the precondition that the states will have to enact the FRL as outlined in Chapter 9. Total relief on this account amounts to Rs. 13,517 crore. The Centre has to compensate this amount to the NSSF. Accordingly, the non-plan revenue expenditure of the Centre will increase by an equivalent amount. Provision has been made for this.

6.37 All other items, viz. non-plan, non-FC grants to states and UTs; grants and loans to foreign governments; non-defence, non-plan capital expenditure; non-plan loans to states and UTs; and other non-plan loans have been assumed to grow at 5 per cent annually over the base year, thus making full provision for inflation. However, postal deficit is assumed to decline at 2.19 per cent per annum, which is also its trend rate of decline for the period 1999-2008.

6.38 In the aggregate, as per our estimates, non-plan expenditure, as a proportion of GDP decreases from 10.06 per cent in 2010-11 to 7.73 per cent in 2014-15. As per the MoF's projections, the percentage comes down from 10.74 to 8.80 during the corresponding period. Our normative projection with respect to subsidies is the major reason for this divergence.

### Plan Expenditure

6.39 In making our recommendations we have been asked to consider, among others, the demands on the resources of the Central Government, especially on account of the projected GBS to the central and state plans. In the dispensation of recent Finance Commissions, GBS emerged as a residual after fully providing for the requirements of the Centre on the non-plan revenue account. If the GBS is taken upfront as a demand on the Centre's resources, the Finance Commission transfers will have to be tailored accordingly. This, in a way, reverses the current practice of arriving at the GBS residually and alters the basic character of the Finance Commission transfers.

6.40 We have examined the matter in detail and our approach has been guided by the

methodological issues involved in first taking GBS as a demand on the resources of the Central Government and then recommending transfers to the states. Projections of GBS are available only for the Eleventh Five-Year Plan period (2007-12) and do not fully cover our award period. Further, these are not broken down year-wise and the estimates of each year are arrived at during the finalisation of the annual plans. There is a tendency to project GBS at higher than realisable levels in order to have a larger plan size. After fully providing for the projected GBS and other demands on the resources of the Centre, there may not be enough fiscal room to fully meet the requirements of the Centre on non-plan revenue account and maintain the current level of transfers to states, while bridging the gaps in the non-plan revenue accounts of the states. The requirements on the non-plan revenue account, of both the Centre and the states, being mostly committed in nature, have to be provided for in the first instance and cannot be provided for in a residual manner. There are also major problems in assessing the requirements of GBS normatively. After examining all these aspects, we are of the view that there are far too many practical difficulties in taking the GBS for plan as a demand on the resources of the Centre and that the balance of advantage clearly lies in arriving at the GBS residually, as has been the practice in the past.

6.41 The MoF memorandum projects an aggregate GBS of Rs. 23,49,515 crore during the period 2010-15. As per the Planning Commission's submission, the requirement of GBS for the same period is projected at Rs. 26,23,701 crore. Based on our assessment of revenue receipts and non-plan revenue expenditure and the FRBM path with respect to the revenue balance as spelt out in Chapter 9, the plan revenue expenditure is a residual. The capital component of plan expenditure, as explained in the next section, has been arrived at after projecting a total capital expenditure consistent with the FRBM target and adjusting for the non-plan capital expenditure determined normatively. The resultant GBS (or plan expenditure) as projected is consistent with the

estimates of the MoF and the Planning Commission. More importantly, the GBS for the last two years of the Eleventh Plan (i.e., the first two years of the FC-XIII award period) is more than the projections of the MoF for the respective years. The total GBS for these two years, taken together, is also higher than that projected by the Planning Commission. Bearing in mind the anticipated increase in the states' contribution to Centrally Sponsored Schemes in the Twelfth Plan period and the need to be prudent in the expansion of these schemes, we are of the view that this adequately provides for the Centre's GBS commitments.

6.42 Annexes 6.1 to 6.4 provide the reassessed base year estimates for 2009-10 and normative estimates for 2010-15, of the Central Government's revenue receipts and revenue expenditure.

### **Capital Receipts and Expenditure**

6.43 The major item of non-debt capital receipts for the Centre has been the recovery of loans and advances from the states. In view of the discontinuation of any further loans extended by the Centre to the states, this source of receipt will decline steadily over the years. However, disinvestment of Central Public Sector Undertakings (PSUs) remains a potent source of non-debt capital receipts and needs to be pursued actively, given the desirability of disinvestment in central PSUs to allow more space to private enterprises for the delivery of goods and services.

6.44 For PSUs which are listed, the government equity invested is valued at approximately Rs. 10,00,000 crore as per market capitalisation information for mid-October, 2009. The available estimates of the average Price/Earning (P/E) ratio and Price/Book (P/B) ratio of these enterprises stand at 22.4 and 3.4, respectively. The market value of listed nationalised banks, also in mid-October, 2009 is estimated at about Rs. 1,90,000 crore. The latest available book value and the profit/loss position for the unlisted PSUs is for 31 March 2008. This is of the order of Rs. 82,934 crore. Applying the P/E and P/B ratio of the listed PSUs, respectively to the earnings (i.e., profit/loss) and book value of the

unlisted PSUs and taking the average of the two, the market value of the unlisted PSUs is estimated at approximately Rs. 3,50,000 crore.

6.45 Assuming divestment of unlisted PSUs from the present holding of 96.79 per cent to 90 per cent to enable them to be listed, an amount of around Rs. 24,000 crore would be unlocked. Also, listing of these enterprises would enhance their quality of corporate governance. Further, for listed companies, divestment from the present holding of 84.73 per cent to 51 per cent could imply additional resources of approximately Rs. 3,41,000 crore. Similarly, for banks, bringing down the government share from the existing 60 per cent to 51 per cent would entail a resource availability in the vicinity of Rs. 17,000 crore. Thus, in the aggregate, an approximate amount of Rs. 3,81,000 crore (unlisted PSUs – Rs. 24,000 crore, listed PSUs – Rs. 3,41,000 crore, listed banks – Rs. 17,000 crore) could become available to the government. Assuming that this is pursued over five years, i.e., till 2010-15, this would provide resources to the tune of around 0.88 per cent of GDP every year on an average.

6.46 The Government of India has recently decided that disinvestment proceeds accruing to the National Investment Fund between April 2009 and March 2012 will be available for utilisation in full on capital expenditure for social sector programmes. We feel this policy is unduly restrictive and needs to be liberalised. We recommend that the proceeds should also be utilised for augmenting critical infrastructure and the natural or environmental capital of the economy. The increasing investment needs of the social sectors, such as education and health to promote inclusive growth and the infrastructure requirements of a growing economy will require greater capital expenditure. This will also 'crowd in' private investments in the economy. There are also emerging needs such as environmental protection and growing urbanisation. For instance, the new solar energy programme launched under the National Action Plan on Climate Change will require enormous investment to increase the supply of solar energy in India. Equally, there will be a need for a rapid urban transport system in almost all the major

cities. These programmes require large investments. Hence, the entire proceeds from disinvestment should be utilised to augment the budget resources of the Centre to finance the changing requirements of the public capital portfolio.

6.47 For the award period, however, we have assumed that non-debt capital receipts, including disinvestment, will increase equi-proportionately from 0.5 per cent of GDP in 2010-11 to 1 per cent of GDP in 2014-15.

6.48 One of the major under-performing assets of the government is institutional land of the central PSUs. The information provided to us on the details of the unutilised lands of central PSUs by the concerned ministries is patchy and incomplete. This highlights the need for a proper inventory of land held by the PSUs. We would strongly urge that the records of landholdings of PSUs be properly maintained so that this scarce resource is put to productive use or made available for other public projects, or else sold. Such a measure will facilitate further development projects without recourse to land acquisition and involuntary displacement.

6.49 Central Government borrowings have been projected keeping in view the FRBM target of achieving a debt-GDP ratio of 45 per cent in 2014-15. The Commission has noted with concern that the debt-GDP ratio of the Centre has been unsustainably high and feels that this should

be reined in. The issue has been discussed in detail in Chapter 9.

6.50 Based on the above estimates of capital receipts and accounting for the revenue deficit/surplus on the basis of the norms adopted for revenue receipts and revenue expenditure, total capital expenditure is projected at 3, 3.13, 3.75, 3.88 and 4.50 per cent of GDP, respectively in each of the years 2010-11 to 2014-15. Plan capital expenditure has been arrived at as a residual after providing for the normatively determined non-plan capital expenditure (i.e., the capital component of defence expenditure; non-plan loans to states, UTs, public sector enterprises and foreign governments; and other non-plan loans).

#### Summary of Recommendations

6.51 To summarise, our recommendations are:

- i) The policy regarding use of proceeds from disinvestment should be liberalised to include capital expenditure on critical infrastructure and the environment, in addition to capital expenditure on the social sectors (Para 6.46).
- ii) Record of landholdings of the PSUs should be properly maintained to ensure that this scarce resource is put to productive use or made available for other public projects, or else sold (Para 6.48).

## CHAPTER 7

# State Finances: Assessment of Revenue and Expenditure and Structural Reforms

7.1 This chapter has two parts. In the first part we have explained the methodology adopted to assess and project the revenues and expenditure of the states during our award period. In the second part we have examined those aspects which critically impact state finances and require the urgent attention of states. We have also made certain recommendations pertaining to reforms in this regard.

### A. Assessment of Revenue and Expenditure:

7.2 In the previous chapter we have analyzed the state of Union Finances and made projections for the Union Government. For a proper assessment of the required proportion of devolution from central taxes and the quantum of grants-in-aid from the Centre to the states, it is essential to assess the finances of the states and make projections thereon.

7.3 The finances of the states have experienced deterioration during the latter half of the previous decade as well as the initial years of this decade, subsequent to which the states undertook far-reaching fiscal reforms that have resulted in considerable improvement. In our assessment we have taken these fiscal reforms into consideration.

### Basic Approach

7.4 Assessing the finances of states is a challenging task because of the diverse nature of their economies as well as their expenditure needs. Keeping in mind this diversity, we have followed a normative approach to ensure that given their respective levels of fiscal capacity,

expectations of efficiency are similar across states. This would require some improvements during the award period, especially for those states that are lagging behind.

7.5 The most important variable to be projected is the Gross State Domestic Product (GSDP) of states, which forms the base for various other items like tax revenues. For the purpose of GSDP projections, we have examined the projections assumed for the Eleventh Five-Year Plan. These projections are relevant for only two years of our award period and precede the recent economic slowdown. We have, therefore, modulated the Planning Commission estimates to factor in the impact of this slowdown and the subsequent gradual recovery to arrive at the yearly estimates of GSDP for states during the award period.

7.6 We had requested the states to provide us their projections of receipts and expenditure. We find that the states have projected Own Tax Revenues (OTR) of 7.5 per cent of GSDP in the year 2014-15 as compared to 7.9 per cent in 2007-08. Similarly, they have projected Non-plan Revenue Expenditure (NPRE) at 12.8 per cent of GSDP in the year 2014-15 as compared to 12.3 per cent in 2007-08. A consolidated picture is presented in Table 7.1 and state-wise details are given in Annex 7.1.

**Table 7.1: Past Performance and Projections of the States' Receipts and Expenditure**

*(per cent of GSDP)*

	2001-02	2007-08	2014-15
OTR	6.6	7.9	7.5
NTR	1.7	2.0	1.0
NPRE	14.4	12.3	12.8

7.7 In our assessment the projections given by states do not adequately reflect the past trend or the current economic outlook. We have, therefore, decided to make our own detailed assessment of the revenue and expenditure of each state. In doing so, we have taken into consideration not only the past trend, but also recent decisions relating to the recommendations of the Sixth Central Pay Commission (CPC), which have had a significant impact with regard to the states' finances. We have adopted a normative approach for receipts and expenditure while assessing the revenue and expenditure of the states.

7.8 The basic approach followed is to assess the base year (2009-10) estimates, based on the past performance and the budget estimates of the states. On the basis of the base year estimates and the norms adopted, we have projected each item for the award period. This approach is similar to the approach followed by previous Commissions. In this part we detail our methodology and the underlying assumptions of our approach.

### Gross State Domestic Product

7.9 Gross State Domestic Product has been used as a proxy for fiscal capacity in projection of Own Tax Revenues of the states. It has also been used as the base to determine the fiscal reform path for states.

7.10 There are some differences in the methodologies for computing GSDP across states. Following the practice of past Commissions, we requested the Central Statistical Organization (CSO) for comparable figures of GSDP. They have given their estimates, which we have adopted. As is well known, GSDP is estimated at factor cost.

7.11 Comparable estimates are available for the 1999-2000 series, from 1999-2000 to 2006-07. This data has been used to obtain GSDP estimates for 2007-08, 2008-09 and 2009-10. The estimation has been carried out sectorally for each state, aggregated and then adjusted for consistency with the Gross Domestic Product (GDP) growth rates. Subsequently, a target rate of incremental growth has been fixed for each state depending on the projected growth rate for the Eleventh Five-

Year Plan, to be achieved by the terminal year. The growth rates have been fixed in each of the years of the award period so as to reach the targeted growth rate in the terminal year in such a way that the all-state GSDP is consistent with the GDP projected for the award period.

### Base Year

7.12 The comparable GSDP estimates are available till 2006-07. Our first task is to project GSDP for the base year. In order to estimate the GSDP for each state for the base year and the intervening period, the GSDP figures for the primary, secondary and tertiary sectors were projected separately for each state, and then aggregated to obtain the state GSDP. As the first step, the Trend Growth Rate (TGR) for the all-state GSDP at factor cost as well as for GDP at factor cost has been calculated separately for each sector and the ratio of TGRs of the all-state GSDP and GDP has been arrived at for each of the three sectors. This ratio has been applied to the sectoral GDP growth rate for 2007-08 to obtain the all-state GSDP growth rate for each sector, for 2007-08. This, in turn, has been applied to the all-state GSDP for 2006-07 to obtain the all-state GSDP for each sector, for 2007-08.

7.13 As the next step, the annual average growth rate for each state for each sector has been calculated for the period 2001-07. These growth rates have been proportionately adjusted with a common factor across all states in such a way that the individual state GSDP estimates for each sector for 2007-08 add up to the sectoral all-state GSDP estimated, as explained in the previous para. The sectoral GSDP figures for each state have been added to arrive at the aggregate GSDP for 2007-08. This process has been repeated for the 2008-09 and 2009-10 figures.

7.14 It has been observed that the ratio of the aggregate GSDP and GDP at market prices has been stable at 0.8 across the entire series (the ratio has a coefficient of variation of 1 per cent). To ensure consistency between the growth rates for GSDP and GDP, the aggregate GSDP figures for 2007-08,

2008-09 and 2009-10, calculated as explained in the previous para, have been further adjusted with a constant factor across all states in such a way that the ratio between the all-state aggregate GSDP and the GDP at market prices equals the average of the ratios of aggregate GSDP of all the states and the GDP at market prices. This gives us the estimates of GSDP at market prices for 2007-08, 2008-09 and 2009-10 as well as the corresponding growth rates.

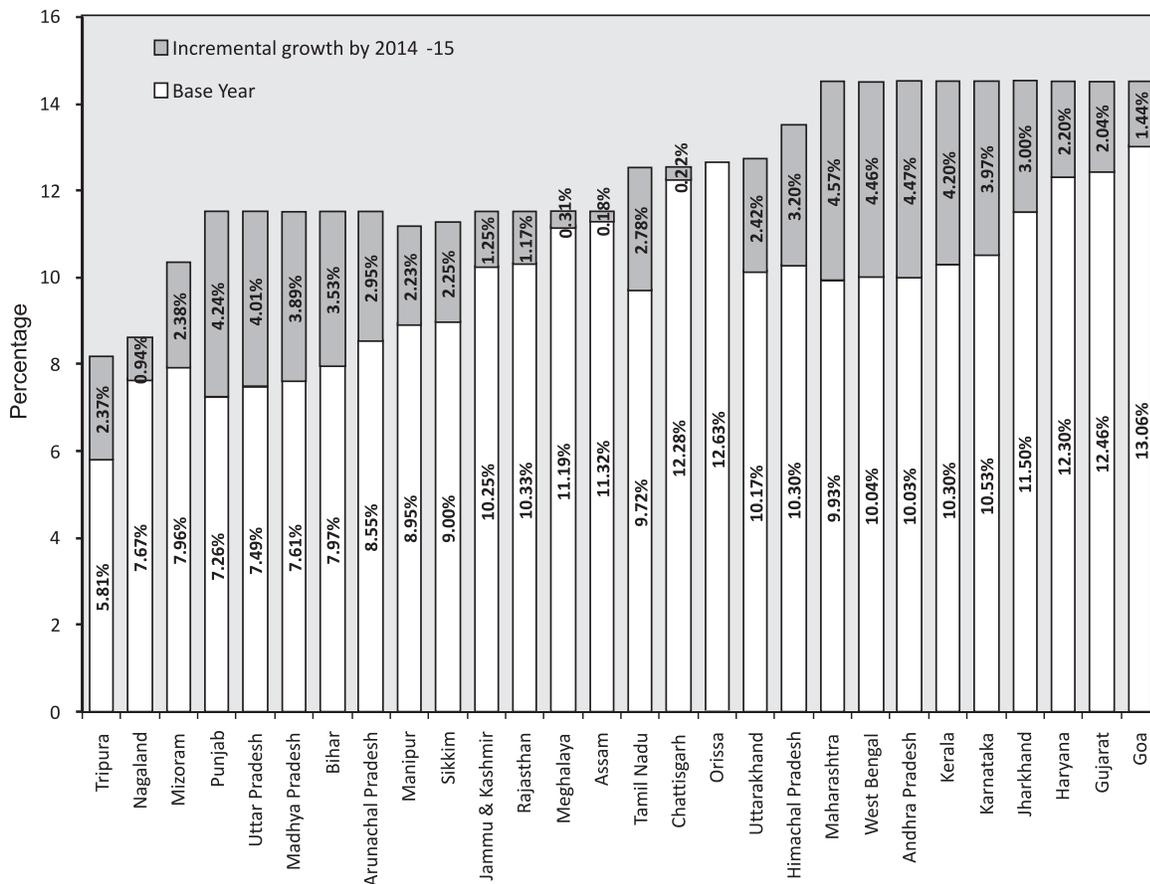
**Projections**

7.15 The Plan document for the Eleventh Five Year Plan has projected real growth rates by state for the plan period. Based on these growth rates, the states have been divided into three categories, viz. states with projected real growth rate of less than 8 per cent, states with projected real growth rate between 8 and 9 per cent, and states with projected real growth rate of 9 per cent and

above. As stated in Chapter 6, we have projected a nominal growth rate of 13.5 per cent for GDP for the terminal year. To ensure consistency with the GDP growth rate for the terminal year, the states in the first, second and third categories have been assigned terminal-year nominal GSDP growth rates of 11.5 per cent, 12.5 per cent and 14.5 per cent respectively. For special category states, the lesser of the category growth rate and TGR has been taken as GSDP growth rate for the terminal year. This may be seen from Figure 7.1.

7.16 For the period 2010-15, a growth path has been worked out such that the ratio of aggregate GSDP to GDP is held constant at the level used for estimation of the base year GSDP. The incremental growth has been distributed across states in such a way that the ratio of year-on-year improvement for each state to the total improvement to be achieved during the award period is same for all

**Figure 7.1: GSDP Projections**



the states. State-wise, year-wise projected GSDP growth rates are given in Annex 7.2.

### Own Tax Revenue

7.17 Para 6(v) of our Terms of Reference (ToR) states that: In making its recommendations, the Commission shall have regard, among other considerations, to 'the taxation efforts of the Central Government and each State Government and the potential for additional resource mobilisation to improve the tax-Gross Domestic Product ratio in the case of the Union and tax-Gross State Domestic Product ratio in the case of the States.'

7.18 Own Tax Revenue (OTR) of the states mainly comprises Value Added Tax (VAT), state excise, stamp duty and registration fee, and motor vehicles and passenger tax. The share of OTR within the own revenue resources of the states has increased in recent years.

7.19 We have analyzed and projected Own Tax Revenue together, as was done by both FC-XII and FC-XI. However, deviating from the FC-XII methodology, which used the TGR, we have made use of buoyancies for projection of the base year and have assumed an improvement path for the tax-GSDP ratio for the projection period. The reason for this deviation is that a TGR-based approach would not have captured the assumed changes in GSDP. Our GSDP estimates for the base year are lower than the trend-based estimates due to the recent economic slowdown. In other words, buoyancies are more relevant than TGR for estimation of tax growth rate in the base year in terms of ensuring that the impact of the slowdown on GSDP is translated into an equivalent impact on OTR.

7.20 Since 2005-06, the states have replaced the sales tax regime with a VAT regime. The initial negative impact of VAT on the OTR of states has been compensated by the Centre. In order to ensure that the trend is properly captured, we have treated

this compensation obtained by the states (otherwise classified as grant-in-aid to states) as OTR of states.

### Base Year Estimates

7.21 The base year estimates for OTR have been arrived at on the basis of buoyancies observed in the states over the years 2001-08. The buoyancies have been used to obtain tax growth rates for 2008-09 and 2009-10 with the help of the GSDP growth rates estimated for these years. Further, the tax growth rates for 2008-09 have been applied to the actual figures for 2007-08 to arrive at the estimates for 2008-09, upon which the growth rate for 2009-10 has been similarly applied to calculate the projected OTR for 2009-10. This figure has been compared with the budget estimates for 2009-10 and the higher of the two has been taken as the base year estimate.

7.22 FC-XII had suggested a detailed fiscal reform path to enable each state to reach the targeted revenue balances by 2008-09. All states, barring West Bengal, Punjab and Kerala, successfully achieved this target by 2007-08 itself. In the case of these three states, however, the revenue balance is seen to fall far short of their revised estimates for 2008-09, resulting in continued revenue deficits in their budget estimates for 2009-10. Other than these three states that have either not adopted a Fiscal Responsibility and Budget Management (FRBM) framework or have not adhered to it, performance of all the states has been exemplary, although to varying degrees. Keeping this in mind, we do not feel the need for any base year normative correction for OTR for them, as was done by some of the previous Finance Commissions.

7.23 However, for the three states that have not been able to eliminate revenue deficit, we observe that the budget estimates for 2009-10 for OTR are higher than the projections arrived at using the buoyancies. The budget estimates of OTR for West

Bengal, Punjab, and Kerala exceed our projections by 0.9 per cent, 1.29 per cent, and 0.77 per cent of GSDP respectively. Thus, taking the higher of the two normalises the base year estimates of these three states.

### Projections

7.24 For the purpose of projecting Own Tax Revenues of the states we have defined an improvement path for the tax-GSDP ratio of the states. While the average tax-GSDP ratio has improved from 6.6 per cent in 2001-02 to 8.4 per cent estimated in the base year, the degree of performance varies across states. Thus, there is a need to link improvement in the tax-GSDP ratio over the base year level with an attempt to close the gap between states. For this purpose we have adopted different paths for the general and special category states.

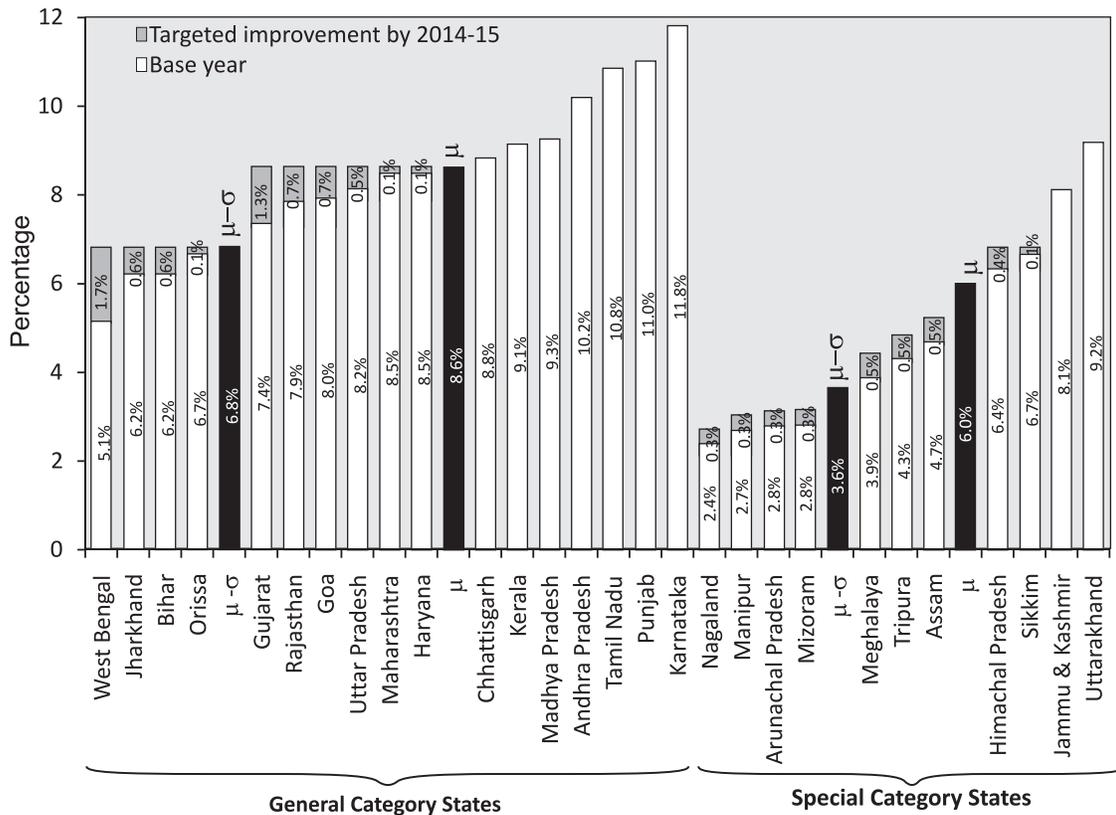
7.25 For general category states, the mean tax-GSDP ratio and standard deviation are 8.6 per cent and 1.7 per cent respectively in the base year. Within these, the highest tax-GSDP ratio is 11.8 per cent and the lowest is 5.1 per cent. Depending on their respective tax-GSDP ratio estimates in the base year, each state has been given an improvement path over the projection period, keeping in mind the need to ensure that the targeted improvement is realistic and reduces the inter-state variation in tax-GSDP ratios. For this purpose the states have been divided into three groups: those with tax-GSDP ratio above the mean, those less than one standard deviation below the mean and those more than one standard deviation below the mean.

7.26 The states with tax-GSDP ratio more than one standard deviation below the mean, viz. West Bengal, Jharkhand, Bihar, and Orissa, have been projected to reach the 'one standard deviation below the mean level' by the end of the projection period with equal annual adjustments. Similarly, the states with tax-GSDP ratio less than one

standard deviation below the mean, viz. Gujarat, Rajasthan, Goa, Uttar Pradesh, Maharashtra, and Haryana, have been projected to reach the mean level by the end of the projection period with equal annual adjustments. For the rest of the states, i.e., those with tax-GSDP ratios above the mean, the tax-GSDP ratios have been projected to remain at their base year levels during the projection period, thereby implicitly assigning a buoyancy of one. With this, the mean tax-GSDP ratio for general category states for the terminal year will improve to 8.9 per cent and the standard deviation will reduce to 1.4 per cent.

7.27 For special category states, the mean and standard deviation in the tax-GSDP ratio for the base year are 6 per cent and 2.3 per cent respectively, with the maximum at 9.2 per cent and minimum at 2.4 per cent. The special category states have a lower mean and higher standard deviation as compared to the general category states, since these states have wide variations in their tax capacities and composition of GSDP. All north-eastern states except Sikkim fall below the mean. The states with tax-GSDP ratio more than one standard deviation below the mean, viz. Nagaland, Manipur, Mizoram, and Arunachal Pradesh, are all hilly states with limited tax potential. These states have been projected to improve their tax-GSDP ratio by 0.3 per cent by the terminal year with equal annual adjustment. The states with tax-GSDP ratio less than one standard deviation below the mean, viz. Tripura, Assam, and Meghalaya, are slightly better off in terms of economic capacity and tax potential and have been projected to improve their tax-GSDP ratio by 0.5 per cent by the terminal year with equal annual adjustments. Of the remaining states, i.e., states with tax-GSDP ratio above the mean, those which are below the lowest level required to be achieved by any general category state ( $\mu - \sigma$  of general category states) are projected to reach that level by the terminal year with equal annual improvement. The ratios for the rest of the states are projected to remain constant at their base year levels during the projection period. With this, the average

Figure 7.2: Tax-GSDP Ratio



tax-GSDP ratio will improve to 6.3 per cent and the standard deviation will reduce to 2.2 per cent by the terminal year. The levels of base year tax-GSDP ratios and the improvement envisaged may be seen in Figure 7.2. The state-wise projected tax-GSDP ratios for each year is given in Annex 7.3.

7.28 One of the upcoming tax reforms that will impact the tax structure at the state level is introduction of Goods and Services Tax (GST). With introduction of GST, various state level taxes will get subsumed in it. There would be major reshuffle in the tax bases of both the Centre and states consequent to introduction of GST. However, since the proposed GST will be revenue neutral, our projections shall not get affected by it.

### Own Non-tax Revenues

7.29 Own Non-tax revenues of states comprise receipts from a variety of sources including interest

on loans extended by the State Governments, return on investments made, royalty from minerals, forestry and wildlife, commercial operations undertaken by the states, user charges from irrigation and other services.

7.30 Most of the items have been assessed on trends based on data for the years 2001-08. This period has been chosen to avoid complexities due to bifurcation of three of the states.

7.31 For the purpose of estimating non-tax revenues in the base year, receipts under general, social and economic services have been disaggregated. Within these, items which are major contributors to the states' own non-tax revenues or those which do not follow the general pattern, have been further disaggregated and projected. These are interest receipts, dividends and profits, lotteries, miscellaneous general services, elections, royalty, forestry and wildlife and irrigation.

7.32 In the course of this exercise, we have made suitable adjustments in the data for the years 2001-08 to ensure uniformity across states as well as across years within a state. While some states have departmentally run power, transport and dairy utilities, some have statutory boards and yet others have corporatised entities for provision of these facilities. Thus, in some cases, transactions from power, transport and dairy enter the consolidated fund, while in other cases they don't. To ensure uniform comparability, receipts from power, transport, and dairy have been removed from the data series (the same as has been done for expenditure under these heads).

7.33 For lottery operations gross receipts are accounted as Own Non-tax Revenue of the states and gross expenditure is accounted as non-plan revenue expenditure. This leads to a notional increase in both receipts and expenditure of the states and also introduces year-to-year volatility. To ensure that these changes do not affect projections, net lottery receipts (receipts net of payments) have been taken under receipts.

7.34 The amount of debt waived under the Debt Consolidation and Relief Facility (DCRF) recommended by FC-XII has been accounted as non-tax receipts under 'miscellaneous general services' in the finance accounts. This item is not shown separately in finance accounts, but indicated as a footnote, and that too, not uniformly. Thus, instead of taking the figure of debt waiver from finance accounts of states, we have used the corresponding figure provided by the Ministry of Finance and deducted this amount to ensure that it does not get captured in either the trend or the base year.

### Interest Receipts

7.35 We have observed that the current level of recovery on loans advanced by the states is extremely poor. Therefore, we have projected the interest receipts of states on a normative basis without linking it to the current level.

7.36 In order to project interest receipts, the loans outstanding at the end of 2009-10 have been estimated by adding the revised estimates and budget estimates of loans and advances made

during the years 2008-09 and 2009-10 respectively, to the loans outstanding at the end of 2007-08 as reported in the finance accounts, and subtracting the recoveries made in these two years. The outstanding loans and advances at the end of 2009-10 have been projected as constant over the projection period. An interest rate of 7 per cent has been applied to these outstanding loans and taken as the interest receipt in each of the years.

7.37 The interest rate is chosen such that it is lower than the average cost of funds for the state, yet allows a positive real interest rate. This has been done because most of these loans have been extended to state PSUs, and in some cases the states may have decided to provide an implicit subsidy. In addition some of these could be short term loans bearing lower interest rates.

### Dividends and Profits

7.38 Similarly interest receipts, dividends and profits on government investments have been projected normatively on the basis of level of investment. Past levels of return on investment, which have largely been dismal, have been ignored. We have projected dividends and profits at 5 per cent on the total amount of investment as at the end of 2007-08, including those in power utilities, as reported in the finance accounts and held constant over our award period.

### Elections

7.39 Receipts from elections have been considered as a five-year block (2010-15). Projections for receipts for each year in this block have been made on the basis of receipts of the corresponding years in the previous block (2005-10) by applying a 5 per cent increase successively for five years. Thus, projections for 2010-11 were arrived at by assuming 5 per cent growth for five years over the receipts for the year 2005-06.

### Lotteries and Miscellaneous General Services

7.40 Within general services, receipts under 'miscellaneous general services' do not include a uniform set of items across states. This head

includes receipts from lottery operations for the states that have online or paper lotteries, and has, thus, been deducted and treated separately. For lotteries, the higher of net receipts in 2009-10 (BE) and average of 2006-07, 2007-08 and 2008-9 (RE) has been taken as the base year estimate and has been held constant, in nominal terms, over the projection period.

7.41 Receipts from 'other miscellaneous general services' also include the amount of debt waiver received by the states under the DCRF scheme, which has been deducted, as explained earlier. However, it is observed that the year in which these receipts have been booked in the finance accounts of a state may differ from the year in which MoF has made the releases. To nullify the effect of any mismatches we have taken the average of 2005-06 to 2008-09 (RE) as the base year estimate for 'other miscellaneous general services'. Since this covers the entire period during which debt relief has been provided, all entries get accounted for. For the projection period we have assumed a growth of 5 per cent.

### Royalties

7.42 For the purpose of estimating royalties from minerals, we have taken the higher of 2009-10 (BE) and average of 2006-07, 2007-08 and 2008-09 (RE) as the base year estimate. There has been a major shift in the policy for levy of royalty on coal and lignite as well as on major minerals, changing from specific to partial/full *ad valorem* basis. The policy change for coal and lignite occurred earlier and its impact has been captured in the receipts of the states.

7.43 However, royalties on other major minerals may not have been accounted for in the 2009-10 (BE) figures as the shift to *ad valorem* regime took place only around mid-2009. For this purpose, estimates of receipts of royalties from major minerals, other than coal and lignite, were sought from the Ministry of Mines, GoI for the period 2009-15. The amount shown for each state in 2009-10 has been deducted from their base year estimates and the residual, including royalty from minor minerals and coal and lignite, has been projected to grow at the rate of 5 per cent. To this, the projections provided by the Ministry of Mines for all major minerals other than

coal and lignite have been added under the relevant year. Further, the projections of receipts from royalties on upcoming on-shore oilfields and the share in profit petroleum as indicated by the Ministry of Petroleum have also been added.

### Power

7.44 As stated earlier in this chapter, the power sector is run departmentally in some of the states, while in others, it is run through statutory boards/corporations. To ensure uniformity across states, receipt and expenditure of the power sector has been removed for making projections. Some states have projected revenues from power sector for the award period; others have not provided these separately. We have projected these revenues on the basis of a detailed study sponsored by the Commission for the award period and added to the non-tax revenues of the relevant states. This revenue would accrue from sale of surplus power available to states after taking into account their own power requirements.

### Forestry and Wildlife

7.45 Receipts from forestry and wildlife for the base year have been taken to be the higher of 2009-10 (BE) and average of 2006-07, 2007-08 and 2008-09 (RE). During the projection period, we have held the receipts constant at the base year level in nominal terms in order to take account of the current restriction on extraction of forest resources.

### Irrigation

7.46 Receipts from irrigation have been estimated on cost recovery basis. The current level of recovery from irrigation projects is at 23 per cent of the non-plan revenue expenditure on irrigation, which is very low and needs to be improved in order to ensure viability of irrigation projects. Keeping this in mind, we have normatively enhanced receipts from irrigation from 25 per cent of NPRES on irrigation in 2010-11 to 35 per cent in 2011-12, 45 per cent in 2012-13, 60 per cent in 2013-14 and 75 per cent in 2014-15.

### Other Non-tax Revenues

7.47 The residual items under each service have been projected together. To arrive at the base year

estimates, the 2007-08 actuals have been projected to grow at the 2001-08 TGR for each service, for each state. These estimates have been compared with 2009-10 (BE) figures and the higher of the two has been taken as the base year estimate.

7.48 For the projection period, receipts under other general services, social services and other economic services have been projected to grow at 8 per cent, 12 per cent and 13 per cent respectively, which are the 2001-08 all-state Trend Growth Rate (TGR) of aggregate receipts under these categories after excluding certain outlying states.

7.49 All the above items have been added to arrive at the projections of non-tax revenues of the states.

### **Non-plan Revenue Expenditure**

7.50 Non-plan revenue expenditure (NPRE) of the states has been projected in a manner similar to that of the non-tax revenues. Some of the significant items, viz. salaries, pensions, interest payments, food subsidy, committed liabilities and maintenance expenditure for roads and irrigation projects, have been projected separately while the remaining items have been projected in aggregate.

7.51 We have used expenditure data for 2001-08 (post-bifurcation of the three states) while estimating the NPRE of states.

7.52 Some adjustments have been made in the 2001-08 data series for NPRE to ensure uniformity in data across states. Expenditure on power, transport and dairy has been removed, as in the case of receipts, in order to ensure that states where these sectors are run departmentally are brought on the same footing as the states that have separate boards/corporations/companies providing services in these sectors. Further, in our assessment we have not taken into consideration any subsidies in these sectors. Only food subsidy has been projected on a normative basis. Expenditure on calamity relief has been removed as the needs of states on this account have been assessed separately.

7.53 'Contra-entries' and 'transfer from and to funds' are those entries in the accounts that do not have any cash outgo but are adjustments either

between one head of account and another (within the consolidated fund) or from the consolidated fund to the public account. These entries, except those relating to Consolidated Sinking Fund and Guarantee Redemption Fund, have been removed from the NPRE series. These funds were created by most states as per the recommendation of FC-XII, and in order to ensure consistency, we have taken transfers to them into consideration in our assessment. However, in case the fund has been closed at any point of time, all transfers in this regard for the previous years have also been removed from the data series.

7.54 We have come across cases where receipts of states that should have been credited to the consolidated fund have been credited to funds maintained outside the consolidated fund. These resources have been used for activities that are primarily the responsibility of the respective State Governments. Such a practice is not transparent and should be discouraged. Hence, these receipts and expenditure have been treated as if they were taking place through the consolidated fund.

7.55 We have deducted the average non-plan grants other than FC grants received during the three year period (2005-08) from expenditure under 'other general services' since these grants are not projected on the receipt side. Of the Finance Commission grants, non-plan revenue deficit grant and grants for education and health were in the nature of gap filling grants, acknowledging that the current level of expenditure is low and needs to be augmented and, thus, have not been deducted from the data series. State-specific grants are for expenditure items that are more in the nature of capital projects and, in addition, are difficult to capture under the exact expenditure head, and have thus not been deducted either. Grants for local bodies have also not been deducted since these have not always been accounted for under the heads recommended by the Controller General of Accounts (CGA), a problem that we have addressed in Chapter 10. The remaining grants, as released from 2005-06 to 2008-09, have been deducted from the relevant heads in the 2001-08 data series of the states.

## Salary

7.56 Salaries and pensions, two of the major items of expenditure of State Governments, are expected to be substantially impacted consequent to the award of the Sixth CPC. FC-XI had faced a similar situation in the context of the Fifth CPC. In its assessment, FC-XI had assumed that any change expected on account of implementation of the recommendations of the Fifth CPC had been captured in the base year expenditure, and hence, used the trend growth rate to make its projections. Further, FC-XI had recommended that there was no need to routinely appoint a Pay Commission at 10-year intervals. It had also observed that since the recommendations of the CPC had a bearing on the finances of states, they should be consulted on the ToR whenever such a Commission is appointed.

7.57 A strict interpretation of the role of the CPC and its impact would be that its recommendations are only for Central Government employees, which the states are not obliged to follow; the states have the freedom of option with regard to these recommendations in view of their own resources and their ability to pay. The joint memorandum of states presented to us, as well as individual memoranda of State Governments, strongly emphasised that the decisions of the Central Government with regard to the recommendations of the Sixth CPC would have immediate implications on the pay structure of State Government employees, and consequently, on state finances. The State Governments have urged that this Commission should provide assistance to the extent of at least 50 per cent of the additional financial burden on states on this account. On the basis of past trends as well as ground realities, we are persuaded by the argument that our assessment of states' expenditure needs to take into account the impact of the pay revisions across states arising out of the implications of the Sixth CPC. However, we do not recommend any specific grant for this purpose.

7.58 We have observed that the states have either followed the recommendations of the Sixth CPC or revised their pay scales in light of these recommendations. For the purpose of our projections, a uniform normative set of parameters

has been adopted across all states. We have assumed that the revised pay scales have been implemented from 1 April 2009, with retrospective effect from 1 April 2006.

7.59 The most important aspect in this exercise is to capture the likely one-time increase in salary expenditure on implementation of the revised pay scales. To project the salary expenditure of states, the number of employees in each group (A, B, C and D) have been projected at a net attrition of 1 per cent per annum assumed on the basis of the observed trend over the past five years for select states and for the Central Government. Within each group, the mean pay for all scales has been assumed as the basic pay for the group. The median grade pay for all grades within a group has been assumed as grade pay for all employees in that group. This has been used to calculate the ratio of grade pay to basic pay over the projection period from the date of implementation. Allowances have been assumed to be at the rate of 18 per cent, taking into account the nature of allowances paid by the states. The Dearness Allowance (DA) rates, as announced by the Central Government, have been adopted in the assessment.

7.60 Based on the above parameters, it has been found that, on an average, the one-time increase in salary expenditure is 35 per cent in 2006-07. The growth in salary expenditure in subsequent years has been estimated at 6 per cent taking into account annual increment of 3 per cent, annual increase in DA rate of 6 per cent, and assumed attrition of 1 per cent. This has been used for projecting the revised salary expenditure of states for the projection period as well the notional pre-revised salary for 2006-10.

7.61 We find that there is a difference in the manner in which the salary of local body employees, to the extent to which it is borne by the states' budgets, is being accounted for across states. While some states show it as salary expenditure, others book it as grant-in-aid or other expenditure. To ensure uniformity, we have added the expenditure of State Governments on the salaries of local body employees, whatever may be the manner of accounting, to the government salary expenditures

as reported in the finance accounts. While doing so, certain normative adjustments have been made to ensure that per employee, per month salary, is capped at the level of the average for all states.

7.62 FC-XII had recommended that the states should follow a recruitment policy such that salary expenditure does not exceed 35 per cent of revenue expenditure net of interest payments and pensions. We have limited the impact of pay revision to salary expenditure within this normative ceiling and the expenditure over and above the ceiling has been successively reduced by 10 per cent of the amount every year.

7.63 Our exercises in normalisation have attempted to capture state specific situations. Newly created states of Chhattisgarh, Jharkhand and Uttarakhand drew our attention to the fact that they have faced severe staff shortages since the bifurcation of the state cadres. Acknowledging this fact we have assumed a net increase of 1 per cent in the working strength for these states as against 1 per cent attrition in other states, while projecting their salary expenditure. Another exercise has been carried out for states such as Karnataka and Kerala, whose own Pay Commissions' recommendations were implemented during the period 2001-08. For these states, their last pre-State Pay Commission salary has been projected to grow at 6 per cent to arrive at the 2006-07 salary expenditure, whereafter, the common procedure outlined in Para 7.60 has been adopted.

### **Pension**

7.64 Estimating pension payments by adopting the procedure used for salary is difficult because data on pensioners and their profiles is generally not available. We have calculated the impact of pension revisions post-Sixth CPC on state finances by assuming that the ratio of the impact would be the same as that in the case of the Fifth CPC between central and state pensions. The impact of pension revisions after implementation of Sixth CPC on central finances without arrears has been estimated at 23 per cent in 2008-09 over the pension bill of 2007-08. Applying the ratio thus

worked out, the impact on state pensions is estimated to be 21 per cent.

7.65 Thus, pension payment for the base year has been estimated at 21 per cent over the 2008-09 pension payments, arrived at by applying TGR over the actual figure for 2007-08. Pension payments post-2009-10 have been projected to grow at 10 per cent. For states having their own Pay Commissions, a procedure similar to that adopted for salaries has been adopted.

### **Arrears**

7.66 While the treatment of State Pay Commission (SPC) recommendations has been, more or less, uniform across all states, the treatment of arrears varies widely. Some states have decided to stagger payments, while the total amount of arrears has been paid in some other states. Further, the amount of arrears is a function, not only of the structural changes in pay, but also of the time lag between the effective and actual dates of implementation. While, payment of the arrears may fall partially within the projection period, these actually pertain to expenditure for a prior period. Due to these factors it is not possible to assess the liability of states on account of arrears on a uniform normative basis. We have, therefore, decided not to include arrears in our assessment of NPPE of states.

### **Interest Payments**

7.67 Interest payments have been projected on the basis of the debt stock indicated in the fiscal reform path shown in Chapter 9. For the years 2008-09 and 2009-10 the lower of Revised Estimates (RE) or 3.5 per cent of GSDP and Budget Estimates (BE) or 4 per cent of GSDP respectively, has been taken as the fiscal deficit for projection of debt stock.

7.68 The debt stock has been divided into three components. The breakup of the outstanding debt stock at the end 2009-10 for each state is given in Annex 7.4. The first component, non-interest bearing loan, has been pegged at the 2007-08 levels in nominal terms on the assumption that the fiscal deficit will be financed only through borrowings.

Any increase in non-interest bearing debt would not be due to the fiscal deficit. This component has been deducted from the debt stock for purposes of projecting interest payments.

7.69 Out of the interest bearing debt, the borrowings with the highest cost are the loans from the National Small Savings Fund (NSSF). Within the outstanding debt stock of NSSF loans of Rs. 4.3 lakh crore, Rs. 4.1 lakh crore pertains to loans contracted till 2006-07, for which we have recommended an interest rate of 9 per cent (Chapter 9). The remaining stock of Rs. 20,000 crore carries an interest rate of 9.5 per cent, implying an effective rate of 9.02 per cent on the entire stock of NSSF loans. We have used this rate to estimate interest payments on the NSSF loans. Gross collection under NSSF has dropped in recent years and net collection for 2008-09 has been negative. In line with the institutional reforms recommended by us in Chapter 9, we have assumed that there would be no net addition to the debt stock of NSSF for the base year and the projection period.

7.70 The remainder of the debt stock comprises open market loans, loans from the Centre, and loans from financial institutions such as National Bank for Agriculture and Rural Development (NABARD), Life Insurance Corporations (LIC)/General Insurance Corporations (GIC). Central loans have been consolidated at 7.5 per cent by FC-XII, which is also the interest rate for most of the market loans. Rural Infrastructure Development Fund (RIDF) loans are cheaper, while some of the negotiated loans may carry an interest rate marginally higher than 7.5 per cent. Thus, for this component of the stock, we have assumed an interest rate of 7.5 per cent. Based on the projected debt stock and the interest rates assumed, the interest payments have been calculated for each state for each year in the projection period.

### **Elections**

7.71 As in the case of receipts, expenditure on elections does not follow an annual trend, and has been projected as a five year block (2010-15). Projections for expenditure in each year for this block have been made on the basis of the

expenditure in the corresponding year of the previous block (2005-10) by providing 5 per cent increase compounded annually for five years. Thus, projections for 2010-11 were arrived at by assuming 5 per cent growth for five years over the receipts for the year 2005-06.

### **Compensation and Assignment to Local Bodies**

7.72 Compensation and assignment to local bodies pertain to one major head of account, namely 3604. This item contains transfer of funds from the states to their local bodies and, in most cases, is governed by the decision on implementation of award of the respective State Finance Commissions (SFC). Thus, we have assumed that the budget estimates would be as per the decisions taken regarding SFC awards and have thus been adopted as the base year estimate. To enable real increase, 8 per cent growth has been projected on the base year over the projection period.

### **Committed Liabilities**

7.73 Para 6(ix) of the ToR requires the Commission to consider the following while making its recommendations: '... 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 31<sup>st</sup> March, 2010 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.'

7.74 The expenditure on operation and maintenance of plan schemes completed by the end of a plan period becomes a 'committed' liability on the non-plan account from the following year. As per the guidelines of the Planning Commission, maintenance expenditure of completed plan schemes is transferred to the non-plan revenue account at the end of the relevant Five-Year Plan. States find it difficult to incorporate this expenditure in their projected non-plan revenue expenditure since: (i) Finance Commission award and Five-Year Plan periods are not co-terminus; (ii) the task of identifying completed schemes and

estimation of their committed liabilities across various departments of a state is an elaborate and time consuming exercise and (iii) there is a perceived risk of resources for the plan shrinking and the plan size coming down. Thus, there is a need for separate assessment of these liabilities.

7.75 On the lines of previous Finance Commissions, we have estimated maintenance expenditure for capital works, i.e., on maintenance of irrigation projects, and roads and bridges separately in paras 7.82 to 7.85 of this chapter and discussion in this section is confined to maintenance expenditure arising out of plan revenue expenditure.

7.76 The important parameters in estimating the maintenance expenditure of completed plan schemes are the relevant years of the award period for which such expenditure needs to be provided, norms for projecting the expenditure, treatment for special category states and liabilities arising out of maintenance of assets created under Centrally Sponsored Schemes (CSS).

7.77 The ToR require us to take into consideration the non-wage related maintenance expenditure on plan schemes to be completed by 31 March 2010. As the Eleventh Plan will conclude in 2011-12, we feel there is no need to factor in the maintenance expenditure for the first two years of our award period. We, therefore, propose to take into account the requirement of states for maintenance of plan schemes to be completed during the Eleventh Plan for the period 2012-13 to 2014-15. Such an approach is consistent with that adopted by the previous Commissions.

7.78 Assessing the expenditure on committed liabilities of the completed plan schemes has been problematic due to lack of accurate information from the states. The information received from the states was widely varying and, *prima facie*, not reliable. Thus, we have adopted the norm of 30 per cent of the plan revenue expenditure of states assessed for the year 2011-12 to estimate the committed liabilities in accordance with the practice of recent Finance Commissions. For assessing the plan revenue expenditure of the

states for 2011-12, the last year of the Eleventh Plan, the plan revenue expenditure in 2008-09 (RE) has been projected to grow at 10 per cent, which broadly reflects the long term trend growth rate of plan revenue expenditure of the states. Thirty per cent of this plan revenue expenditure has been adopted as maintenance expenditure for 2012-13, which has been projected to grow at 5 per cent in 2013-14 and 2014-15.

7.79 Special category states have highlighted the problems faced by them in transferring maintenance expenditure of completed schemes to the non-plan account, mainly due to low provision of committed liabilities while assessing their non-plan revenue expenditure in the past. The decision of previous Finance Commissions in this regard was based on the fact that these states are allowed to divert 20 per cent of the Normal Central Assistance (NCA) under the plan to meet non-plan expenditure. The current practice of meeting the committed liabilities by way of utilisation of 20 per cent of NCA under state plans is non-transparent and has led to many states often not transferring the committed expenditure to the non-plan side and has also led to a lower real plan expenditure of these states. Further, not providing for committed liabilities in these states results diversion of their legitimate allocated plan assistance for non-plan purposes making the entire planning process less transparent. Therefore, we have treated these states on par with general category states for the provision of committed liabilities. We also recommend that, with adequate provision for committed liabilities, the practice of diversion of plan assistance to meet non-plan needs of special category states should be discontinued to leave these states with adequate plan expenditure.

7.80 States are mandated to not only share the cost of implementing the CSS, but also to maintain such schemes upon completion. We feel that committed liabilities arising out of these schemes should be included in their NPRES to ensure that the gains of these schemes are not lost. However, as noted by some previous Commissions, there is need to make suitable adjustments for those CSS which are likely to continue in the next plan and, therefore, have no significant implications for non-

plan expenditure. The major schemes in this category are Sarva Shiksha Abhiyan (SSA), National Rural Health Mission (NRHM), Indira Awas Yojana (IAY) and Integrated Child Development Scheme (ICDS) which have a long term development perspective and are likely to continue during our award period. Only the states' contribution is reflected in the state budgets for SSA, NRHM, and IAY while the central share towards these schemes flows directly to the executing agencies. In case of ICDS the entire scheme allocation is reflected in the state budgets as central funds are also routed through the states' consolidated funds. Budgetary allocations for 2008-09 for the four schemes mentioned above have been excluded from the plan revenue account of 2008-09 (RE) of each state for projections as detailed in Para 7.78. The projected committed liabilities for each state is given in Annex 7.5.

7.81 The ToR require us to consider only non-wage related expenditure for the completed plan schemes. The states have expressed the view that with emphasis on social infrastructure, plan schemes in this sector involve large wage related expenditure and that the states would not be able to afford maintenance expenditure for such schemes. They have also drawn our attention to the fact that no distinction is made between the wage and non-wage components of the committed liabilities of the Centre. After due consideration of the matter, we have decided not to make a distinction between the wage and non-wage component of maintenance expenditure of the states in order to ensure that the sustained delivery of public services created under the plan schemes is not disrupted. Such an approach would also ensure symmetry in treatment between the Centre and the states on this issue.

### **Irrigation**

7.82 For projecting the maintenance expenditure on irrigation schemes (major heads 2700, 2701 and 2702), norms were obtained from the Ministry of Water Resources (MoWR). The ministry suggested an amount of Rs. 1500 per hectare for major and medium surface irrigation and Rs. 3000 per hectare for lift irrigation schemes for the utilised potential

as maintenance expenditure. While the ministry suggested separate norms for maintenance of surface and lift irrigation schemes, the breakup of irrigation potential into these two categories of schemes was available only for two states. Thus, it would be difficult to adopt norms separately for flow and lift irrigation schemes. Given the need for adequate provision for maintenance of irrigation schemes, we have adopted the norm of Rs. 1175 per hectare for the utilised potential and Rs. 588 per hectare for the unutilised potential for major and medium irrigation schemes respectively, in the base year, implying a step-up of 52 per cent from the norms adopted by FC-XII. After adjustment for inflation, with an annual growth of 5 per cent thereafter, these would reach the level of Rs. 1500 per hectare for utilised and Rs. 750 per hectare for unutilised potential in the terminal year of our award period.

7.83 For minor irrigation works, the ministry suggested an expenditure norm of two-thirds of that for major and medium irrigation schemes. We have restricted this to half, in pursuance of the practice adopted by previous Finance Commissions. Accordingly, we have provided the norm of Rs. 588 per hectare in the base year for only the utilised potential of minor irrigation schemes and have ignored the unutilised potential as being insignificant. For special category states, the ministry had suggested a step-up of 60 per cent on the maintenance norms. However, drawing upon the practice of our predecessors, we have allowed a 30 per cent step-up on these norms for the special category states.

7.84 We have used state-wise utilised and unutilised potential, as reported by the MoWR at the end of the Tenth Plan, to work out maintenance expenditure. For each state, the norm-based estimates for 2009-10 have been compared with those of 2009-10 (BE), and the higher of the two has been adopted as the base year estimates to ensure that the current level of expenditure is retained in the case of states that are spending more. An annual growth rate of 5 per cent has been applied over the base year estimates so worked out to generate projected expenditure levels in the forecast period. The projected NPPE on irrigation for each state is given in Annex 7.6.

## Roads and Bridges

7.85 Maintenance of roads and bridges has been projected for the base year as part of the overall economic services, i.e., expenditure in 2007-08 has been projected to grow on the basis of TGR to arrive at the 2009-10 estimates. While doing so, the grants provided by FC-XII, as released in each of the relevant years, have been deducted from the expenditure to eliminate their impact on expenditure. The base year amount has been projected to grow at 5 per cent for general category states and a higher rate of 7 per cent for special category states.

## Food Subsidy and Other Non-plan Expenditure

7.86 As stated in Para 7.52, we have not taken the states' expenditure on subsidies in our assessment. However, a normative amount of food subsidy has been added to the NPRE of states. Food subsidy has been provided at Rs. 20 per capita per year for each of the years in the projection period, calculated on the basis of the population projected for 2008.

7.87 Other non-plan revenue expenditures under each service have been projected at the respective 2001-08 TGR or 7.5 per cent, whichever is higher, to reach the base year level.

7.88 We have deliberated upon the question whether to give differential rates of growth for each service or a common growth rate for all services during the projection period. The line between expenditure booked under different services is becoming blurred and high priority expenditure sectors are uniformly spread across services. For example, while items like police and judiciary fall under general services; education and health are under social services. Similarly, while urban development is under social services; rural development, agriculture and related services are booked under economic services. We have also noted that many items of expenditure are not uniformly booked under the same head of account across states and that the practice varies from state to state.

7.89 Therefore, we feel that it would be proper to aggregate all the residual items and project them to grow at a rate of 8 per cent, which is higher than the assumed price rise but less than the nominal GSDP growth rate.

## Summary of Assessment

7.90 Based on our assessment of revenue and expenditure of states, the pre-devolution non-plan revenue deficit has been worked out for each state. The summary of the assessed revenues and expenditure of states is given in Annex 7.7. The all-state picture of the assessed revenue and expenditure is given in Table 7.2.

**Table 7.2: Summary of Assessment**

	<i>(per cent of GSDP)</i>				
	2010-11	2011-12	2012-13	2013-14	2014-15
ORR	10.10	10.13	10.14	10.17	10.19
NPRE	10.62	10.15	10.57	10.06	9.59
Gross Pre - devolution Deficit	1.76	1.45	1.61	1.31	1.06
Gross Pre - devolution Surplus	-1.24	-1.43	-1.18	-1.42	-1.66
Net Pre - devolution Deficit	0.52	0.02	0.43	-0.11	-0.6

7.91 The aggregate pre-devolution non-plan revenue deficit of the states reduces from 0.52 per cent of GSDP in 2010-11 to -0.6 per cent in 2014-15. This has primarily been on account of overall improvement in the tax-GSDP ratio and reduction of NPRE as a percentage of GSDP. We have based our recommendations for grants-in-aid to cover the post-devolution non-plan revenue deficit in Chapter 12 on this assessment.

## B. Structural Reforms at the State Level:

7.92 Para 6 (iv) of our ToR requires us to consider the objective of not only balancing the revenue account but also generating surplus for capital investments. In addition, Para 6 (x) of the ToR requires us to consider the need for ensuring commercial viability of certain important sectors such as irrigation and power, and of departmental undertakings. There are certain areas that urgently need reforms to ensure that their impact on the

economy and state finances is positive. Reforms in these areas are critical for any fiscal reform programme to succeed. Issues relating to irrigation have been covered by us in this chapter in our projections for receipts and expenditure, and also in chapters 4 and 12. In this section we elaborate on the current status of State Public Sector Undertakings (SPSU), the power sector and other aspects which impact state finances.

### **Performance of State Public Sector Undertakings**

7.93 The total turnover of 1160 State PSUs was Rs. 3.07 lakh crore in 2007-08, representing about 6 per cent of GDP. The aggregate investment in these PSUs is about Rs. 3.69 lakh crore comprising Rs. 1.41 lakh crore in equity and Rs. 2.28 lakh crore in loans from all sources. They employ over 18 lakh persons. They thus occupy an important place in the national economy. However, their operations have not been encouraging. They incurred an aggregate loss of Rs. 5930 crore in 2007-08. Their accumulated loss stands at Rs. 65924 crore. PSUs of only nine states have earned aggregate profits. Some states have been reporting losses of more than Rs. 2,000 crore per annum on account of PSUs. States need to assess the viability of their loss making PSUs and identify those functioning in non-core areas for closure.

### **Finalisation of Accounts**

7.94 An essential requirement for identification of viability is the availability of audited financial accounts of state public sector undertakings as well as other companies which get substantial support as grants-in-aid from the government. During our visits to the states, we have come across certain disturbing features. Despite their statutory obligations to finalise their accounts and lay them before the Annual General Meetings (AGMs) within six months of the close of the financial year, there is a huge deficit in compliance. More than 70 per cent of the state PSUs have their accounts in arrears. There were 2329 annual accounts in arrears from 607 working state PSUs as of September 2008. It is disturbing that the accounts arrears in respect of

working PSUs is increasing, indicating their inability to finalise at least one account per year. A more disquieting feature is that state governments continued to invest significant sums (Rs. 49,237 crore as on September 2008) in working PSUs whose accounts were in arrears without any assurance in the form of audited accounts that their continued investments were being properly utilised and accounted for. The position in respect of non-working companies is worse. In one state, audit of PSUs is pending from as early as 1992-93. We have come across a public sector undertaking whose accounts have not been finalised for the past 37 years. Such a position is extremely detrimental to financial accountability as well as fiscal transparency. Keeping in mind the contingent liabilities of the State Governments on account of these PSUs, any future switchover to accrual accounting will be dependent upon such a problem being tackled upfront.

7.95 We therefore recommend that:

- i) All State Governments should proactively ensure clearance of the accounts of all PSUs through focused assistance and close monitoring of progress. If necessary, they could, in consultation with the Comptroller and Auditor General of India (C&AG), outsource the preparation of accounts to qualified personnel.
- ii) States should use the flexibility provided by C&AG to clear the backlog in their accounts. Statutory auditors could take up audit for succeeding years before the accounts for a particular year are laid before the AGM, and provide certification after the relevant accounts are approved. The company can hold a series of general body meetings (GBMs) within a short period to clear the arrears in its accounts.
- iii) All State Governments should draw up a road map by March 2011 for closure of non working companies in consultation with the Accountant General. All pending commercial and other disputes should be resolved promptly—if necessary by

empowering the Board to approve a settlement scheme. States could consider setting up of a holding company which would be responsible for the liquidation of all non-working PSUs. Such a holding company could employ legal, management, and accountancy experts, thereby obviating the need to appoint individual liquidators for each company. This company would also take over the assets and liabilities of the non working PSUs, thus simplifying the process of closing them down.

- iv) The Ministry of Corporate Affairs should closely monitor the compliance of state and central PSUs with their statutory obligations. It could also consider introducing ways to assist companies prepare long overdue accounts. Earlier initiatives like the Simplified Exit Scheme which permitted the use of the latest available balance sheet to arrive at the current balance sheet could be considered for revival.

#### **Measures to Enhance Financial Viability of SPSUs**

7.96 There is need to ensure that all working enterprises, except those in the welfare and utility sectors, become financially viable. A minimum dividend of 5 per cent on government equity should be paid by all such enterprises. Our estimation of resources for the states has been premised on this basis (Para 7.38). For loans given, the states should ensure that the effective rate of interest paid by all State Public Sector Enterprises (SPSEs) should not be below 7 per cent, which has also been assumed by us for estimation of resources of the states (Para 7.36). Rating of enterprises by an accredited rating agency should be made mandatory as this will result in an independent assessment of the financial health of the enterprise. Setting up of independent regulatory authorities will also help the enterprises to enhance viability as the prices will be fixed on actual commercial considerations.

#### *Restructuring/Divestment/Privatisation*

7.97 The State Governments should actively consider withdrawal/reduction of SPSUs in non-

welfare and non-utility sectors. There is an immediate need to reduce the number of SPSUs in most of the states as the large number of such enterprises not only engages the productive assets of the government, but also promotes inefficiency due to lack of proper monitoring by the State Governments. Divestment and privatisation should also be considered and actively pursued.

#### *Institutional Mechanism*

7.98 In order to design suitable strategy and policies and oversee the process of restructuring, including disinvestment/privatisation, a task force may be constituted. This task force should suggest unit-wise specific steps to be taken for restructuring with regard to both working and non-working companies. A Standing Committee on Restructuring under the Chairmanship of the Chief Secretary may also be constituted to operationalise the recommendations of the task force. To advise the Finance Department on restructuring/divestment proposals an independent technical secretariat may also be set up by the states.

#### **Power Sector**

7.99 The deficit in power supply in the country, in terms of peak availability and of total energy availability during 2008-09, was 12 per cent and 11 per cent respectively. The National Electricity Policy envisages the demand for power to be fully met by 2012. Electricity is in the Concurrent List in the Constitution, and though both the Centre and the states have a decisive and positive role to play in the development of the sector, the primary responsibility of structuring its availability and distribution is that of the states.

7.100 The Electricity Act, 2003 (the Act) was enacted to address some of the core issues that affect the power sector. The Act aims to bring in new capacity across the electricity value chain through introduction of competition in the sector. Simultaneously, institutional reforms like utility unbundling and independent regulation have been mandated in the Act.

7.101 Since one of the fundamental triggers for introduction of market reforms was the bankrupt

finances of the State Electricity Boards (SEBs), progress in expansion of power supply and introduction of market reforms needs to be accompanied by corresponding improvements in utility finances to prevent competitive markets from adversely impacting utility finances so as to enable adequate availability of power generation capacity with the utilities.

7.102 We have noted the impact of power sector performance on the finances of the states. This is likely to become even more crucial in future with increasing exposure of the sector to market forces. We sponsored a study for a detailed analysis of the finances of state power utilities, their impact on the overall finances of states and the future roadmap. The following section highlights the critical issues raised in the study and our recommendations for improvement of the sector.

#### Projected Finances of State Power Utilities

7.103 The losses of state power utilities across the country and the subsidy provided for the period 2005-06 to 2008-09 (BE) are given in Table 7.3.

**Table 7.3: Net Losses of State T&D Utilities**

(Rs. crore)

	2005-06	2006-07	2007-08 (RE)	2008-09 (BE)
Financial				
Loss	6634	13398	9985	9206
Subsidy	11741	13277	16950	18111
Total	18375	26675	26935	27317

7.104 The projected aggregate losses of state T&D utilities at the 2008 tariffs are given in Table 7.4. These financial projections assume a reasonable reduction in transmission and distribution (T&D) losses in each state, based on their reported levels of T&D losses at present, and a trajectory for reduction of such losses, derived from the historical performance of some of the better performing state-

**Table 7.4: Net Losses of State T&D Utilities at 2008 Tariffs**

(Rs. crore)

2010-11	2011-12	2012-13	2013-14	2014-15
68643	80319	88170	98664	116089

owned power distribution utilities in the country. Other elements of cost have been appropriately projected. Power purchase costs have been estimated for each utility through a detailed modelling exercise. The employee expenses estimated reflect the impact of the Sixth CPC on the utility payroll costs. These projections are exclusive of the subsidies extended by state governments to the utilities.

7.105 As against the enormous financial losses indicated above, subsidies in 2007-08 were of the order of Rs. 16,950 crore. Thus, there is a large and burgeoning uncovered gap. The key reasons for the increasing gap can be summarised as follows:

- i) Inability of the state utilities to enhance operating efficiencies and reduce T&D losses adequately.
- ii) High cost of short term power purchases. Several utilities have not planned capacity addition in time and are relying on short term purchases at high rates (an average of Rs. 7.31 per kwh as compared to Rs. 4.52 per kwh in 2007-08). The inability to reduce T&D losses has increased the purchase levels and supply costs.
- iii) Absence of timely tariff increases has increased the gap and has impaired utility operations further. Some states have not raised tariffs for the past eight to nine years in spite of increasing deficits.

7.106 Tariff increase requirements to bridge the gap, even in the better performing states, are as much as 7 per cent per annum on an average (considering the 2007-08 subsidy levels). In some of the poorly performing states the increase in requirements is as much as 19 per cent per annum, which is indeed difficult to achieve. Table 7.5 indicates the period for which the various states have had tariff revisions.

**Table 7.5: Status of Tariff Revision in States**

Tariff last Revised	No of states
1 year	9
1-2 years	3
2-3 years	2
3-5 years	2
> 5 years	5

7.107 It also needs to be noted that in several states where tariff revisions have taken place, the gap has been reduced by not recognising the true extent of the costs, eventually resulting in large financial deficits.

### Financial Exposure of States to Power Utilities

7.108 In addition to direct subsidies and subventions as referred earlier, equity investments made in the state utilities by the respective governments amounted to Rs. 71,268 crore as on 31 March 2008. Barring isolated instances, these investments have not been earning financial returns for the State Governments. Similarly, there is considerable debt financing to the power utilities by the states, aggregating to Rs. 70,652 crore as of March 31 2008. Interest on this is generally adjusted against subsidy and subventions, and is rarely paid for in cash. Much of this debt is used for financing current deficits. Over and above this, the utilities carry large accumulated losses, which ultimately devolve on the state.

7.109 The states have also been extending very substantial guarantees to state utilities. The overall outstanding guarantees extended by the states to power sector utilities as on 31 March 2008 amounted to Rs. 88,385 crore. Total financial exposure of the states to power utilities is summarised in Table 7.6.

**Table 7.6: Financial Exposure of the States to Power Utilities**

(Rs. crore)	
As of March 31, 2008	
Equity Investments	71268
Outstanding Loans	70652
Outstanding Guarantees	88385

### Projection of Total Financing Requirements of Power Sector

7.110 As already noted, there is a huge gap between demand and supply of power in many states, calling for large investments in the sector. Development and operation of the T&D network across the country is, for the most part, in the hands of state-owned utilities. Apart from investments required for generation from the states, financing

of T&D investments presents considerable additional burden on state finances. The investment requirements are indicated in Table 7.7. (These figures refer to only the equity component funded from state budgets. In addition, utilities would require other funds for financing power generation/transmission projects).

**Table 7.7: Future Equity Investment Requirements of Generation, Transmission and Distribution**

(Rs. crore)				
2010-11	2011-12	2012-13	2013-14	2014-15
19802	21455	20717	19824	17739

7.111 As against the deficit financing requirements indicated in Table 7.4 and capital investment financing requirements indicated in Table 7.7, the states also have some income through interest

**Table 7.8: Projected Income from Power Sector**

(Rs. crore)					
	2010-11	2011-12	2012-13	2013-14	2014-15
Electricity Duty	12872	14046	15373	16868	17776
Interest on State Government Loans	1567	1567	1567	1567	1567
Sale of Surplus power	1251	1682	1968	2075	2909
<b>Total Income</b>	<b>15,690</b>	<b>17295</b>	<b>18908</b>	<b>20510</b>	<b>22252</b>

earnings against loans extended, electricity duty and sale of surplus power as given in Table 7.8. After adjusting for these factors, the net financing requirements of the states are indicated in Table 7.9. (Difference in figures in table 7.9 and those arrived by simple summation/substitution of figures in tables 7.5, 7.7 and 7.8 is due to computation of financial losses and investments respectively on accrual and cash basis).

**Table 7.9: Total Financing Requirements of Power Sector**

(Rs. crore)				
2010-11	2011-12	2012-13	2013-14	2014-15
75880	88529	93604	101271	115637

7.112 Clearly, this presents a very large exposure for the states, impacting their overall finances. For some of the states, these pose a high risk to the stability of their finances. Urgent measures need to

be taken to bring about efficiency in the functioning of utilities in the states.

### Recommendations

7.113 Notwithstanding the poor overall picture of state utilities, some states have made better progress than others. These states have been able to add substantial capacity in recent years. Of these, the hill states have benefited from free power from hydro projects. Such states have to rely to a much lesser extent on purchase of power, especially from spot markets. However, a majority of the states continue to suffer severe shortages and, therefore, continue to rely on power purchases, thereby placing their finances under severe stress.

7.114 Reduction in T&D losses and collection efficiency remain key concerns for the sector. Even utilities with a very high proportion of industrial consumption have very large T&D losses and low collection efficiency levels. The unmetered supply component of power (primarily to agriculture) in many of the states is increasing rapidly. In the absence of measurement, these estimates of agricultural and rural power supplies tend to essentially obfuscate the levels of T&D losses. Efforts need to be made towards feeder separation, introduction of High Voltage Distribution Systems (HVDS), metering of distribution transformers and control of supply as per policy. Large amounts of energy are wasted in agricultural pumpsets on account of poor equipment efficiency as also wasteful use caused by unmetered tariffs. These need to be checked urgently. Distribution franchising and Electricity Services Company (ESCO)-based structures for efficiency improvement need to be considered by the utilities on a large scale.

7.115 For improvement of operating efficiency, GoI has launched a comprehensive Restructured Accelerated Power Development Reforms Programme from September 2008, which should help in arresting losses in urban areas. In rural areas some of the states have themselves undertaken significant measures in this regard like feeder separation, HVDS and franchising in urban and

rural pockets. Such measures need to be scaled up significantly in all states.

7.116 The electricity transmission sector has been witnessing positive developments after unbundling on account of specific focus on transmission investments and efficiency. Most states have shown appreciable reduction in transmission losses after unbundling. The remaining states that are yet to unbundle their boards should consider it at the earliest. Open access to transmission needs to be strengthened and governance needs to be improved through the State Load Despatch Centres (SLDCs). Eventually the load despatch function needs to be made completely autonomous with improved functioning on the lines suggested by the Pradhan Committee set up by GoI.

7.117 On the resource development front there are certain key concerns. Development of hydro projects has been slower than desired. Less than half the anticipated hydro capacity is expected to come on stream during the Eleventh Plan period. There are several reasons for the delayed development, including:

- i) Lack of quality Detailed Project Reports (DPRs) for projects.
- ii) Inadequate facilitation of the projects by the Central/State Governments.
- iii) Inadequate institutional framework for development at the state level.
- iv) Delays in consents and clearances.
- v) Infrastructure and access issues.
- vi) Lack of peak pricing and market access.

7.118 Hence, a strong implementation focus needs to be brought about with regard to these. The states have a particular role to play since the free power that accrues can result in substantial benefits to them.

7.119 On the thermal power front, there is a need to locate the projects more efficiently. As a rule, transmission of power over long distances is preferable to transportation of coal. While the private sector, in general, has been looking at more efficient

siting of their projects, several states, located far away from the resources, are still focused on developing plants within the state. These states need to evaluate joint ventures (JVs) in or near the coal-rich states to reduce their costs.

7.120 The states also need to initiate more competitive procurement processes. In spite of sustained deficits in supply, only a handful of states have completed Case-1<sup>1</sup> bid processes till date. This leaves them vulnerable to high-cost market purchases. There is urgent need to float more Case 1 tenders since the prices ought to be much more competitive than those for short term procurement. The states also need to initiate appropriate demand forecasting and portfolio optimisation exercises.

7.121 In addition, regulatory institutions need to be strengthened and following are required:

- i) The regulatory institutions, in general, lack sufficient capabilities, which is evident from the fact that even routine tariff increases have not taken place in the recent past. There is need for massive capacity building efforts to strengthen them and help them discharge their functions effectively. There is also need to promote consumer education to apprise consumers on the imperative for such increases. Tariffs should be linked to service levels and performance improvement. Tariff reforms (including Multi-year Tariff implementation as required by the Act) need to be expedited.
- ii) Institutional strengthening and corporate governance of utilities needs reinforcement. Unbundling of utilities, a statutory requirement, should not be deferred any further.
- iii) Public sector companies, whether they have raised funds from the market or not, should follow the provisions of the Company Law in finalising accounts, appointment of independent directors, appointment of audit

committees, and implementing the Guidelines on Corporate Governance issued by the Department of Public Enterprises.

### **New Pension Scheme**

7.122 The Government of India introduced a defined, contribution based New Pension System (NPS) with effect from 1 April 2004 to cover all new entrants to government service. Twenty-three states have notified adoption of the NPS for their employees. The interim Pension Fund Regulatory and Development Authority (PFRDA) has set up the institutional architecture of the NPS. The National Securities Depository Limited (NSDL) has been selected as the Central Record-keeping and Accounting Agency (CRA) while three pension fund managers, a custodian, and a trustee bank have also been appointed. However, despite the formal announcements by states, implementation of NPS has been slow across states. Only 12 states have executed agreements with the CRA and eight states have entered into agreements with the NPS Trust, since states face administrative difficulties in identification of eligible employees and implementing a pay-roll linked arrangement for periodic transfer of individual and government contributions to PFRDA-regulated service providers. Thus, while GoI has transferred over Rs. 1,117 crore to the pension fund managers, as on 31 March 2008, only two State Governments have transferred a total amount of Rs. 133 crore so far. The contributions of state employees are lying in the state public accounts earning a return equal to the interest rate allowed for the General Provident Fund. The migration to the NPS needs to be completed at the earliest. In order to facilitate such migration, we have recommended a grant to assist states to build the database of their employees and pensioners (Para 12.108).

### **Cash Management**

7.123 We have examined the cash balances held by the states in the form of Treasury Bills. With

<sup>1</sup>Guidelines issued by the Ministry of Power for procurement of Power by distribution licensees refer to Case-1 as the bidding process for procurement of power where, location, technology or fuel is not specified by the procurer. The Case-2 bidding process is for location specific projects where the procurer assists the bidder in securing land, necessary clearances and fuel, etc.

reduction in fiscal deficits of the states and improved liquidity, states have mostly been in cash surplus in the past few years. Such balances are not uniform across states; at the end of 2007-08 about half the states had cash balances exceeding the total expenditure for one month. While states require some float for smooth expenditure at the implementation level, accumulation of cash beyond a level can be treated as inefficient, as it would lead to avoidable interest burden.

7.124 The primary reason for accumulation of these balances is borrowing more than the fiscal deficit. While the difference between the net increase in debt and fiscal deficit in 2001-02, 2002-03, and 2003-04 was Rs. 3,998 crore, Rs. (-) 490 crore, and Rs. 353 crore respectively, this difference increased steeply to Rs. 10,926 crore in 2004-05 and then to Rs. 25,992 crore in 2005-06. The difference, reduced to Rs. 16,873 crore in 2006-07 and further to Rs. 11,116 crore in 2007-08, but still remains unnecessarily high. These excess borrowings can be partially attributed to high inflows from NSSF but the role of sub-optimal debt management cannot be ignored.

7.125 Other factors also contribute to cash balances at the state level. One of them is the mechanism of release of central assistance wherein, the grants are released to the states leading to a temporary build-up of cash balances that get used up only in due course of time. The total amount of plan grants and loans to the states in 2007-08 was of the order of Rs. 0.78 lakh crore. Although, these transfers are linked to utilisation of previous releases, there have been capacity constraints on implementation in many states. Transfer of unspent funds to deposit accounts maintained in the public account at the end of the financial year by states leads to build-up of cash balances. In addition, flows from the Centre not budgeted by the states and end of the year releases in CSS, also leads to increase in cash balances.

7.126 Another important factor is the accumulated balances in the public account of the states, especially under Reserve Funds and Deposits and Advances. The total amount outstanding under

these heads has increased from Rs. 99,868 crore in 2000-01 to Rs. 1.85 lakh crore in 2007-08. Of course, the entire accumulation under these heads does not lead to increase in cash balances. Sinking funds, guarantee redemption funds and CRF investment accounts are invested in longer term instruments. The public account needs to be examined and reconciled by the states. The public account should not be treated as an alternative to the consolidated fund and government expenditure should be directly incurred from the consolidated fund as far as possible, avoiding transfers from consolidated fund to the public account.

7.127 Efficient debt management is an essential part of cash management. Inefficiencies either way can lead to higher interest costs, whether it is accumulation of cash due to unnecessary borrowings or availing of ways and means advances. With reduced fiscal deficits, it is essential that states follow the practice of borrowing on requirement rather than on availability. Amongst different sources of debt, the only source of borrowing on which states have free control is the open market loans. Most of the negotiated loans and external aid (received through Central Government on back to back terms) are tied to projects, and thus, do not have much flexibility. Parameters controlling flows from NSSF are also beyond the control of states. We have indicated the need for essential reforms in NSSF in Chapter 9. Overall, there should be a directed effort by states with large balances towards utilising their existing cash balances before resorting to fresh borrowings. Many states would be facing larger than usual bullet repayments of market borrowings during the next few years due to bonds raised for debt swaps during the period 2002-05. While estimating the gross borrowing limits for this purpose, we would encourage states to attempt to use the cash balances, if these remain substantial at that point in time. The proposed National Debt Management Office can offer their expertise to the states in their debt management strategies.

### Accounting Reforms

7.128 Article 150 of the Constitution mandates that the accounts of the Union and the states shall be

kept in such form as the President may, on the advice of the Comptroller and Auditor General of India, prescribe. The finance accounts of the states provide details of receipts and expenditure for the consolidated fund, the contingency fund, and public account. These accounts usually consist of 19 statements and a number of appendices. Allowing for significant variation between budget estimates and actuals, these accounts form the bedrock for examination of the fiscal performance of states. Our analysis of state finances is primarily based on these accounts. However, during the course of our exercise, we have found that there are still many areas where reforms are required to make these accounts more meaningful as well as comparable across states.

#### **Uniform Adoption of the Coding System in Accounts**

7.129 FC-XII had recommended that a uniform classification code for all states upto the object head level be adopted. Such uniform application would facilitate comparison across states while ensuring consistency. Further preparation of financial statements under economic classification would also require that information on primary allocation basis, i.e., object head level, be uniform. However, the flexibility in the operation of object heads at state level continues. We, therefore, recommend that the Government of India ensure uniformity in classification code across all states.

#### **Uniform Booking of Expenditure under Different Heads**

7.130 The treatment of expenditure on similar schemes is often not uniform across states. For example, while most states book NREGS expenditure in the revenue account, at least one state books it in the capital account, citing the practice adopted during the earlier Food for Work Programme (FWP). Some states show local body grants as capital expenditure. Such divergences in the finance accounts across states make it difficult to analyse whether these programmes have been implemented as mandated including payment of states' share.

#### **Contra - Entries**

7.131 Contra - entries (refer to Para 7.53) in the accounts impede the estimation of the true revenue and expenditure of a State Government. Similarly, funds transferred between the consolidated fund and the public account are merely book transactions without any cash import. The frequency of these entries varies across states. For an objective and normative comparison of the performance of State Governments across the country, it is necessary that such entries be identified in every state's accounts and then be filtered out. Unfortunately, there is no easy way to detect contra entries in the finance accounts. We, therefore, recommend a separate annex be provided to the finance accounts giving details of contra entries as well as a summary of transactions between the public account and the consolidated fund.

#### **Funds Outside the Budget Framework**

7.132 An undesirable trend noticed is the tendency to divert public expenditure from the budget to nominated funds which are operated outside the authority of the legislature. In one state, four such funds have been created outside the budget. These funds were ostensibly set up to promote sectors which should have been legitimately taken up within the budget. The total amount transferred to these funds was significant. The expenditure incurred through these irregular arrangements not only bypassed the oversight of the state legislature but also the audit of the C&AG and hence should be discouraged.

7.133 Another common practice is the transfer of budgetary allocations from the consolidated fund to civil deposits in the public account at the end of a financial year to avoid lapse. These deposits inflate the state's total liabilities. It also appears that audit scrutiny by the C&AG of expenditures incurred from civil deposits is not consistent across states. We recommend that such funds and transactions be brought under the audit jurisdiction of the C&AG as the responsibility for the funds should also eventually be towards the State Legislature.

### Appendices to Finance Accounts

7.134 The finance accounts of all states contain clarificatory appendices. Finance accounts of most states contain nine appendices which provide details of government investments and instances where verification of balances has been delayed, list incomplete capital works costing Rs 1 crore and above, and provide expenditure on salaries and subsidies, etc. In addition, FC-XII has recommended inclusion of seven additional statements in the finance accounts. However, a significant number of finance accounts do not provide all the appendices. For example finance accounts of 16 states do not provide the appendix on 'instances where verification and acceptance of balances involving large amounts has been delayed'; finance accounts of 10 states do not provide information on details relating to reconciliation of balances; finance accounts of four states do not provide a statement of incomplete capital works costing Rs 1 crore and above, and finance accounts of four states do not provide details of expenditure on subsidies. We recommend that the list of appendices to the finance accounts be standardised keeping in view the recommendations of FC-XII and be followed in all states.

### Statement of Subsidies

7.135 Appendix VI of the state finance accounts is a statement of subsidies disbursed during the relevant year. This statement is expected to bring out all expenditures of the states in the nature of subsidy, rather than only those that are classified as subsidy. There are instances where states have classified subsidies as 'other expenditure' or 'grant-in-aid' and which have, thus not been reflected in the finance accounts as subsidies. In many cases, the accounts of the recipient of assistance show it as subsidy, and thus, it has been accounted as subsidy by the Audit report (Commercial) of the C&AG but not in the finance account. Thus, in some cases, the statement does not provide a true reflection of the aggregate subsidies provided. To be relevant, it is essential that these statements provide comprehensive data on all subsidies.

### Statement of Salaries

7.136 The salary statement presently included in the state finance accounts provides expenditure details major head-wise, but does not provide the number of employees under each major head. It also does not provide the number of employees in each category and the expenditure on each category. A number of State Governments conduct employee census where they list out the number of employees in each grade as well as department-wise. As per Section 4 (x) of the Right to Information Act, each public authority is required to publish the monthly remuneration received by all its employees including the system of compensation, as provided in its regulations. Fiscal Responsibility Legislation adopted by a number of State Governments requires them to provide a statement giving details on the number of employees in the government, public sector and aided institutions, and related salaries and pensions as part of the disclosure criteria. There exist a number of independent silos with partial information on the number of employees at each level, and the commitment on their salary. The statement on salary expenditure needs to be made more comprehensive.

7.137 There are certain expenditure items of states that are not strictly salary expenditure, but are in the nature of assistance for salary to bodies such as autonomous organisations and local bodies. To make the statement of expenditure on salary more comprehensive, it is recommended that a statement on the expenditure of State Governments on assistance for salary also be separately incorporated.

### Statement of Maintenance Expenditure

7.138 Neither the Central Government nor the various State Governments provide this information. It is understood that the Controller General of Accounts has identified six major heads—public works; housing; major irrigation; medium irrigation; minor irrigation and roads and bridges. The CGA has issued instructions that maintenance expenditure under these heads should be divided into the two sub heads—work charged expenditure and other maintenance expenditure. However, State Governments (and Union Ministries) are yet

to carry out these changes in the budget documents. In view of the insight such information will provide into the quality of the maintenance being undertaken, we recommend that these changes be brought into the State and Union Budgets and finance accounts immediately.

### Summary of Recommendations

7.139 To summarise, our recommendations are as follows:

- i) The practice of diversion of plan assistance to meet non-plan needs of special category states to be discontinued (Para 7.79).
- ii) With reference to public sector undertakings:
  - a) All states should endeavour to ensure clearance of the accounts of all PSUs (Para 7.95).
  - b) States should use the flexibility provided by C & AG to clear the back log of PSU accounts (Para 7.95).
  - c) All States need to draw up a roadmap by March 2011 for closure of non-working companies. Divestment and privatisation of PSUs should be considered and actively pursued. (paras 7.95 and 7.97).
  - d) Ministry of Corporate Affairs to closely monitor the compliance of state and central PSUs with their statutory obligations (Para 7.95).
  - e) A task force may be constituted to design a suitable strategy for disinvestment/privatisation and oversee the process. A Standing Committee on restructuring may be constituted under the chairmanship of Chief Secretary to operationalise recommendations of the task force. An independent technical secretariat may be set up to advise the Finance Departments in states on restructuring/disinvestment proposals (Para 7.98).
- iii) With reference to power sector:
  - a) Reduction of T&D losses should be attempted through metering, feeder separation, introduction of High Voltage Distribution Systems, metering of distribution transformers and strict anti-theft measures. Distribution franchising and Electricity Services Company based structures for efficiency improvement should be considered (Para 7.114).
  - b) Unbundling should be done on priority and open access to transmission should be strengthened. Governance should be improved through state load dispatch centres and this function should eventually be made autonomous. (Para 7.116).
  - c) Proper system should be placed to avoid delays in completion of hydro projects (Para 7.117).
  - d) Instead of putting up thermal power plants far away from coal sources, states should consider JVs in or near the coal rich states (Para 7.119).
  - e) Case 1 bid process should be extensively used to avoid vulnerability to high cost purchases during peak demand periods (Para 7.120).
  - f) Regulatory institutions should be strengthened through capacity building, consumer education and tariff reforms like multi - year tariff. Best practices of corporate governance should be introduced in power utilities (Para 7.121).
- iv) The migration to the New Pension Scheme to be completed at the earliest (Para 7.122).
- v) States with large cash balances to make efforts towards utilising their cash balances before resorting to fresh borrowings (Para 7.127).
- vi) With reference to accounting reforms:

- a) GoI to ensure uniformity in the budgetary classification code across all states. List of appendices to the finance accounts of the states be also standardised (paras 7.129 and 7.134).
- b) Details of contra-entries as well as summary of transactions between public account and Consolidated Fund to be provided as a separate annex to finance accounts of the states (Para 7.131).
- c) Public expenditure through creation of funds outside consolidated fund of the states needs to be discouraged. Expenditure through such funds and those from civil deposits be brought under the audit jurisdiction of the C&AG (paras 7.132 and 133).
- d) Following statements to be provided with finance accounts of the states.
  - Comprehensive data on all subsidies (Para 7.135).
  - Consolidated information on number of employees at each level along with the commitment on salary. This statement to also include information of employees and their salary where such expenditure is shown as grants booked under other expenditure head (paras 7.136 and 7.137).
  - Details of maintenance expenditure (Para 7.138).

## CHAPTER 8

# Sharing of Union Tax Revenues

8.1 One of the core tasks of a Finance Commission as stipulated in Article 280 (3) (a) of the Constitution is to make recommendations regarding 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 of Part XII of the Constitution and the allocation between the states of such proceeds. This is the most important task of any Finance Commission, as the share of states in the net proceeds of Union taxes is the predominant channel of resource transfer from the Centre to states. In the total resource transfers recommended by the Finance Commissions, from the First to the Twelfth, tax devolution accounted for an average of over 84 per cent. The share of tax devolution in the total transfers recommended varied from 73.9 per cent by FC-VI to 92.3 per cent by FC-VII. In the total transfers recommended by FC-XII, tax devolution accounted for 81.1 per cent as compared to the 86.5 per cent share recommended by FC-XI.

### Vertical Devolution

8.2 Our first task is to arrive at the share of states in the net tax revenues of the Centre. For this purpose it is necessary to assess the vertical gap between the Union and the states. The vertical gap is the difference between the normatively assessed expenditure share and revenue capacities of the Union and the states. Our normative assessment of the revenues and expenditures of the Union and the states is presented in chapters 6 and 7, respectively. In addition, while formulating our recommendations, we have considered the views of the Centre and the states, developments having a

bearing on the finances of the Centre and the states, as well as the overall macroeconomic and fiscal situation in the country.

### Views of the Union and the States

8.3 The Ministry of Finance, in its memorandum, has drawn our attention to the steady increase in the resources transferred to states, both by way of the share in central taxes and in the form of grants, particularly since 2005-06. The ministry has also indicated that there has been an increase in the net transfers to states since 2005-06 following the discontinuation of the practice of on-lending to states. The other issues raised in the memorandum relate to increasing direct transfers to state level agencies and the rising expenditure of the Centre on food and fertiliser subsidies. The ministry has contended that expenditure on food and fertiliser subsidies, in a way, amounts to negative taxation and that such expenditure is incurred on behalf of the states. We have been requested to keep these points in view while recommending transfers to states. The ministry has reiterated in its submission made to FC-XII that tax devolution should be gradually reduced to a maximum of 28 per cent of the net proceeds of central taxes. The ministry has further contended that the tax devolution recommended by FC-XI may not be changed as there has been no change in the responsibilities of the Centre or states, as envisaged in the Constitution.

8.4 The states have, for the first time, submitted a joint memorandum to the Commission. In this joint memorandum, the Commission has been urged to enhance the share of the states in the net

proceeds of central taxes from 30.5 per cent to at least 50 per cent considering the fact that the states' share in the combined developmental expenditure is much higher than that of the Centre. The states have further urged that the divisible pool of central taxes should include all cesses and surcharges. The states have contended that the requirement for an increase in their share of central taxes is much stronger now as the implementation of state-level Value Added Tax (VAT), with its built-in documentation of value addition, has simultaneously contributed to growth in income and corporate tax revenues. The memorandum also states that pay revision of Central and State Government employees will further enhance income tax collections by the Centre.

8.5 The states, in their individual memoranda have, without exception, sought an increase in their share of central taxes. The majority have sought an increase from the present 30.5 per cent share in net tax revenues of the Centre to 50 per cent. Increase in the share of states in a phased manner, to 50 per cent, has been suggested by a few states. A minimum guaranteed tax devolution to insulate the states from a possible shortfall in the Centre's revenues as compared to the forecast made by the Finance Commission has been suggested by some states. Earmarking of 30 per cent of the divisible pool to special category states has been suggested by a few states belonging to this category.

8.6 On the issues of cesses and surcharges, views expressed by states ranged from capping the cesses and surcharges as a percentage of gross tax revenue of the Centre to their inclusion in the divisible pool of central taxes. While some states have sought an increase in the indicative ceiling on overall revenue account transfers to states from 38 per cent of gross revenue receipts of the Centre recommended by FC-XII, some others have sought removal of the indicative ceiling on the grounds that such a ceiling restricts the scope of central transfers to states. A share in the non-tax revenues of the Centre, such as sale proceeds of spectrum and off-shore royalties has been sought by some states.

8.7 The states have advanced a number of reasons for seeking an increase in their share of central taxes. These include reduction in the size of the divisible pool due to increase in the scope of cesses and surcharges; growing vertical imbalances in the form of increasing number of Centrally Sponsored Schemes (CSS), declining shares of state plan outlays and increasing expenditure needs of states in areas such as infrastructure development, social and human development, environmental protection and establishment in the wake of the pay revision.

### **Recommendations on Vertical Distribution**

8.8 After due consideration of the views of the Centre and states, we are of the opinion that vertical devolution should be informed by the revenue-raising capacity of the Centre and states as well as emerging pressures on their expenditure commitments. We have observed that buoyancy of central taxes, at 1.49, has been higher than that of the states (1.18) during the period 2000-08 and that there are reasons to believe that the Centre's revenue buoyancy will continue to remain higher than that of states. Further, the Centre has the advantage of resorting to levy of cesses and surcharges to meet some of its expenditure commitments. As indicated in Chapter 4, the share of cesses and surcharges in gross tax revenue of the Centre increased sharply from 3.51 per cent in 2001-02 to 13.63 per cent in 2009-10 (BE). This has led to considerable reduction in the divisible pool as a percentage of gross revenue receipts of the Centre.

8.9 There has been a significant increase in non-tax revenues of the Centre, particularly from royalties and the telecommunication sector. Receipts from telecommunication services increased from Rs. 8018 crore in 2001-02 to Rs. 26,729 crore in 2007-08. Royalties from off-shore hydrocarbon resources are expected to increase substantially in the near future. The Union Government presently shares profit petroleum only from on-shore fields under the New Exploration Licensing Policy (NELP). The resource position of the Centre is expected to improve on account of buoyant non-tax revenues. Thus, there is a case for

increasing the share of states in the net tax revenue of the Centre.

8.10 The increasing number of CSS, though largely funded by the Centre, has, nevertheless, significant expenditure implications for states in terms of cost sharing, provision of supporting infrastructure and committed liability. The sharp increase in outlays on CSS, thus, requires greater contribution from states as well. There has also been an increase in the share of states in the funding of CSS. Under the Sarva Shiksha Abhiyan (SSA), the matching contribution of states has gone up from 15 to 40 per cent. It is proposed to further increase the contribution of states in this regard to 50 per cent. In addition, the responsibility of maintaining the services and assets created under CSS ultimately rests with the states. There are substantial direct transfers to implementing agencies in states under the CSS. The assets created by local bodies through direct transfers have to be ultimately maintained by states as own revenue generation by these local bodies is very poor.

8.11 There are a few other developments as well, which are likely to increase the expenditure commitments of states. The Government of India has proposed building up of a legal structure of rights and entitlements in a number of areas to ensure provision of uniform quality of services all over the country. Food, social security and land compensation are some of the areas where the legislative process has commenced. The Right of Children to Free and Compulsory Education (RTE) Act, 2009 has proposed free and compulsory education for all children in the age group of 6 to 14 years. The Act contains a number of provisions relating to teacher-student ratio, infrastructure facilities in schools and qualifications of teachers. These provisions are likely to have significant financial implications for states. The President, in her address to Parliament on 4 June 2009, announced that a new law—the National Food Security Act would be legislated to set out a statutory framework for providing food security. Under the proposed legislation it is envisaged that every below poverty line (BPL) family will be entitled by law to a certain quantity of food grains

every month. While the Centre is likely to provide subsidised food grains, states will probably need to take on the responsibility of putting in place storage infrastructure as well as maintaining a comprehensive distribution system.

8.12 As emphasised in the Eleventh Five-Year Plan document, protection of environment has to be a central part of any sustainable inclusive growth strategy. Environment is a residual central subject and the responsibility for its maintenance rests on all levels of government, more particularly on state governments. There are a number of central and state enactments in the area of environmental protection. The compliance cost of most central legislation falls on the states. During our visits, states have contended that the benefits derived from mining were insignificant as compared to the additional costs in terms of pollution of water resources, degradation of land, loss of agricultural output, damage to roads and air pollution. States have also drawn our attention to additional costs towards rehabilitation of displaced persons. Until the cost of environmental damages is internalised by all polluting industries, state governments will continue to bear these additional costs. This Commission is required, as per its Terms of Reference (ToR), to consider the need to manage ecology, environment and climate change consistent with sustainable development. Implementation of such a mandate would require that the states be provided additional assistance to enable them to address these issues upfront.

8.13 The states have a major responsibility in terms of provision of both rural and urban infrastructure. The proportion of urban population of the country is projected to increase from 28 per cent of the total population to about 38 per cent in 2026. Further, the projected growth of urban population will account for two-thirds of the total population increase. The current state of supply of core services in the urban areas, viz. water supply, sewerage, solid waste management and street lighting, is inadequate by any standards. The higher growth of urban population will add further pressure on provision of these services.

8.14 The size and scope of infrastructure projects sponsored by the State Governments is smaller than those sponsored by the Central Government. Thus, State Governments have relatively less scope than the Central Government for resorting to Public Private Partnerships (PPP) to meet the funding gaps in these projects. This imbalance in scope is likely to result in states having to depend more on own funding.

8.15 Our assessment indicates that the impact of implementation of the recommendations of the Sixth Central Pay Commission (CPC) is likely to be asymmetrical as between the Centre and the states. Incremental expenditure on civilian and defence employees at the Centre on account of the implementation of the recommendations of Sixth CPC is estimated at Rs. 37,130 crore per annum. For the states, the incremental expenditure is estimated at Rs. 49,532 crore per annum. Income tax collection on the additional salary expenditure of the Centre is estimated at Rs. 3294 crore, net of tax exemptions. Additional salary expenditure by states is likely to improve income tax collections by Rs. 4393 crore. Thus, the aggregate additional income tax revenue amounts to Rs. 7687 crore per annum. Of this additional revenue, Rs. 2306 is likely to accrue to states as their share in central taxes while the remaining amount of Rs. 5381 crore accrues to the Centre. The ratio of net additional expenditure on account of pay revision between the Centre and states is 1:1.49. Thus, net additional liability on account of pay revision is higher for states.

8.16 FC-XII recommended the share of states in net central taxes at 30.5 per cent. For the purpose of tax devolution, the proceeds of additional excise duties in lieu of sales tax on textiles, tobacco and sugar were treated as part of the divisible pool of central taxes. FC-XII further recommended that the states' share in the net proceeds of shareable central taxes shall stand reduced to 29.5 per cent in the event of the termination of the tax rental agreement and states being allowed to levy sales tax (or VAT) on these commodities without any prescribed limit.

8.17 There has been a long term stability in the relative shares of the Centre and the states in the combined revenue receipts and in the combined revenue expenditure as discussed in Chapter 4. We are of the view that such fiscal stability be maintained during our award period. The share of states after transfers will be constant only if their share in central taxes is increased by a margin by which the buoyancy of central taxes exceeds the buoyancy of combined tax revenue.<sup>1</sup> As indicated in para 8.8, the buoyancy of central taxes has been higher than that of state taxes. This points to the need for increasing the share of states in central tax revenues. After considering all the reasons adduced in paras 8.8 to 8.15, we recommend that the share of states in the net proceeds of shareable central taxes be raised from 30.5 per cent to 32 per cent. The recommended increase in the share of states in net central taxes is unlikely to impose a burden on the Centre and can be accommodated by pruning and better targeting of subsidies as well as through the restructuring of some of the CSS.

8.18 The position with respect to the levy by the Centre of additional excise duties in lieu of sales tax has changed since submission of the report of FC-XII. All the goods under the Additional Duties of Excise (Goods of Special Importance) Act, 1957 have been exempted from the payment of duty under the Act from 1 March 2006. Following this exemption, the Centre had made suitable adjustments in the basic excise duty rates on cigarettes, beedis and sugar. The three goods covered under the tax rental agreement, namely, textiles, tobacco and sugar continue to remain in the list of declared goods under the Central Sales Tax Act, 1956 thus binding the states to prescribed rates in case states decide to levy VAT on these commodities. The Ministry of Finance has indicated that releases of states' share in net central tax revenue are in conformity with the states' share of 30.5 per cent as recommended by FC-XII. Keeping in view these developments, we are not earmarking any portion of the recommended 32 per cent states'

<sup>1</sup> Rangarajan, C. and Srivastava, D.K. 'Reforming India's Fiscal Transfer System: Resolving Vertical and Horizontal Imbalances', *Economic and Political Weekly*, 7 June 2008

share in shareable net central tax revenue as attributable to additional duties of excise in lieu of sales tax and are not recommending any reduction in the share of the states in the event of levy of VAT on textiles, tobacco and sugar by them.

8.19 For the purpose of determining the states' share in central taxes, we have treated proceeds of service tax as part of the divisible pool. In terms of the 88<sup>th</sup> Amendment to the Constitution, the power to levy service tax is vested with the Centre and distribution of the tax proceeds between the Union and states shall be in accordance with the principles to be determined by the Parliament. So far, the amendment has not been notified. It is unlikely that it will be notified, in view of the proposed introduction of the Goods and Services Tax (GST). FC-XII recommended that in the event of such notification, it should be ensured that the revenue accruing to a state under the notification should not be less than the share that would accrue to it, had the entire service tax proceeds been part of the shareable pool. We fully endorse the recommendation of FC-XII in this regard.

8.20 We are unable to accede to the states' demand for inclusion of cesses and surcharges imposed by the Centre in the divisible pool of central taxes, as under Article 270 of the Constitution, taxes referred to in Articles 268 and 269, surcharges on taxes and duties and cesses levied for specific purposes shall not form part of the divisible pool. However, we recommend that the Centre review the current surcharges and cesses with a view to reducing their share in the gross tax revenues. We hope that with the introduction of GST, most of the cesses and surcharges will be subsumed under the basic rate of central GST.

8.21 The Commission has taken into account the overall central transfers to states on revenue account in relation to gross revenue receipts of the Centre, while recommending the states' share in net central taxes. For the first time, FC-XI recommended an indicative ceiling on all revenue account transfers, at 37.5 per cent of the Centre's gross revenue receipts. This was raised by FC-XII to 38 per cent. In Chapter 4, we broadly discussed

the trends in the overall transfers on revenue account. We recommend raising of this indicative ceiling to 39.5 per cent of the Centre's gross revenue receipts. In fact, transfers on revenue account are already above 39 per cent of the revenue receipts of the Centre in the years 2008-09 (RE) and 2009-10 (BE).

### Horizontal Sharing

8.22 Recent Finance Commissions have used equity and efficiency as the two guiding principles while recommending *inter se* shares of states in tax devolution. The principle of equity addresses the problem of differences in revenue raising capacity and cost disabilities across states. When capacity is assessed on the basis of observed revenue collected there is the risk of moral hazard in making the states lax in terms of improving their revenue effort and managing their finances prudently. The principle of efficiency is intended to address this issue and to motivate the states to exploit their resource base and manage their fiscal operations in a cost effective manner. A combination of these two principles has found wide acceptability and addressed the concerns of reforming states. Our recommendations on horizontal sharing have been informed by these principles.

8.23 Having decided on the basic principles, the next issue is that of selecting the criteria representing these principles. Before we come to the selection of criteria, there is the issue of whether these criteria should be forward looking or based on past trends. There is no doubt that forward looking indicators are better, as devolutions are linked to future performance rather than past performance. As there is no certainty that the criteria will remain the same in future, there may not be enough incentive for states to improve their performance. However, a Finance Commission can only recommend the criteria but cannot determine the shares of states based on future performance, as it is not a permanent body. There is no mechanism currently in place to arrive at the shares of states on the basis of year-to-year performance. Besides, the performance indicators become available only

after a gap of a few years. Therefore, we do not consider it feasible to adopt forward looking indicators for tax devolution involving yearly updating of *inter se* shares of states. However, we have considered such an option in the context of our recommendations for grants.

### Views of State Governments

8.24 A majority of states, in their memoranda, favoured population as a criterion for determination of *inter se* shares of states in tax devolution. While some states are in favour of using the population figures of 2001, a few others have urged the Commission to use 1971 population figures, as mandated in the ToR. The weights sought to be assigned to this criterion varied from 10 per cent to 70 per cent. A few states have suggested that suitable weightage be assigned to the SC/ST population in a state. Population below the poverty line has also been suggested as a criterion. A majority of states favoured retention of income distance as a criterion. However, the weight suggested for this criterion varied widely, from a low 10 per cent to a high 70 per cent.

8.25 A number of states favoured continuation of area as a criterion in the distribution formula, with some states suggesting an increase in the weightage and others suggesting a reduction. Continuation of tax effort and fiscal discipline as criteria for tax devolution has been suggested by the majority of states. Other criteria suggested by states include forest cover, length of international border, index of infrastructure, levels of backwardness, human development index, share of primary sector in Gross State Domestic Product (GSDP) of a state, contribution to central taxes and expenditure on social sectors and infrastructure. Criteria and weights for tax devolution suggested by states are summarised in Annex 8.1.

### Criteria for Horizontal Sharing

8.26 FC-XII assigned a weight of 25 per cent to population, 50 per cent to per capita income distance, 10 per cent to area and 7.5 per cent each to tax effort and fiscal discipline in the formula for arriving at the share of each state in tax devolution.

We have taken into account each one of these criteria and have also examined the suitability of other criteria in our effort to arrive at an appropriate formula for tax devolution. The components of the distribution formula recommended by us are discussed below.

### Population

8.27 Population is an indicator of the expenditure needs of a state. It is a simple, objective and transparent indicator that ensures predictability. The criterion ensures equal per capita transfers to all states, not taking into account cost disabilities across states because of differences in the geographic spread of population. FC-XII assigned a weight of 25 per cent to population. We consider population as an important indicator of the needs of a state and assign it a weight of 25 per cent, as was done by FC-XII. For this purpose, we are bound by our ToR to take into account population figures for states based on the 1971 Census (Annex 8.2).

### Area

8.28 Area as a criterion in the devolution formula was first introduced by FC-X on the grounds that a state with larger area has to incur additional administrative costs to deliver a comparable standard of service to its citizens. As pointed out by that Commission, the differences in the costs of providing services may increase with the size of a state, but only at a decreasing rate and that, beyond a point incremental costs may become negligible. The Commission further pointed out that states with small areas have to incur certain minimum costs in establishing the framework of government machinery and the costs of providing services in many of these smaller states may be higher because of the terrain. Taking into account these considerations, FC-X used an adjustment procedure whereby no state received a share higher than 10 per cent at the upper end or less than 2 per cent at the lower end. The Commission assigned a small weight of 5 per cent to area subject to the above adjustment. FC-XI assigned a weight of 7.5 per cent to area, subject to the minimum of 2 per cent and maximum of 10 per cent as recommended by

FC-X. Area was assigned a weight of 10 per cent by FC-XII. The Commission assigned a minimum of 2 per cent share to those states whose share in total area is less than 2 per cent but did not fix an upper ceiling of 10 per cent.

8.29 We have assigned a weight of 10 per cent to the area criterion as adjusted on the lines of FC-XII. States with less than 2 per cent share in total area, but assigned a minimum share of 2 per cent, are Goa, Haryana, Himachal Pradesh, Kerala, Manipur, Meghalaya, Mizoram, Nagaland, Punjab, Sikkim, Tripura and Uttarakhand. There is no upper limit on the shares of other states (Annex 8.3).

#### *Fiscal Capacity Distance*

8.30 Population and area have both been adopted by this Commission as criteria in the horizontal devolution formula, with the same weights as those used by FC-XII (paras 8.27 and 8.29). These are equity-neutral measures of fiscal need. In a country like India, where there is a 10:1 ratio between the per capita incomes of the highest and lowest income states (based on average comparable per capita GSDP for the years 2004-05 to 2006-07), there is an overwhelming case for an equity component in determination of relative fiscal need and indeed, this has been recognised by every Finance Commission from FC-VI. The intent of the equity component in the devolution formula is to ensure that all states have the fiscal potential to provide comparable levels of public services to their residents, at reasonably comparable levels of taxation. The equity component is justified, not merely to ensure equal treatment of citizens by governments, but also for economic efficiency reasons, so as to minimise fiscally-induced migration. However, it does not, by itself, ensure achievement of common standards in quality or outcomes in public services. For that to happen, it is necessary that the comparable level of tax effort assumed to hold across states actually prevails in each state and that efficiency in delivery is reasonably uniform. One of the terms of reference of this Commission requires us to look at improvement in public service delivery and we do so through the design of the conditionalities

attached to some of our grants. The equity component in the devolution formula is an enabling provision that does not, by itself, guarantee uniformity in public service delivery across states.

8.31 The income distance criterion used by FC-XII, measured by per capita GSDP, is a proxy for the distance between states in tax capacity. When so proxied, the procedure implicitly applies a single average tax-to-GSDP ratio to determine fiscal capacity distance between states. This Commission recommends, instead, the use of separate averages for measuring tax capacity, one for general category states and another for special category states. The justification for doing this is that between the two categories, a single average applied (implicitly) to GSDP does not accurately capture the fiscal distance between the two groups. This is because overall GSDP does not accurately capture the taxable base for two reasons. The first is that the sectoral composition of GSDP varies across states and the sectors are not uniform in their taxability. Agriculture, for example, is not effectively taxable in states, except where there are plantations. The second reason is that GSDP estimates presently available are at factor cost and therefore, exclude income such as that accruing in the form of remittances. The cross-state average ratio of tax-to-GSDP is higher for general category states than for the special category, where this difference encapsulates the combination of factors underlying the relative fiscal capacity of the two groups. Thus, group-specific averages are applied to the two categories so as to obtain a closer approximation to the distance in fiscal capacity between states, which is ultimately what is sought to be captured. Ideally, tax frontiers specific to each state should be estimated, but an exercise of this kind was constrained due to lack of the necessary data.

8.32 The procedure used is, therefore, as follows. We have first worked out the three-year average per capita GSDP for the individual states based on comparable estimates for the years 2004-05 to 2006-07 (Annex 8.4). In the next step, the average tax to comparable GSDP ratio has been obtained as a weighted mean separately for general category and special category states (Annex 8.5). These

group-specific averages are then applied to the constituent states in each group so as to obtain the per capita tax revenue in each state, potentially available at the average tax effort for the group in which it falls. This is an estimated average. Observed per capita tax revenue will be higher than the estimate generated here in states with observed tax-to-GSDP ratios higher than the group average and lower in states with lower ratios. The intent is to estimate per capita fiscal capacity at reasonably comparable levels of taxation by application of the observed group average.

8.33 Fiscal distance is obtained for each state by the distance of its estimated per capita revenue, by the procedure described in the previous para, from the estimated per capita revenue of Haryana, the second highest in the per capita income ranking after Goa. The distance so computed for all states, barring Haryana and Goa, defines the per capita revenue entitlement of each state based on fiscal distance. For Haryana and Goa, a revenue entitlement of Rs. 100 per capita has been assigned. For Maharashtra, with average per capita GSDP slightly lower than that of Haryana, the fiscal distance computed based on the procedure described in the earlier paragraph worked out to be negative. We have assigned it a notional revenue entitlement of Rs. 100 per capita, at par with Haryana and Goa. These per capita entitlements are then multiplied by the respective 1971 population figures of each state to arrive at the share of each state in tax devolution. We have assigned a weight of 47.5 per cent to the fiscal capacity distance criterion.

8.34 The use of average tax-to-GSDP ratios specific to each category neutralises to an extent the fiscal disadvantage of special category states in terms of tax capacity.

8.35 Finally, another principle governing devolution has to be cost disability, so that the amounts devolved conform to equity-based fiscal need, modified by differing costs of service delivery. Cost disability affects both general and special category states. Within the general category, there are many states with spatially dispersed human habitations, which raise the cost of equivalent service provision. The weight assigned to area is conventionally designed to take this into account.

One of the suggestions made to the Commission was to use a three-dimensional measure of area, with topographical variation factored in, to better capture the relative cost disabilities of states and to place them all on a uniform platform. However, the necessary data for such an exercise were not available from the Surveyor General of India. In states with hilly terrain, the ratio of uninhabited area to total area will be higher. To the extent that the entire area has been used in our devolution formula, the provision per square kilometre of inhabited area will be higher. This implicitly covers the cost disability of such states, to a limited degree.

#### *Fiscal Discipline*

8.36 Fiscal discipline as a criterion for tax devolution was used by FC-XI and FC-XII to provide an incentive to states managing their finances prudently. Both these Commissions assigned a weight of 7.5 per cent to this criterion. The index of fiscal discipline was arrived at by relating improvement in the ratio of own revenue receipts of a state to its total revenue expenditure to average ratio across all the states. FC-XII had worked out the index with the reference period of 2000-01 to 2002-03 and the base period of 1993-94 to 1995-96. We have retained this criterion and have worked out the index of fiscal discipline with 2005-06 to 2007-08 as reference years and 2001-02 to 2003-04 as the base years (Annex 8.6). The own revenue receipts of a state include own tax revenues and thus, the criterion of fiscal discipline also captures the tax effort of states. We have, therefore, dropped the use of tax effort as a separate criterion. FC-XII assigned a weight of 7.5 per cent each to fiscal discipline and tax effort. Thus, the combined weight assigned by FC-XII to these two criteria was 15 per cent. There is a strong case to incentivise states following fiscal prudence, particularly in the context of the need to return to the path of fiscal correction. We have, therefore, assigned a weight of 17.5 per cent to fiscal discipline. Under this criterion, if all states have improved their respective ratios of own revenue to total revenue expenditure, then the states with relatively higher improvement than the average receive higher transfers.

Similarly, if the ratio has deteriorated in all states, then states with lower deterioration than the average receive higher transfers.

8.37 The criteria for determining the *inter se* shares of states in tax devolution, along with the weights assigned to them, are summarised in Table 8.1. The formula for deriving the *inter se* shares of states in tax devolution under each of the criterion are given in the end note to this chapter.

**Table 8.1: Criteria and Weights for Tax Devolution**

Criteria	Weight
1. Population (1971)	25.0
2. Area	10.0
3. Fiscal Capacity Distance	47.5
4. Fiscal Discipline	17.5

8.38 Our recommendations on tax devolution are based on the considerations of need, fiscal deficiency and adequate incentivisation for better performance. The *inter se* shares of states in the net proceeds of central taxes (excluding service tax) as recommended by us in each of the five years 2010-15 are specified in Table 8.2.

8.39 At present, service tax is not levied in the state of Jammu & Kashmir. Therefore, net proceeds of service tax are not assignable to this state. The shares of the remaining 27 states in the proceeds of service tax will be as indicated in Table 8.3.

8.40 In case service tax is levied in the state of Jammu & Kashmir, the share of each state, including Jammu & Kashmir, will be in accordance with the percentages indicated in Table 8.2 from the year in which the service tax is levied in Jammu & Kashmir. If in any year during our award period of 2010-15, any tax of the Union is not leviable in a state, the share of that state in the tax should be treated as zero and the entire proceeds of that Union tax should be distributed among the remaining states by proportionately adjusting their shares.

**Table 8.2: Inter se Shares of States**

States	Share
Andhra Pradesh	6.937
Arunachal Pradesh	0.328
Assam	3.628
Bihar	10.917
Chhattisgarh	2.470
Goa	0.266
Gujarat	3.041
Haryana	1.048
Himachal Pradesh	0.781
Jammu & Kashmir	1.551
Jharkhand	2.802
Karnataka	4.328
Kerala	2.341
Madhya Pradesh	7.120
Maharashtra	5.199
Manipur	0.451
Meghalaya	0.408
Mizoram	0.269
Nagaland	0.314
Orissa	4.779
Punjab	1.389
Rajasthan	5.853
Sikkim	0.239
Tamil Nadu	4.969
Tripura	0.511
Uttar Pradesh	19.677
Uttarakhand	1.120
West Bengal	7.264
<b>All States</b>	<b>100.000</b>

8.41 The Commission also noted that, relative to FC-XII, there is an increase in the ratio of devolution to GSDP (as projected by us) for each state (Table 8.4). Thus, every state, taken individually, gains in terms of devolution relative to its GSDP.

**Table 8.3: Share of States other than Jammu & Kashmir in the Service Tax**

<i>(per cent)</i>	
<b>States</b>	<b>Share</b>
Andhra Pradesh	7.047
Arunachal Pradesh	0.332
Assam	3.685
Bihar	11.089
Chhattisgarh	2.509
Goa	0.270
Gujarat	3.089
Haryana	1.064
Himachal Pradesh	0.793
Jammu & Kashmir	NIL
Jharkhand	2.846
Karnataka	4.397
Kerala	2.378
Madhya Pradesh	7.232
Maharashtra	5.281
Manipur	0.458
Meghalaya	0.415
Mizoram	0.273
Nagaland	0.318
Orissa	4.855
Punjab	1.411
Rajasthan	5.945
Sikkim	0.243
Tamil Nadu	5.047
Tripura	0.519
Uttar Pradesh	19.987
Uttarakhand	1.138
West Bengal	7.379
<b>All States</b>	<b>100.000</b>

**Table 8.4: Average Devolution as Percentage of GSDP**

<b>States</b>	<b>FC XIII</b>	<b>FC XII</b>	<b>Difference (FC XIII-FC XII)</b>
Andhra Pradesh	3.34	2.80	0.54
Arunachal Pradesh	14.24	8.91	5.33
Assam	7.79	5.16	2.63
Bihar	19.44	13.57	5.87
Chhattisgarh	5.47	4.55	0.92
Goa	2.14	1.74	0.40
Gujarat	1.48	1.44	0.04
Haryana	1.10	0.93	0.17
Himachal Pradesh	3.59	1.83	1.74
Jammu & Kashmir	6.66	4.23	2.43
Jharkhand	5.44	5.15	0.29
Karnataka	2.69	2.21	0.48
Kerala	2.13	1.94	0.19
Madhya Pradesh	8.61	5.61	3.01
Maharashtra	1.36	1.04	0.32
Manipur	12.92	7.24	5.68
Meghalaya	7.64	5.20	2.44
Mizoram	13.77	8.31	5.46
Nagaland	9.20	4.95	4.25
Orissa	6.73	5.69	1.04
Punjab	1.92	1.22	0.70
Rajasthan	5.52	3.88	1.64
Sikkim	18.05	12.08	5.97
Tamil Nadu	2.58	2.07	0.51
Tripura	9.31	4.74	4.57
Uttar Pradesh	10.09	6.79	3.30
Uttarakhand	5.35	3.40	1.95
West Bengal	3.67	2.82	0.85

Notes: 1. Average devolution is determined over the five year period of each of the Finance Commissions, as projected.  
 2. Comparable GSDP used for 2005-06 and 2006-07.  
 3. Comparable GSDP projected over the period 2007-08 to 2014-15 has been used.

## End Note

The *inter se* share of  $i^{th}$  state in the tax sharing formula,  $s_i$ , is determined as the weighted sum of state shares by the four parameters. Thus,

$$s_i = \sum_{m=1}^4 s_i^m w_m$$

$$\text{where } \sum_{m=1}^4 w_m = 1; \quad \sum_{i=1}^{28} s_i = 1$$

$w_m$  = weight of the  $m^{th}$  parameter;  $m=1, \dots, 4$   
 $i$  = index for states;  $i = 1, \dots, 28$

The formula for each of the four parameters used by the Commission is as follows:

### 1. Population

For the  $i^{th}$  state the share under this criterion ( $s_i^{m=1}$ ) is derived as

$$s_i^{m=1} = \text{pop}_i^{1971} / \sum_{i=1}^{28} \text{pop}_i^{1971}$$

where  $\text{pop}_i^{1971}$  = 1971 population of the  $i^{th}$  state

### 2. Area

For the  $i^{th}$  state the share under this criterion ( $s_i^{m=2}$ ) is derived through a two stage procedure. In the first stage

$$s_i^{m=2} = \text{area}_i / \sum_{i=1}^{28} \text{area}_i$$

where  $\text{area}_i$  = area of  $i^{th}$  state

In the second stage, the share of each state is subject to a floor of 2 per cent, i.e., states having area less than 2 per cent of the total area are assigned a share of 2 per cent, and the shares of the other states are reduced proportionately so as to restore the sum across all states to unity.

### 3. Fiscal Capacity Distance

For the  $i^{th}$  state the share under this criterion ( $s_i^{m=3}$ ) is derived as

$$s_i^{m=3} = \text{pop}_i^{1971} d_{i,j} / \sum_{i=1}^{28} (\text{pop}_i^{1971} d_{i,j})$$

where  $d_{i,j} = (kY^* - k_j Y_{i,j})$  for all states except Goa, Haryana & Maharashtra  
 = 100 for Goa, Haryana & Maharashtra

$k$  = three year (2004-07) average tax to comparable GSDP ratio of all states

$k_j$  = three year (2004-07) average tax to comparable GSDP ratio of general/special category states;  $j=1,2$

$Y^*$  = three year (2004-07) average comparable per capita GSDP of Haryana

$Y_{i,j}$  = three year (2004-07) average comparable per capita GSDP of  $i^{th}$  state in  $j^{th}$  category

$\text{pop}_i^{1971}$  = 1971 population of the  $i^{th}$  state

### 4. Fiscal Discipline

The share of the  $i^{th}$  state under this criterion ( $s_i^{m=4}$ ) has been derived as

$$s_i^{m=4} = \text{pop}_i^{1971} f_i / \sum_{i=1}^{28} (\text{pop}_i^{1971} f_i)$$

where,  $f_i = \left[ \frac{A}{B} \right]^{2005-08} / \left[ \frac{A}{B} \right]^{2001-04}$

$$A = \left( \frac{\text{own revenue}}{\text{revenue expenditure}} \right)_i$$

$$B = \frac{\sum_{i=1}^{28} (\text{own revenue})_i}{\sum_{i=1}^{28} (\text{revenue expenditure})_i}$$

$\text{pop}_i^{1971}$  = 1971 population of the  $i^{th}$  state

# CHAPTER 9

## Revised Roadmap for Fiscal Consolidation

9.1 Para 8A of the Terms of Reference (ToR) requires the Commission to undertake the following task: ‘Having regard to the need to bring the liabilities of the Central Government on account of oil, food and fertilizer bonds into the fiscal accounting and the impact of various other obligations of the Central Government on the deficit targets, the Commission may review the roadmap for fiscal adjustment and suggest a suitably revised roadmap with a view to maintaining the gains of fiscal consolidation through 2010 to 2015.’ In addition, the Commission has also been asked, vide Para 5 of the ToR, to ‘review the state of the finances of the Union and the States, keeping in view, in particular, the operation of the States’ Debt Consolidation and Relief Facility (DCRF) 2005-10 introduced by the Central Government on the basis of the recommendations of the Twelfth Finance Commission and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth.’ This chapter addresses these ToR.

### The Overall Macro-fiscal Position: Assessment and Targets

9.2 The fiscal roadmap for 2010-15 needs to take account of the combined macro-fiscal position of the Central and State Governments and to set macro-fiscal targets with reference to the overall position. The two key indicators in this context are the combined fiscal deficit and the combined debt to GDP ratio. The latter is not a simple aggregation of the outstanding liabilities of the Central and State Governments. Inter-governmental transactions such as loans to states from the Centre need to be netted

out. Table 9.1 provides a picture of the combined liabilities and combined fiscal deficit of the Central and State Governments from 2004-05 to 2008-09 (BE). Combined liabilities<sup>1</sup> have fallen consistently from 91.7 per cent of Gross Domestic Product (GDP) in 2004-05 to 81.9 per cent by the budget estimates for 2008-09. The combined fiscal deficit also fell from 7.3 per cent in 2004-05 to 5.0 per cent in 2008-09 (BE). Subsequent to the budget for 2008-09, there was a global slowdown which continued in the year 2009-10.

**Table 9.1: Aggregate Position of Centre and States**

*(per cent of GDP)*

	2004-05	2005-06	2006-07	2007-08 (RE)	2008-09 (BE)
RD	3.6	2.6	1.2	0.6	0.4
FD	7.3	6.6	5.3	5.3	5.0
Debt	91.7	91.2	88.2	86.5	81.9

Source: Indian Public Finance Statistics 2008-09

9.3 The macro-fiscal correction prescribed by the Twelfth Finance Commission targeted the combined fiscal deficit of the Centre and states, in line with the assumed availability of household savings at 10 per cent of GDP and an acceptable level for the current account deficit at 1.5 per cent of GDP. After allowing for absorption by the private sector at 4 per cent of GDP and by non-departmental public sector enterprises at 1.5 per cent of GDP, this yielded a feasible, sustainable, combined fiscal deficit of 6 per cent of GDP. However, it should be noted that this fiscal deficit was the target for the last year of FC-XII projections (2009-10) and that the combined deficit figures projected for the years

<sup>1</sup> These liabilities include external debt at book value.

leading up to the final year were higher. A constant fiscal deficit of 6 per cent with nominal GDP growth rate of 12 per cent for the economy, as assumed in the FC-XII projection exercise, would stabilise debt in the long term at 56 per cent. However, the economy approaches such a long term resting point, asymptotically, only at infinity. After factoring in the fiscal deficit progression assumed for the projection period of FC-XII, to the final targeted fiscal deficit of 6 per cent of GDP, their targeted debt for 2009-10 worked out to 75 per cent of GDP.

9.4 Despite the commendable fiscal correction achieved by the Centre and states, as described in Chapter 4, the closing debt to GDP ratio for 2009-10 is estimated to reach 82 per cent, well above the FC-XII target of 75 per cent, owing largely to the adverse macroeconomic circumstances in 2008-09. Given the imperative of creating an environment favourable to private investment in the Indian economy, it is necessary that the ratio of consolidated liabilities to GDP be reduced, not merely below the level presently estimated for the close of 2009-10, but also that targeted by the previous Finance Commission.

9.5 In our view, it should be possible to reduce the combined debt of Centre and states to around 68 per cent of GDP by 2014-15. This target has been arrived at as the feasible and desirable correction, based on our projections of the medium term macroeconomic situation during the award period and our assessment of the resource position of the Centre and states over this horizon. Accordingly, the fiscal deficit targets prescribed for the Centre and states are such as to secure the targeted correction in the combined debt to GDP ratio to around 68 per cent. In the sections that follow, we obtain the individual components of the Centre and states within this overall target.

9.6 The Fiscal Responsibility and Budget Management Act (FRBMA), 2003 is, in essence, a target-based framework to ensure that government finances are managed with a view to achieving equitable, long term macroeconomic stability consistent with attainment of the medium term growth target of the Indian economy. It requires the

government to maintain a medium term fiscal strategy that can be monitored over a multi-year period.

9.7 It is clear that in spite of improved performance in the first three years of the FC-XII award period, the Centre will not be able to achieve the FRBM targets by the end of 2009-10. Looking ahead, the government has not set a firm time limit for fiscal performance to be brought back on its FRBM envisaged path. This, then, becomes a central task for this Commission. In addition, the impact of the recent counter-recessionary measures on the fiscal stance indicate two important priorities for the present Commission: (i) to ensure that the fiscal sustainability of the Centre is protected and improved through measures to reduce the debt to GDP ratio, which rose as a consequence of not meeting the FRBM targets and (ii) to be mindful of the need for the FRBM Act targets to be adjusted when exogenous unanticipated shocks occur.

9.8 The Commission has considered the targets prescribed in the FRBMA and has taken into account the views of the Central Government and Reserve Bank of India (RBI) on the value and utility of these targets. Our discussions and a perusal of their memoranda reinforce our belief that a target-based framework needs to be maintained for the award period of this Commission.

9.9 The enactment of Fiscal Responsibility Legislation (FRL) in 26 states has resulted in significant fiscal correction. In aggregate, these states have reached their expenditure and debt targets ahead of schedule. Revenue buoyancy, both due to improved own tax revenues of the states and due to the derived benefit of high central tax buoyancies (through share in central taxes) has mainly been responsible for the fiscal correction. Another encouraging feature is that, in the aggregate, the states have been able to reduce their debt to Gross State Domestic Product (GSDP) ratio to less than 30 per cent. An equally, noteworthy outcome of the implementation of FRL has been the welcome exit of all general category and three special category states from a post devolution non-plan revenue deficit. However, there is wide

variation in performance among the states. The Commission's objectives are, therefore, to maintain the virtuous improvements in state finances, to protect state finances against exogenous shocks to the extent feasible and to incentivise those states that continue to face fiscal stress towards undertaking urgent fiscal correction.

### **Stakeholders' Views on Existing FRBM Framework**

9.10 The states, in their individual memoranda, have raised various issues regarding the roadmap for fiscal consolidation and debt relief. On the issue of elimination of revenue deficit, the states have agreed with the approach of FC-XII and accept that, as a prudent fiscal policy, borrowings should not be used for government consumption expenditure. They have suggested that this 'golden rule' should be made an integral part of the roadmap for 2010-15. On the issue of fiscal transparency the states have criticised the practice of off-budget borrowings. Some states have represented that this should not be used as an excuse for relaxation in the fiscal targets for the Centre. In their collective memorandum the states have pointed out that all grants to local bodies and to other aided institutions are classified as revenue expenditure. Hence, a mechanical application of the revenue deficit conditionality detracts from the efforts of State Governments to decentralise development expenditure.

9.11 On the subject of fiscal targets, the states have suggested that targets should not be mechanically set, but should depend on the states' capacity to service debt. Some states have suggested that the targets should allow them to take up their development spending. A few states have pointed out that the path to fiscal correction should allow countercyclicality and in years of high revenues, restrict excessive spending. They have also suggested the setting up of a National Fiscal Stabilisation Fund. It has further been represented that GSDP is not a very reliable denominator for fixing the targets and the roadmap. Instead, they suggest that targets be set for both interest payments and debt stock in terms of total revenue receipts.

9.12 With regard to debt relief, the states have asserted that interest rates on loans from the National Small Savings Fund (NSSF) are high and sought an intervention on this front. While some states have sought reduction of interest rates to 9.5 per cent on the pre-2003-04 loans, some have sought its inclusion in the Debt Consolidation and Relief Facility (DCRF) at an interest rate of 7.5 per cent. Some states have sought a reduction in the difference between the interest rates on open market loans and NSSF loans. It has also been suggested that the interest rate should not be more than 50 basis points higher than the average cost of funds. Some states have suggested that it should be linked to the Central Government Securities (G-Sec) rate to eliminate the anomalies in interest rates for all time. The joint memorandum of the states urges us to take into account the total loan burden of the states, including NSSF loans and loans of ministries other than Finance in recommending effective debt relief measures.

9.13 On debt management, states have protested that they are saddled with high cost debt. It has been pointed out that while states take 80 per cent of the high-cost NSSF loans, the Centre takes 80 per cent of the aggregate open market loans, which are low-cost. Some states have argued that the ratio of the shares of the Centre and states should be similar for all sources of borrowings. It has also been pointed out that the repayment obligation is expected to be higher than ever before during the award period of FC-XIII due to the loans taken for debt swap and increased market borrowings due to reduction in NSSF loans. It has been suggested that this should be taken into account while recommending debt relief schemes and drawing up the revised fiscal consolidation path.

9.14 On DCRF, some states have argued that the size of relief recommended was inadequate and have asked for inclusion of NSSF loans under the DCRF scheme. Some states have suggested that the benefit of the debt waiver was not concomitant with its extremely stringent conditionalities. We have received requests for continuation of the scheme during our award period.

9.15 The Central Government, in its memorandum, has stated that the Centre has been moving towards fiscal consolidation. It has argued that debt relief schemes tend to give perverse incentives to those who have contracted high debts in the past and thus, need to be carefully designed.

9.16 In its comments, the Reserve Bank of India has maintained that the design of the post-FRBM fiscal architecture should ensure long term sustainability, inter-generational equity and ability to stabilise the fluctuations in employment and output in the economy. Deficits and debt should be contained at tolerable levels so as not to hinder monetary policy objectives. RBI has noted that due to the economic slowdown, the FRBM rules have been relaxed for fiscal years 2008-09 and 2009-10. Therefore, post-FRBM fiscal architecture should exclude these two exceptional years and begin when normalcy returns. RBI is of the opinion that there is need to maintain a balanced revenue account with a ceiling on deficits and debt. Hence, there is need for a revenue deficit target along with a cap on the fiscal deficit. According to an exercise carried out by RBI, the absorption capacity of the economy for the combined market borrowings of the Centre and the states is in the range of 5 to 6 per cent of GDP during the period 2010-11 to 2014-15. Hence, the combined fiscal deficit of 5 to 6 per cent may be apportioned equally between the Centre and the states. RBI's opinion is that off-budget liabilities must be captured in the calculation of debt. However, in the case of NSSF, the part of the fund utilised by State Governments is to be excluded before setting up any debt targets for the Centre.

9.17 The Planning Commission, in its comments, has pointed out that the entire practice of meeting the subsidy requirements through off-budget borrowings and not taking it into account in the revenue and fiscal deficits is a clear violation of the definitions under the FRBM Act. One of the important points raised by the Planning Commission is that the recommendation of elimination of the revenue deficit should be reviewed in the light of the blurring line between revenue and capital spending of governments, at both the central as well as the state level. It has

argued that capital expenditure involves a 'sacrifice' of present consumption by the present generation and thus, the future generations have an obligation to repay this sacrifice. The Commission further points out that the current framework provides a straitjacketed approach to the fiscal roadmap and does not prescribe any cyclically adjusted budget balance to build in counter cyclicity in government spending. It has also pointed out that the conformity of the current classification to the distinction between expenditure on revenue account and other expenditure referred to in the Constitution should be examined. With regard to the fiscal deficit, the Planning Commission has suggested that the approach should be to set a trajectory for the debt stock instead of fixing uniform targets for fiscal deficit. It has also suggested that one aspect of debt sustainability is liquidity of government, which can be assessed as a ratio of debt servicing requirement to the revenues of the government. Putting a cap on this ratio can be an additional measure in the direction of ensuring debt sustainability.

## **Central Government: Roadmap and Recommendations**

### **Fiscal Targets**

9.18 A long term and permanent target for the Central Government should be to maintain, at the minimum, a zero revenue deficit. In essence, this target is based on the 'golden rule' which is simply that, in the absence of economic emergencies no economic agent should borrow to finance current consumption. Borrowing should be undertaken for investment purposes only. In the context of the public sector, this requires the government not to use national savings to finance consumption. Thus, all items of consumption expenditure need to be financed from current receipts, a practice which is widely implemented in most countries that have successfully addressed the issue of fiscal responsibility.

9.19 While some allowances may be made for revenue deficits during recessionary phases, the medium-term fiscal framework must plan for all current expenditures to be financed entirely out of

current revenues. This is an essential requirement for prudent long term fiscal policy. It is salutary to note the importance that has been attached to maintaining progress towards a zero revenue deficit in the speeches of all the Finance Ministers since the passing of the FRBM Act, even in a situation where a high growth rate and a comfortable balance of payments position afforded them room to manoeuvre and where, unlike in the 1990s, the deficit situation posed no immediate threat to fiscal solvency. Thus, we are of the view that there is a general consensus on maintenance of the golden rule and on setting the associated revenue deficit target at zero, with surpluses on the revenue account as a desirable goal.

9.20 We recognise that the revenue deficit is but an approximation for the current deficit in India. It includes spending that is not consumption and does not include spending of a consumption nature. We have, in a subsequent section, recommended an urgent review of this issue. However, we do not feel that this shortcoming is of such magnitude as to render the revenue deficit inadequate as a measure of borrowing for government consumption spending. The definition of consumption spending is fairly clear and is fully captured in the economic classification of government expenditure. While definitional refinements are certainly important and desirable, they do not present a barrier to setting revenue deficit targets.

9.21 We also feel that it is important to strictly follow the accepted definition of what items are treated as current (or recurrent) expenditures in the economic classification of public expenditures. It is necessary to make this point because we have, in the course of our consultations and perusal of international literature, noted that there is an argument that outputs ‘constructed by the public sector providing longer-term benefits to society over time’ should be treated as capital expenditures. For example, the National Rural Health Mission (NRHM) uses labour in the form of doctors and nurses and other factors such as hospitals and buildings, to produce health services. The outcome—improved health—yields returns in the future through higher productivity from a healthier

workforce as well as through improvement on the human development front. It has been argued that public expenditure on teachers’ or nurses’ salaries be treated as capital expenditure, given that they yield all kinds of returns in the future.

9.22 It has been further argued that since development on account of health and education gets embodied in the beneficiaries once health standards improve or educational standards are stepped up, the expenditure incurred on these is more akin to investment and hence, it would be fair to treat it as capital expenditure. Moreover, in the absence of nurses, doctors and teachers, the capital expenditure incurred on hospital buildings or school buildings is of little use.

9.23 We have considered the above argument carefully. However, we are of the view that it is not valid for the following reasons.

- i) The services provided by teachers and health workers are ‘exhausted’ or fully delivered when their job is done (teaching children/ treating patients). A teacher paid an annual salary to educate a class of children has provided his or her human resource inputs when the payment is made across the academic year. The same is true of medicines, etc.—they are fully consumed in the process of providing the service within the financial year in which they are purchased (less any positive changes in inventories, which are carried forward as additions to capital stock). The same is not true of hospital buildings and school buildings (less depreciation, which is treated as current expenditure).
- ii) The services do not, on their own, create future human capital. This is created through a combination of capital inputs (like hospitals) to which we apply current inputs (like doctors and nurses) on a continuous and recurrent basis—which is why current expenditures are sometimes referred to as ‘recurrent’ expenditures. Thus, a doctor needs to be paid to treat patients on a periodic basis for the time that

that s/he devotes to such treatment. The same is not true of hospital buildings.

9.24 The existing classification of revenue and capital expenditure cannot be disturbed in an *ad hoc* manner. It has to be the result of a comprehensive study. Any disturbance of this classification has wide-ranging implications for the finances of both the Union and the states. In view of this, it is not possible to accept the suggestion mentioned earlier about reclassifying some portions of revenue expenditure as capital expenditure. It would, thus, be appropriate to continue with the existing classification of expenditure as 'revenue' or 'capital'.

9.25 There are also other related issues, such as classification of grants. At present all grants to other tiers of government are classified as revenue expenditures, irrespective of purpose. Even when a grant is provided for the explicit purpose of creating a capital asset, it is classified as revenue expenditure because the capital asset so created is owned by the grant recipient and not the grant provider. No provision presently exists to define a grant for creation of assets as a capital grant. This issue is taken up further in Chapter 13.

9.26 We now turn to the fiscal deficit target for 2014-15 and the roadmap for adjustment of the fiscal deficit across the award period. The terminal year fiscal deficit target needs to be consistent with reduction in the debt to GDP ratio to a desired level, concomitantly with maintenance of a desired level of capital expenditure across the award period. Hence, it is necessary to first specify the debt to GDP ratio desired in the terminal year

9.27 For the purpose of our analysis we have adjusted the outstanding debt figures of the Central Government for the year 2009-10. We have netted out certain liabilities that have been double counted, in particular the NSSF liabilities of State Governments. We have also adopted the Ministry of Finance revaluation of external debt at current exchange rates.

9.28 Since the National Small Savings Fund is maintained in the public account of the Central Government, the total amount invested by the Fund in special securities of the Central and State Governments is accounted under 'other liabilities' within the 'total outstanding liabilities' of the Central Government. However, the amount invested in State Government securities are loans to the states from the Fund, primarily financing the fiscal deficit of the State Governments. It is shown within the outstanding liabilities of the Central Government merely for accounting purposes, but should be treated as outstanding debt of the states alone. While arriving at the outstanding debt of the Central Government, this amount has been deducted from the reported debt stock. Finally, an adjustment has been made to account for external debt at the current exchange rate. This is presently accounted at book value in 'outstanding debt' as reported in the Union Budget. The adjustments made to arrive at the outstanding debt at the end of 2009-10 are as shown in Table 9.2.

9.29 In line with the above adjustments, Central Government debt is projected at 54.2 per cent of

**Table 9.2: Adjusted Debt Stock of Central Government**

Component	As on 31 March 2010 (Rs. crore)
1. Outstanding Liabilities (Budget Documents 2009-10)	3495152
2. Investment in Special State Government Securities	463337
3. Outstanding Liabilities of GoI Net of Amounts Invested in State Securities [1-2]	3031815
4. Off-Budget Liabilities <i>Of which</i>	201236
(a) Securities Issued to Oil Companies	157536
(b) Securities Issued to FCI	16200
(c) Securities Issued to Fertiliser Companies	27500
5. Adjustment on Account of Valuation of External Debt on Current Exchange Rate	142441
6. Adjusted Debt [3+5] (as per cent of GDP)	3174256 (54.2%)

GDP at the conclusion of 2009-10. Taking into account the expected reduction in fuel and fertiliser prices, along with the expected return to the trend growth rate of over 13 per cent from 2011-12, in conjunction with other reforms including reduction of subsidies along a prescribed path, we project a feasible level for outstanding liabilities of the Centre at 45 per cent of GDP by 2014-15, while at the same time maintaining adequate resources for public investment.

9.30 The first step in constructing the fiscal correction trajectory was to prescribe the revenue deficit path, starting with the projections of revenue receipts and expenditures of the Centre provided to us by the Ministry of Finance for 2010-15 and applying normative corrections for some elements of revenue expenditure, such as explicit subsidies (refer to Chapter 6).

9.31 The Commission recognises that making progress towards the golden rule of zero revenue deficit during the award period has to take account of the sharp increase in the revenue deficit to GDP ratio expected in 2009-10. Our analysis led us to conclude that it would be unrealistic to expect that the revenue deficit to GDP ratio would be zero across all years of the award period. Accordingly, based on our normative assessment of central revenues and expenditure, the ratio is projected to decline from 4.8 per cent of GDP as budgeted for 2009-10, to a revenue surplus of 0.5 per cent of GDP by 2014-15. These projections imply, on average, a revenue deficit to GDP ratio of 1.25 per cent across the award period. Details of the underlying GDP growth rates, other parameters and adjustments are in annexes 6.1 and 6.3.

9.32 In the initial years of our projection horizon, when the revenue deficit is expected to

be high, the target for capital expenditure is held at the same percentage of GDP as budgeted in 2009-10. As per the budget estimates for 2009-10, the fiscal deficit of 6.8 per cent, in conjunction with the budgeted revenue deficit of 4.8 per cent and non-debt capital receipts at 0.1 per cent of GDP, yields a capital expenditure of 2.1 per cent of GDP. As indicated in Para 6.47, non-debt capital receipts have been projected to increase from 0.5 per cent of GDP in 2010-11 to 1 per cent in 2014-15. Capital expenditure has been increased to 3 per cent of GDP in the first and 3.1 per cent in the second year of the projection horizon. In view of the projected reduction in revenue deficit, the permissible capital expenditure has been allowed to increase to 3.8 per cent, 3.9 per cent and 4.5 per cent in the third, fourth and fifth year, respectively of our award period (see Table 9.3). Higher capital expenditure than that projected by us will be possible in all the years of the projection period if there are increased receipts from disinvestment.

9.33 Currently, with regard to government guarantees, the FRBM rules prescribe a ceiling of 0.5 per cent of GDP for the annual flow, rather than for the stock. We recommend that this be converted to a ceiling of 5 per cent of GDP for the stock of outstanding guarantees at the end of every year. In 2007-08 government guarantees amounted to 2.2 per cent of GDP, which was within the above limit. We elaborate on the guarantees covered by this rule in a later section.

### Reforms to FRBM Legislation

9.34 The Commission undertook extensive consultations on the content of FRBM legislation

**Table 9.3: Fiscal Consolidation Path for the Centre**

	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Revenue Deficit	4.8	3.2	2.3	1.2	0.0	-0.5
Non-Debt Capital Receipts	0.1	0.5	0.6	0.8	0.9	1.0
Capital Expenditure	2.1	3.0	3.1	3.8	3.9	4.5
Fiscal Deficit	6.8	5.7	4.8	4.2	3.0	3.0
Outstanding Debt (Adjusted)	54.2	53.9	52.5	50.5	47.5	44.8

(per cent of GDP)

and the issues raised during its implementation over the last five years. Based on these consultations, the issues raised can be grouped into three categories:

- i) Making the FRBM process more transparent and comprehensive.
- ii) Ensuring that the FRBM process takes account of changes in the values of parameters exogenous to government action and is sensitive to exogenous shocks.
- iii) Improving monitoring and compliance.

9.35 Before detailing the recommendations it is important to recognise that the implementation of Fiscal Responsibility Legislation cannot be fully effective when the time frame for policy making is largely annual in nature. For the FRBM legislation to work more effectively, with the flexibility required to adapt to exogenous shocks and changes in parameter values (like oil prices), what is required is an annually adjusted, medium term fiscal framework, that sets medium term targets consistent with achievement of FRBM and provides evidence-based rationale for deviations in actual out-turns from these medium term targets.

9.36 We think that the budgeting process in India needs significant reform to enhance the medium term dimensions to fiscal policy design and that far more attention needs to be devoted to this issue than has historically been the case. A beginning has, indeed, been made by the annual presentation of a medium term fiscal policy statement. However, this document is less than adequate to assess the fiscal impact of major policy decisions of the government and has a tenuous link with the annual budget which continues to be the major policy document guiding the design of the Central Government's public finances.

9.37 The transition from an annual statement of revenue and spending (such as that embodied in the annual budget) to a rolling medium term fiscal framework (of which the annual budget is but one part) has been an important reform in countries where target-based fiscal policy has proved to be effective and durable. Conversely, target-based fiscal policy has been gestural in countries where such a transition has not been made. This is because

the benefits of fiscal consolidation are more likely to accrue when policy decisions are made with a view to medium term impact and where the medium term horizon allows governments to be flexible when exogenous or unanticipated events occur.

9.38 Thus, it is recommended that the Central Government revises the existing medium term fiscal policy statement with a more detailed Medium Term Fiscal Plan (MTFP) which contains three-year-forward estimates of revenues and expenditures, with detailed breakup of major items that form a part of the revenue and expenditure, together with a narrative explanation of how these estimates have been generated. In other words, the estimates of revenues and expenditures should be arrived at as the sum of their parts and should be in conformity with the broad roadmap for fiscal parameters set out under the Act. Thereafter, the government could increase the time horizon of the MTFP by one year in each subsequent year and provide fresh estimates for the other years. The estimates of the first year would be converted into budget estimates, along with a narrative explanation of such revisions. In effect, this would mean that the Central Government would provide a fiscal roadmap for three years into the future. This would ensure tighter integration of the MTFP into the budget and make the MTFP more a statement of commitment rather than merely one of intent. These changes, when implemented, will also facilitate our more effective participation in the G-20 Forum's mutual assessment mechanism.

9.39 We are of the view that this is the most significant reform that India needs to make in the context of effective design and implementation of fiscal responsibility legislation. Such legislation can be effective and its credibility enhanced when there is a medium term plan that is used by the government as an operational policy document. In the following paragraphs we recommend a number of steps that will need to be taken for progress in this direction. We have tried to ensure that these recommendations can be implemented within the existing Constitutional framework and only require incremental changes that build on the existing institutional processes and procedures.

### **Making the FRBM Process More Transparent and Comprehensive**

9.40 The economic and functional classification of the budget is an important tool—this is what makes a budget or a MTFP an instrument of policy as distinct from an instrument of accounting and legislative compliance, which is the principal function of a line item budget. This is currently produced with a considerable time lag. We recommend that the government prepare to present a detailed economic and functional classification of the expenditure budget as part of the MTFP. The budget preparation process should be modified to enable this, so that expenditure proposals are concurrently presented in line item format as well as in the economic and functional format. This will enhance the operational value of the budgetary process and enable progress in assessing the quality of public expenditure by relating fiscal proposals to their economic and developmental impact. We recommend that this process commence from the 2011-12 fiscal year with respect to the economic classification, as the information necessary for this purpose is already being collected in the budget exercise, with the full economic and functional classification to be presented as soon as practicable.

9.41 We have noted that there is considerable difficulty in identifying the volume and incidence of central transfers to states. We recommend that all central transfers to states be set out in an independent statement including, in the case of central transfers under budget head 3601, a detailed breakup into the constituent flows, such as Finance Commission grants (separate components), other non-plan grants, normal central assistance, additional central assistance and special central assistance. The Ministry of Finance should produce this statement with retrospective effect once the format is available, in order to enable inter-temporal analysis that would facilitate the work of future Finance Commissions.

9.42 The Central Government has commenced reporting tax expenditures in a separate statement from the 2006-07 Budget, which is a laudable and useful initiative. We recommend that this be

systematised in all future budgets and the basis for calculation of these expenditures be made explicit.

9.43 We recommend that the Central Government should initiate measures to report the compliance costs of major tax proposals in the MTFP. We recognise that this move would require sufficient preparatory action and hence, recommend that this should be done from the 2013-14 Budget.

9.44 In its memorandum to the Commission, the Ministry of Finance has pointed out: ‘... a plan expenditure proposal without reference to the ability of the state/project to finance its maintenance by user charges or by a specific future charge on the revenues of the state is essentially faulty design/planning process. There is a need to correct these upfront and to limit the provision of maintenance grants by the Commission, to the real unmet needs.’ This is an important proposition requiring fiscal reform and recognises that there is a mismatch between capital expenditure programmes and maintenance allocations for such programmes. The consequence has been that Finance Commissions have sought to redress this imbalance through provision of maintenance grants.

9.45 We recommend that all capital expenditure proposals for inclusion in the Government of India Budget are accompanied by a statement of the Revenue Consequences of Capital Expenditure (RCCE) for the lifetime of the proposed projects. RCCE statements should be annually modified to take into account price and other changes. The RCCE statements should be used to calculate revenue expenditure requirements in the years covered by the MTFP such that revenue expenditure projections are consistent with the RCCE statements. This activity will need to be coordinated with the Planning Commission, which will also need to institute a process of producing RCCE statements for plan expenditure proposals, in the preparation of Annual Plans and for the Twelfth Five Year Plan. RCCE statements should begin to be provided from the 2013-14 Budget for all projects requiring Public Investment Board (PIB) approval.

9.46 Government policies are, by nature, forward looking. Many important development initiatives such as the National Rural Employment Guarantee Scheme (NREGS) and measures to implement the Right of Children to Free and Compulsory Education (RTE) Act have expenditure consequences for future years. Hence, we recommend that new policy initiatives that are known to involve future expenditure commitments should be reflected in the MTFP. In addition, the MTFP should also provide the projections for transfers to states, either in the form of plan assistance or under Centrally Sponsored Schemes (CSS). This, too, should be done from the 2013-14 Budget.

9.47 It is important that contingent liabilities be reported fully and that adequate provisioning be made for such liabilities. We have recommended modification of the fiscal rule that limits government guarantees. The public sector as a whole is vastly enhancing its use of the Public Private Partnership (PPP) mode for project financing. This frees valuable fiscal space for the provision of public goods in areas where such finance is unlikely to be forthcoming.

9.48 We welcome this trend of private participation in the public sector. We also recognise that PPPs create explicit and implicit obligations on the part of the public entity that is party to them so that, in the final instance, they become contingent liabilities of the Government of India. The fiscal fallout of such partnerships could reflect on the health of the aggregate balance sheet of the public sector and may create demands for enhanced budgetary support to the public sector entities contracting such liabilities. Explicit contingent liabilities, which may be in the form of stipulated annuity payments over a multi-year horizon, should be spelt out. Implicit contingent liabilities in this context are obligations to compensate the private sector partners for contingencies such as changes in specifications, breach of obligations and/or early contract termination for *force majeure*. These are relatively difficult to quantify. We think that the FRBM Act should stipulate these contingent liabilities.

9.49 We, therefore, recommend that the documentation associated with each PPP should

contain a short report that comprehensively details and quantifies the financial obligations of the public sector in the PPP arrangement. These should be collated for all central undertakings. The collation should form the basis of a statement in the MTFP, detailing the aggregate obligations of the Government of India and the risks involved. Simultaneously, GoI should initiate a review of the provisions regarding termination payments in existing PPP projects and report these in the MTFP prepared from the fiscal year 2011-12 onwards.

9.50 In a market economy, the government maintains a portfolio of physical and financial capital assets in order to secure its geopolitical and strategic priorities, provide national and global public goods and address market failures that impact affordable access to merit goods for the poor and disadvantaged sections of society. Historically, India's strategic priorities have included diversification of the production base, fostering of infant industries and provision of key infrastructure assets and commodities that the domestic private sector was not able to provide due to various reasons during the early stages of national economic development. With economic liberalisation, rapid economic growth, diversification of the production base, growth of capital markets and creation of the knowledge economy, there has been a transformation of the potential and capacity of the Indian private sector to deliver goods and services in a broad range of areas. Infant industries have become global players. At the same time, new strategic imperatives like environmental sustainability, human development, rapid urbanisation and expansion of a knowledge society to capitalise on the demographic dividend have emerged, as discussed in Chapter 3. A reordering of the government's public investment priorities is, therefore, both necessary and desirable.

9.51 To this end, disinvestment and privatisation serve as avenues for the government to increase fiscal space to meet these emerging strategic challenges. Disinvestment allows the

government space to rebalance its public investment portfolio to meet new challenges, while at the same time maintaining fiscal prudence. It enables the Government of India to meet its overriding fiscal priority—to reduce the debt to GDP ratio to levels consistent with long term debt sustainability—and simultaneously increase the volume of public investment in key strategic areas.

9.52 Disinvestment increases non-debt capital receipts and so, *ceteris paribus*, allows the government to increase its capital expenditure without impacting the fiscal deficit. We recommend that transfer of disinvestment receipts to the public account, as has been the practice in the past, be discontinued and that all disinvestment receipts be maintained in the consolidated fund. This will enable the use of these funds to be decided as part of the medium term fiscal planning exercise. In addition, we recommend that to improve the quality and transparency of disinvestment, the government should list all public sector enterprises that yield a lower rate of return on assets than a norm to be decided by an expert committee set up for the purpose. This disclosure should be made annually and placed before Parliament along with the budget documentation.

9.53 We further recommend that the Government of India direct all its administrative departments as well as departmental and non-departmental undertakings to prepare an inventory of vacant land and buildings valued at market prices. When this is ready, a consolidated list should be prepared in a statement, also to be placed before Parliament along with budget documentation. Such an exercise will contribute to better protection of these public assets against the threat of encroachment. It would also enable effective utilisation of land for projects and minimise the need for fresh land acquisitions.

9.54 We recognise that the actions recommended in paras 9.52 and 9.53 will require considerable preparation and therefore, recommend that the above disclosures commence from fiscal year 2013-14 onwards.

### Sensitivity to Shocks and Countercyclical Changes

9.55 The path of fiscal correction laid down in the FRBM Act has been halted since 2008-09 on account of unanticipated changes in the prices of key commodities, especially fuel and fertiliser and thereafter in 2009-10, in view of the impact of the global economic recession on the Indian economy. The subsidy bill shot up from Rs. 70,926 crore in 2007-08 to Rs. 1,29,243 crore in 2008-09 (RE), an increase of 82.2 per cent.

9.56 Gross tax receipts of the Centre grew by 25.3 per cent in 2007-08 over the 2006-07 level. This rate of increase came down to 5.9 per cent in 2008-09 (RE) over the 2007-08 level. The expected growth in 2009-10 (BE) over the 2008-09 levels is only 2.1 per cent. While the fall in direct taxes was mainly due to shrinking economic activity, the fall in excise and customs receipts was primarily due to counter-recessionary concessions given to boost economic activity. As per the Statement of Revenue Foregone by the government, the revenue loss from tax concessions aggregated to 58.0 per cent in 2007-08 and 76.3 per cent of gross tax collections in 2008-09. The basis of assessment of the tax foregone, however, is not clearly spelt out.

9.57 On the expenditure side the major increase was on subsidies and plan expenditure. The total amount of bonds issued to petroleum companies in these two years amounted to Rs. 96,496 crore while that for fertiliser companies amounted to Rs. 27,500 crore.

9.58 Increased plan expenditure, especially on schemes like NREGS and expenditure on recession hit sectors, led to a spurt in expenditure since the second half of fiscal year 2008-09. As a result, plan expenditure grew by 38 per cent in 2008-09 over the 2007-08 level. The corresponding increase in 2007-08 over 2006-07 was 20.7 per cent and is expected to be 14.9 per cent for 2009-10 over the 2008-09 level. Over and above this, the government also announced a scheme of agricultural debt waiver and debt relief with the total value of overdue loans being waived estimated at Rs. 50,000 crore. The amounts budgeted for this purpose in 2008-09 and

2009-10 are Rs. 10,000 crore and Rs. 15,000 crore respectively.

9.59 The fiscal correction path of the economy was thus reversed. The revenue deficit increased from 1.11 per cent of GDP in 2007-08, to 4.53 per cent in 2008-09 (RE). In 2009-10 (BE) it is estimated to be even higher at 4.83 per cent. The fiscal deficit also shot up from 2.69 per cent in 2007-08 to 6.14 per cent in 2008-09 (RE) and is projected at 6.85 per cent in 2009-10 (BE).

9.60 An important lesson from the implementation of the FRBMA during 2005-10 is, therefore, the need to allow the fiscal system to adapt to exogenous shocks and/or changes in exogenous parameter values. This is a core objective of the stabilisation function of public finance which no roadmap can afford to ignore. We, therefore, recommend three changes in the design of the existing fiscal responsibility legislation to address this challenge.

9.61 First, we recommend that the MTFP make explicit the values of the parameters underlying expenditure and revenue projections and the band within which these parameters can vary while remaining consistent with FRBMA targets. This will enable the government to make an evidence-based case for relaxation of these targets, should such circumstances arise. Recent history indicates that some of the important parameters that are likely to impact the path of FRBM achievement are the prices of key commodities (like oil), the exchange rate and the interest rate.

9.62 Second, we recommend that the FRBMA specify the nature of shocks that would require a relaxation of FRBM targets. These would include agro-climatic events of a national (rather than regional or state-specific) dimension, global recessions impacting the country's exports and shocks caused by domestic or external events like asset price bubbles or systemic crises in important sectors like the financial markets. It is clear that these shocks would affect some targets more than others. Thus, shocks requiring a boost to aggregate demand, or sharp increases in global oil prices would require a temporary relaxation of the revenue

deficit target. Shocks addressed through expanding public investment would impact the debt-to-GDP ratio and, therefore, the fiscal deficit target.

9.63 Finally, macroeconomic stabilisation and counter-recessionary actions are the primary responsibility of the Central Government. It is true that the implementation of counter-recessionary measures has, to some extent, been customised, requiring measures which the State Governments are best placed to implement. However, the associated fiscal costs should be borne nationally and hence, be financed by the Centre. This is because the desired outcomes—macroeconomic stability and maintenance of the highest possible growth rate—are targets that need to be secured nationally. Hence, we recommend that rather than raising the borrowing limits for states when such shocks occur, the Central Government should assume the entire additional resource mobilisation responsibility and pass on the resources so mobilised to the states in the form of increased devolution. The *inter se* distribution of these resources should be determined in accordance with the horizontal devolution formula recommended by the Finance Commission. This formula would serve as the most pertinent estimate of the differential requirements of the states, having been designed specifically with reference to fiscal capacity and fiscal need. Such a policy would also maintain the integrity and improve the expenditure predictability of the state budgets as well as the medium term fiscal plans, with only the Centre needing to initiate 'pauses' or seek postponements in achievement of its FRBM targets.

9.64 Other than exogenous shocks and parametric changes, there are also policy processes which create macroeconomic shocks and distortions, but are within the control of the Central Government. Pay Commission recommendations are an important example of this. In our discussions with State Governments a significant portion of the memoranda presented and the discussions on the future fiscal roadmap centred around the impact of this award on state finances. For the Centre, arrears alone amounted to Rs. 28,160 crore on a salary base of Rs. 44,360 crore. While many reforms can and

should be, contemplated to end this self-inflicted distortion, one action that could be taken immediately is that of making the pay award commence from the date on which the recommendations of future Pay Commissions are accepted by the government. In effect, this would do away with the need for arrears. Since State Governments' awards typically follow those of the Central Government, this would allow states to time their awards such that the need for arrears does not arise. In our view, if Finance Commissions are able to present their inter-governmental recommendations without any need for retrospective fiscal transactions, then the same should be possible in the case of Pay Commissions as well.

### Monitoring and Compliance

9.65 Previous Finance Commissions have sought to incentivise State Governments to undertake fiscal reforms by providing conditionality-linked incentives such as debt relief. These incentives have been remarkably successful in delivering improved fiscal health in state finances. However, many state FRBM legislations also provided for an independent review of implementation of the respective FRBMAs. These reviews were critical in improving the credibility and transparency of actions taken by the State Governments for implementation of fiscal responsibility legislation. In our opinion, they have been a major contributor to the success of fiscal reform initiatives at the state level. We recommend that the Centre institute a similar process of independent review and monitoring of the implementation of its own FRBM process. This could initially be done by setting up a committee to conduct an annual independent and public review of FRBM compliance, including a review of the fiscal impact of policy decisions on the FRBM roadmap. This review should present its findings concurrently with the annual budget and the medium term strategy.

9.66 It is to be hoped that this Committee would, over time, evolve into a full-fledged Fiscal Council. We are of the view that given India's legislative and executive structure, the Council should act as an autonomous body reporting to the Ministry of Finance, which should report to Parliament on

matters dealt with by the Council in accordance with current Constitutional provisions. As the size and complexity of the Indian economy expands, it is imperative that such an institution be developed to assist the government in addressing its fiscal tasks in a professional, transparent and effective manner. Fiscal Council like institutional arrangements exist in many countries such as Brazil, Japan, Korea, Mexico, Sweden and these have been found to add considerable value to the integrity and effectiveness of medium term fiscal policy and design.

### State Finances: Roadmap and Recommendations

9.67 In Para 9.5 we specified the medium term combined debt to GDP ratio target for 2014-15 at 68 per cent. With the target Central Government debt at 45 per cent of GDP in 2014-15, this implies a target debt to GDP ratio of 25 per cent for all states in the same year (the state and central ratios do not add up to the combined ratio because central loans to the states have to be netted out).

9.68 This is a feasible target from the perspective of the states. In the 2005-09 period, the states have undertaken considerable fiscal correction and their aggregate debt to GDP ratio is not expected to be higher than 30 per cent in 2009-10. Given that the ratio was 27 per cent in 2008-09, we consider any increase from this ratio to be temporary, in the sense that it reflects the allowance for debt financed counter-recessionary expenditures by State Governments. Recognising the need for such expenditures, the Government of India has relaxed the borrowing limits for the states to 3.5 per cent and 4 per cent of GSDP for all the states for the years 2008-09 and 2009-10 respectively, as opposed to the 3 per cent target set out in the roadmap of the Government of India for states, following the action taken on the recommendation of FC-XII.

9.69 It should, therefore, be feasible to undertake a small reduction in the aggregate debt to GDP ratio of the states from about 27 per cent of GDP in 2007-08 to 25 per cent by 2014-15, especially if, as we recommend above, the Central Government assumes responsibility for all borrowings due to unanticipated shocks and/or

parameter changes of a global or national dimension. However, the adjustment path will have to allow for temporary increases in revenue and fiscal deficits in 2008-09 and 2009-10, given the need for counter-recessionary expenditure.

9.70 A long term and permanent target for the states should be to maintain a zero revenue deficit. The arguments advanced in favour of the application of the 'golden rule' to the Centre also apply in the case of the states. It is encouraging that most states in the Union are already following this rule. In essence, all that the future fiscal roadmap requires is that they continue to do so and the few states that have not yet reduced revenue deficits to zero, endeavour to do so, by 2014-15.

9.71 We recognise that the exceptional circumstances of 2009-10 may increase the fiscal pressure on all states. We are unable to provide a quantified assessment of the extent to which this is likely to be the case in individual states in 2009-10 on account of data lags. However, given our growth assumptions, we are of the view that all states that incurred zero revenue deficit or achieved a revenue surplus in 2007-08 should be able to undertake fiscal corrections to return to a zero revenue deficit by 2011-12. Thus, we recommend that the zero revenue deficit target be attained by all such states from 2011-12 onwards.

### General Category States

9.72 Three of the general category states incurred a revenue deficit in 2007-08. For these we recommend an adjustment path commencing 2011-12, to eliminate the revenue deficit by 2014-15. This is shown in Table 9.4

**Table 9.4: RD Path for General Category States with RD in 2007-08**  
(per cent of GSDP)

State	2007-08	2011-12	2012-13	2013-14	2014-15
1 Kerala	2.3	1.4	0.9	0.5	0.0
2 Punjab	2.9	1.8	1.2	0.6	0.0
3 West Bengal	2.7	1.6	1.1	0.5	0.0

9.73 In order to attain a target aggregate debt-to-GDP ratio of 25 per cent, it will be necessary that the aggregate fiscal deficit/GDP ratio of the states be maintained at 3 per cent of GDP. This is

an aggregate indicator and does not take into account the individual circumstances of states. For the purpose of striking a balance between the virtues of customisation and the need to adopt the same procedure for determining targets for all states in similar circumstances, we recommend the differentiated adjustment paths detailed in the subsequent paras.

9.74 All states having a revenue surplus in 2007-08 had fiscal deficits of less than 3 per cent of GSDP, except Uttar Pradesh, which had a fiscal deficit of 3.9 per cent. A state should have adequate room for capital expenditure by using its revenue surplus and a deficit not exceeding 3 per cent of GSDP. Any state that has a revenue surplus along with a higher fiscal deficit should compress its capital expenditure, or alternately, increase its surplus on the revenue account. We, therefore, expect that Uttar Pradesh too will be able to come back to the 3 per cent level of fiscal deficit by 2011-12.

9.75 We recommend that in the case of all states that attained a zero revenue deficit or a revenue surplus in 2007-08, a fiscal deficit of 3 per cent of GSDP be achieved by 2011-12 and maintained thereafter. We expect that the maximum fiscal deficit that these states would incur in 2009-10 is 4 per cent of GSDP, which corresponds to the maximum allowable net borrowing ceiling for that year. The reform path sets targets from the year 2011-12 onwards. The methodology to be adopted for 2010-11 is given in Para 9.86.

9.76 In the case of states having revenue deficit in 2007-08, we recognise that the process of adjustment in the revenue deficit would have a concomitant virtuous impact on the fiscal deficit. Since we have recommended an achievable correction path for revenue deficit, an abrupt reduction in fiscal deficit would lead to compression of capital expenditure, which is not desirable. Thus, it is required that a fiscal deficit higher than 3 per cent is allowed till the revenue deficit comes down to a certain level, so as to prevent any undesirable compression of capital expenditure. We have noted in these states' memoranda their willingness to attempt a fiscal correction exercise that would allow them to maintain and even increase their fiscal

space for capital expenditure. Thus, in the case of these states, the fiscal adjustment path requires them to have capital expenditure less than the states that have already carried out fiscal correction, but with a slightly relaxed fiscal deficit target in the years 2011-12 and 2012-13, so that capital expenditure is not compressed to undesirable levels. Moreover, additional reduction in the revenue deficit will allow these states greater fiscal space on the capital account. The fiscal adjustment path is indicated in Table 9.5.

**Table 9.5: FD Path for General Category States with RD in 2007-08**

*(per cent of GSDP)*

State	2007-08	2011-12	2012-13	2013-14	2014-15
1 Kerala	3.6	3.5	3.5	3.0	3.0
2 Punjab	3.5	3.5	3.5	3.0	3.0
3 West Bengal	3.8	3.5	3.5	3.0	3.0

### Special Category States

9.77 Unlike in general category states where the fiscal adjustment path has been fixed on the basis of 2007-08, in the case of special category states the deficit parameters are highly volatile and, thus, the fiscal adjustment path cannot be fixed depending only on 2007-08 levels. For this purpose we have taken the average of three years, viz. 2005-06, 2006-07 and 2007-08 to determine the base fiscal parameters on which the future adjustment path can be decided.

9.78 While the revenue deficit is the primary driver of the fiscal deficit amongst the general category states, this is not the case with special category states. All the special category states have had an average revenue surplus over the 2005-08 period, while six states have an average fiscal deficit higher than 3 per cent of GSDP over the same period. The reason is that these states are highly dependent on central grants and although all grants from the Central Government are classified as revenue receipts, capital expenditure incurred out of these grants is not accounted in the revenue deficit. Thus, for special category states, the revenue balance is not of much significance for purposes of fiscal adjustment.

9.79 Depending upon the base figure for the fiscal deficit, special category states can be divided into three groups. Four states viz Manipur, Nagaland, Sikkim and Uttarakhand have a base level fiscal deficit of more than 3 per cent but less than 6 per cent. These states will need to make a relatively higher effort in terms of achieving a 3 per cent fiscal deficit and thus, we require that they achieve this level by 2013-14, following the same path prescribed for the three general category states in Table 9.5.

9.80 Jammu & Kashmir and Mizoram have even higher levels of base fiscal deficits, at 7.8 per cent and 10.3 per cent of GSDP respectively. We recognise that these states require more customised fiscal correction paths, which require reforms at their end, but are achievable, nevertheless. Jammu & Kashmir had a fiscal deficit of 7.8 per cent in 2007-08 that included Rs. 606 crore interest payment on NSSF loans of past years due in the previous year. Thus, the fiscal deficit of Jammu & Kashmir for 2007-08 is overstated by this amount. Correcting for this one-time expenditure, the fiscal deficit adjustment path of Jammu & Kashmir can start from 5.9 per cent to reach 3 per cent in 2014-15, with equi-proportional adjustments each year (for J&K please also refer to Para 12.177). Mizoram had a fiscal deficit of 6 per cent in 2006-07 and 11 per cent in 2007-08. The primary reason for this has been the grant received in 2006-07, a considerable portion of which got spent only by 2007-08. Thus, a better point to start the fiscal adjustment path of Mizoram would be the average of the two, i.e., 8.5 per cent, to be reduced to 3 per cent by 2014-15, with equi-proportional annual adjustments. The fiscal adjustment path of the six states with a base level fiscal deficit of more than 3 per cent is as shown in Table 9.6.

**Table 9.6: FD Path for Special Category States with High Base FD**

*(per cent of GSDP)*

State	Base	2011-12	2012-13	2013-14	2014-15
1 Jammu & Kashmir	5.9	4.7	4.2	3.6	3.0
2 Manipur	4.1	3.5	3.5	3.0	3.0
3 Mizoram	8.5	6.4	5.2	4.1	3.0
4 Nagaland	4.8	3.5	3.5	3.0	3.0
5 Sikkim	5.2	3.5	3.5	3.0	3.0
6 Uttarakhand	5.2	3.5	3.5	3.0	3.0

*Note: The base in the case of each state is explained in paras 9.77 and 9.80.*

9.81 The remaining five states, viz. Arunachal Pradesh, Assam, Himachal Pradesh, Meghalaya and Tripura, have a base level fiscal deficit of less than 3 per cent and thus, we require that these states attain a fiscal deficit of 3 per cent of GSDP or less by 2011-12 while maintaining their revenue balance in the same way as general category states with revenue surplus in 2007-08. All special category states are required to remain in surplus on revenue account during the period. The path for debt, fiscal deficit and revenue deficit is given at Annex 9.1, 9.2 and 9.3 respectively.

### Monitoring and Compliance

9.82 To facilitate implementation of the above roadmap we recommend that the states' enactment/amendment of their FRLs incorporating the above targets should be a conditionality for release of all state-specific grants.

9.83 Some of the structural reforms recommended for the Centre in this chapter need to be replicated at the state level as well. The most important of these is the structure of the MTFP, which, as explained earlier, should be more comprehensive, giving details of all significant items on receipts and expenditure along with the underlying assumptions made for projection purposes. MTFP should become an iterative process where the receipts and expenditure are arrived at as the sum of the building blocks thereof and conform to the overall fiscal targets.

9.84 Independent review/monitoring is a feature that is desirable in the FRBM Act and some states already have such a system in place. It is recommended that all states introduce this feature in their Acts. The states should also attempt to incorporate statements on RCCE, PPP and related liabilities, physical and financial assets and vacant public land and buildings.

9.85 We recommend that the Central Government set net borrowing limits for states based on the fiscal deficit path outlined above for each state. While determining the net borrowing limits for any state for any year  $t$ , the only possible way by which to generate a GSDP estimate for year  $t$  is by applying

our projected nominal growth rate for year  $t$  to the best estimate of GSDP for year  $t-1$ . Advance Estimates (AE) of the GSDP at factor cost for the previous fiscal year  $t-1$  are issued only just before the close of the year  $t-1$ , in the month of January at the earliest. This, unfortunately comes a little too late for the exercise of setting state borrowing limits, which is completed by November of year  $t-1$ . However, by November, the Provisional Estimate (PE) for the year preceding,  $t-2$ , should be available for all states (a Final Estimate for year  $t-2$  is issued some months before the close of year  $t-1$ , which is usually very close to the PE for  $t-2$ ). Therefore, the estimate of GSDP for year  $t$  can be obtained by application of our projected nominal growth rates for years  $t$  and  $t-1$  to the PE of GSDP for year  $t-2$ , thus:

$$B_t = f_t^* (1 + g_t^*) (1 + g_{t-1}^*) PE_{t-2}$$

Where

- $B_t$  : Net borrowing limit for year  $t$
- $f_t^*$  : Prescribed fiscal deficit for year  $t$  as a ratio to GSDP
- $g_t^*, g_{t-1}^*$  : Projected nominal GSDP growth rates for years  $t$  and  $t-1$ , respectively
- $PE_{t-2}$  : Provisional estimate of GSDP for year  $t-2$

9.86 The equation in Para 9.85 has to be independently estimated for each state, with the parameter values specific to each. An index for the state identifier is not included in the equation so as not to complicate what is in essence a simple formulation. The procedure allows continual updating of the GSDP base for determination of the net borrowing limits of the state, albeit with a time lag of two years. Without updating of this kind, borrowing limits get prescribed in advance through application of projected nominal growth rates to the estimated GSDP in the base year, leading to the kind of excessive fiscal compression observed in high-growth states during the period of FC-XII. Our procedure, through the continuous updating of GSDP estimates for the estimation of net borrowing limits, offers a growth incentive to states. It should be noted at the same time that since these limits are set with respect to projections of GSDP, any departures of fiscal deficits normalised with respect to final estimates

of GSDP could well depart from the projected ratios, for reasons beyond the control of the state in question.

9.87 Since the above mentioned reform path does not include projections for the year 2010-11, the borrowing limits for that year for each state should be fixed in such a manner that the fiscal deficit does not exceed the lower of 3.5 per cent or the fiscal deficit percentage in 2008-09 as a per cent of GSDP of 2010-11, calculated by applying the projected growth rates for 2010-11 to the AE of GSDP for the year 2009-10. Likewise, for Jammu & Kashmir and Mizoram, it may be fixed with a fiscal deficit not exceeding the lower of 2008-09 fiscal deficit (in per cent terms) or 5.3 per cent and 7.5 per cent respectively, applied to the GSDP of 2010-11. In case, this amount is less than 3 per cent of the GSDP for 2010-11 projected as stated above, a figure equal to 3 per cent of GSDP for 2010-11 may be taken.

### Consolidated Fiscal Roadmap

9.88 Based on the fiscal reform path prescribed for the Centre and states, the consolidated position during the award period will be as per Table 9.7. Average lending from the Centre to states on account of external aid for the period 2006-09 has been Rs. 6050 crore. The stock of central loans consolidated as per the recommendation of FC-XII and loans of those states whose loans have not yet been consolidated, put together, amount to Rs. 1.23 lakh crore. Assuming that these have to be paid in twenty equal instalments, the recovery from these loans would be Rs. 6175 crore, which is almost equal to the average disbursement of

loans. Thus, we have assumed that there would be no net disbursement of loans from the Centre to states during the projection period.

9.89 It is important to recognise that for successful fiscal consolidation, the key lies in maintaining the growth dynamism of our economy. There is a two-way relationship between growth and fiscal consolidation; or what is called the 'strategy of expansionary fiscal consolidation', where fiscal consolidation leads to higher growth due to higher levels of public and private investments, which in turn, further facilitates maintenance of fiscal stability.

9.90 However, in order to sustain such a virtuous circle, the proposed fiscal strategy will need to be augmented by reform measures or structural measures in areas such as widening and deepening of markets — particularly factor markets, improving productivity of public expenditure, implementation of competition policy covering both private and public sector enterprises and above all, better governance at all levels of government through increased transparency and accountability.

### Debt Relief for States

9.91 Our Terms of Reference require us to: '... review the state of the finances of the Union and the States, keeping in view, in particular, the operation of the States' Debt Consolidation and Relief Facility 2005-10 introduced by the Central Government on the basis of the recommendations of the Twelfth Finance Commission and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth.'

**Table 9.7: Consolidated Fiscal Reform Path of Centre and States**

(per cent of GDP)

	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Fiscal Deficit – States	2.8	2.6	2.5	2.5	2.4	2.4
Fiscal Deficit – Centre	6.8	5.7	4.8	4.2	3.0	3.0
Net Central Loans to States	0.1	0.0	0.0	0.0	0.0	0.0
Fiscal Deficit – Consolidated	9.5	8.3	7.3	6.7	5.4	5.4
Debt Stock – States	27.1	26.6	26.1	25.5	24.8	24.3
Debt Stock – Centre	54.2	53.9	52.5	50.5	47.5	44.8
Outstanding Central Loans to States	2.5	2.2	2.0	1.7	1.5	1.3
Consolidated Debt	78.8	78.3	76.6	74.3	70.8	67.8

### Debt Consolidation and Relief Facility of FC-XII

9.92 With regard to the broad approach to the issue of debt sustainability, FC-XII was of the view that debt relief measures were required as a pre-requisite for achievement of revenue balance. FC-XII observed that, apart from providing for specific debt relief, qualitative and quantitative measures were also to be prescribed to restrict the future growth of debt stock of states beyond sustainable levels. FC-XII was of the view that the debt relief measures recommended with regard to central loans to states needed to be substantial so as to encourage better fiscal performance on the part of states. FC-XII also recommended disintermediation and accordingly, central lending to states was discontinued, except in the case of fiscally weak states that are not able to raise loans from the market, or in case of external loans. In case of such states, FC-XII recommended that computation of interest rates for future loans to the states be placed on a rational footing. In addition, future repayments, particularly on open market borrowings, needed to be catered to in a manner that would preclude undue fiscal stress in the event of bunching or bullet payments.

9.93 FC-XII also observed that states should make efforts to eliminate their revenue deficits so that borrowings are utilised for generating capital assets, rather than for financing revenue expenditure. It recommended that in the first instance, as a measure of fiscal discipline, all states should enact fiscal responsibility legislation prescribing specific annual targets for reduction of revenue and fiscal deficits as well as providing a ceiling for borrowings. It unambiguously recommended that the fiscal responsibility legislation should provide for revenue deficits of states being brought down to zero by 2008-09.

9.94 FC-XII examined the debt position of the states and recommended debt relief (referred to as DCRF), which had two separate components of relief in the form of debt consolidation and debt write-off. The debt consolidation component provided for consolidation of central loans to states amounting

to Rs. 1,28,795 crore, contracted till 31 March 2004 and outstanding on 31 March 2005, along with rescheduling for a fresh term of 20 years, to be repaid in 20 equal instalments. Interest at the rate of 7.5 per cent was to be charged on the consolidated rescheduled central loans and the repayments due from states during the period 2005-06 to 2009-10 on these were eligible for write-off. The quantum of write-off was linked to the absolute amount by which the revenue deficit was reduced in each successive year during the award period. The DCRF envisaged that if a state was able to bring down its revenue deficit down to zero by the targeted year 2008-09, the entire repayments due from the state during the FC-XII award period would be written off. Enacting the fiscal responsibility legislation, as stated above, was to be a necessary pre-condition for availing of debt relief. For debt write-off, there was an additional pre-condition stipulating that the fiscal deficit of the states should be contained at the level of 2004-05.

9.95 The performance of states in aggregate under DCRF is given in Table 9.8. Twenty-six states have availed of debt consolidation till October 2009. This has resulted in interest relief amounting to Rs. 15,689 crore to these states as against Rs. 21,276 crore estimated by FC-XII. Sikkim and West Bengal have failed to receive the benefit of debt consolidation, not having met the conditionality of enacting fiscal responsibility legislation. Cumulatively, central loans amounting to Rs. 1,13,601 crore have been consolidated, which is lower than the FC-XII estimates by Rs. 15,194 crore. Out of the said differential, Rs. 9893 crore is accounted for by West Bengal (Rs. 9700 crore) and Sikkim (Rs. 192 crore). The balance is attributable to disparity in the actual base year stock of debt and delays in enactment of FRLs by some states. As regards the debt waiver component, waiver benefit of Rs. 18,717 crore has accrued to the states by the end of 2008-09,

**Table 9.8: Summary of Performance under DCRF**

	(Rs. crore)	
	Estimated by FC-XII for 2005-10	Availed of by States till 2008-09
Debt Consolidation	1,28,795	1,13,601
Interest Relief	21,276	15,689
Debt Waiver	32,199	18,717

**Box 9.1: National Small Savings Fund**

The National Small Savings Funds (NSSF) was created in the Public Account of India with effect from April 1999 with the Central Government taking on the responsibility of servicing the small savings deposits outstanding as on the date of creation of NSSF. The modality was that the Central Government issued special securities to NSSF for Rs. 1,76,221 crore equal to the face value of the outstanding deposits as on April 1999. These special securities against outstanding deposits carried interest rate of 11.5 per cent per annum on the date of issue and did not have any specific term. Since loans against the deposits outstanding on April 1999 had been extended to State Governments from the Consolidated Fund of India (CFI) prior to creation of NSSF, interest from states on these loans was also credited to CFI and accounted as a non-tax receipt of GoI. These loans were included in the corpus of high-coupon loans pre-paid by the states under the Debt Swap Scheme as well as in the subsequent debt relief awarded by the Twelfth Finance Commission.

Till 2001-02, the net small savings collections in a state (gross collections minus repayments to depositors) were being shared between the Central and State Governments, with the share of the State Government being progressively increased from 66.66 per cent to 75 per cent from 1 April 1987 and to 80 per cent from April 2000. From 1 April 2002 to 31 March 2007, the entire net collections in a state were being invested in special securities issued by the concerned State Government. However, with effect from 2007-08, the mandatory share of State Governments has been reduced to 80 per cent with the option to go upto 100 per cent.

The sums received in NSSF on redemption of special securities are re-invested in special Central Government securities. The special securities issued by the Central Government against such redemption amounts carry a tenure of 20 years with bullet repayment on maturity and coupon rates benchmarked to average secondary market yields on Central Government securities (G-sec) of comparable maturity.

With effect from 2007-08, an enabling provision has been made through amendment to the NSSF (Custody and Investment) Rules, 2001 to allow for investment in other instruments. A sum of Rs. 1500 crore has been given as loan @ 9 per cent per annum (payable annually), to India Infrastructure Finance Company Limited (IIFCL) in 2007-08 for financing infrastructure development. The loan carries a bullet repayment after a period of 15 years.

The interest paid to depositors plus the management cost is expenditure of the Fund while the interest received from the Central Government and State/UT Government with legislature on investment of the collections in their long term securities is income of the Fund. The management cost comprises remuneration to post offices/banks for operating the schemes, commission to agents for mobilising deposits and cost of printing of certificates.

as against the estimate of Rs.32,199 crore by FC-XII for the five year award period.

9.96 The scope of FC-XII recommendations excluded two categories of loans, viz. loans given to the states from NSSF and central loans given to State Governments for centrally sponsored schemes/central plan schemes through central ministries/departments other than Ministry of Finance. NSSF loans were excluded from the scope of debt relief on the grounds that NSSF is maintained in the public account of the Government of India and central loans not administered by MoF were excluded on the grounds that data for the same were not available.

**Loans from National Small Savings Fund**

9.97 NSSF was created in the public account of India with effect from 1 April 1999 with the objective

of de-linking small savings transactions from the Consolidated Fund of India and ensuring their operation in a transparent and self-sustaining manner. Since NSSF operates in the public account, its transactions do not impact the fiscal deficit of the Centre. Box 9.1 provides details of the scheme.

9.98 All deposits under small savings schemes are credited to NSSF and all withdrawals by the depositors are made out of accumulations in the Fund. The balance is invested in special securities issued by Central and State/UT Governments as per their respective shares. These securities are issued for a period of 25 years, including a moratorium of five years on the principal amount. The special securities carry a rate of interest as fixed by the Government of India from time to time. The current rate of interest is 9.5 per cent per annum.

9.99 During the period 1999-00 to 2008-09, the states had issued special securities to NSSF amounting to Rs. 4,48,857 crore, of which an amount of Rs. 16,919 crore has been redeemed, leaving a balance of Rs. 4,31,938 crore outstanding as on 31 March 2009. Four states, viz. Maharashtra, West Bengal, Gujarat and Uttar Pradesh, account for 52 per cent of the total outstanding NSSF debt of states as on 31 March 2009.

9.100 Even though the interest rates have come down over this period, the states have had various issues with the overall scheme regarding the inflexibility of having to borrow based on availability rather than requirement, asymmetry between effective interest rates to the states and the Centre and the difference between cost to the NSSF and interest rates.

9.101 In 2005, a sub-committee of the National Development Council was set up to examine the various issues raised by the states. Based on its recommendations, the following changes were made in the scheme:

- i) The states were not compelled to take 100 per cent of the net collections under small savings and were permitted to go down to 80 per cent, with the remainder being taken by the Centre.
- ii) The rate of interest payable on NSSF securities issued during the years 1999-2000 to 2001-02 was reduced from 13.5 per cent, 12.5 per cent and 11 per cent per annum respectively, to 10.5 per cent per annum with effect from 1 April 2007 as shown in Table 9.9.

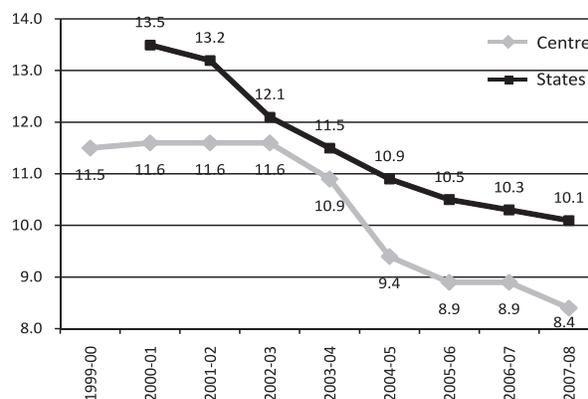
**Table 9.9 : Interest Rates Applicable on Loans from NSSF**

Year	(per cent)	
	Original Interest Rates	Interest Rates post NDC sub-committee recommendations
1999-2000	13.5	10.5
2000-01	12.5	10.5
2001-02	11.0	10.5
2002-03	10.5	10.5
2003-04 onwards	9.5	9.5

- iii) The states were allowed to pre-pay a part of their liabilities to NSSF (this was availed of only by Tamil Nadu and Orissa with pre-paid sums of Rs. 1126 crore and Rs. 200 crore respectively during 2007-08).

9.102 Despite this relief, there is a difference between the effective rate of interest payable by the Centre and that by the states. Figure 9.1 shows the effective interest rates on NSSF loans to the Centre and states and their difference since inception of the Fund.

**Fig 9.1: Effective Rate of Interest of NSSF Loans to Centre and States**



9.103 Both the Centre and the states have seen the interest cost of their respective NSSF debts decline over the years. However, the average interest rate paid by the states has been higher than that of the Centre from the commencement of NSSF in 1999-2000. This is primarily because the states have been paying interest only on securities issued against collections on current small savings from 1 April 1999, whereas the Centre is also paying interest on securities against the deposits outstanding on that date, which, at 11.5 per cent, was lower than the rate of interest on transfers during 1999-2000 and 2000-01. The gap between the average interest paid by the states and the Centre on their respective NSSF debt had narrowed from 1.9 percentage points in 2000-01 to 0.5 percentage points in 2002-03, but thereafter, increased to 1.7 percentage points in 2007-08.

9.104 This widening after 2002-03 has arisen due to the following decisions taken by the Centre:

- i) Reduction in interest rate on central special securities issued against outstanding

balances on central liabilities from 11.5 per cent to 10.5 per cent with effect from 1 March 2003, in line with general softening of market interest rates.

- ii) Use of debt swap receipts from states to partly redeem the central special securities issued against the initial outstanding balances and to replace them with fresh securities at lower market rates of interest. The total amount redeemed between 2002-03 and 2004-05 was Rs. 92,652 crore.
- iii) Further redemption of high-interest central special securities against outstanding balances for a sum of Rs. 10,000 crore in 2007-08 in order to infuse cash into the NSSF consequent upon negative cash balance in the Fund due to a drastic decline in net small savings collections.

9.105 Consequent to the NDC sub-committee recommendations, the interest rate on pre-2002-03 loans was reset to 10.5 per cent and the collections from NSSF are being shared by Centre to the extent of 20 per cent. However, the asymmetry has continued in favour of the Centre even after the implementation of the recommendations of the National Development Council sub-committee. Therefore, we feel that there is a case for relief to the states on loans advanced from the NSSF.

9.106 Since the collections, from 2007-08 onwards, have been flowing to the Centre as well, we have decided to consider relief on loans contracted till 2006-07. The state-wise position of loans contracted till 2006-07 and outstanding estimated as at the end of 2009-10 can be seen in Annex 9.4. Keeping in view the existing effective rate of interest for the Centre, the fact that now the Centre too is using 20 per cent of the collections and the recent trends in flows to NSSF, we recommend that the loans contracted till 2006-07 and outstanding at the end of 2009-10 be reset at a common interest rate of 9 per cent per annum in place of 10.5 per cent or 9.5 per cent. The repayment schedule, however, should remain unchanged.

9.107 The total benefit that would accrue to states, estimated on the basis of outstanding at the end of 2009-10, is Rs. 13,517 crore during our award period. State-wise details of estimates of the benefit are given in Annex 9.4. The benefit shall continue to accrue even beyond the award period and is estimated to reach Rs. 28,360 crore by the maturity of the last loan coming under purview.

9.108 While the relief recommended above only addresses the interest asymmetry between the Centre and states, the structural problems in the existing arrangement need to be reviewed. The issue of high interest rate on these instruments arises because of the administrative mechanism presently in place.

9.109 A rise in the difference between the interest rates paid on small savings instruments and the market rate causes an increase in subscription to these instruments, thereby increasing flows of NSSF loans to states. With overall borrowings capped by FRBM targets, the states cannot take recourse to open market borrowings. This has already been witnessed during 2003-04 and 2004-05. Thus, states may not be able to benefit from the lower interest rates, even when market rates go down, as they are saddled with high inflows from high-cost NSSF loans. Conversely, when market interest rates increase, the subscriptions to small savings instruments dip and flows from NSSF dry up. This has been witnessed in 2006-07 and 2007-08 when net flows for many states even became negative.

9.110 States have also raised issues about the tenor of this loan, extending to 25 years, which has been used to justify the high interest rate and has led to a situation where states are locked with fixed interest debt for a long time with no option of reset and pre-payment. There is a significant mismatch between the maturity period of five to seven years for most small savings instruments and the term of the loan extended from NSSF.

9.111 These issues highlight the need for more comprehensive reforms in the overall administration of the National Small Savings Fund. Various committees constituted in the past to look into these issues have made far-reaching recommendations.

One of the important recommendations has been linking of interest rate on small savings instruments to the prevailing G-sec rates, which we endorse. We recommend, against this background, that all aspects of the design and administration of the scheme be examined with the aim of bringing transparency, market linked rates and other, much needed reforms to the scheme.

9.112 Some reforms are also required at the state level. In the past there has been a practice of giving various incentives such as cash awards to officials and other similar measures to promote subscription to small savings instruments. These measures also interfere with normal market dynamics. While most of these incentives, like awards to officials, have outlived their utility, all such incentives that either add to the cost of administration or affect normal market linked subscription, should be proactively withdrawn by the states.

#### **Loans not Consolidated in 2005-10**

9.113 As pointed out earlier, FC-XII did not consider central loans given to State Governments for Centrally Sponsored Schemes/central plan schemes through ministries other than Ministry of Finance, under DCRF, primarily because they did not have the requisite data. The balance outstanding in this regard stands at Rs. 4506 crore as at the end of 2007-08. The state-wise position for these is shown in Annex 9.5.

9.114 We feel that continuation of these loans is not consistent with the policy of disintermediation recommended by FC-XII, which is being followed today. Therefore, we recommend that these loans, as outstanding at the end of 2009-10, be written off. It is also recommended that any further lending from Centre to states, under any Centrally Sponsored Scheme, should be completely avoided. However, as per the recommendations of FC-XII, a window for borrowing from the Central Government should be available for the fiscally weak states that are unable to raise loans from the market.

9.115 While 26 states have availed of debt consolidation, two states, viz. West Bengal and Sikkim, have not legislated FRBM Acts and, thus,

did not get the benefit of consolidation. We recommend that this facility be extended to these states during our award period, on the condition that they put in place an FRBM Act as stipulated in this chapter. On meeting this condition, the loans contracted by these states till 31 March 2004 and outstanding as at the end of the year preceding the year in which the Act is put in place, shall be consolidated as per the same terms and conditions as recommended by FC-XII. However, the benefit of waiver, as recommended by FC-XII, need not be continued any further to any state.

#### **Implementation and Compliance**

9.116 The relief measures recommended by us in this chapter are all in the nature of one-step actions leading to relief over the long term. The above relief should be given to states only if the states with FRBM Acts already in place amend the same as indicated in Para 9.82 and those not having an FRBM Act legislate their FRBM Acts. For interest relief on NSSF loans, the loans contracted till 2006-07 and outstanding till the end of the year preceding the year in which this condition is met should be considered for reset. We have set no conditionalities with regard to compliance with the targets since we believe that the mechanism mentioned in Para 9.85 for setting borrowing limits and allowing open market borrowings to states can act as an effective tool.

9.117 The debt waiver, as recommended by FC-XII, was booked in the finance accounts of the states as non-tax revenues under 0075- 'miscellaneous general receipts'. We feel that this is not desirable as it artificially overstates the non-tax revenues of the states. Second, since it is accounted as non-tax revenue, it allows states to spend more within the same fiscal deficit cap, reducing the intended impact on the debt stock of states. Ideally, if it were not treated as notional repayment of debt, it would have ensured that, given a fiscal deficit target, the gross borrowing of states would have to go down, thereby having a dampening impact on debt stock, which was the primary purpose of FC-XII in granting the relief. We recommend that the debt write-off recommended

by us is accounted in a manner such that it does not artificially affect the revenue or fiscal deficit of the states.

### Summary of Recommendations

9.118 To summarise, our recommendations are as follows:

- i) Revenue deficit of the Centre needs to be progressively reduced and eliminated, followed by emergence of a revenue surplus by 2014-15 (paras 9.18 and 9.31).
- ii) Target of 68 per cent of GDP for combined debt of Centre and states to be achieved by 2014-15. Fiscal consolidation path embodies the steady reduction in augmented debt stock of Centre to 45 per cent of GDP by 2014-15 and for the states to less than 25 per cent of GDP by 2014-15 (paras 9.29 and 9.69, Table 9.7).
- iii) MTFP to be reformed and made a statement of commitment rather than a statement of intent. Tighter integration between the multi-year framework provided by MTFP and annual budget exercise (Para 9.38).
- iv) The following disclosures to be made along with the annual Central budget/MTFP:
  - a) Detailed breakup of grants to states under the overall category of non-plan and plan grants (Para 9.41).
  - b) Statement on tax expenditure to be systematised and the methodology to be made explicit (Para 9.42).
  - c) Compliance costs of major tax proposal to be reported (Para 9.43).
  - d) Revenue Consequences of Capital Expenditure to be projected in MTFP (Para 9.45).
  - e) Fiscal impact of major policy changes to be incorporated in MTFP (Para 9.46).
  - f) PPP liabilities to be reported along with MTFP (paras 9.48 and 9.49).
  - g) MTFP to make explicit the values of parameters underlying projections for receipts and expenditure and the band within which they can vary while remaining consistent with targets (Para 9.61).
- v) Transfer of disinvestment receipts to the public account to be discontinued and all disinvestment receipts be maintained in the consolidated fund (Para 9.52).
- vi) GoI should list all public sector enterprises that yield a lower rate of return on assets than a norm to be decided by an expert committee (Para 9.52).
- vii) The FRBM Act specify the nature of shocks that would require a relaxation of FRBM targets (Para 9.62).
- viii) In case of macroeconomic shocks, instead of relaxing states' borrowing limits and letting states borrow more, the Centre to borrow and devolve the resources using the Finance Commission tax devolution formula for *inter-se* distribution among states (Para 9.63).
- ix) Structural shocks such as arrears arising out of Pay Commission awards to be avoided by, in the case of arrears, by making the pay award commence from the date on which it is accepted (Para 9.64).
- x) Independent review mechanism to be set-up by the Centre to evaluate its fiscal reform process. The independent review mechanism to evolve into a Fiscal Council with legislative backing over time (paras 9.65 and 9.66).
- xi) Given the exceptional circumstances of 2008-09 and 2009-10, the fiscal consolidation process of the states was disrupted. It is expected that states would be able to get back to their fiscal correction path by 2011-12, allowing for a year of adjustment in 2010-11.

- a) States that incurred zero revenue deficit or achieved revenue surplus in 2007-08 should eliminate revenue deficit by 2011-12 and maintain revenue balance or attain a surplus thereafter. Other states to eliminate revenue deficit by 2014-15 (paras 9.69 to 9.72).
- b) The general category states that attained a zero revenue deficit or a revenue surplus in 2007-08 should achieve a fiscal deficit of 3 per cent of GSDP by 2011-12 and maintain such thereafter. Other general category states to achieve 3 per cent fiscal deficit by 2013-14 (paras 9.74 to 9.76, Table 9.5)
- c) All special category states with base fiscal deficit of less than 3 per cent of GSDP in 2007-08 could incur a fiscal deficit of 3 per cent in 2011-12 and maintain thereafter. Manipur, Nagaland, Sikkim and Uttarakhand to reduce their fiscal deficit to 3 per cent of GSDP by 2013-14 (paras 9.79 and 9.81).
- d) Jammu & Kashmir and Mizoram should limit their fiscal deficit to 3 per cent of GSDP by 2014-15 (Para 9.80).
- xii) States to amend/enact FRBM Acts to build in the fiscal reform path worked out. State specific grants recommended for a state to be released upon compliance (Para 9.82).
- xiii) Independent review/monitoring mechanism under the FRBM Acts to be set up by all states (Para 9.84).
- xiv) Borrowing limits for states to be worked out by MoF using the fiscal reform path, thus acting as an enforcement mechanism for the fiscal correction by states (Para 9.85).
- xv) Loans to states from National Small Savings Fund contracted till 2006-07 and outstanding at the end of 2009-10 to be reset at 9 per cent rate of interest subject to conditions prescribed (Para 9.106).
- xvi) National Small Savings Scheme to be reformed into a market-aligned scheme. State Governments also required to undertake relevant reforms at their level (paras 9.111 and 9.112).
- xvii) Loans from GoI to states and administered by ministries/departments other than MoF, outstanding as at the end of 2009-10, to be written off subject to conditions prescribed (Para 9.114).
- xviii) A window for borrowing from the Central Government to be available for the fiscally weak states that are unable to raise loans from market (Para 9.114).
- xix) For states that have not availed the benefit of consolidation under DCRF, the facility, limited to consolidation and interest rate reduction, to be extended subject to enactment of FRBM Act (Para 9.115).
- xx) Benefit of interest relief on NSSF and write-off available to states only if they bring about the necessary amendments/enactments of FRBM (Para 9.116).

# CHAPTER 10

## Local Bodies

### Introduction

10.1 The Commission is required to make recommendations on ‘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 recommendations made by the Finance Commission of the State.’

10.2 There has been considerable progress in the empowerment of Panchayati Raj Institutions (PRIs) and municipalities since the Tenth Finance Commission (FC-X) first made a provision for explicitly supporting local bodies through grants, subsequent to the passage of the 73rd and 74th amendments to the Constitution in 1993. Approximately 30 lakh representatives are regularly elected to about 2.5 lakh local institutions all over the country. Providing basic services at the grassroots level makes them the primary interface of the citizens’ interaction with the government. The principle of subsidiarity implies that matters are best handled by the least centralised competent authority. Following this, these institutions need to be adequately empowered—both functionally and financially—to enable them to fulfil the role envisaged for them in the Constitution. The State Finance Commissions (SFCs), which buttress the functioning of local bodies, also need to be strengthened so as to make their functioning more predictable and the process of implementing their recommendations more transparent. A number of recommendations were made by FC-XI and FC-XII towards this end. Some of these recommendations, though important, have not been implemented so far. More needs to be done to promote effective

decentralisation. We also need to put in place a stronger incentive mechanism aimed at persuading State Governments to decentralise further.

### Previous Finance Commissions’ Flows to Local Bodies

#### Framework for Recommendations

10.3 There was no reference in the ToR of FC-X about making recommendations relating to local bodies. However, since the 73rd and 74th amendments to the Constitution had become effective before the Commission had finalised its report, it felt obliged to make recommendations regarding measures to augment the consolidated funds of the states for this purpose. It pointed out that it could recommend such measures only after ascertaining the need for them, and the primary basis for this would have to be the SFCs’ reports, which however, were unavailable. Therefore, it recommended *ad hoc* grants.

10.4 The ToR of FC-XI had two specific references to local bodies:

- i) A reference to the measures needed to augment the consolidated funds of states to supplement the resources of panchayats and municipalities on the basis of the recommendations made by the Finance Commissions of the concerned states.
- ii) Another reference reiterating the need to take into account the recommendations of the SFCs. Where such recommendations were not available, the Commission was directed to make its own assessment about

the manner and extent of augmentation of the consolidated fund required. This assessment was to take into account the provisions for emoluments and terminal benefits of employees (including teachers); the ability of local bodies to raise financial resources and the powers, authority and responsibilities transferred to them under articles 243(G) and 243(W) of the Constitution.

10.5 In its report FC-XI noted the following features of SFC reports:

- i) Lack of synchronicity in the periods covered by the reports of the SFCs and the Finance Commission.
- ii) Extreme diversity in the approach, the content, the period covered as well as quality of the reports of the different SFCs.
- iii) Delay on the part of the State Governments in finalising Action Taken Reports (ATRs) and placing them in the state legislatures.

10.6 FC-XI, therefore, underlined its inability to take into account the recommendations of the SFC's. It, therefore, recommended *ad hoc* grants.

10.7 The ToR of FC-XII had a single reference relating to the measures needed to augment the consolidated fund of a state to supplement the resources of the panchayats and municipalities on the basis of recommendations made by the Finance Commissions of the concerned states.

10.8 FC-XII noted that both the data furnished by the states as well as the SFC reports failed to provide a sound basis for estimation of the required augmentation of the consolidated funds of the states. It, therefore, recommended grants on an *ad hoc* basis.

### Quantum of Flows

10.9 FC-X recommended a grant of Rs. 100 per capita of rural population as per the 1971 Census to PRIs, which worked out to a total of Rs. 4380.93 crore. In the case of urban local bodies (ULBs), the Commission recommended an amount of Rs. 1000 crore. The aggregate grant of

Rs. 5380.93 crore represented 1.38 per cent of the divisible pool as estimated by them.

10.10 FC-XI recommended a grant of Rs. 8000 crore for PRIs and Rs. 2000 crore for ULBs for the five-year period starting 2000-01. The aggregate grant of Rs. 10,000 crore represented 0.78 per cent of the divisible pool as estimated by them.

10.11 FC-XII recommended a sum of Rs. 20,000 crore for the PRIs and Rs. 5,000 crore for municipalities for the five year period starting 2005-06. The aggregate grant of Rs. 25,000 crore represented 1.24 per cent of the divisible pool as estimated by them.

### Basis of Horizontal Distribution

10.12 FC-X distributed the PRI grant amongst the states on the basis of state-wise rural population as per the 1971 Census. The grant for urban local bodies was allocated to the states on the basis of the inter-state ratio of slum population derived from the urban population figures of the 1971 Census.

10.13 FC-XI distributed grants amongst the states as per the following parameters:

- i) Population: 40 per cent
- ii) Distance from highest per capita income: 20 per cent
- iii) Revenue effort: 10 per cent
- iv) Geographical area: 10 per cent
- v) Index of decentralisation: 20 per cent

10.14 FC-XII made allocations to states based on the following indicators:

- i) Population: 40 per cent
- ii) Distance from highest per capita income: 20 per cent
- iii) Revenue effort:
  - a) With respect to state's own revenue: 10 per cent
  - b) With respect to GSDP: 10 per cent
- iv) Geographical area: 10 per cent
- v) Index of deprivation: 10 per cent

**Table 10.1: Amounts Allocated by Previous FCs & Amounts Drawn**

(Rs. crore)

Commission	Amount Allocated		Amount Drawn		Amount not Drawn	
	PRIs	ULBs	PRIs	ULBs	PRIs	ULBs
FC-X (1995-2000)	4380.93*	1000	3576.35 (66.46 %)	833.88 (83.39 %)	804.58 ( 33.54%)	166.12 (16.61%)
FC-XI ( 2000-05)	8000	2000	6601.85 (82.52%)	1751.89 (87.59%)	1398.15 (17.48%)	248.11 (12.41%)
FC-XII** (2005- 09)	18000	4500	16664.77 (92.58%)	4024.54 (89.43%)	1335.23 (7.42%)	475.46 (10.57%)

Note: \* Rs. 100 per capita of rural population.

\*\* From 1 April 2005 to 6 November 2009.

Source: Ministry of Finance, Government of India

### Utilisation of Funds Allocated by the Previous Commissions

10.15 The funds allocated by previous Finance Commissions to PRIs and ULBs, along with amounts actually released are detailed in Table 10.1.

10.16 Under the FC-XII award 7.42 per cent of the eligible allocations for PRIs and 10.57 per cent of those for ULBs had not been drawn as on 6 November 2009. While some improvement can be noticed in the draw down between 1995 and 2000, the percentage of amounts not drawn remains significant. Such a situation is not desirable.

### Conditionalities Imposed

10.17 FC-X stipulated that its grant was not to be applied to establishment costs. It also expected local bodies to provide matching contributions for the schemes drawn up to utilise these grants. It mandated that the amount provided would be additional to the normal devolution by the State Governments.

10.18 It recommended that this grant be made available in four equal instalments from 1996-97, when it expected that the local bodies would be in place.

10.19 FC-XI listed the core civic services which it would support, including primary education, health, drinking water, street lighting and sanitation. It indicated that the funds released should be earmarked for operation and maintenance of these functions. The funds were

otherwise untied with the proviso that they should not be used for payment of salaries and wages.

10.20 Specific state-wise amounts were earmarked for maintenance of accounts (Rs. 98.60 crore) and creation of a data base of the finances of local bodies (Rs. 200 crore). FC-XI directed that these activities would have the first charge on the grants.

10.21 FC-XII recommended that the grant for PRIs be utilised to improve service delivery in respect of water supply and sanitation schemes subject to their recovering at least 50 per cent of the recurring cost in the form of user charges. It also stipulated that at least 50 per cent of the grants provided to each state for ULBs should be earmarked for solid waste management through public-private partnership.

10.22 FC-XII also noted the importance of building data bases and maintenance of accounts by local bodies and urged that part of their support be earmarked by the State Governments for this purpose.

10.23 FC-XII made a number of recommendations with regard to the constitution, composition, mode and methodology of working of SFCs aimed at improving their functioning.

10.24 FC-XII recognised that the conditionalities imposed for release of funds to local bodies ultimately handicapped the very local bodies for which they were meant. Amounts not drawn essentially reflected non-performance by State Governments. The Commission felt that conditionalities needed to be discouraged. It recommended that no additional conditionality be imposed over and above the conditions suggested by

them, viz. provision of Utilisation Certificates (UCs) for the previous instalment and the need for the release to be passed on by State Governments within 15 days, apart from the end use conditionalities described in Para 10.21 above. However, despite such a liberal approach, some states have not been able to draw down even the FC-XII grants. About 8 per cent of the grants for the period 2005-09 – the first four years covered by FC-XII recommendations—have not been drawn as on 6 November 2009. We understand that this is primarily due to non-submission of UCs by the State Governments. It appears that part of this handicap is attributable to lack of maintenance of accounts by the local bodies and their slack attitude towards getting accounts audited. This clearly reinforces the need for all local bodies to create and maintain a data base encompassing their resources, operations, and financial performance indicators. Using this as a basis, the accounts could be drawn up, which could then be regularly audited. Both FC-XI and FC-XII accorded priority to these areas. While a few states have set up an excellent set of accounts, the majority of states, regrettably, have not done so. It appears that earmarking of grants by FCs for such critical purposes has not yielded the desired results over the last 10 years. A stronger incentive system needs to be built in.

#### **Treatment of Schedule V and VI Areas**

10.25 FC-X stipulated that the grant would be distributed to even those states which are not required to have panchayats, to supplement the resources of similar local level representative bodies.

10.26 FC-XI identified shares for normal areas and excluded areas separately while making state-wise allocations. It also stipulated that the shares for the local bodies in the excluded areas should be made available only after the relevant legislative measures were put in place for extending the provisions of the 73rd and 74th amendments to them.

10.27 FC-XII did not make separate recommendations for excluded areas, leaving this to be done by the respective states in 'a fair and just manner'. They did so on the grounds that the

Ministry of Home Affairs was considering a proposal for amendment in Schedule VI to make autonomous district councils more effective and these proposals envisaged an enhancement of the powers of these councils.

#### **Other Recommendations Relating to Measures to Augment the Consolidated Funds of States**

10.28 FC-X made no specific recommendations on the other measures needed to augment the consolidated funds of State Governments.

10.29 FC-XI felt that the states could adopt the following measures to augment their consolidated funds to supplement the resources of the panchayats and municipalities:

- i) Imposition of taxes on land/farm income.
- ii) Surcharge/cess on state taxes.
- iii) Levy of profession taxes.

10.30 FC-XI suggested improvement in efficiency of collection of property/house tax as well as assignment of a suitable tax with buoyant revenues in lieu of octroi which was abolished. It also recommended levy and periodic revision of user charges.

10.31 FC-XI also recommended:

- i) Review of the accounting heads under which funds are transferred to local bodies to ensure clarity.
- ii) Prescription of the format for maintenance of accounts by the Comptroller and Auditor General (C&AG). State bodies would be responsible for preparing the accounts which would then be supervised by the C&AG.
- iii) Audit of accounts by the C&AG, whose report should be placed before a committee of the State Legislature constituted on the same lines as Public Accounts Committee.

10.32 FC-XI further recommended the following legislative changes:

- i) Transfer of functions and schemes to local bodies to be specifically mandated by

legislation and made operational at the earliest.

- ii) Enactment of legislation to clearly delineate the functions of all three tiers of the PRIs
- iii) Integration of the district rural development agencies and urban development agencies with the PRIs/ULBs.
- iv) Review of the Constitutional provision mandating states having a population of more than 20 lakh to have a three-tier Panchayati Raj system.
- v) Defining a strategy for extension of the 73rd and 74th amendments to uncovered areas in states like Meghalaya, Mizoram, Manipur and Nagaland, which have been excluded from the purview of these amendments.
- vi) Revitalisation of district planning committees.

10.33 FC-XII noted that the recommendations by FC-XI relating to maintenance of accounts and audit of local bodies had still to be implemented. It suggested that the SFCs should follow the procedure for data acquisition as well as report writing adopted by the Finance Commissions, by using a similar format and recommending transfer of resources in a like fashion.

10.34 FC-XII identified 14 best practices which PRIs could usefully adopt, including enhancing taxation powers, levy of user charges, setting up of SFCs in a timely manner and regular maintenance of accounts and audit.

10.35 High priority was to be given to creation of a data base and maintenance of accounts through the use of modern technology and management systems.

## Views Expressed During Consultations

### Ministry of Panchayati Raj

10.36 In its memorandum to the Commission the Ministry of Panchayati Raj has pointed out that the first generation of Panchayati Raj reforms—setting up of the State Election Commissions, conducting

regular elections, constituting the State Finance Commissions (SFCs) periodically, as well as devolving functions through legislation—has broadly been implemented by almost all the states. The ministry proposes to implement a five-pronged strategy to invigorate the functioning of the PRIs consistent with the spirit of the 73rd Amendment. These activities, which comprise the second generation of reforms, include:

- i) Implementing activity mapping such that each tier of Panchayati Raj is allotted clear-cut functions and responsibilities for those of the 29 activities listed in Schedule XI which have been devolved by the State Governments to the PRIs.
- ii) Providing budgetary support to the PRIs in consonance with the devolution of functions as well as ensuring transparency for such devolution through a Panchayati Raj window in the budget of both the Central Government and State Governments.
- iii) Encouraging preparation of participative plans for all the panchayats which are consolidated at the district level.
- iv) Capacity building of the PRIs and imparting training to their representatives in their core functions.
- v) Making PRIs more accountable and enhancing opportunities for citizens to review performance and approve plans in gram sabhas.

10.37 The Ministry of Panchayati Raj highlighted the growing agency functions of the PRIs relating to the implementation of Centrally Sponsored Schemes (CSS) including National Rural Employment Guarantee Scheme (NREGS), National Rural Health Mission (NRHM), Mid-day meals, Sarva Shiksha Abhiyan (SSA), Pradhan Mantri Gram Sadak Yojana (PMGSY), Accelerated Rural Water Supply Programme (ARWSP), Integrated Child Development Scheme (ICDS), Indira Awas Yojana (IAY), Rajiv Gandhi Gramin Viduyutikaran Yojana (RGGVY) and Backward Regions Grant Fund (BRGF). The total amount of funds to be released

directly to PRIs for 2009-10 is estimated to be Rs. 95,000 crore. The ministry also noted the relative incongruity of PRIs having substantial funds to implement these CSS on the one hand, and little by way of 'discretionary' funds for adequately meeting their administrative costs, performing their core functions, and leveraging the CSS releases to meet local needs on the other.

10.38 The ministry classified the requirements of PRIs into two categories. The first category is aimed at improving the operational infrastructure of the panchayats. They proposed that 4 per cent of the divisible pool be allotted to local bodies and earmarked for the following activities:

	(Rs. crore)
(i) Construction of Panchayat Ghars	23,587
(ii) Providing skeleton staff for each Panchayat as well as honoraria and sitting fees for elected representatives	87,730
(iii) Office expenses and e-governance	11,650
<b>Total</b>	<b>1,22,967</b>

10.39 Under the second category, the ministry proposed that 1 per cent of the divisible pool be given as a specific purpose grant-in-aid to panchayat for preparation of data bases; incentivisation of State Governments to empower panchayats; and provision of grants for area planning and capacity building.

10.40 Referring to funding of PRIs, the ministry highlighted the delays in disbursement and diversions of funds earmarked for local bodies and stressed the importance of panchayats receiving predictable financial support in a timely manner to enable them to plan their activities in a comprehensive and smooth manner. It proposed that all funds transferred to panchayats be undertaken through bank transfers and that this process be streamlined by electronically tagging and tracking all releases by both the Central and the State Governments using an independent agency on the lines of the work being done by National Securities Depository Limited (NSDL) for direct taxes.

10.41 It has also suggested that the State Governments should be discouraged from following the recently established trend of abolishing

panchayat level taxes like property tax and profession tax, and that towards this end, a significant component of the fiscal discipline criterion should be related to the State Governments' stance towards enlargement and maintenance of the panchayat tax base.

10.42 The ministry has also made a number of suggestions aimed at improving the quality of the SFC reports and aligning them with the reports of the National Finance Commissions. It also suggested that the amounts proposed for the PRIs be distributed even to those areas which are outside the purview of Part IX of the Constitution (which deals with panchayats) to achieve a commonality of purpose in the treatment of local bodies across the nation.

### Ministry of Urban Development

10.43 The ministry noted that the urban population, which was 28 per cent of the total population in 2001, was slated to rise to 38 per cent by 2026. Urban growth would account for two-thirds of the aggregate population increase during this period. This significant growth would pose a number of challenges to civic bodies in terms of meeting the basic needs of the existing as well as incremental population. Municipal bodies would need to ensure inclusive growth, while planning for optimal utilisation of urban space and creation and maintenance of assets for providing essential services.

10.44 Despite the increased scope and scale of their engagement, the fiscal space of municipalities is shrinking. According to the ministry's memorandum, the combined expenditure of urban local bodies shrank from 1.74 per cent of Gross Domestic Product (GDP) in 1998-99 to 1.56 per cent of GDP in 2002-03 and 1.54 per cent in 2007-08. Internal resources provide for less than half the total expenditure of local bodies. Octroi has been abolished in all but one state without a viable substitute being put in place. Local bodies have been unable to exploit property tax as a major source of revenue. SFCs have been recommending that a portion of the state revenues be transferred to local bodies. Grants from the Centre provide additional support. However, these transfers have not been adequate for local bodies to provide the

desired level of services. A significant part of resource transfer is tied and non-discretionary, limiting the abilities of the urban local bodies to match resources to locally felt needs.

10.45 The ministry stated that expenditure of local bodies has significantly increased in the recent past due to three reasons: first, the impact of the Sixth Pay Commission; second, additional operation and maintenance costs due to larger investments in civic infrastructure and third, additional investments necessary for improving the accounting system, computerisation of operations, tax administration, and project monitoring.

10.46 On the basis of data collected from 19 states, the ministry estimates the resource gap of the urban local bodies as under:

	(Rs. crore)
(i) Requirement for all 28 states based on a uniform per capita requirement of Rs. 1578 per annum for provision of core services	63,893
(ii) Requirement of O&M for new assets funded under central schemes	20,000
(ii) Requirement under state schemes	16,400
(iv) Impact of the Sixth Pay Commission	24,288
(v) Capacity building	1,290
<b>Total</b>	<b>1,25,871</b>

10.47 The ministry also pointed out that the aggregate resource requirement of ULBs for fulfilling all their functions is significantly larger. For the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) cities this is estimated at Rs. 2,76,822 crore for 2005-12. The requirement for all urban areas is projected at Rs. 7,91,080 crore.

10.48 The ministry stated that FC-X, FC-XI, and FC-XII had adopted an *ad hoc* approach to supporting local bodies. The quantum of funds released was also very low. They urged that FC-XIII should adopt a structured approach and provide for support to local bodies in the form of a percentage of the divisible pool over and above the share earmarked for the State Governments.

10.49 The ministry suggested that 3 per cent of the divisible tax pool of the Union be devolved to urban local bodies over and above the share of the State Governments. Such an approach will not

only further integrate ULBs into the constitutional framework but also provide them with a buoyant source of revenue. They pointed out that such an approach will not be violative of Constitutional provisions inasmuch as such a share of the divisible pool can be provided to the consolidated funds of the states with the express mandate that this be utilised to supplement the finances of the ULBs. They proposed that the horizontal distribution amongst the states be carried out on the basis of a few simple parameters which could include progress made in decentralisation of funds, functions and functionaries (FFF) as well as implementation of key reforms. The ministry proposed that the reform agenda set out under the JNNURM programme could be considered as a conditionality for assistance by FC-XIII to ULBs. They also urged that a permanent SFC cell be set up in each state to monitor local government finances, including transfer from line ministries.

10.50 The proposals made for devolution to PRIs and ULBs by the ministries of Panchayati Raj and Urban Development respectively aggregate to 8 per cent of the divisible pool.

#### Department of Drinking Water Supply, Ministry of Rural Development

10.51 The Department of Drinking Water Supply pointed to the significant efforts made to provide access to potable drinking water, with 97 per cent of the rural habitations having been covered in the past. However, due to lack of focus on the sustainability of the sources tapped and schemes implemented earlier, many of the fully covered habitations had slipped back to either 'partially covered' or 'not covered' status. Further, only 52 per cent of the rural population has access to basic sanitation. The department highlighted its priority for increasing coverage, ensuring sustainability, tackling water quality issues and institutionalising reforms. This can be best done by adopting a demand-driven approach and ensuring community participation in implementation as well as maintenance of the schemes through empowerment of the panchayats in this sector.

10.52 It further observed that supply of drinking water and sanitation are subjects under the State List which find mention in the Schedule XI. These subjects need to be transferred to the PRIs who should assume responsibility for their operation and maintenance. The department highlighted the steps being taken by them to empower PRIs and requested the Commission to provide resources to PRIs to manage, operate and maintain water supply systems as well as implementing sanitation programmes. They posed a requirement of Rs. 48,160 crore for the following purposes:

	(Rs. crore)
(i) Maintenance of functional rural drinking water supply assets such as hand pumps, rural piped water supply schemes, multi-village water supply schemes, public stand posts, etc.	12,124
(ii) Replacement and rejuvenation of non-functional rural drinking water assets	5,500
(iii) Augmentation of 10% of the functional schemes	2,121
(iv) Garbage/solid waste management services	9,300
(v) Sewage disposal	18,601
(vi) O&M in rural sanitation programmes	273
(vii) Capacity building of PRIs	240
<b>Total</b>	<b>48,160</b>

### State Governments' Views

10.53 In their memoranda to the Commission, 14 State Governments have made suggestions relating to the functioning of local bodies. Most of them wanted the Finance Commission to significantly increase its support to local bodies. Seven State Governments have suggested that local bodies be given a share of the divisible tax pool over and above the states' share to enable them to participate in the buoyancy of central tax revenues. Suggestions on the amount of such a share ranged from 4 per cent to 10 per cent.

10.54 It was urged that the increasing obligations of local bodies to provide basic services, infrastructure, as well as meeting other civic needs required a significant stepping-up of assistance. In view of the significant burden arising from the implementation of the recommendations of the Sixth Pay Commission, states requested that for FC support should be allowed to be used for payment

of wages and salaries. The need for such support to be untied as far as possible was emphasised by a number of State Governments.

10.55 These State Governments also suggested horizontal devolution parameters for *inter se* distribution of local body grants. Most of these states were of the view that population, area, income distance, revenue effort, and index of decentralisation could be considered as criteria, though their perception on the weights to be given for each parameter varied. A few states suggested that the deprivation index, tax effort, quality of expenditure, scheduled caste (SC)/scheduled tribe (ST) population ratio, revenue requirement, and proportion of own resources be also considered as parameters for horizontal devolution. Two states suggested a pure per capita devolution based upon the population in 2001—one suggested Rs. 150 per capita and the other Rs. 500 per capita.

10.56 A number of state-specific proposals also found place in the respective state memoranda. These included, variously, requests to discard the revenue effort as a criterion, discard population as a criterion, use 2001 population as a criterion, use 1971 population as a criterion, and use the extent of scheduled areas in the state as an additional criterion within the area criterion.

10.57 Three states suggested computing an index of decentralisation and using it as a parameter. The sub-indices they proposed to compute this index included: (i) untied investible funds devolved to Local Self Governments (LSGs) as a percentage of state expenditure; (ii) own revenue of LSGs as a percentage of the state's own revenue; (iii) the number of personnel directly employed by the local bodies vis-à-vis those in the employment of the State Government; (iv) the percentage of local bodies not having elected representatives and (v) delegation of financial and administrative authority and responsibilities to local bodies and the extent of fiscal decentralisation.

### Consultations with Local Body Representatives in State Capitals

10.58 We consulted with representatives of both urban and rural local bodies of each tier, as well as

the autonomous district councils during our visits to the states. These included 37 mayors, 65 zilla parishad presidents, 112 PRI representatives and 114 ULB representatives. They made many relevant and useful suggestions which have been listed in the three categories below:

#### *Decentralisation Issues*

- i) States should be incentivised to delegate funds, functions and functionaries to the local bodies. Expenditure of PRIs as a proportion of GDP is very low. This should be increased to at least 5 per cent.
- ii) All national rural schemes relating to health and education should be implemented through the panchayats only.
- iii) Centrally Sponsored Schemes such as NREGS should have sufficient flexibility to take into account local needs and provide for adequate material component in order to create proper assets.
- iv) Small towns which cannot access JNNURM are in a precarious financial position. They should be supported with regard to provision of core services.

#### *Operational Issues*

- i) The maximum limit of profession tax collectable should be raised from the present value of Rs. 2,500 per annum.
- ii) Local bodies should be permitted to levy tax on the properties of the Central Government.
- iii) Support should be provided to the Schedule VI areas where the 73rd and 74th amendments are not applicable.

#### *Issues Related to Support from the Finance Commission*

- i) Some representatives suggested that 10 per cent of the funds devolved to each state should be earmarked for the local bodies. Others suggested that 3 per cent of the divisible pool should be earmarked for ULBs.

- ii) Keeping in mind the rapid pace of urbanisation, funds should be distributed among urban and rural bodies in the ratio of 70:30 instead of 80:20 as was allocated by FC-XII.
- iii) Earmarking of funds should not be confined to water supply and solid waste management. Support should also be provided for roads, storm water drains, and sewerage.
- iv) The Finance Commission should support the establishment of a geographic information system (GIS)-based property tax system for all local bodies aimed at strengthening their revenues.
- v) Grants should be untied.
- vi) Each panchayat should be given a minimum grant of Rs. 10 lakh irrespective of population or any other criteria. Each zilla panchayat should be given a special grant of Rs. 5 crore to meet local needs.
- vii) The Finance Commission should directly devolve funds to autonomous district councils instead of routing it through State Governments.
- viii) Funds should be earmarked for creation of data bases at the level of local bodies while providing the flexibility to hire or outsource specialised manpower to undertake this.
- ix) FC support should be made available in a single annual grant, rather than in half-yearly instalments. At least 5 per cent of the grant should be allowed for administrative expenditure.
- x) Construction of assets should also be permitted, apart from maintenance of assets.

#### **Planning Commission**

10.59 The Planning Commission noted a significant increase in the agency role of the panchayats in the recent past. A number of Centrally Sponsored Schemes and plan schemes are being implemented

by the panchayats. Substantial tied funds are being transferred to them for fulfilling these functions. However, this has not been accompanied by a corresponding increase in devolution of untied funds to the panchayats. This has restricted their ability to respond to local needs and synergise the impact of various development programmes.

10.60 Despite this, however, the Planning Commission noted that this situation does not justify the consideration of any proposal to transfer a share of the divisible pool directly to the local bodies, as such an action does not have the sanction of the Constitution. Such a proposal would vitiate the Constitutional mandate that the Finance Commission recommend augmentation of the consolidated fund of the states on the basis of the recommendations of the SFCs.

#### **Eleventh Plan Document**

10.61 The Eleventh Plan document recognises the criticality of involving PRIs in planning, implementing, and supervising the delivery of essential public services. It notes that this would be essential to ensure inclusiveness in the growth process and would require adequate incentives to be put in place for State Governments to empower PRIs through devolution of funds, functions, and functionaries to the PRIs. This could be done through a suitably designed devolution index.

10.62 It further proposes that local governments be given a pivotal place in centrally sponsored schemes in keeping with their constitutional mandate of economic development and social justice. Local governments being closer to the people, are in the best position to appreciate problems holistically, identify local priorities and forge a consensus amongst disparate socio-economic groups. They are also better placed to come out with cross-sectoral solutions based upon appropriate technologies. It notes that the devolution of functions to panchayats through legislative or executive order has not been matched by a concomitant transfer of funds. This is a major weakness. At the same time, panchayats themselves have also failed to effectively utilise their inherent taxation powers.

#### **Administrative Reforms Commission**

10.63 The Second Administrative Reforms Commission (SARC), in its second report on 'Local Governance – An Inspiring Journey into the Future', has made detailed recommendations covering a wide gamut of areas relating to rural and urban local bodies. The recommendations cover changes in the constitutional and functional structure of rural and urban local bodies, improvements in the working of their allied institutions – the State Finance Commissions (SFC) and the State Election Commissions (SEC), the scope for effectively implementing decentralised planning, improving functional devolution as well as enhancing the role of these institutions in improving the delivery of public services. While most of the recommendations relate to areas which are outside the scope of the ToR of the Commission, some of these are connected with the work of this Commission and it is to these that we now turn.

10.64 The SARC has recommended amendment of articles 243G and 243W to make it mandatory, for state governments to vest power and authority in local bodies, consistent with the XI and XII Schedules of the Constitution. The SARC has traced the progress of empowering local bodies to make plans and implement programmes aimed at economic development and social justice since the 73rd and 74th amendments were passed in 1993. It has pointed out that substantial progress still needs to be made. It has suggested a number of steps, including a clear delineation of functions for each tier through activity mapping and passing of a framework law to formalise the relations between the state and local governments. It also suggested that five additional subjects be included in Schedule XII as part of the responsibility of urban local bodies.

10.65 The SARC has supported the recommendations made by FC-XII directed at improving the working of the SFCs. It also reiterated the recommendation of FC-XI proposing amendment of Article 243 to ensure synchronicity between the recommendations of the SFCs and those of the National Finance Commission. It has supported

capacity building initiatives for the local bodies and encouraged outsourcing of specific functions. It proposes setting up of district councils to replace the present district planning committees, and the metropolitan planning committees envisaged in the Constitution. These councils would prepare comprehensive district plans for both the urban as well as the rural areas in their respective districts.

10.66 The SARC notes the importance of enhancing accountability of the panchayats parallel to the process of enhancing their powers and authority. It proposes setting up of audit committees in the local bodies as well as a separate standing committee for local bodies in the state legislature which would consider the reports of the C&AG, besides constituting a separate ombudsman for local bodies by amending the respective state Panchayati and Municipal Acts. The proposed ombudsman, with jurisdiction over a group of districts and large municipal corporations, would investigate cases and submit reports relating to corruption and maladministration in local bodies, including its elected representatives, to the Lok Ayukta, who would forward the report with his recommendations to the Governor. Simultaneously, the powers of the State Government to suspend panchayats and rescind the resolutions passed by them would be withdrawn.

10.67 In the matter of accounting and audit, the SARC endorses the National Municipal Accounts Manual (NMAM) for adoption by all State Governments. It emphasises the need to ensure the suzerainty of the C&AG over the audit of accounts of urban local bodies, even if they are to be initially undertaken by other agencies. It calls for institutionalising the existing arrangements under which the C&AG provides technical guidance and supervision over maintenance of accounts and audit of PRIs and ULBs, as well as for providing functional independence to the Director, Local Fund Audit at the State Government level. It proposes that FC grants be released to local bodies only after State Governments accept the technical guidance and supervision (TG&S) of the C&AG.

10.68 The SARC recognises the need for local governments to broaden and deepen their own

revenue receipts through widening of their tax base, improvement of collection efficiency and increase in tax rates subject to fiscal capacity constraints. To effectively monitor devolution and assignment of funds, it recommends that a separate panchayat line be created in every State Government budget and funds be electronically transferred to the local bodies.

10.69 It also exhorts State Governments to effectively implement the Panchayats (Extension to Scheduled Areas) Act (PESA) and calls for amendment of all legislation (both central and state) to make it consistent with PESA.

10.70 The SARC has recommended that State Governments should ensure that all local bodies switch over to the unit area method or capital value method of assessing property tax and limit exemptions. Tax details should be placed in the public domain and a computerised data base of all properties using GIS mapping should be prepared for all municipal areas. Land should be leveraged as a resource by local bodies. Sale proceeds of land collected by development authorities should be shared with the municipalities to the extent of at least 25 per cent. Legislation should be introduced to regulate the real estate sector.

10.71 This Commission endorses most of the recommendations which fall within our Terms of Reference. Such recommendations seek to empower local bodies and provide them with a statutory base for collecting revenue and providing core civic services, while at the same time, emphasising the need for accountability through a formal audit and accountability mechanism. The present constitutional structure envisages that the State Governments will drive the degree to which local bodies are empowered. Implementation of a number of SARC recommendations requires legislative (including Constitutional) changes which demand the consent and active support of State Governments. They can, at best, be implemented only in the medium term.

10.72 Other recommendations of the SARC, like those relating to accounting and audit, and improving the performance of SFCs, have not yet

been implemented despite having been on the agenda for a significant period of time. Other bodies including previous Finance Commissions have made similar recommendations earlier on, which do not require Constitutional changes, but which have not been implemented either. It is, therefore, necessary that State Governments be strongly incentivised to implement the recommendations in the latter group—a task which we propose to address.

### **National Commission for Review of the Constitution**

10.73 We discuss only those recommendations of the National Commission to Review the Working of the Constitution which are of direct relevance to our work. The Commission concluded that some State Governments were unwilling to share their fiscal powers with local bodies despite the 73rd and 74th amendments. Even in the case of those State Governments which had decentralised their functions, such an exercise had merely been limited to entrusting these bodies with the responsibility for implementation of State Government schemes. Local bodies had not been given an opportunity to prepare and implement plans on their own, thus reducing them to an implementing arm of the State Government. The Commission proposed that the Constitution be amended and the subjects listed in Schedules XI and XII be mandatorily assigned to rural and urban local bodies respectively, so that these subjects could statutorily form a distinct fiscal domain of the local bodies. This would enable them to fulfil their constitutionally assigned role as units of local self-government.

10.74 The Commission also found that the requirement in Article 280(bb) and (c) of the Constitution, that the Finance Commission make its recommendations about local bodies on the basis of the recommendations of the SFCs, was unduly restrictive. It felt that a requirement that the reports of the SFCs be considered by the National Finance Commission was adequate. It recognised the need to ensure synchronicity in the periods covered by the National FC and SFCs and suggested a suitable amendment in Article 243(I)

of the Constitution to provide for this. It suggested that the ceiling on profession tax imposed by Article 276 of the Constitution be removed and Parliament be vested with the power to determine this limit.

10.75 The Commission underlined the importance of prompt audit of accounts of local bodies and recommended that the C&AG be empowered to conduct the audit or lay down accounting standards for the panchayats. It should also be ensured that the audit cycle starting from conduct of audit through submission of report and ending with taking action on the audit findings be limited to one year after the close of the concerned financial year.

### **Studies/Seminars Sponsored by FC-XIII**

#### **Conference on ‘Empowering Panchayati Raj Institutions’**

10.76 The Commission sponsored a conference on ‘Issues before the Finance Commission: Empowering Panchayati Raj Institutions’ conducted by the Institute of Rural Management, Anand on 22-23 December 2008 wherein a number of important issues relating to devolution of funds, functions and functionaries, capacity building and constitutional provisions were discussed. The findings of the conference were presented to a select group of SFC Chairmen the next day and their views as well as suggestions incorporated into the conference recommendations.

10.77 The major recommendations of the conference have been listed in the three categories below:

#### *Decentralisation Issues*

- i) Some states have followed a ‘big bang’ approach to decentralisation. While this may be difficult to emulate, states should be incentivised to fully empower local bodies through linking the volume of both CSS and FC releases in proportion to the extent of decentralisation achieved.

- ii) Local bodies should be assisted both by the Central and State Governments for developing their administrative structure as well as meeting the costs of establishment.
- iii) It is desirable that all funds relating to local governments be routed through the local bodies and not through any statutory or non-statutory body whose activities overlap with theirs. All such parallel bodies may be abolished so that funds flow directly to the local bodies through the State Governments.
- vi) The C&AG should issue directions for classification of revenue receipts of the states providing details of duties, tolls and fees collected consistent with Article 243(I) of the Constitution so that the SFCs can make appropriate recommendations.
- vii) The work of the SFCs needs to be streamlined and strengthened in many ways. There needs to be some standardisation in the methods and approaches of the SFCs. SFCs could use templates which help in assessing needs as well as in preparing their reports more systematically and uniformly. SFCs are also hampered by lack of good quality data. FC-XIII also needs to address these issues.

#### *Operational Issues*

- i) PRIs, in turn, should be motivated to maximise their own tax and non-tax revenues through streamlining administration, enhancing tax assessment and collection efficiency and improving quality of services.
- ii) There should be an arrangement for advance sanction as well as automatic transfer of funds to local bodies to ensure predictability of devolutions, in terms of both volume as well as timing.
- iii) The recommendations of the FC-XI to enhance the ceiling on profession tax as well as taxing Central Government properties should be operationalised.
- iv) ULBs should be supported in implementing reforms to enable them to improve their credit rating and obtain market-based financing.
- v) PRIs should be provided support for meaningful compilation of accounts. This should include firming up of accounting formats and standards facilitating appropriate audit of their transactions as well as building an interactive electronic network linking accounting, auditing, performance review, financing, and monitoring functions. As submission of utilisation certificates has proved a major hurdle in the past, these steps will also ensure that State Governments are able to fully draw down the grants of the Finance Commission.
- viii) The National Finance Commission and the State Finance Commissions should be constituted simultaneously. Synchronising the periods of the FC and the SFCs may be required to avoid the problem of 'gap' years in the transfers.
- ix) There should be an SFC cell in each state to monitor efficient and effective data availability. This cell could also monitor and evaluate the performance of the PRIs at regular intervals. Setting up of an independent national agency to facilitate data and support exchanges among different SFCs could also be considered.

#### *Issues Related to Support from the Finance Commission*

- i) The previous Finance Commissions should not have assumed that decentralisation is fiscally neutral and does not entail any extra financial burden on the states. Decentralisation results in widening the ambit and improving the quality of services being provided by the local bodies. This requires substantially larger outlays. FC-XIII should attempt to enhance the local governments' share of public expenditure from the present 5-6 per cent to about 15-16 per cent in the short run.

- ii) The Commission should enable local bodies to improve their functioning by significantly increasing the volume of funds transferred to them. It should discard the *ad hoc* approach adopted by previous Commissions and provide for transfer of 5 per cent and 3 per cent of the divisible pool to the rural and urban local bodies, respectively.
- iii) Horizontal distribution of the transfers should be based upon a few simple fiscal parameters. These could include the share of untied funds devolved to total devolution and the share of own funds as a percentage of own resources of State Governments. Both these parameters should be verifiable through accounts.
- iv) The FC should be more proactive towards ULBs. Funding should be provided so as to be consistent with the norms for core service provision.
- v) In the areas where parts IX & IXA of the Constitution do not apply, there are no PRIs. Support is required for the agencies which provide local government functions in these areas.

### Study of Municipal Best Practices

10.78 A study on municipal best practices was also supported by the Commission. The report identified a number of best practices which could be usefully emulated by most municipalities. These included:

- i) Maintenance of municipal finance statistics.
- ii) Resource mobilisation.
- iii) Expenditure compression through outsourcing and Public Private Participation (PPP).
- iv) Adoption of accrual accounting.
- v) Delegation of funds, functions and functionaries (FFF).
- vi) Transfer of funds from GoI/State Governments.
- vii) Accountability of local bodies to the Citizens' Charter/NGO participation, etc.

- viii) Slum development.

10.79 This report has been published on our website ([www.fincomindia.nic.in](http://www.fincomindia.nic.in)). We would urge urban local bodies to consider such practices for implementation.

### Urban Property Tax Potential in India— Cities and Towns

10.80 This study had three objectives: first, to assess the present property tax collection in the country; second, to estimate the potential for property tax in all the municipalities in the country; and third, to suggest how this potential can be best exploited by municipalities. A detailed survey was conducted in 36 large municipal corporations, each with a population of more than 1 million. This formed the basis of the analysis. These cities account for 35 per cent of the urban population in the country. The main findings of the study are outlined below:

#### *Present Status of Property Tax Collections*

- i) Property tax revenues in the 36 largest cities in India are estimated at Rs. 4522 crore, yielding a per capita revenue of Rs. 486. In these cities, on an average, property tax revenues constitute 23 per cent of the total municipal revenues and 28.5 per cent of own source revenues. There are large inter-city variations in property tax revenues, with the Mumbai Municipal Corporation registering a per capita annual revenue of Rs. 1334 as against Rs. 25 for the Patna Municipal Corporation.
- ii) Property tax revenues depend upon: (a) enumeration of properties in the municipal tax register; (b) the collection rate; (c) the assessment and valuation system; (d) the extent of exemptions and (e) the level of tax rate.
- iii) On all these counts, there are serious shortcomings in municipalities today which hinder efficient collection. Absence of a formal count of properties in municipalities is one of the major handicaps in exploiting

the true potential of property tax in India. The percentage of assessed properties actually paying taxes in this 'large city sample' was found to be 63 per cent, and it is estimated that this would amount to 56 per cent of the universe of properties. Even for the house properties actually assessed, poor collection efficiency at 37 per cent of demand for the sample, along with non-indexation of property values exacerbated the problem.

- iv) The all-India collection of property tax yield blown up from the 36-city sample is estimated to be between a low of Rs. 6274 crore and a high of Rs. 9424 crore, or between 0.16 and 0.24 per cent of the country's GDP.

#### *Potential for Property Tax*

- i) It is clear from the low ratio, even within the 36 large city sample of assessed properties to the universe of all properties, and the low collection to demand ratio, that there is tremendous scope for improvement in revenue from property tax, even without increasing rates, and indeed, even without any structural alteration of the basis of levy. However, because the observed percentages of tax collection efficiency cannot be extended to all urban areas from the sample, it is not possible to quantify the revenue increase to be expected by improving tax collection efficiency. It is urgently required that the municipalities in India complete formal registration of all properties, whether assessable or not. This needs to be followed by the complete assessment of all registered

properties and collection of the demands raised on assessable properties at a minimum of 85 per cent efficiency.

#### *How Best to Exploit this Potential*

- i) States should focus on improving coverage and collection efficiency. Property tax revenues could increase to Rs. 22,000-32,000 crore, merely by bringing all cities to an 85 per cent coverage level and 85 per cent collection efficiency, without changing any other variables.
- ii) States should establish a Central Valuation Board on the lines of the West Bengal Central Valuation Board in order to standardise property assessment and valuation. Property values should be indexed and guidance values used.
- iii) States should institute a GIS system for mapping all properties in cities, which will result in increased coverage.
- iv) The Centre should introduce specific conditionality in JNNURM aimed at reducing the gap between the assessed and market value of properties.

10.81 The international experience on property tax collections as a percentage of GDP is summarised in Table 10.2 below. The present estimates for collection in India at 0.25 per cent are well below even the developing countries' average of 0.60 per cent and far lower than the developed countries' average of 2 per cent. The need for reform is evident.

10.82 While increasing the tax coverage and improving collection efficiency are immediate, compelling objectives, reform of the property tax system also requires improved valuation and

**Table 10.2: International Experience on Property Tax Collections**

	1970-1980	1980-1990	1990-2000	2000-2009
OECD Countries (number of countries)	1.24 (16)	1.31 (18)	1.44 (16)	2.12 (18)
Developing Countries (number of countries)	0.42 (20)	0.36 (27)	0.42 (23)	0.60 (29)
Transition Countries (number of countries)	0.34 (1)	0.59 (4)	0.54 (20)	0.67 (18)
All Countries (number of countries)	0.77 (37)	0.73 (49)	0.75 (59)	1.04 (65)

rationalisation of the structure of tax rates. The real potential of property taxes lies in correctly assessing the property values and in choosing an appropriate rate structure. An appropriate strategy will include the following elements:

- i) Broadening the tax base by instituting a geographic information system for mapping properties in all cities with a population of more than 1 lakh.
- ii) Establishing a Central Valuation Board in each state, on the lines of the West Bengal Central Valuation Board in order to standardise property valuation, which will also be charged with setting guidance values and subsequent updating.
- iii) Improving collection efficiency, identifying tax evasion and delinquency and enforcing penal clauses.

### **Institutions to Assist Municipalities in Assessing Property Tax**

#### **Municipal Property Assessment Corporation**

10.83 In Canada, the provincial governments determine municipal responsibilities and what taxes municipalities can levy, sets standards for service delivery, prohibits municipalities from running an operating deficit; restricts municipal borrowing for capital expenditures and provides conditional and unconditional transfers to them. While federal and provincial governments are funded by various taxes including income tax, gas tax and excise taxes, municipal governments are significantly dependent upon property tax. Property tax forms 54 per cent of municipal revenues followed by user fees (22 per cent) and provincial transfers (16 per cent).

10.84 Municipal Property Assessment Corporation (MPAC) is a not-for-profit corporation funded by Ontario's 445 municipalities. All Ontario municipalities are its members. Its board of directors is appointed by the Ontario Ministry of Finance. MPAC provides assistance to municipalities to assess properties on a comprehensive, consistent and

predictable basis. It prepares property tax assessment notices for all the municipalities in Ontario.

10.85 There are 4.7 million properties in the province of Ontario. Approximately 80,000 new properties are added to the inventory each year through subdivision of land; 90 per cent of these properties are residential in nature. MPAC uses a differentiated approach to value property. Depending upon the property to be valued, it uses either a direct comparison approach or an income approach or a cost approach. Wherever feasible, it uses a computer-assisted mass appraisal system. Under this, a number of models are built for each distinct category of property, which are then used as one of the inputs for assessing the property value of that category.

10.86 The work of the MPAC involves collection of property related data from all municipalities. Data on location, area, structural characteristics, ownership and utilisation are collected through field offices of the MPAC. The next steps include data analysis, fine-tuning of assessment value findings through field offices, production of assessment notices and mailing them to municipalities, conduct of open houses and considering requests for reconsideration of assessments. The actual levy and collection of property tax is done by the municipalities. Appeals against the assessment lie before an Assessment Review Board set up by the State Government. The Board's decision is final.

10.87 From 1 January 2009, MPAC has moved to a four-year assessment cycle. Property value as on 1 January 2008 will be built into the assessment, step-wise over the next four years, rising from the 1 January 2005 value such that tax on the full value as on 1 January 2008 will be applied for the 2012 tax year. Thus, property is taxed on value with a four-year lag.

10.88 Triggers for assessment include the issue of building permits, sale of property, appeal or request for reconsideration as well as vacancy applications. These are inherent mechanisms to increase coverage and update property values outside the assessment cycle.

10.89 MPAC provides a fine example of how municipalities can combine to avail of high value

services aimed at enhancing the efficiency of their mainstay—property tax collections.

### **West Bengal State Valuation Board**

10.90 A parallel effort in India is the West Bengal Valuation Board. This Board, set up on the basis of the West Bengal Valuation Board Act 1978, seeks to bring about a uniform and rational system of valuation of municipal properties throughout the state excluding the Kolkata Municipal Corporation limits. The primary function of the Board is to enumerate and assess the value of properties in all the municipalities in the state. It has adopted a transparent approach to its functioning and has made available publicly the procedure it adopts for valuation of property. It has undertaken survey work in 117 ULBs and published 217 valuation lists till 2007-08. The Board has faced a number of teething problems since its inception, including resource and capacity constraints, thus constraining its service delivery.

### **Data Collected by the Commission**

10.91 This Commission sought information from State Governments on the functioning of SFCs, the status of implementation of recommendations of FC-XI and FC-XII, as well as the physical and financial performance of local bodies. The specific issues on which particulars were sought are detailed in Annex 10.1.

10.92 The data provided varied in quality across State Governments. While some State Governments furnished good quality data, most of them provided data which was sparse, and frequently inconsistent with the data furnished to earlier Finance Commissions. Despite considerable follow-up as well as an attempt to give the State Governments an opportunity to confirm the data submitted by them, significant problems remain with the quality of data supplied to us by State Governments. Compounding this problem was the fact that the SFC reports submitted to the Commission were widely divergent in the quality of their analyses and the scope and scale of their recommendations. Non-synchronicity of the period of recommendations of the SFCs and this Commission was an additional handicap. Details of

the SFCs set up by the states are provided in Annex 10.2. Only three states have appointed SFCs whose recommendations cover the period 2010-15, the period covered by this Commission. For the above reasons, the data supplied by the State Governments as well as the reports of the SFCs did not provide a sound basis to quantify uniformly across all states the supplementation required to the resources of their respective rural and urban local bodies. Annex 10.3 lists the number of rural and urban local bodies in each state. As will be seen, the aggregate number of local bodies reported to this Commission by State Governments was 2,49,918 against a figure of 2,47,408 reported to the FC-XII. This increase is consequent to the bifurcation of existing panchayats during the interregnum.

10.93 There are significant discontinuities in data relating to revenue and expenditure of local bodies submitted by State Governments to FC-XI, FC-XII, and to this Commission. These discrepancies detract from the credibility of the data. Unfortunately, successive Finance Commissions, including our own, have been unable to independently verify the data provided on local bodies. The need to put in place a system where financial and performance data of local bodies can be audited and confirmed credibly cannot be overemphasised. The data on fiscal performance provided by State Governments is being verified by the FCs with reference to the respective State Finance Accounts. A similar system needs to be put in place for data relating to local bodies as well. While we have not utilised the information on revenue and expenditure of local bodies received from states, we are placing it on our website for information.

10.94 Ten years have elapsed since FC-XI underlined the need for maintaining a data base as well as up-to-date accounts and made a provision for supporting State Governments in addressing these shortcomings. Five years have elapsed since FC-XII highlighted similar inadequacies and made similar recommendations. Much has been said by the earlier Finance Commissions on this important subject. Despite this, little improvement has been noted in the situation. While we recognise, appreciate and support

the recommendations of the previous Commissions on the issue of data bases, accounts, and audit, clearly an alternative approach may need to be adopted to address these issues beyond funding support for these initiatives.

### Issues to be Addressed by the Commission

10.95 Based upon the consultations described above, the studies sponsored by the Commission, the recommendations of the previous Commissions, as well as the status of their implementation, the following issues have been identified by us as needing resolution. In our view these issues need to be effectively addressed to further empower local body institutions, improve their service delivery and ensure their financial sustainability.

### Devolution-Related Issues

#### *Use of a Devolution Index*

10.96 Some State Governments have proposed the use of a devolution index as a parameter for *inter se* distribution of local body grants. They have argued that it is necessary to incentivise states to devolve functions and funds to local bodies, although an index of this kind is basically a reward for past moves in this direction rather than an incentive for further effort.

10.97 The most significant initiative so far for creation of a devolution index has been the Panchayati Empowerment Accountability and Incentive Scheme (PEAIS) implemented by the Ministry of Rural Development through the National Council for Applied Economic Research (NCAER). Data on panchayati functions, finances and functionaries were directly collected from state governments by NCAER. Data collected on finances included delegation of powers to collect taxes; implementation of SFC reports; delegation of powers to prepare plans; presence of separate line items in state budgets; percentage of local bodies whose accounts are audited; own revenue as a percentage of expenditure and untied funds as percentage of total plan and non-plan grants. Data collected on functions included the number

of functions transferred based upon notifications; the number for which activity mapping has been completed; whether district planning committees are being involved in the preparation of the district plans; whether gram panchayats are implementing the flagship programmes of the government; and to what level these bodies have been empowered to sanction expenditure. Data collected on functionaries include the nature of their support to PRIs, accountability and training. A simple average of 5 sub-indices for functions, 15 sub-indices for finances and 14 sub-indices for functionaries then determined the devolution index, based upon which the states have been ranked.

10.98 This is an excellent ground-breaking initiative to measure the extent of devolution to PRIs across states. The questionnaire adopted is reflective of the areas where panchayats need to be empowered. We are, however, hesitant to adopt this index for the following reasons:

- i) Data provided by the State Governments have not been independently verified. For the reasons mentioned in Para 10.93, this is a critical requirement.
- ii) This index was not inclusive. All states were not covered. Seven states were eliminated in the framework component test which required states to establish SFCs, set up district planning committees and conduct regular elections to be eligible for ranking. Only the remaining 21 states were ranked.
- iii) Some states felt that the data collected were not comprehensive. They felt that implementation of e-governance by some states, and the degree of comprehensiveness of the delegation to local bodies made by other states had been ignored.
- iv) No parallel initiative has been taken for ranking devolution amongst urban local bodies.

10.99 Other suggestions made for computing a devolution index have been described in Para 10.57. Use of these parameters requires credible data, which regrettably, are presently unavailable.

*Providing a Share of the Divisible Pool to LBs*

10.100 A number of State Governments have proposed that local bodies should be provided assistance directly from the divisible pool over and above the share of State Governments. This was also a major recommendation in the Conference of PRIs sponsored by this Commission. While a separate study sponsored by us on this issue proposes that this can indeed be done taking a broader view of the Constitution, a legal opinion obtained by the Commission finds that such a proposal is not consistent with the Constitution.

10.101 The differential treatment presently accorded to transfer of proceeds of tax devolution to the states and transfer of grants provided to states in the Union Budget reflects the different status of these two modes of assistance. The share of central taxes devolved to the states does not enter the Consolidated Fund of India while the grants recommended by the FCs are voted. Providing local bodies with a percentage of the divisible pool as direct support would elevate this support to the level of tax devolution. This does not appear to be within the mandate of Article 280.

10.102 However, there is considerable justification for this proposal. The proposed introduction of the Goods and Services Tax (GST) will remove some tax instruments traditionally allocated to local bodies. These include entertainment tax, entry tax, as well as share in stamp duty. It is, therefore, important that local bodies be provided with a buoyant source of revenue as an alternative to fixed grants. This will also be in line with best international practice.

*Delay in Sending Funds to PRIs*

10.103 A number of states have delayed transmitting funds to local bodies despite the injunction of FC-XII that interest be paid by the State Governments to local bodies in case of any delay. We have come across a state which did not pay this interest, arguing that it had, on occasion, provided funds in advance to local bodies. We have also come across states which did pay this interest. While the states have generally passed on funds to

local bodies immediately, this process needs to be quickened and made predictable.

*Use of Conditionalities*

10.104 The conditionalities imposed by previous Commissions have been detailed in paras 10.17 to 10.24. These conditionalities have directed expenditure away from establishment costs and towards provision of core services, and have focussed on setting up of data bases and maintenance of accounts.

10.105 Such attempts have met with limited success. Maintenance of accounts still poses challenges. It has been argued that local bodies need to hire qualified staff to set up and maintain data bases and accounts. Further, during our field visits, local body representatives forcefully emphasised the need for providing untied support. The use of conditionalities linked to desired performance outcomes may, therefore, need to be reviewed.

**Accounts of Local Bodies**

10.106 As indicated in paras 10.92 to 10.94, data on financial and operational performance of all local bodies continues to be of poor quality. Notwithstanding substantial progress by local bodies in a few states on this account, the data remains cross-sectionally unreliable for the determination of local body grant amongst states. The exhortations of the previous Commissions have been seen as indicative rather than imperative and State Governments have been either unable or unwilling to implement them. It appears that an incentive-based approach may yield better results than an exhortation-based one, in matters relating to maintaining a comprehensive data base as well as an upto-date accounting system.

10.107 The assistance given to local bodies is presently required to be booked by the State Governments under the following minor heads below the respective functional major heads:

- i) Minor head 191-Assistance to Municipal Corporations.
- ii) Minor head 192-Assistance to Municipalities/ Municipal Councils.

- iii) Minor head 193-Assistance to Nagar Panchayats/Notified Area Committees or equivalent thereof.
- iv) Minor head 196-Assistance to zilla parishads/district level panchayats.
- v) Minor head 197-Assistance to block panchayats/intermediate level panchayats.
- vi) Minor head 198-Assistance to gram panchayats.

10.108 Any assistance given by the State Governments to PRIs is presently booked as a lump sum under the minor heads 196, 197 & 198 which appear in the budget documents as well as in the finance accounts of the State Governments. However, neither the budget documents nor the finance accounts of most State Governments depict the details relating to the expenditure incurred by the PRIs by detailed heads and object heads. Further, it is not possible to determine the corresponding expenditure incurred by the PRIs as they do not maintain similar accounts that could capture these details.

10.109 Accurate data on the financial performance of local bodies are best obtained from accounts of the local bodies themselves, apart from the budget documents of the State Governments and the respective finance accounts. This requires that all State Governments make distinct budget provisions for local bodies, the expenditures relating to which are reported in the finance accounts. Such an approach has been recommended by previous Commissions as well as the SARC. A number of states do maintain distinct budgetary provisions for amounts transferred by them to each tier of PRIs and each category of ULBs. They provide 'object head-wise' details in the budget documents. Object heads like salary, wages and office expenses are captured under the relevant detailed heads.

10.110 It is desirable that this best practice be emulated by all states. We recommend that a supplement to the budget documents be prepared by the State Governments. This supplement should show the details of plan- and non-plan-wise

classification of transfers separately for all categories of ULBs and all tiers of PRIs, from major head to object head, which have been depicted in the main budget under the minor heads 191, 192 and 193; and 196, 197 and 198 respectively. This supplement could also incorporate details of funds transferred directly to the local bodies outside the State Government's budget. The supplement should aim to provide details of spatial distribution of transfers—at least upto district level. Parallel to this, the finance accounts should also reflect such a distinction. A separate statement needs to be included in the finance accounts showing the detailed plan- and non-plan-wise classification of transfers separately for all categories of ULBs and all tiers of PRIs, from major head to object head, which have been depicted in the finance accounts under the minor heads 191, 192 and 193; and 196, 197 and 198 respectively.

#### *Panchayati Raj Institutions*

10.111 In its recommendation relating to formats for the budget and accounts of local bodies, FC-XI had recommended that the C&AG prescribe the format in which local bodies should prepare their budgets and maintain their accounts. C&AG and the Ministry of Panchayati Raj have finalised a Model Panchayat Accounting System which is proposed to be introduced from 1 April 2010. The accounting system uses a simplified cash-based system (with provision to shift to accrual accounting) along with the list of codes for functions, programmes and activities capturing receipts and expenditure in respect of all 29 subjects mentioned in Schedule XI of the Constitution. It is desirable that all states adopt an accounting framework and codification pattern consistent with the Model Panchayat Accounting System.

10.112 In addition, for proper monitoring of the budget allocation and consolidation of accounts of PRIs at the state level, the states will have to allot specific codes to each zilla parishad, block panchayat and gram panchayat. Similarly, arrangements need to be put in place for consolidation of accounts of PRIs at the national level. Further, the eight data base formats prescribed by the C&AG for local bodies have not been compiled by any state. This also requires to be done.

*Urban Local Bodies*

10.113 The C&AG had set up a task force in February 2002 to recommend appropriate accounting and budget formats for ULBs. Based on the report of the task force, the National Municipal Accounts Manual was prepared by the Ministry of Urban Development and circulated to all the State Governments in December 2004. The National Municipal Accounts Manual provides for a codified structure that facilitates the capture of all financial information within an urban local body. This framework, based upon accrual accounting, has been agreed to by almost all the states. They are in the process of customising and adapting the NMAM to meet their individual requirements.

10.114 The codification and classification system for ULBs has been suggested in Chapter 4 of the National Municipal Accounts Manual which covers all 18 functions of the ULBs as given in Schedule XII of the Constitution.

10.115 As per instructions issued by the C&AG in the year 2002, assistance given by the State Governments to the municipal corporations, municipalities, and nagar panchayats is to be shown separately under the minor heads 191, 192 and 193 respectively in the budget and finance accounts. None of the State Governments comply fully with these instructions. A few State Governments operate the minor heads 191 and 192 for the first two classes of ULBs. Other State Governments club assistance to all three categories of ULBs in one minor head, i.e., 191, which makes it very difficult to ascertain the end-use of the assistance given by them. For the purposes of enhanced transparency, it is desirable that:

- i) All states comply with the instructions of Controller General of Accounts (CGA) and show assistance to all categories of ULBs separately under the minor heads 191, 192 and 193 below the respective major heads of accounts in the budget documents as well as in the finance accounts.
- ii) As mentioned in Para 10.110, a supplement to the budget documents needs to be prepared

by State Governments. This supplement should show the details of plan and non-plan classification of transfers to all categories of ULBs and all tiers of PRIs from major head to object head which have been depicted in the main budget under the minor heads 191, 192 and 193. The supplement should aim to provide details of the spatial distribution of the allocations, at least upto district level.

10.116 The states should implement in all urban local bodies an accounting framework consistent with the accounting format and codification pattern suggested in the National Municipal Accounts Manual.

**Audit and Accountability of Local Bodies**

10.117 The state-wise position of audit arrangements of local body accounts is placed in Annex 10.4 below. As per the FC-XI report, the Technical Guidance and Supervision (TG&S) of maintenance of accounts and audit was to be entrusted to the C&AG. The components of TG&S include: (i) setting audit standards & audit planning; (ii) adoption of improved audit methodologies; (iii) training in audit and accounts and (iv) annual transactions audit by random selection and supplementary audit of institutions audited by the State Director of Local Fund Audit.

10.118 As will be seen, there are three groups of states:

- i) The first group comprises 18 states which have entrusted all tiers/categories of both Panchayati Raj and urban local body audit to the technical guidance and supervision of the C&AG. The C&AG issues an Annual Technical and Inspection Report which is laid before the legislature.
- ii) The second group comprises four states which have partially entrusted this responsibility to the C&AG, excluding variously, different parts of PRIs, ULBs or both.
- iii) The third group comprises three states which have not entrusted any audit to the C&AG at all.

Another three states are exempt from the purview of the 73rd and 74th amendments.

10.119 As per the office of the C&AG, audit by the State Accountants General has been completed for the year 2007-08 and audit of the year 2008-09 is in progress in those states where entrustment has taken place. C&AG is not undertaking certification of accounts, except in Karnataka. Only transaction audit is being taken up for all the states where audit has been entrusted.

10.120 In six states, viz. Andhra Pradesh, Karnataka, Kerala, Maharashtra, Rajasthan, and Tamil Nadu, the C&AG's Audit Report on Local Bodies is prepared under Section 14/19 (3) of the C&AG's Duties, Powers, and Conditions of Service (DPC) Act and laid in the respective assemblies. Karnataka's Panchayati Raj Act and Kerala's Municipality Act also provide for laying of reports of local bodies in the state legislature. In West Bengal, the Examiner of Local Accounts' Report on PRIs is laid in the state legislature as per the West Bengal Panchayati Raj Act. There is no provision for laying of reports in the state legislature as per the TG&S arrangement. A separate legislature committee has been formed in Kerala and West Bengal for considering the C&AG's reports.

10.121 As mentioned in paras 10.92-10.94, the Commission has been unable to obtain credible data on the financial performance of local bodies. We have noted during our state visits that while a number of Panchayati Raj and urban local bodies maintain up to-date and audited accounts, the majority are unable to do so. Such a situation inhibits the study of the sector as a whole as well as each category of local body. This handicap can be overcome if accounts of local bodies are prepared and audited on a regular basis in a uniform manner across all states. For this reason, it is necessary that the C&AG be entrusted with TG&S for all local bodies for all states. This will also be a necessary consequence of the standardisation of accounting formats for all local bodies across states. Further, the Annual Technical Inspection Report of the C&AG as well as the Annual Report of the Director of Local Fund Audit should be placed before the

state legislature. If necessary, this may need to be institutionalised by introducing relevant legislation.

10.122 While such an arrangement will provide a credible assurance of the audit of accounts, an independent authority for investigating complaints of malfeasance and administrative laxity by local body representatives is still not in place in most states. The recommendations of the SARC referred to in Para 10.66 are, therefore, extremely relevant.

### **State Finance Commissions**

Major issues relating to the functioning of Finance Commissions include:

#### *Synchronicity with Central Finance Commissions*

10.123 Article 243-I of the Constitution requires that SFCs be appointed at the 'expiration of every fifth year'. The intention of this clause appears to be that all State Government transfers to local bodies should be governed by the mandate of a current SFC. The mandate given to an SFC should thus be applicable only for a period of five years and should not be extended. In practice, this has not happened. In one state the SFC report for the period 2005-06 to 2009-10 was submitted to the State Government as late as 31 January 2009. The State Government has yet to finalise its action taken report. In the interregnum, the recommendations of the previous State Finance Commissions are being implemented.

10.124 Clearly, an urgent need exists to ensure that SFCs are appointed on time, the period covered by the SFCs is synchronous with the period covered by the National Finance Commission, and action taken reports are placed by State Governments in the state legislature in a timely manner.

10.125 Since the timing of the National Finance Commission's constitution as well as the period for which it makes recommendations is known, State Governments should be empowered to constitute and direct their respective SFCs to give their report well before the National Finance Commission finalises its recommendations. We, therefore, endorse the recommendation of the SARC that Article 243-I (1) of the Constitution should be

amended to include the phrase ‘or earlier’ after the words ‘every fifth year’.

#### *Quality of SFC Reports*

10.126 The quality of SFC reports continues to be patchy. Though FC-XII had recommended that SFCs collect data in the formats suggested by it, this advice has not been uniformly followed. The basis for determination of support is not uniform across SFCs. Further, the recommendations of the SFCs do not follow a uniform pattern, thus detracting from their usability.

10.127 This problem was also recognised by the Conference on Empowering PRIs referred to in Para 10.76 which was attended by a number of chairmen of prior SFCs. This Commission had earlier constituted a task force to prepare a template for SFC reports. This template was discussed during the conference and finalised on the basis of the inputs received. It was then uploaded on the Commission’s website and further amendments made on the basis of the suggestions received. The template finalised after this comprehensive consultation process is placed in Annex 10.5. We recommend that SFCs consider this for adoption.

10.128 The recommendations of FC-XII on membership of the SFCs continue to be valid and merit attention. Important issues—legal, economic, financial and administrative, as well as those relating to decentralisation—need to be examined and SFC members should be well equipped to meet these challenges. Article 243-I (2) of the Constitution enables State Governments to legislate on the requisite qualifications of SFC members. It is desirable that all states legislate in this matter.

#### *Implementation of SFC Reports*

10.129 The experience of SFCs has not been found to be successful for a number of reasons. SFCs themselves are hampered by lack of data. Limited capacity and poor ownership by State Governments compounds this problem. There is little incentive for them to produce a comprehensive report. Further, or because of these reasons, states are not

overly keen either to accept their recommendations or to place the Action Taken Report before the state legislature in a timely manner. This situation provides a further disincentive for SFCs to produce good quality reports. There is, thus, a need for State Governments to ensure that the recommendations of SFCs are implemented without delay and that the Action Taken Report is placed promptly before the legislature.

#### *Article 280(3)(bb) and (c)*

10.130 The SARC as well as previous Commissions have recommended amendments to Article 280(3) (bb) and (c) such that the words ‘on the basis of the recommendations made by the Finance Commission of the State’ are changed to ‘after taking into consideration the recommendations ....’ We endorse this recommendation.

#### **Role of Other Development Authorities**

10.131 During our consultations, it was pointed out that there are a number of parastatal bodies which operate in areas earmarked for local bodies by XI and XII Schedules, thus emasculating them both financially and operationally. It was proposed that all funds relating to the subjects listed in the XI and XII Schedules, devolved either by the Central or the State Government, be given to the local bodies instead of to agencies whose activities intersect with theirs. It was suggested that all such parallel bodies be abolished and that funds should flow directly to the local bodies through the State Government.

10.132 One major argument for such a proposal is the potential for the use of land as a financing option by municipalities. A study sponsored by this Commission, which examined the position in this regard in four major cities, found that revenue from land lease/sale by Urban Development Authorities (UDAs) in these cities accounted for between 6 and 390 per cent of the aggregate own revenue sources of the four municipal bodies, between 5 and 120 per cent of their total revenues, and between 35 and 4412 per cent of property tax revenues. We recognise the difficulty in making generalisations based upon a study of only four cities. However, we

feel that two valuable lessons of general applicability across local bodies can be drawn from the study. First, the scope for exploiting land sales as a source of revenue can be very considerable, from the upper end of the range observed. This is especially necessary in the light of the number of infrastructure building programmes taken up, like the Pradhan Mantri Gram Sadak Yojana (PMGSY), Accelerated Power Development and Reforms Programme (APDRP), Rajiv Gandhi Gramin Vidyutikaran Yojana (RGGVY) and National Rural Employment Guarantee Scheme (NREGS), which indirectly tend to raise the price of land. These revenues can accrue to local bodies if development authorities are either merged with them or are made to share revenues with them. Second, the study points to the need for a common approach to fund sharing between local bodies and development authorities across all states in the country. Presently there are a variety of fund-sharing arrangements in place. In some states development authorities do not share revenue with municipalities at all. Other states mandate statutory transfer of funds from these authorities to municipalities. Still others have administrative arrangements aimed at this. We note that one of the reform measures mandated under JNNURM is 'Assigning or associating elected ULBs with city planning functions and transferring over a period of seven years, all special agencies that deliver civic services in urban areas to ULBs'. We would urge speedy implementation of this reform measure.

### Nagar Panchayats

10.133 Article 243Q(1) provides for constitution of nagar panchayats in areas that are in the process of transition from rural to urban areas. There are no uniform guidelines to define this transition and in some states nagar panchayats have been created even if the population does not exceed 10,000. In such cases, the nagar panchayat is deprived of the benefit of rural development programmes such as PMGSY and NREGS. Further, these institutions may incur higher establishment costs than gram panchayats. State Governments should lay down guidelines consistent with Article 243Q(2) of the Constitution, or else, review existing ones with regard to creation of nagar panchayats and municipalities.

### Areas Where Parts IX and IX A do not Apply

10.134 Provisions contained in parts IX and IX-A of the Constitution providing for panchayats and municipalities, respectively, exempt certain areas from the applicability of these parts. These provisions are contained in articles 243(M), 243(ZC) in parts IX and IXA of the Constitution respectively, read with Article 244. The main areas to which either of the provisions of parts IX and IX-A of the Constitution do not apply are described in Table 10.3.

10.135 With the passage of the Panchayats (Extension to the Scheduled Areas) Act of 1996, the provisions of Part IX of the Constitution relating to

**Table 10.3: Areas Where Provisions of Parts IX and IX-A do not Apply**

State/Area within a State	Provisions Under Which Exempt
Meghalaya	Exempt under Article 243M and covered by Schedule VI except selected wards of Shillong Municipal Area
Mizoram	Exempt under Article 243M, with two administrative districts Lawngtai and Saiha covered by Schedule VI
Assam: Bodoland, North Cachar, and Karbi Anglong districts	Covered by the Schedule VI
Tripura	Only the Tripura Tribal District is covered by Schedule VI
Nagaland	Exempt under Article 243M and not covered by Schedule VI
Manipur: Hill areas for which District Councils exist	Exempt under Article 243M and not covered by Schedule VI
West Bengal: The hill areas of the district of Darjeeling, covered by the Darjeeling Gorkha Hill Council	Exempt under Articles 243M/243ZC of the Constitution and not covered by Schedule VI

the panchayats have been extended to Schedule V areas. The tribal areas included in Schedule VI still remain outside its purview.

10.136 Concern has been expressed about the perception that Schedule VI areas of the Constitution have been getting less favourable treatment as compared to other areas of the states. The Seventh SARC Report entitled 'Capacity Building for Conflict Resolution' indicates that an emerging area of conflict is the rising disparity between the autonomous councils and the local bodies established in pursuance of the 73rd Amendment as the latter are being more liberally funded by SFCs. It goes on to recommend that State Governments initiate a system of meeting at least the establishment costs of the councils from sources outside the tribal sub-plan and incorporate the resultant financing needs in their projections to the next Finance Commission. We understand that consensus needs to be built for extension of the 73rd and 74th amendments to the Schedule VI area. We urge that this be done speedily.

10.137 While the general power of sanctioning grants for rendering financial assistance is left to Parliament by Clause 1 of Article 275 of the Constitution, specific grants are enabled through the two provisos to the clause:

- i) The first proviso concerns payment from the Consolidated Fund of India (without vote in Parliament) of sums necessary for schemes of development, for the welfare of scheduled tribes and for raising the level of administration of Scheduled Areas, as may have been undertaken by a state with the approval of the Government of India.
- ii) The second proviso concerns similar payments to the state of Assam, for the development of the tribal areas in that state only.

10.138 It has been observed that the powers conferred by Article 275(1) are not limited or restricted, but would cover all grants, whether of capital or revenue nature, whether for general or special purpose, whether unconditional or conditional, and whether on plan or non-plan account.

10.139 FC-X, FC-XI, and FC-XII have preferred to provide grants to the scheduled areas through the local bodies route. The view in taking such a course of action appears to be premised on the fact that the provision regarding measures to augment the consolidated funds of the states is included in Article 280 and not in parts IX and IX-A of the Constitution. This course of action followed by the previous Finance Commissions may have been dictated by the fact that their Terms of Reference excluded consideration of grants-in-aid under the provisos to Clause(1) of Article 275.

10.140 Another point of view goes thus: The Finance Commission is required to recommend measures to augment the consolidated fund of a state to supplement the resources of panchayats and municipalities on the basis of the recommendations made by the Finance Commission of the state. Thus, grants-in-aid meant for panchayats given to the states' consolidated funds cannot be expected to be apportioned to the 'excluded areas', and the Schedule VI areas as these areas are excluded from the ambit of the recommendations of the SFCs. The argument then would be to earmark grants for such 'excluded areas' under Article 275, notwithstanding the specific exclusion in the Terms of Reference.

## Recommendations

### Grants to Local Bodies

10.141 A feature observed uniformly across states is that all local bodies indicated their inability to meet the basic needs of their constituents and urged this Commission to increase the volume of grants to them. They particularly cited the need to provide core services—drinking water, sewerage, solid waste management, and street lights at acceptable levels of service. They also requested support for enhancing their operational infrastructure including office buildings and skeleton staffing for maintaining accounts and data bases.

10.142 The Ministry of Panchayati Raj has urged this Commission to substantially support PRIs to enable them to effectively provide basic services to their

constituents. Only 52 per cent of the rural population has access to basic sanitation. The Department of Drinking Water has underlined the large investments required to be made in rehabilitation and maintenance as well as for new schemes to ensure full coverage of drinking water and sanitation to the entire rural population. The Ministry of Urban Development highlighted the major challenges currently being faced by the urban sector. On the one hand, the urban population of the country is projected to increase from 28 per cent of the total population to about 38 per cent by 2026. Urban growth will account for two-thirds of the projected population increase. On the other hand, the current state of supply of core services in the urban areas is below norms. Only 70 per cent of urban households have access to piped water, only 74 per cent of urban households have access to latrines, only 23 per cent of sewage is treated, only 30 per cent of solid waste generated is treated prior to disposal. In addition to core services, other responsibilities like roads and citizen facilities also require investment.

10.143 There is, thus, an undisputed need to bolster the finances of the rural as well as urban local bodies. All local bodies need to be supported through a predictable and buoyant source of revenue, substantially higher than the present levels, in addition to their own tax revenues and other flows from State and Central Governments.

Simultaneously, local bodies should also be made more accountable in the discharge of their functions. Their accounts and audit must be up-to-date.

10.144 We have examined the Constitutional imperatives on transfers to local bodies earlier in paras 10.100 to 10.102. Taking into account the demand of local bodies that they be allowed to benefit from the buoyancy of central taxes and the Constitutional design of supplementing the resources of panchayats and municipalities through grants-in-aid, we recommend that local bodies be transferred a percentage of the divisible pool of taxes (over and above the share of the states), as stipulated by us, after converting this share to grant-in-aid under Article 275. The value of the grant must be commensurable at the start of the year, since the grant would have to be included in the Union Budget. We, therefore, recommend that the volume of the divisible pool for the previous year (t-1) be used as a basis for computing the grant eligibility of local bodies for a particular year (t). For example, the grants-in-aid for local bodies in 2010-11 would be based on a percentage of the divisible pool of 2009-10 (Revised Estimates). After the 'actuals' of that year are determined, adjustments may be made in the second tranche of the two-tranche system that we recommend.

10.145 Keeping these factors in mind, we recommend that grants be given to local bodies as detailed in the Table 10.4.

**Table 10.4: Recommended Grants for Local Bodies**

(Rs. crore)

Year	BE 2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2010-15
<b>Percentage of the previous years' divisible pool to be given to all states as grant under Article 275 of the Constitution-General Basic Grant and Total Special Areas Grant</b>							
General Performance Grants		1.50%	1.50%	1.50%	1.50%	1.50%	1.50%
<b>Aggregate Grants to Local Bodies</b>		<b>1.50%</b>	<b>2.00%</b>	<b>2.50%</b>	<b>2.50%</b>	<b>2.50%</b>	<b>2.28%</b>
<b>Projected (Rs crore) Divisible Pool: 2009-14</b>							
General Basic Grant and Total Special Areas Grant	545463	636183	746179	880156	1038188	1224595	3846169*
General Basic Grant		8182	9543	11193	13202	15573	57693
General Performance Grant		8022	9303	10873	12883	15253	56335
<b>General Basic Grant &amp; General Performance Grant</b>		<b>8022</b>	<b>12484</b>	<b>18335</b>	<b>21685</b>	<b>25635</b>	<b>86161</b>
<b>Total Special Areas Grant</b>		<b>160</b>	<b>239</b>	<b>319</b>	<b>319</b>	<b>319</b>	<b>1357</b>
Special Areas Basic Grant		160	160	160	160	160	798
Special Areas Performance Grant		0	80	160	160	160	559
<b>Aggregate Grants to Local Bodies</b>		<b>8182</b>	<b>12724</b>	<b>18654</b>	<b>22004</b>	<b>25955</b>	<b>87519</b>

\* Period 2009-10 to 2013-14. Totals may not tally due to rounding off.

10.146 As shown, the proposal is to award 2.28 per cent of the relevant divisible pool (2009-14) as a grant to local bodies. This is equivalent to 1.93 per cent of the 2010-15 divisible pool—the relevant period for this Commission.

10.147 The grant will have two components—a basic component and a performance-based component. The basic grant will be equivalent to 1.50 per cent of the previous year's divisible pool. All states will have access to this grant for all the five years as per the criteria and weights mentioned in Para 10.158. The performance grant—effective from 2011-12—will be 0.50 per cent for the year 2011-12 and 1 per cent thereafter, upto 2014-15. Only those states which meet the stipulations outlined in Para 10.161 will have access to the performance grant.

10.148 We recognise the need to specially support areas covered by the V and VI Schedules and the areas exempted from the purview of Part IX and IX A of the Constitution, for a number of reasons including those mentioned by SARC (Para 10.136). We therefore propose to carve out a small portion of the basic grant and allocate it exclusively for the development of these areas which we term 'special areas'. Eligibility for the special areas grants has been computed on the basis of population in these areas. An amount of Rs. 20 per capita per year has been allocated as the 'special area basic grant'. This special area basic grant will be accessible by all the eligible states for all five years. A special areas performance grant of Rs. 10 per capita for 2011-12 and Rs. 20 per capita for the subsequent three years will be made available to those states which meet the stipulations in Para 10.162. The state-wise allocation of the aggregate special areas grant is provided in Annex 10.6.

10.149 The general basic grant and the total special areas grant has been estimated as aggregating to Rs. 57,693 crore for the five year period 2010-15. As indicated above, Rs. 1357 crore has been allocated to the special areas grant. This amount represents 2.35 per cent of the basic grant for the local bodies. This leaves Rs. 56,335 crore as the general basic grant to be divided amongst states in the manner specified in paras 10.150 to 10.158.

10.150 The general basic grant and the general performance grant will initially be segmented into rural and urban shares on the basis of their respective populations as per the 2001 Census, with 26.82 per cent as the urban share and 73.18 per cent as the rural share. By thus splitting the total grant provision, we are, in effect, providing a uniform per capita entitlement in both sectors of the economy. The grant for rural and urban local bodies will then be separately allocated amongst states as discussed below. However, the special areas grants, both general and performance, will be distributed as per Annex 10.6 without distinguishing between urban and rural areas.

10.151 We are conscious of the need to ensure a certain degree of predictability in the devolution criteria adopted, both in terms of generally accepted criteria as well as in the need to nurture incentives which have been set up by previous Commissions. A number of states have suggested that population, area, income distance, revenue effort and index of decentralisation be considered as criteria, though their perceptions on the weights to be assigned to each parameter have varied. We have decided to retain the population, area and income distance criteria. Though we are strongly inclined to use the revenue effort criteria, the available data do not appear credible. The reasons for not doing so are mentioned in Para 10.93. We appreciate the reasons for FC-XII devising and using an index of deprivation as a criteria for devolution. However, we consider that using the 2001 Census figures in November 2009 to compute this index would not truly reflect the relative deprivation of the population in different states with respect to minimum needs like water and sanitation. The Accelerated Rural Water Supply Programme, the Total Sanitation Campaign and the Nirmal Gram Panchayat Scheme have made a significant difference to the position as determined by the 2001 Census. A number of villages may also have slipped from the 'fully covered' category for water supply to 'uncovered' due to failure of the source or breakdown of the system. We have, therefore, discarded the use of this index in our calculations. In its place we propose to use the aggregate percentage of scheduled castes and

scheduled tribes in a state as a criterion, as a proxy for deprivation. However, we recognise that this criterion is more relevant in the rural areas than in the urban areas. In the urban areas, in our view the income distance criterion dominates the caste criterion. We, therefore, propose to allot differential weights for rural and urban areas in relation to the criteria of percentage of SC/STs. The percentage of SC/STs is available separately for the rural sector in the 2001 Census data. This criterion has been given a weight of 10 per cent. No weight has been assigned to this parameter for ULBs.

10.152 We recognise the need to incentivise states to empower panchayats and are inclined, in principle, to use an index of decentralisation as a parameter for devolution. However, for the reasons mentioned in paras 10.98 and 10.99, we are unable to do so. In its place, we propose to use an index of devolution derived from the finance accounts for the years 2005-06, 2006-07, and 2007-08. The amounts devolved to local bodies in the finance accounts have been aggregated across the following heads:

- i) For rural local bodies under sub heads 196, 197, and 198 under applicable major heads in the non-plan category.
- ii) For urban local bodies under the sub heads 191, 192, and 193 under applicable major heads in the non-plan category.
- iii) For other assistance to all local bodies under the head 3604 in the non-plan category.

10.153 From the above aggregated amount FC-XII grants released to local bodies for the same period were deducted. Since there is a possibility that FC-XII grants might have been received in a year subsequent to the year of recording of the respective devolutions, we used figures summed up over a three-year period. The figure so obtained was the amount devolved to local bodies from the State Governments' own resources. Even so, this figure was negative for nine states. One reason could be that the state may not have devolved all FC-XII grants to the local bodies. Alternatively, it could have devolved them under the plan head. Also, it may not have recorded this expenditure under the sub-heads mentioned above. Having carefully considered the

existing modalities for booking such expenditure and weighing all alternatives, we decided that the best approach would be to assign the negative entries under the non plan head a minimum value of zero. Where a state had recovered unspent balances available with local bodies at the end of the year, a suitable correction was made. The modulated transfer so determined was divided by the states' non-plan revenue expenditure for the three years (after deducting FC-XII grants for this period) and state-wise percentages obtained. These percentages were then weighted by their respective 2001 populations to obtain the state-wise devolution index. The calculations are shown in Annex 10.7. We allot this index a weight of 15 per cent.

10.154 As mentioned earlier, we used the 2001 Census to determine state-wise shares in grants for the rural and urban populations. As far as local bodies are concerned, population continues to be the best indicator of need. We therefore depart from FC-XI and FC-XII, and allocate to the population criterion an enhanced weight of 50 per cent. Rural and urban areas have also been determined on the basis of the 2001 Census. We allot a weight of 10 per cent to area and follow the FC-XII in computing the income distance criterion. For the rural sector, we have used the average per capita comparable Gross State Domestic Product (GSDP) from the primary sector, derived on the basis of comparable GSDP figures supplied by the Central Statistical Organization (CSO) for the years 2004-05, 2005-06 and 2006-07. The corresponding mid year state-wise population figures for these years were obtained from the report of the Technical Group on Population Projections, chaired by the Registrar General of India and published by the National Commission on Population in May 2006. While measuring the per capita income distance of each state from the maximum, outliers were eliminated as their use tended to suppress the relative income distance of the weaker states. Thus, income distance was measured from the state with the second highest sectoral per capita income in case of the rural sector (Punjab). To ensure inclusion, one quarter of a standard deviation from the average per capita sectoral income of all states was added to the per capita sectoral income of the benchmark state. This determined the target per capita sectoral income.

States with per capita sectoral income equal to or higher than the benchmark state were awarded the same distance as the benchmark state, i.e., one quarter of the standard deviation indicated above. For all other states, the income distance was determined as the difference between the target per capita sectoral income and the states' own per capita sectoral income. These income distances were then weighted by the rural populations (2001) of the respective states to arrive at the share of the panchayats. A similar approach was followed in case of urban local bodies as well. We have used the average per capita GSDP excluding the primary sector on the basis of the GSDP data supplied by the CSO. The population projections made by the technical group mentioned above were used. The distance of each state was measured from the state with the third highest average per capita GSDP in the non primary sector (Goa) plus one quarter standard deviation from the average per capita sectoral income. The distances were then weighted by the urban population (2001) of the concerned state to arrive at its share. The data used, along with these computations, are placed in annexes 10.8 to 10.10. Income distance is a more significant criterion in the urban sector when compared to the rural sector. We therefore allot this criterion a weight of 10 per cent for the rural sector and 20 per cent for the urban sector.

10.155 As pointed out in Para 10.17, of the eligible allocations under the FC-XII award; 7.42 per cent of the allocation in the case of for PRIs and 10.57 per cent in the case of ULBs had not been drawn as on 6 November 2009. The percentage of undrawn amounts was significant during earlier periods as well. This has led to an anomalous situation where grants recommended by the FC-XI are being drawn-down during the period of FC-XII. Rs. 319.56 crore of grants approved by the FC-XI were released in February 2007. Such a situation is not desirable and we propose using the level of draw down of FC-XII funds in the past as a criterion for inter-state distribution of grants. We include this to signal the importance of timely releases to local bodies. We, however, propose to allot to it a weight of only 5 per cent. For computing this index, we confine ourselves to an examination of the grants awarded by FC-XII and the releases made to State Governments thereafter.

10.156 Local body grants are released in two instalments every year—in January and in July.

State Governments were required by FC-XII to submit the following details prior to the release of every instalment:

- i) Details of allocation of funds to local bodies for the forthcoming instalment.
- ii) Details of release of funds to local bodies at all levels at all tiers for the previous instalment.
- iii) Percentage of grants spent on solid waste management by ULBs and on water supply and sanitation by PRIs.
- iv) Details of recurring costs recoverable by PRIs on water supply schemes.

10.157 FC-XII had stipulated that all local body grants drawn by State Governments should be immediately transferred to local bodies and interest would be payable if the delay in doing so exceeded 15 days. Since transfer of releases by State Governments to local bodies was effectively a criterion for release of the subsequent instalment, the releases of the FC-XII grants would reflect the commitment of State Governments to promptly providing the documentation to GoI necessary for such releases, and thus, display their commitment to the local bodies. FC-XII releases to State Governments from 2005-06 onwards for local body grants are placed in Annex 10.11a&b. A total of nine tranches of FC-XII grants were eligible for release as on November 2009. The percentage eligibility of each state has been worked out on the basis of the actual number of tranches released. These computations are also shown in Annex 10.11 a&b. We are confident that the states will make all possible efforts to draw down all the grants made by this Commission in a timely fashion.

10.158 The summary of criteria and weights allotted is as shown in Table 10.5.

**Table 10.5: Weights Allotted to Criteria for Grants to Local Bodies**

Criterion	Weights Allotted (%)	
	PRIs	ULBs
Population	50	50
Area	10	10
Distance from highest per capita sectoral income	10	20
Index of devolution	15	15
SC/STs proportion in the population	10	
FC local body grants utilisation index	5	5
<b>Total</b>	<b>100</b>	<b>100</b>

10.159 Based upon the above criteria and the weights allotted, the state-wise percentage share of the basic grant to be transferred to PRIs is given in Annex 10.12. The state-wise percentage share of transfers to urban local bodies is given in Annex 10.13. The state-wise composite percentage has been worked out in Annex 10.14. The same shares apply to the performance grant although access to that grant is subject to the conditionalities listed in Para 10.161. The projected share of each state has been worked out in Annex 10.15 as under:

- i) The state-wise general basic grant is detailed in Annex 10.15a.
- ii) The state-wise general performance grant is detailed in Annex 10.15b.
- iii) The state-wise special areas basic grant is detailed in Annex 10.15c.
- iv) The state-wise special areas performance grant is detailed in Annex 10.15d.

The computations in Annex 10.15b and 10.15d assume that all states will become eligible to draw down their general performance grant and special areas performance grant respectively at the earliest. These annexes assume fulfilment of all conditionalities by all states and to that extent they are tentative and contingent upon the performance of the states. If any state is unable to draw down the performance component of the grants allocated to it, its share will be distributed in the manner specified in paras 10.163 and 10.164 and Annex 10.15b&d will stand amended to that extent.

### **Incentive Framework for General Performance Grant**

10.160 This distribution arrangement outlined above will be subject to the following conditions. For all five years between 2010-11 and 2014-15, all states will be eligible to draw down their share of the general basic grant shown in Annex 10.15a. This will be done in two instalments, latest by 1 July and 1 January of each year, subject to submission of a utilisation certificate (UC) for the previous instalment drawn. No other documentation need be stipulated. This utilisation certificate will provide

details of the distribution of the concerned instalment to urban and rural local bodies and is not required for the first instalment in 2010-11.

10.161 For the years 2011-2012, 2012-13, 2013-14 and 2014-15, a State Government will be eligible to draw down its share of the general performance grant shown in Annex 10.15b only if it complies with the following nine conditions. These conditions must be met by the end of a fiscal year (31 March) for the state to be eligible to draw down its performance grant for the succeeding fiscal year.

- i) The State Government must put in place a supplement to the budget documents for local bodies (separately for PRIs and ULBs) furnishing the details (other than those relating to Finance Accounts) indicated in Para 10.110. They should require the PRIs to maintain accounts as specified in paras 10.111 and 10.112. They should also require urban local bodies to maintain accounts as provided in Para 10.116. To demonstrate compliance with this condition, a State Government should: (a) submit the relevant supplement to the budget documents and (b) certify that the accounting systems as recommended have been introduced in all rural and urban local bodies.
- ii) The State Government must put in place an audit system for all local bodies (all categories of ULBs and all tiers of PRIs) as indicated in Para 10.121 above. The C&AG must be given TG&S over the audit of all the local bodies in a state at every tier/category and his Annual Technical Inspection Report as well as the Annual Report of the Director of Local Fund Audit must be placed before the state legislature. Certification from the C&AG will demonstrate compliance with this condition.
- iii) The State Government must put in place a system of independent local body ombudsmen who will look into complaints of corruption and maladministration against the functionaries of local bodies, both elected members and officials, and recommend

suitable action. This system should be made applicable to all elected functionaries and officials in all municipal corporations, municipalities and zilla parishads at least. The passage of relevant legislation and its notification will demonstrate compliance with this condition. In the event that all or a class of the functionaries mentioned above fall under the jurisdiction of the Lok Ayukta of the state, we leave it to the state to decide whether to continue with these arrangements or to shift the functionaries to the jurisdiction of the ombudsman. Self-certification by State Governments will demonstrate compliance with this condition.

- iv) The State Governments must put in place a system to electronically transfer local body grants provided by this Commission to the respective local bodies within five days of their receipt from the Central Government. Wherever this is not possible due to lack of easily accessible banking infrastructure, the State Governments must put in place alternative channels of transmission such that funds are transferred within ten days of their receipt. Self-certification by the State Governments with a description of the arrangements in place will demonstrate compliance with this condition.
- v) The State Governments must prescribe through an Act the qualifications of persons eligible for appointment as members of the SFC consistent with Article 243I (2) of the Constitution. The passage of relevant legislation and its notification will demonstrate compliance with this condition.
- vi) All local bodies should be fully enabled to levy property tax (including tax for all types of residential and commercial properties) and any hindrances in this regard must be removed. Self-certification by the State Government will demonstrate compliance with this condition.
- vii) State Governments must put in place a state level Property Tax Board, which will assist

all municipalities and municipal corporations in the state to put in place an independent and transparent procedure for assessing property tax. The Board (a) shall, or cause to, enumerate all properties within the jurisdiction of the municipalities and corporations; (b) shall review the present property tax system and make suggestions for a suitable basis for assessment and valuation of properties; and (c) shall make recommendations on modalities for periodic revisions. The findings, suggestions and recommendations of the board will be communicated to the respective urban local bodies for necessary action. The exact model to be adopted is left to the respective state. The board should be staffed and equipped in such a manner as to be able to make recommendations relating to at least 25 per cent of the aggregate number of estimated properties across all municipal corporations and municipalities in the state by 31 March 2015. The board should prepare a work plan indicating how it proposes to achieve this coverage target and the human and financial resources it proposes to deploy. Passage of the relevant legislation or issue of the necessary executive instructions by the State Government for creation of the Property Tax Board as well as publication of the work plan by the Board in the State Government gazette will demonstrate compliance with this condition.

- viii) Lack of resources often results in local bodies diluting the quality of services provided by them. State Governments must gradually put in place standards for delivery of all essential services provided by local bodies. For a start, State Governments must notify or cause all the municipal corporations and municipalities to notify by the end of a fiscal year (31 March) the service standards for four service sectors-water supply, sewerage, storm water drainage, and solid waste management proposed to be achieved by them by the end of the succeeding fiscal year.

This could be in the form of a declaration of a minimum level of service for the indicators mentioned against each of these four service sectors in the *Handbook on Service Level Benchmarks* published by the Ministry of Urban Development. For example a State Government may notify before 31 March 2011 that by 31 March 2012, all municipalities and municipal corporations in the state will provide a specified minimum level of service for each of the indicators for the four service sectors of water supply, sewerage, storm water drainage and solid waste management. These levels may be different for different municipalities. We envisage such a commitment to be achieved through a consultative process with the local bodies. Such a notification will be published in the State Government gazette and the fact of publication will demonstrate compliance with this condition.

- ix) All municipal corporations with a population of more than 1 million (2001 census) must put in place a fire hazard response and mitigation plan for their respective jurisdictions. Publication of these plans in the respective State Government gazettes will demonstrate compliance with this condition.

### **Incentive Framework for Special Area Performance Grant**

10.162 A state will be able to draw down its special area performance grant only if it satisfies the following conditions:

- i) It indicates in a supplement to its budget documents the details indicated in Para 10.110 while specifying the agencies which will receive the special area basic and performance grant and the conditions under which it is given including the procedure for auditing these expenditures. If these agencies are panchayats, then the conditions mentioned in Para 10.161 (i), (ii), (iii) and (vi) must be satisfied. Compliance will be

demonstrated as described in the respective paragraphs.

- ii) If these agencies are not panchayats, they must maintain accounts consistent with the instructions in force. These accounts should be up-to-date, the audit of these accounts should be completed by the C&AG, and the audit reports tabled, wherever so mandated. Compliance will be demonstrated by a certificate from the C&AG to this effect.
- iii) At least, the district level elected functionaries and officials of these agencies must be brought under the ombudsman mentioned in Para 10.161 (iii). The passage of relevant legislation and its notification will demonstrate compliance with this condition.
- iv) The stipulation in Para 10.161 (iv) regarding transfer of funds within the stipulated time is also required to be satisfied. Self-certification by the State Government with a description of the arrangements in place will demonstrate compliance with this condition.

### **Processes for Release of Funds**

10.163 As explained in Para 10.147, each state is entitled to a share of the basic grant from 2010-11 and a share of the general performance grant from the year 2011-12 onwards, respectively. In addition, the states listed in Annex 10.6 are also entitled to a share of the special area basic grant from 2010-11 and to a share of the special area performance grant from the year 2011-12 onwards. The aggregate entitlements for all grants for all states will be computed every year and budgeted in accordance with the Table 10.4. From the year 2011-12 onwards, where a state meets the conditionalities specified in paras 10.160 and 10.161, it will be eligible to receive both the basic grant and the general performance grant as shown in annexes 10.15a and 10.15b respectively. However, where a state is unable to meet these conditionalities by 31 March of a particular fiscal year, it will only be entitled to the basic grant for the succeeding fiscal year, provisional upon submitting UCs as specified

in Para 10.160. Its share of the performance grant as indicated in Annex 10.15b will be forfeited. The forfeited performance grant for the state will be divided into PRI & ULB components in the proportions indicated against that state in Annex 10.15b. It is possible that more than one state may not become eligible to draw down their performance grants. In such a case, the PRI & ULB components of the general performance grant forfeited will be aggregated separately across all such non-performing states. The total amount of PRI & ULB performance grants forfeited by the non-performing states for that particular year will then be distributed as under:

- i) Fifty per cent of the PRI amount so forfeited will be divided amongst all the states (both performing and non-performing) by the shares indicated in Annex 10.12 and 50 per cent of the ULB amount forfeited will be distributed by the share indicated in Annex 10.13.
- ii) The remaining 50 per cent of the forfeited PRI & ULB performance grants will be distributed only amongst the performing states which have complied with the stipulations in Para 10.161, in the ratio of their entitlements specified in annexes 10.12 and 10.13 respectively. If no state is eligible, this amount shall not be disbursed.

10.164 Similarly, from the year 2011-12 every state listed in Annex 10.6 will be eligible to draw the share of the basic special areas grant and its share of the special areas performance grant if it meets the conditionalities stipulated in paras 10.160 and 10.162. In case, a state does not meet these conditionalities, its entitlement will be restricted to only the basic special area grant as indicated in Annex 10.15c subject to its submitting UCs as specified in Para 10.160. Its share of the special area performance grant will be forfeited. It is possible that more than one state of those listed in Annex 10.6 may not be eligible to draw down the special areas performance grant. The special areas performance grant so forfeited will be aggregated across all non-performing states. The total amount forfeited by these non-

performing states for that particular year will then be distributed as under:

- i) Fifty per cent of the amount will be distributed amongst all the eligible states (both performing and non-performing states) as listed in Annex 10.6.
- ii) The balance 50 per cent of the amount will be distributed only amongst the performing states from those listed in Annex 10.6 which have complied with the stipulations in Para 10.162 in the ratio of their entitlements specified in the same annex. If no state is eligible, this amount shall not be disbursed.

10.165 If a state is unable to meet the stipulations in Para 10.161 or Para 10.162, as the case may be, by 31 March 2011, but meets the above stipulations by 31 March of any succeeding fiscal year, it will be entitled to its share of performance grant only prospectively from the fiscal year after the fiscal year during which it demonstrates compliance with the conditions.

10.166 We recognise the criticality of supporting all local bodies through adequate levels of devolution. They are increasingly being called upon to meet the challenges of environmental degradation, population pressure, exhaustion of resources and revenue constraints. We have, therefore, provided for a broad level of unconditional support for both urban and rural local bodies for the entire five-year period governed by our recommendations. However, all these flows need to be consistently accounted for and audited within a uniform framework across the country. Local bodies also need to be adequately empowered through appropriate transfers in a timely manner. It is for addressing these issues that we have put in place a regime of conditionality which acts as a gateway to performance grants. The conditions imposed are prudential rather than output-based; they are concerned with processes rather than being expenditure-directed and they are aimed at putting in place a credible framework for analyzing the performance of all local bodies as well as making them responsible for their service levels. These

conditions have been derived from our consultation process. We have attempted to put in place conditionalities which will increase responsibility, enhance transparency and augment accountability of local bodies to the public. These steps, which are consistent with the subsidiarity principle, will, in our view, improve the quality of expenditures of local bodies and result in better outputs and outcomes.

10.167 The substantial increase in the volume of transfers to local bodies envisaged by this Commission requires that State Governments strengthen their audit framework. While the C&AG will provide technical guidance and supervision, the major portion of the work will have to be undertaken by the local fund audit department. We recommend that all State Governments strengthen their local fund audit departments appropriately through both capacity building as well as augmentation of personnel.

#### **Role of Other Development Authorities**

10.168 Ideally, development authorities should be dissolved and their functions taken over by the local bodies in whose jurisdiction they operate. As pointed out in Para 10.132, one of the reform measures mandated under JNNURM is 'assigning or associating elected ULBs with city planning functions and transferring all special delivery civic services in urban areas to ULBs over a period of seven years'. We urge speedy implementation of this reform measure. In the interim, we recommend that these bodies share a percentage of their income (including income from land sales) with local bodies.

10.169 A number of the 62 cantonments in the country are now located within city boundaries. It is necessary that the development plans made for the city incorporate the civilian portions of the cantonment areas as well. We recommend that the development plans for the civilian areas within the cantonment areas (excluding the areas under the active control of the forces) be brought before the district planning committees. This would also enable integration of services like water supply and

schemes like JNNURM from the other areas into the cantonment areas.

#### **Areas where Parts IX and IX-A do not Apply**

10.170 The terms of reference of this Commission do not include the provisos to Article 275(1) relating to grants to the Schedule VI areas. This Commission finds no reason to depart from the course of action followed by the previous Commissions and recommends that the states may appropriately allocate a portion of their share of the general basic grant and general performance grant, to the specials areas described in para 10.148, in proportion to the population of these areas. This will also promote uniformity of approach across all states in the country in the matter of devolution to local bodies. This allocation will be in addition to the special area basic grant and special area performance grant recommended by us in Para 10.148. We are confident that these steps will lead to national policies like gender representation being integrated into the working of the agencies functioning in these areas. We understand that proposals for improving the functioning of the ADCs based upon the report of an Expert Committee are under consideration of Government of India. We recommend that this issue be addressed promptly.

#### **Revamping Fire and Emergency Services**

10.171 The National Disaster Management Authority (NDMA) has drawn the Commission's attention to the dismal state of fire services in the country. NDMA has estimated the deficiency of the services in the country as under:

i) Fire Stations	- 97.54%
ii) Fire Fighting & Rescue Vehicles	- 80.04%
iii) Fire Personnel	- 96.28%

10.172 NDMA argued for allocation of grants worth Rs. 7,000 crore to the states to meet these shortages. We accept the need to restructure fire and emergency services across the urban and rural areas of the country and recognise that the stipulation in Para 10.161(ix) is merely a first step. Though this is

an important area, we are not imposing an expenditure conditionality on local bodies in view of our approach to conditionality outlined in Para 10.166. We recommend that a portion of the grants provided by us to the urban local bodies be spent on revamping of the fire services within their respective jurisdictions. These bodies could provide financial support to the State Fire Services Department towards this objective. In this process, they could draw upon the expertise of state agencies and the National Disaster Management Agency, as required.

### **Strengthening the Local Body Framework**

10.173 Though our recommendations provide enhanced support to local bodies, we recognise that there is no substitute for local bodies raising their own tax and non-tax revenues and for State Governments augmenting their tax assignment and transfers to them. Local bodies must be encouraged to fully exploit those taxation powers which have been assigned to them by their respective State Governments. They should be in a position, not only to fully exploit sources like property tax and profession tax, but also to recover at least maintenance costs for services like water supply, solid waste management and sewerage. Where construction of a road has led to tangible commercial benefits being provided, a suitable user charge could be considered. The issue of collection of user charges from roads is elaborated in a subsequent chapter. We recognise that local bodies should be incentivised for such efforts. This, in our view, can best be done if own revenue of local bodies is used as one parameter for devolution. Unfortunately, due to data frailties mentioned earlier, we were unable to do so. We have, however, through the use of conditionalities, attempted to ensure that all stakeholders including the Finance Commissions in future will have access to comparable and audited data of local body revenues across all the states in the country. The State Governments, in turn, can incentivise own revenue collection by local bodies through a variety of methods, such as mandating some or all local taxes as obligatory at non-zero rates of levy; by deducting

deemed own revenue collection from transfer entitlements of local bodies, or through a system of matching grants. We have not imposed any stipulation that State Governments maintain their present level of transfers such that FC transfers become an additionality. We believe that funds, functions and functionaries are interdependent. This virtuous circle will get enlarged with increased financial support to local bodies and enhanced devolution of functions and more functionaries will follow. We trust that these issues will be examined carefully by the respective State Finance Commissions and that they will make appropriate recommendations.

10.174 Given the rapid growth in urban population and the need to improve urban infrastructure, ULBs need to look for market-based financing to provide additional funds for infrastructure investments. Ahmedabad Municipal Corporation was the first ULB to access the capital markets in January 1998. Since then, ULBs have raised funds through both taxable and tax-free municipal bonds to the tune of Rs. 1200 crore. Several of these municipal bonds have been issued without State Government guarantees. In recent years, the Tamil Nadu Urban Development Fund and the Greater Bengaluru Water Supply and Sewerage Project have raised funds through the pooled financing arrangements, which allows local bodies to pool their resources and jointly access the capital market. Although the municipal bond market has been limited so far, we expect that more and more ULBs will, in future, be able to access market-based financing or urban infrastructure, using the pooled finance model. However, proper accounting and audit mechanisms and adequate transparency would be critical for the success of the municipal bond issues. Hence our emphasis on the quality of accounting and auditing processes as well as data on all aspects of the functioning of ULBs.

10.175 We recommend that the system of notification of minimum levels of service described in Para 10.161(viii) and stipulated only for municipal corporations and municipalities would be gradually extended in future to all local bodies, both urban and rural.

10.176 We would urge State Governments to consider gradually putting in place the ombudsman system to cover all local body functionaries including gram panchayats, block panchayats and nagar panchayats at the earliest.

### **Changes to the Finance Accounts**

10.177 To buttress the accounting system stipulated in Para 162(i) and (ii), we recommend that the finance accounts should include a separate statement indicating head-wise details of actual expenditures for both PRIs and ULBs. under the same heads as used in the budget. Details are provided in Para 10.110. We recommend that these changes be brought into finance accounts with effect from 31 March 2012.

### **Other Measures to Strengthen Local Bodies**

#### **Payment of Service Charges**

10.178 Article 285 (1) of the Constitution exempts all properties of the Central Government from tax imposed by local bodies in the states. However, the Central Government, as early as May 1954, recognised the need to make payment for the unallocable civic services provided by the local bodies. It was noted that while metered services like electricity and water could be paid for, based upon consumption, there was need to reimburse local bodies for unallocable services like street lighting and roads which are normally funded through the property tax route. The Central Government reiterated these instructions in 1967, 1976, and 1986. FC-XI had recommended that all government properties of the Centre as well as the states should be subject to levy of user charges which should be regulated by suitable legislations. There has been little progress in this area over the last ten years. A common refrain during our state visits has been the need for municipalities to be compensated for the unallocable civic services provided by them. We endorse the recommendation of the FC-XI that payment of service charges by Central and State Governments should be regulated by suitable legislation. This may take time. We urge both the Government of India and the State Governments to

issue executive instructions that all their respective departments pay appropriate service charges to the local bodies. We are of the view that user charges levied on Central Government properties should not exceed the charges levied on similarly placed State Government properties, and where no charges are collected by the local bodies in respect of State Government properties, Central Government properties should be equally exempt.

### **Sharing of Mining Royalties**

10.179 In our discussions with representatives of local bodies they asked that mining royalties received by the states should either be assigned to the local bodies or shared with them. During field visits in the states we witnessed significant environmental degradation affecting the lives of people in the mining regions. There is a feeling that while natural resources are extracted from resource-rich areas, the local population does not benefit from the exploitation of these resources. They, however, have to bear the negative externalities. We recommend that State Governments share a portion of their income from royalties with those local bodies from whose jurisdiction such income originates.

### **Setting up SFC-like Bodies in Areas not Covered by Part IX**

10.180 We endorse the recommendation of the Expert Committee on 'Planning for the Sixth Schedule Areas' set up by the Ministry of Panchayati Raj relating to setting up of bodies similar to the SFC in states which are not covered by Part IX of the Constitution, and are thus, not required to set up SFCs. As recommended by them, the terms of reference of these SFC-like bodies may be patterned on the provisions of Article 243I of the Constitution. The Union Government has to take the necessary steps in this regard.

### **Summary of Recommendations**

10.181 Article 280 (3) (bb) & (c) of the Constitution should be amended such that the words 'on the basis of the recommendations of the Finance Commission of the State' are changed to 'after taking into consideration the

recommendations of the Finance Commission of the State' (Para 10.130).

10.182 Article 243-I of the Constitution should be amended to include the phrase 'or earlier' after the words 'every fifth year' (Para 10.125).

10.183 The quantum of local body grants may be provided as per Table 10.4. The general basic grant as well as the special areas basic grant be allocated amongst states as specified. The state-wise eligibility for these grants is placed in annexes 10.15a and 10.15c. (Para 10.159)

10.184 State Governments will be eligible for the general performance grant and the special areas performance grant only if they comply with the stipulations in paras 10.161 and 10.162 respectively. These grants will be disbursed in the manner specified in paras 10.163 and 10.164. The state wise eligibility for these grants is placed in annexes 10.15b and 10.15d.

10.185 States may appropriately allocate a portion of their share of the general basic grant and general performance grant, to the 'excluded areas' in proportion to the population of these areas. This allocation will be in addition to the special area basic grant and special area performance grant recommended by us (Para 10.170).

10.186 State Governments should appropriately strengthen their local fund audit departments through capacity building as well as personnel augmentation (Para 10.167).

10.187 The State Governments should incentivise revenue collection by local bodies through methods such as mandating some or all local taxes as obligatory at non-zero rates of levy; by deducting deemed own revenue collection from transfer entitlements of local bodies or through a system of matching grants (Para 10.173).

10.188 To buttress the accounting system, the finance accounts should include a separate statement indicating head-wise details of actual

expenditures under the same heads as used in the budget for both PRIs and ULBs. We recommend that these changes be brought into effect from 31 March 2012 (Para 10.177).

10.189 The Government of India and the State Governments should issue executive instructions that all their respective departments pay appropriate service charges to local bodies (Para 10.178).

10.190 Given the increasing income of State Governments from royalties, they should share a portion of this income with those local bodies in whose jurisdiction such income arises (Para 10.179).

10.191 State Governments should ensure that the recommendations of SFCs are implemented without delay and that the Action Taken Report is promptly placed before the legislature (Para 10.129).

10.192 SFCs could consider adopting the template suggested at Annex 10.5 as the basis for their reports (Para 10.127).

10.193 We recommend setting up of bodies similar to the SFC in states which are not covered by Part IX of the Constitution (Para 10.180).

10.194 Local bodies should consider implementing the best identified practices (Para 10.79).

10.195 A portion of the grants provided by us to urban local bodies may be used to revamp the fire services within their jurisdiction (Para 10.172).

10.196 Local bodies should be associated with city planning functions wherever other development authorities are mandated this function. These authorities should also share their revenues with local bodies (Para 10.168).

10.197 The development plans for civilian areas within the cantonment areas (excluding areas under the active control of the forces) may be brought before the district planning committees (Para 10.169).

10.198 State Governments should lay down guidelines for the constitution of nagar panchayats (Para 10.133).

# CHAPTER 11

## Disaster Relief

### Terms of Reference

11.1 Para 8 of the Terms of Reference (ToR) requires us to ‘...review the present arrangements as regards financing of disaster management with reference to the National Calamity Contingency Fund and the Calamity Relief Fund and the funds envisaged in the Disaster Management Act, 2005 (53 of 2005).’

### Approach of Previous Finance Commissions

11.2 In India, the financing of disaster relief is an important aspect of federal fiscal relations. There are significant variations in the disaster proneness profiles of different states and wide regional disparities in terms of levels of economic development. This implies that the coping capacity of a majority of the states to deal with disasters on their own is inadequate. This is compounded by the fact that the poorer states are often the most disaster prone. The financing of disaster relief has, as a result, come to be firmly accepted as a joint endeavour of the Central and State Governments. Finance Commissions, therefore, have considered it appropriate to comment on the subject even before this issue was formally included in their remit.

11.3 Although the term ‘financing of relief expenditure’ first found place in the ToR of FC-VI, Commissions from FC-II onwards have commented on this subject. FC-II assessed the need to finance expenditure on relief as it was ‘struck by the dislocation caused to the finances of many states by unforeseen expenditure on calamities like famine, drought and floods’ and was ‘impressed

with the need for making some provisions to meet this type of expenditure’. FC-II initiated the ‘margin money scheme’ (see Box 11.1), which envisaged setting apart specific amounts by states in order to meet the expenditure on relief measures. FC-VI was the first to be given a formal term of reference relating to the financing of relief expenditure. It stated: ‘The Commission may review the policy and arrangement in regard to the financing of relief expenditure by the States affected by natural calamities and examine inter-alia the feasibility of establishing a national fund to which the Central and State Governments may contribute a percentage of their revenue receipts.’

11.4 Subsequent Commissions have also had similar provisions in their terms of reference. However, none of the Commissions upto FC-VIII felt any necessity to change the system put in place by FC-II and adopted the same approach.

11.5 FC-IX examined the then existing scheme of margin money and acknowledged the need for replacing the ‘existing arrangements of financing relief expenditure involving the provision of margin money, preparation of States’ memoranda, visits of central teams, etc. by a scheme which is qualitatively different in the sense that generous funds are placed at the disposal of the states and they are expected to look after themselves in almost all situations’. FC-IX recommended the establishment of a Calamity Relief Fund (CRF) for each state, the size of which was decided on the basis of the average of the actual ceiling of expenditure approved for a state over a 10-year period ending 1988-89; 75 per cent of the fund was to be contributed by the Centre and 25 per cent by the states. The ToR of FC-IX also

**Box 11.1: Margin Money Scheme**

The Second Finance Commission (FC-II), while assessing the revenue expenditure of the states, acknowledged that financing expenditure on relief was an unforeseen item that affected their finances in a significant manner. The Commission, in the estimate of the states' committed expenditure, included a 'margin for enabling them to set apart annually from their revenues sizeable sums to be accumulated in a fund for meeting expenditure on natural calamities'. The state-wise amounts were based on the average expenditure on relief in the past decade. The Commission also advised that the amounts be kept in a fund and invested in marketable government securities so as to be available for relief expenditure without putting undue pressure on the states' finances. Concurrently, the Central Government had a scheme to assist the states in financing relief expenditure over and above the amounts indicated by the Finance Commission. Subsequent Commissions till the Eighth, including the Sixth to the Eighth which had a specific term of reference regarding financing of relief expenditure, continued this arrangement originally instituted by FC-II. Finally, this was replaced by the Calamity Relief Fund scheme as per the recommendations of FC-IX.

required it to examine 'the feasibility of establishing a national insurance fund to which the State Governments may contribute a percentage of their revenue receipts'. FC-IX, however, concluded that providing insurance cover to all affected/ vulnerable people, most of whom are poor with little to insure, would not be a viable option and would run into serious operational difficulties.

11.6 Subsequent Finance Commissions advocated the continuation of the basic framework recommended by FC-IX. FC-X recommended putting in place certain operational arrangements for the CRF. It also recommended the setting up of a National Fund for Calamity Relief (NFCR) to assist any state affected by a calamity of rare severity. It suggested that such calamities would have to be adjudged on a case-by-case basis. Management of this fund was to be under a National Calamity Relief Committee chaired by the Union Minister for Agriculture. Both the Centre and the states would contribute to this fund. The objective of this fund

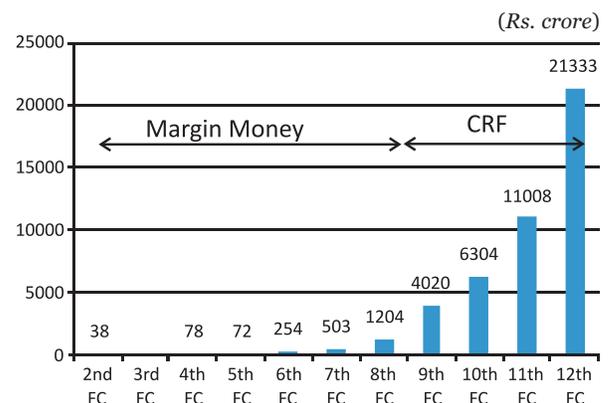
was to create a sense of 'national solidarity in a common endeavour which would then abide beyond the period of distress'.

11.7 FC-XI continued with the prevailing system of the Calamity Relief Fund, while further refining the administrative arrangements in this respect. It also reviewed the functioning of the National Fund for Calamity Relief and found that not only had the entire corpus of the fund been exhausted in three years, but also that it had failed to make adequate funds available for meeting the requirements of calamities of rare severity. FC-XI recommended the setting up of a National Calamity Contingency Fund (NCCF) with an initial corpus of Rs. 500 crore which was to be recouped through the levy of a special surcharge on central taxes.

11.8 FC-XII observed that the CRF scheme had, by and large, fulfilled the objective of meeting the immediate relief needs of the states. It 'found considerable justification in widening the list of calamities' and added a few events to the list covered under the scheme. The Commission also recommended continuation of the scheme of NCCF in its existing form. The projections of various FCs (FC-III did not make any projections) with respect to margin money/CRF are depicted in Figure 11.1.

**Studies Commissioned**

11.9 We commissioned two studies to analyze various aspects of disaster relief. The first study focused on the impact of disasters in the past, trends in occurrences of natural disasters, projected

**Figure 11.1: Projections made by FCs**

expenditure on relief during 2010-15 on the basis of projection of occurrences, and review of plan schemes on mitigation undertaken by different ministries and departments at the Centre and in the states. The second study was commissioned with the objective of examining the current financing arrangements in the light of the Disaster Management Act (DM Act), effectiveness of the NCCF, role of the Finance Commission in financing relief, impact of ongoing plan schemes on relief and mitigation requirements and the principles of allocation under the CRF.

### Existing System

11.10 The existing system of financing relief expenditure, thus, mainly revolves around the CRFs maintained at the state level and the NCCF at the Central level. Both these funds target immediate relief measures and exclude measures for mitigation or post-calamity reconstruction. The CRF is a resource available to the states to meet the expenses of relief operations for a range of specified calamities. The NCCF is a national fund to provide assistance to states for calamities of rare severity, beyond the

coping capacities of the states' CRFs. While the total amount of assistance for the CRFs is decided by Finance Commissions on the revealed needs of individual states, the NCCF has a dedicated source of funding through a special duty on selected items.

### Calamity Relief Funds

11.11 The Calamity Relief Funds, as in operation today, are broadly based on the recommendation of FC-IX. They are used to meet the expenditure for providing immediate relief to victims of cyclone, drought, earthquake, fire, flood, tsunami, hailstorm, landslide, avalanche, cloud burst and pest attack. The essential features of the CRFs are as follows:

- i) The fund is maintained in the public account of the state.
- ii) Seventy-five per cent of the fund is financed by the Centre and 25 per cent by the respective states.
- iii) The Centre's share is paid in two instalments, the second instalment to be released only after receipt of the Annual Report on Natural

#### Box 11.2: Accounting System under Calamity Relief Fund

The accounting system for transactions relating to the Calamity Relief Fund is prescribed by the Central Government as under:

1. **The Fund:** The Calamity Relief Fund is maintained in the public account under the interest bearing deposit 8235 – General and Other Reserve Funds – 111 Calamity Relief Fund.
2. **Receipt and Transfer to the Fund:** The grant received from the Central Government is shown as a revenue receipt of the state under 1601-01-101 and the Centre's share (75%), along with the state's share (25%) is shown as a transfer to the CRF as a revenue expenditure of the state under 2245 – Relief on Account of Natural Calamities, – 05 Calamity Relief Fund, – 101 Transfer to Calamity Relief Fund. The CRF under the public account is credited with an equivalent amount.
3. **Expenditure on Relief:** The actual expenditure on relief work is booked under the respective heads within 2245 (01 for drought, 02 for floods, cyclones, etc., 05 for Calamity Relief Fund, and 80 for others). Out of this expenditure, the amount that needs to be charged to the CRF is shown as a negative entry under 2245-05-901 – Deduct amount met from CRF. The CRF in the public account is debited by this amount.
4. **Investment and Return on the Investment:** From time to time, the SLC shall give instructions to the RBI or a bank designated by them, to invest the amounts in instruments prescribed by the Central Government in this regard. The amount invested shall be shown under 8235-112 – Calamity Relief Fund – Investment Account. The returns on these investments shall be credited to the government's account.
5. **Liquidation and Maturity:** The instruments shall be liquidated and the proceeds credited to the Calamity Relief Fund either on maturity or on the instructions of the SLC. In case the SLC so instructs, the amounts can also be reinvested on maturity.

Calamities giving the details of expenditure incurred on relief.

- iv) The fund is administered by a State Level Committee (SLC) headed by the Chief Secretary of the state.
- v) Unspent balances in the fund are to be invested from time to time, and the interest earned accrued to the fund.
- vi) The Ministry of Home Affairs is the nodal ministry for overseeing the relief operations for all natural calamities, other than drought, hailstorm and pest attack, for which the Department of Agriculture and Cooperation is the nodal department.
- vii) The unspent balances in the CRFs at the end of FC-XII award period can be used to finance the state plans if FC-XIII recommends the discontinuation of the scheme.

11.12 The Ministry of Home Affairs has issued detailed guidelines on the items and norms of expenditure for assistance from the CRF. The Central Government has released Rs. 12,208 crore under the CRF in the four-year period 2005-09 against the Rs. 12,547 crore share recommended by FC-XII for the same period.

#### National Calamity Contingency Fund

11.13 The National Calamity Contingency Fund is operated under the broad framework laid down by FC-XI. It has a core corpus of Rs. 500 crore and is replenished through the National Calamity Contingent Duty imposed on cigarettes, pan masala, beedis, other tobacco products and cellular phones. Its other features are:

- i) It is maintained in the public account of the Government of India.
- ii) It is administered by a high level committee comprising the Agriculture Minister, Home Minister, Finance Minister, and the Deputy Chairman of the Planning Commission.
- iii) The claim on the NCCF is made through a memorandum submitted by the State

**Table 11.1 : Releases from NCCF**

(Rs. Crore)					
States	2005-06	2006-07	2007-08	2008-09	Total
Andhra Pradesh	100	203	38	30	371
Arunachal Pradesh	68	44		26	138
Assam				300	300
Bihar				1000	1000
Gujarat	304	546			850
Himachal Pradesh	113	25	25	40	203
Jammu & Kashmir	310		14		324
Karnataka	359	385	69	189	1002
Kerala	18		51	9	78
Madhya Pradesh		31			31
Maharashtra	657	590	169		1416
Manipur				5	5
Mizoram			9	50	59
Nagaland		1			1
Orissa		25		99	124
Rajasthan		100	0		100
Sikkim		5		8	13
Tamil Nadu	1132			523	1655
Uttarakhand		7			7
<b>States</b>	<b>9</b>	<b>12</b>	<b>8</b>	<b>12</b>	
<b>Total</b>	<b>3061</b>	<b>1962</b>	<b>375</b>	<b>2279</b>	<b>7677</b>

Government, which is assessed by a central team deputed for the purpose. The report of the team is assessed by an inter-ministerial group, which makes recommendations to the high level committee for release.

- iv) The assistance from the NCCF is only for immediate relief and rehabilitation and not for any reconstruction of assets or restoration of damaged infrastructure.

11.14 Over the period 2005-09, the Central Government has released Rs. 7677 crore to states for various calamities. The details are shown in Table 11.1.

#### Additional Central Assistance

11.15 In order to finance post-disaster reconstruction which is not covered under the NCCF, Additional Central Assistance (ACA) has been given to states in recent years, particularly for the Gujarat earthquake of 2001, the Indian Ocean tsunami of 2004, the Kashmir earthquake of 2005 and the Kosi floods of 2008 in Bihar. In the year

2008-09 Rs. 645 crore has been released to 10 states under ACA for long term reconstruction of assets, including Rs. 180 crore to Arunachal Pradesh, Rs. 98 crore to Gujarat, Rs. 92 crore to Himachal Pradesh, Rs. 73 crore to Andhra Pradesh and Rs. 65 crore to Tamil Nadu.

### **Convergence with Centrally Sponsered Schemes**

11.16 Various employment generation schemes, especially those such as the National Rural Employment Guarantee Scheme (NREGS) assure financial relief to needy families in drought-affected areas. They can be easily integrated with relief programmes to increase the availability of funds for relief expenditure.

11.17 Another scheme that has been effectively dovetailed with calamity relief is the Indira Awas Yojana (IAY), which has accomplished useful relief work in terms of providing housing to the affected families. Ten per cent of the annual allocation under IAY is earmarked for this purpose. Similar allocation (5 per cent) is also made under the Accelerated Rural Water Supply Programme (ARWSP).

### **Overall Disaster Management**

11.18 Disaster management in our country has had a commendable record with efficient convergence of human and financial resources. Projects such as management of tsunami relief, relief for the Jammu & Kashmir earthquake and relief to the flood-affected areas of Kosi in the past four to five years have underscored this fact.

### **Disaster Management Act, 2005**

11.19 The Government of India, with a view to providing for the effective management of disasters and related matters, enacted the Disaster Management Act, 2005. All its provisions have been notified excepting those relating to sections 46 & 47 that deal with the constitution of the National Disaster Response Fund and National Disaster Mitigation Fund. The ToR require us to examine the issue of financing of disaster management with reference to these funds as well. Legislation of this

Act has thrown up various new issues that require this Commission's consideration.

### **Disasters**

11.20 To date, Commissions have not used the term 'disaster' but have mostly referred to 'natural calamities'. FC-XII felt that although their terms of reference included the term, 'disaster', it was not feasible to expand the scope of their consideration beyond the existing list of natural calamities, except for some additions to cover a few more events. FC-XII recommended that other disasters including chemical and industrial, as also air/railway accidents, may continue to be taken care of by the respective ministries.

11.21 While previous Finance Commissions have taken such a view, the DM Act provides a far wider definition of disaster as 'a catastrophe, mishap, calamity or grave occurrence in any area, arising from natural or man-made causes, or by accident or negligence which results in substantial loss of life or human suffering or damage to, and destruction of property, or damage to, or degradation of environment, and is of such a nature or magnitude as to be beyond the coping capacity of the community of the affected area'.

11.22 Although the DM Act uses terms like 'substantial loss of life, or human suffering', 'damage to and destruction of property' and 'nature or magnitude as to be beyond the coping capacity of the community of the affected area', it does not quantify these terms.

11.23 Even in the existing system, Finance Commissions have merely drawn up the 'eligible list' of natural calamities while both the *modus operandi* of assessment and the norms of relief have been decided by the Central Government separately.

### **Administrative Mechanism**

11.24 Calamity Relief is currently administered by the Ministry of Home Affairs at the central level and by a SLC chaired by the Chief Secretary at the state level. The DM Act envisages the formation of the National Disaster Management Authority (NDMA) at the apex level to plan, coordinate and implement

disaster management at the central level and lay down guidelines for the state authorities. The Act also envisages a National Executive Committee (NEC) that shall provide execution assistance to the NDMA in the discharge of its functions. Currently, the high level committee and the Ministry of Home Affairs provide guidance at the central level to the relief process.

11.25 Similarly, the DM Act envisages a State Disaster Management Authority (SDMA) with functions similar to those of the NDMA at the state level, as well as a State Executive Committee (SEC) that shall provide executive assistance to the SDMA. Currently, as mentioned above, coordination and monitoring at the state level is being handled by a committee chaired by the Chief Secretary.

11.26 So far, the administrative control of disaster management activities at the district level lay with the District Magistrate in most of the states. The DM Act provides for a District Disaster Management Authority under the District Magistrate/Deputy Commissioner.

### **Roles and Responsibilities in Relief Operations**

11.27 As per the Act, the NDMA shall recommend the minimum standards with reference to the provision of relief in terms of the facilities to be made available in the relief camps, relief to widows and orphans, *ex gratia* assistance on account of loss of life and damage to houses and restoration of means of livelihood. The NDMA may also, in case of disasters of severe magnitude, recommend relief in terms of repayment of loans or grant of fresh loans. Similar responsibilities have been vested with SDMA at the state level. The executive powers with regard to calamity relief as well as powers to ensure compliance with directions in carrying out the relief measures are vested with SEC.

### **Financing Arrangements**

11.28 The Act provides for a Disaster Response Fund (DRF) and a Disaster Mitigation Fund (DMF), each at the national, state and district levels. The National Disaster Response Fund

(NDRF) shall be administered by the NEC to meet the expenses for emergency response, relief and rehabilitation in accordance with the guidelines laid down by the Central Government in consultation with the NDMA. The National Disaster Mitigation Fund is to fund projects exclusively for the purpose of mitigation and is to be administered by the NDMA. Similar provisions have been made for the State and District Disaster Response and Mitigation Funds.

11.29 The Act states that both the national funds shall be credited an amount, which the Central Government may provide, after due appropriation made by the Parliament, by law. The NDRF may receive any grants that may be made by any person or institution for the purpose of disaster management. However, there is no analogous provision for the state and district funds.

### **Views of the Central Government**

11.30 The Commission invited the views of the Department of Agriculture and Cooperation, Ministry of Home Affairs, Planning Commission, Ministry of Finance and the NDMA on the operationalisation of the National Disaster Management Act, 2005 and particularly on the convergence between the CRF, the NCCF and the Response and Mitigation Funds envisaged in the Act. The views expressed by them are presented in the following sections.

#### **Department of Agriculture and Cooperation**

11.31 The Department of Agriculture and Cooperation is the nodal department for the management of drought, hailstorm and pest attack.

11.32 The department has referred to the recommendation of FC-XII that while disaster preparedness and mitigation are important, they need to be built into state plans, as has been the practice, and that the focus of the CRF/NCCF must be primarily on calamity relief.

11.33 The department has expressed the view that the schemes of the Calamity Relief Fund and the National Calamity Contingency Fund are

functioning satisfactorily and may continue in their present form.

### **Ministry of Home Affairs**

11.34 The Ministry of Home Affairs (MHA) is the nodal ministry for the management of notified natural disasters in the country, except drought, hailstorm and pest attack. The ministry has opined that the NCCF should be merged into the NDRF from 1 April 2010 and that the unspent balances in the NCCF be taken as the opening balances under the NDRF. It has suggested that the Commission may recommend allocation of adequate funds to the corpus of the NDRF. Similarly, it has suggested merging of the CRF with the State Disaster Response Fund (SDRF), with the unspent balances under CRFs being treated as the opening balances in the respective SDRFs. With regard to the District Disaster Response Fund (DDRF), it has suggested that 'as per the existing system, allocation of funds to various districts in DDRF out of SDRF may be left to the discretion of the concerned State Government'.

11.35 MHA has suggested the inclusion of cold wave/frost, sea erosion, lightning and heat wave in the list of natural calamities. It has also suggested inclusion of chemical, biological, radiological and nuclear (CBRN) emergencies/disasters, as these have been included by the NDMA in the draft guidelines formulated for operation of the NDRF.

11.36 The Ministry has suggested that the National Disaster Mitigation Fund should be funded through a separate budget head under the ministry's budget on the plan side. The ministry has also suggested that some percentage of funds under Centrally Sponsored Schemes (CSS) should be earmarked for disaster mitigation/long term disaster preparedness.

### **Views of NDMA**

11.37 The NDMA has argued for mainstreaming disaster resilience into the development process and has suggested the incorporation of disaster management into the Five Year and Annual Plans of the central ministries and departments concerned. The NDMA has also suggested creation

of the National Disaster Mitigation Fund as required under the DM Act for mitigation projects in high priority areas, to be taken up by the NDMA. They have suggested a one-time grant for the creation of 'national disaster response reserves', mainly consisting of non-perishable items like tents, tarpaulins, shelters, water purification equipments, lighting equipment, etc. The NDMA has also highlighted the need for capacity building of the states' relief and mitigation machinery.

11.38 The NDMA has focused especially on the current state of fire services in the country and has argued for the upgradation of fire-preparedness and provision of a grant of Rs. 7000 crore to the State Governments for this purpose. We have considered this issue in our chapter on local bodies.

### **Ministry of Finance**

11.39 The Ministry of Finance has stated that the current system has been extremely beneficial to states and has passed the test of time. The ministry has pointed out that the creation of the NDRF encompassing the NCCF may deprive the disaster relief effort of the balancing influence of the NCCF-release exercise. With regard to mitigation, MoF has stated that it should be a part of the overall plan process and that the creation of the fund would add another layer of approval for the relevant ministries and departments.

### **Planning Commission**

11.40 The Planning Commission is of the opinion that the Finance Commissions have been giving their recommendations on the financing of disaster relief to fill in the gap caused by the absence of a statute on this issue. With the DM Act coming into force, this gap has been filled and there is no need for the Finance Commission to make a specific provision in this matter.

### **Views of the State Governments**

11.41 The State Governments, in their memoranda to the Commission, have offered their comments on various aspects of financing of relief expenditure.

### Allocation to CRF

11.42 The states have indicated that the current allocation does not cover their requirement fully and should be considerably enhanced. Some states have suggested that instead of allocations on the basis of past expenditure on disaster relief, these should be made on the basis of the losses suffered due to disasters in the past, the periodicity, duration and severity of calamity and the cost of restoration of infrastructure, while others have suggested that the allocation should be based on the disaster-proneness of the states and that population and area should be made the criteria for determining the size of the CRF. Some states have argued for linking allocation to the value of farm produce. One view expressed is that the allocation for the states that spend more than their CRF should be enhanced by 33 per cent. All the states have argued for timely release of the Centre's share.

### Additional Expenditure Over and Above CRF

11.43 Some states have argued that relief expenditure over and above the CRF eventually becomes the burden of the state alone and should be shared by the Centre in the same ratio as that of the CRF. Some have pointed out that the additional expenditure has been met out of heads other than 2245 and, thus, does not get captured in the calculation of allocations in the future.

### Sharing Pattern

11.44 With regard to the sharing pattern, some states have suggested continuance of the existing sharing pattern while others have argued that the Centre's share should be increased to 90 per cent. Most of the 'special category' states have expressed their inability to meet the states' share and have advocated 100 per cent central assistance. It has been suggested that the states' contribution to the CRF should be included in non-plan revenue deficit.

### Norms for Expenditure

11.45 The states have raised many issues about the norms of relief expenditure. A number of states have demanded that the norms be state-specific as the ground-level situation varies from one state

to another. Some states have suggested that the norms should be indexed for price escalation. Others have suggested that the norms should be such as to allow infrastructure to be restored to pre-disaster levels.

11.46 Some states have advocated revision of the present guidelines that lay down the stipulation that the CRF should only be used after exhausting the allocations under plan schemes like NREGS. The states have also suggested that the expenditure on the material component should be allowed upto 40 per cent. It has been pointed out that the time limit allowed to complete repairs is too short and should be revised. Most of the states have argued that works of a semi-permanent nature should also be allowed.

11.47 While some states have suggested that the balances in the CRF at the end of the award period should be allowed to be taken as a resource for plan expenditure, a few have requested that after the end of every year 50 per cent of the CRF balances should be allowed to be taken as a resource for plan expenditure.

### List of Calamities

11.48 Regarding the list of natural disasters covered under the scheme, the states have variously suggested inclusion of lightning, sea erosion, frost and heat/cold wave, bird flu, rodent attack, sunstroke and snakebite.

### NCCF

11.49 Regarding the NCCF, some states have suggested that 50 per cent of the assistance should be released immediately and the remaining amount can be released after the completion of the entire process of assessment. Many states have suggested that the assessment methodology should be worked out in consultation with the states. Some states have also suggested that releases from the NCCF should be made without any adjustment in the CRF balances. Most states have pointed out that releases from the NCCF are delayed, the process of assessment is non-transparent and *ad-hoc* and that assistance is grossly inadequate.

## **Disaster Management Act**

11.50 The Disaster Management Act has been acknowledged by the states as a major development in the area of disaster management. Some states have suggested that the CRF should be converted into the SDRF and that the NDRF may be used to augment the SDRF in case of additional requirements and, further, that the Finance Commission should recommend detailed arrangements for the fund. They have suggested that the mitigation funds should be at least double the size of the response funds.

## **International Experience**

### **Australia**

11.51 In Australia, Emergency Management Australia (EMA) is the nodal agency for disaster management at the federal level. Natural disaster management is constitutionally a responsibility of the state or territory and EMA offers various programmes for effectively mitigating, responding to, and recovering from their natural disasters. The Australian Government provides funding through the Natural Disaster Relief and Recovery Arrangement (NDRRA), which is administered by EMA on its behalf. Under the arrangement, a state or territory may claim NDRRA funding, if it has spent more than \$240,000 on relief and recovery expenditure in case of a natural disaster. The amount of NDRRA funding would depend on a pre-defined threshold derived on the state's revenue. The NDRRA applies to natural disasters like flood, storm, earthquake, cyclone, landslide, tsunami and the like, but does not apply to 'other unspecified events like drought, frost, heat wave, epidemic', etc.

11.52 The Australian Government also has a Natural Disaster Mitigation Programme which is aimed at identifying and addressing natural disasters in order of risk priority across the nation. Under this scheme, the Federal Government generally contributes up to one-third of the costs of the project, other than certain specific projects like installation of flood warning systems, infrastructure upgrades, etc., where it bears half the cost. Fifty per cent of the central share is paid in advance by the

Australian Government and the remaining 50 per cent is paid out in quarterly instalments on receipt of claims from the states.

### **United States of America**

11.53 In the United States of America, the Federal Emergency Management Agency (FEMA), Department of Homeland Security is the nodal agency for disaster management. FEMA administers various programmes for disaster mitigation response and recovery under the public assistance (PA) grant programme. Assistance is provided to states and tribal local bodies to enable communities to quickly respond to and recover from major disasters or emergency declared by the President. Under this programme assistance is provided for debris removal; emergency protection measures; as well as repair, replacement, or restoration of disaster-damaged, publicly-owned facilities. The federal share of assistance is not less than 75 per cent of the eligible cost for emergency majors and permanent restoration. FEMA also implements many disaster-specific assistance programmes like fire management assistance grant programme, flood mitigation assistance programme, national earthquake hazards reduction programme and repetitive flood claims programme.

11.54 FEMA also implements mitigation programmes like the Hazard Mitigation Grant Programme (HMGP) that provides grants to states and local governments to implement long-term hazard mitigation measures after declaration of a major disaster. The purpose of the HMGP is to reduce loss of life and property due to natural disasters and to enable mitigation measures to be implemented during immediate recovery from the disaster.

### **Canada**

11.55 Public Safety (PS) Canada is the nodal agency for disaster management in Canada. In the event of a large natural disaster, the Government of Canada provides financial assistance to provincial and territorial governments through the Disaster Financial Assistance Arrangements (DFAA), which is administered by PS Canada. The Government of Canada bears upto 90 per cent of the relief

expenditure on a graded basis. Under this arrangement the government supports evacuation operations, restoration of public works and infrastructure, replacement or repair of basic essential personal property of individuals, etc. The Emergency Act of Canada has been put in place to strengthen the emergency management activities in the country. It sets out clear rules and responses for all federal ministries across the full spectrum of emergency management.

### South Africa

11.56 The Disaster Management Act, 2002, of South Africa provides for national, provincial, and municipal disaster management centres. The primary responsibility of disaster management lies with the local and the provincial governments. However, depending upon the intensity of the disaster, the National Government may intervene and provide adequate financial assistance (the Act provides for declaration of a disaster as local, provincial or national disaster). For the purpose of immediate relief, it maintains a Disaster and Emergency Fund, which is used to supplement the efforts of the local and provincial governments and is operated by the central cabinet.

11.57 Activities relating to post-disaster reconstruction are funded from a national reserve established in line with budgetary requirements under the medium-term expenditure framework to provide contingency funds for a range of situations. The Act only deals with preparedness, response, and recovery and leaves mitigation to be taken up by the respective ministries from their budgeted grants.

### Japan

11.58 In Japan, the basic framework of disaster management is provided by the Disasters Countermeasures Basic Act, 1961. The government provides various grants and loans to the Prefectural and Municipal Governments for their effort in meeting response and recovery expenditure.

### Brazil

11.59 In Brazil, the nodal agency for disaster management is the National Civil Defence

Secretariat. The Secretariat works in coordination with the State and Municipal Governments in case of activities relating to civil defence. These activities are funded, at the central level, out of the Civil Defence Action Programme of the Union Budget. The respective states and municipalities have similar budgetary provisions to meet the expenditure on disaster management.

### The Indian Context

11.60 In most countries where relief activity is primarily the responsibility of State/Provincial Governments, assistance from the Federal/Central Government to the lower levels of government is mostly in the form of case-specific grants/reimbursement. These are more in the nature of the NCCF scheme of our country and, in that sense, the CRF scheme that provides for a structured fiscal transfer from the Central to State Governments for the purpose of financing relief expenditure is unique. Through the CRF scheme, successive Finance Commissions have built in the requirement of relief expenditure financing in the overall scheme of fiscal transfers.

### Review of the Existing Schemes

#### CRF and NCCF

11.61 The current schemes of the CRF and the NCCF have served their purpose well. Most of the states, in their memoranda, have acknowledged the utility of these schemes in times of calamity. The states have pointed out certain operational difficulties, some of which are general in nature and some specific to the respective states. Some of the points raised by the states with regard to the scheme layout pertain to issues that are decided by the Central Government post-Finance Commission awards and these need to be addressed by the Central Government.

11.62 The size of the CRF is determined on the basis of past expenditure of the states on calamity relief. Some states have pointed out that the *inter-se* distribution of the CRF should be decided on the basis of losses due to natural disasters, disaster-proneness of the state concerned, and the history of natural disasters, etc. Since the objective

of the fund is to meet expenditure on relief only, past expenditure on calamity relief can be considered as a good proxy for the requirement of the state. Historical expenditure trends may be affected adversely by the revenue raising capacity of the state, where, despite a felt need, the state may not have been able to spend due to lack of resources. To correct such situations, FC-XI gave an *ad-hoc* premium to low-income states over the past average expenditure on calamity relief of 10 per cent, which was raised to 25 per cent by FC-XII. The size of the CRF, as decided by the previous Commissions has been more or less adequate.

11.63 As far as the NCCF is concerned, the fund has a specific role to play in case of disasters that are beyond the coping capacity of the states. Experience shows that the fund has great utility and has been found useful in meeting response requirements immediately.

11.64 The states have also raised the issue of lack of clarity in the assessment of the quantum of assistance and releases. The Comptroller and Auditor General of India has acknowledged this issue in his performance review of tsunami relief and has recommended that the Ministry of Home Affairs and the Ministry of Finance, in consultation with the State Governments, 'need to put in place a generally acceptable system/mechanism of assessment of the damage and determine at least the general criteria based on which the quantum of assistance would be determined in natural calamities so as to bring in transparency and institute a good management practice'.

#### **List of Natural Calamities**

11.65 Over and above the list of six natural calamities (cyclone, drought, earthquake, fire, flood and hailstorm) recognised by the previous Finance Commissions and tsunami (added later by the government), FC-XII included landslides, avalanches, cloud burst and pest attack in the listed calamities. The list was considered to be generally exhaustive, though some states have made representations for the addition of state-specific events like heat/cold wave, frost, lightning and sea erosion to this list.

#### **Existing Schemes and Disaster Management Act**

11.66 With the Disaster Management Act, 2005 coming into force and the funds envisaged constituted, after notification of the relevant sections of the Act, co-existence of the CRF/NCCF and the funds envisaged under the Act would, in our opinion, be an unnecessary overlap. The CRF/NCCF had been constituted by previous Commissions to fill in the structural gap that existed due to the lack of any explicit provisions in the Constitution or any other legislation in force.

11.67 The Act specifies separate funds for response and mitigation. While CRF/NCCF were designed keeping only response in mind, Finance Commissions have been taking the view that mitigation and recovery/reconstruction should be met out of the state/central plans. With respect to the NDRF, the Act specifies that it should be at the disposal of the NEC and receive funds from the Union Budget.

#### **Administrative Mechanisms**

11.68 While earlier Commissions had recommended creation of a high level committee and State Level Committees at the central and state levels, respectively, the Act provides for clear administrative structures from the central to the district level in terms of disaster management authorities and executive committees. In view of the specific statutory provisions in the Act, we feel it would be necessary to ensure that there is no duplication of administrative structures as a result of the transition.

#### **Risk Transfer and Insurance**

11.69 While the vulnerability of various parts of the country to disasters is high, the current level of insurance penetration in India is less than 1 per cent across the country. Pooling of risk of disaster at the individual level is therefore a big challenge. FC-IX was formally given a term of reference relating to the 'feasibility of establishing a national insurance fund to which the State Governments may contribute a percentage of their revenue receipts' and came to

the conclusion that ‘the source of calamity, by its nature and magnitude, would pose problems which no agency, outside government, can tackle exclusively and in full measure.’ Successive Commissions endorsed this view and did not recommend anything specific in this area.

11.70 This conclusion arises out of the fact that it is generally economical to pool risks arising out of low frequency-high intensity disasters, but it is not economical to pool risks arising out of high frequency-low intensity disasters. This could be the reason why FC-IX did not find merit in setting up a comprehensive risk pooling mechanism for financing disaster relief in India.

11.71 FC-XI was of the view that any insurance cover in which the premium is paid fully by the Centre and the states would not reduce the financial burden of the government in dealing with natural calamities. FC-XII observed that the reach of formal institutions in the field of insurance was limited and that micro insurance, while being the need of the hour, was yet to reach out to large segments of the population. They, therefore, endorsed the views of FC-IX and FC-XI that a premium-based insurance scheme to cover calamities would not be viable.

11.72 The Insurance Regulatory and Development Authority has framed micro insurance regulations that allow distribution of micro insurance products by micro insurance agents like non-government organisations (NGOs), self-help groups (SHGs), micro-finance institutions (MFIs), etc. The regulations cover insurance for personal accidents; health care for individual and family and assets like dwelling units, livestock, tools and other named assets. The Central Government has also launched a national health insurance scheme, Rashtriya Swasthya Beema Yojana, that is intended to cover families below the poverty line for proper health care. In addition, similar schemes are already under operation in various states.

11.73 While these efforts would definitely increase insurance penetration in India, it is our considered view that, at the present juncture, insurance schemes do not provide an adequate alternative to government funding for disaster relief.

## Recommendations

11.74 With the introduction of the Disaster Management Act, 2005, the entire spectrum of disaster management will have to undergo a revamp in accordance with the provisions of the Act.

## Financing Arrangements

11.75 The DM Act provides for two funds each at all the three levels, namely, national, state and district. For national funds, although the Act provides for funding to be sourced through the Central Government, there is no specific mention of the criteria to be adopted in fixing the size of the contribution to the fund. Further, the Act is altogether silent on the source of funding for state and district funds.

11.76 With the DRFs coming into existence, there is a need to merge the existing funds into the newly constituted funds.

11.77 At the national level, there is a need for an instrument that can be used to fund the response requirements of disasters that are beyond the coping capacity of the states. Past experience with the NCCF has shown that it has provided valuable resources at the right time, along with pooling of risk at the national level which is necessary as a state may not be an ideal unit for pooling of risk and resources for disasters of all kinds and all scales. In the absence of a dedicated fund, it may be difficult for the Central Government to step in quickly when needed.

11.78 We, therefore, recommend that the existing NCCF be merged into the NDRF proposed under the Act with effect from 1 April 2010, and that the balances in the NCCF at the end of 2009-10 be transferred to the NDRF. As far as financing of the NDRF is concerned, as per the Act it should be credited with amounts that the Central Government may provide, after due appropriations made by the Parliament. FC-XI had recommended a corpus of Rs. 500 crore for the NCCF. Experience shows that the appropriations from the budget to the fund have consistently been of a much higher order. Hence, we recommend that while making the appropriations, past trends of outflows from the NCCF/NDRF be taken into account to ensure

availability of adequate funds for calamities of a severe nature. Since, with the introduction of Goods and Services Tax (GST) all cesses are expected to be subsumed in the tax structure, alternative sources of financing shall have to be identified and necessary budgetary provisions made, linked to the expenditure from the NDRF in the previous year.

11.79 Similarly, it is our view that the CRFs may be merged into the SDRFs constituted under the Act as on 1 April 2010 and that the balances in the CRF, as at the end of 2009-10, be transferred to the SDRFs. Although some states have suggested that unspent balances in the CRF be allowed to be used for plan financing, we feel that using these as an opening balance in the SDRFs would provide a cushion to the states in terms of financing relief expenditure. This will also bring about the required continuity in the existing scheme of relief financing. Regarding financing of the SDRF in the future, in view of the experience with the CRF, it is essential that Central and State Governments jointly contribute to this fund.

11.80 With the DM Act coming into force, the primary responsibility of disaster relief has been cast upon the states. The Act is silent on the source of funding of the SDRFs. However, in our opinion it may not be prudent to assume that the entire requirement for relief can be met out of the states' resources. The existing system of CRF has proved to be beneficial and has had a wide degree of acceptance among the State Governments. Any radical departure from this dispensation may not be desirable. There is, therefore, a sound case for examining the issue of central funding for the SDRFs.

11.81 International experience indicates that the practice that is broadly followed, even in countries where disaster management is the primary responsibility of the State/Provincial Governments, is that there are in place schemes/programmes of the Federal/Central Government for providing financial assistance to sub-national units in relief works.

11.82 We, therefore, recommend that for general category states, the SDRFs should be funded by the Central and State Governments in the ratio of 75:25

respectively as in case of the CRF. However, since funding of their 25 per cent share may overstretch the fiscal capacity of the special category states, we recommend the funding of the SDRFs in the ratio of 90:10 by the Central and State Governments, respectively, for the special category states.

### **Disaster Mitigation**

11.83 As far as disaster mitigation is concerned, we believe that it should be a part of the plan process and that the expenditure therein should be met out of the plan resources of the respective ministries of the Union and the states. This is also advisable as there are already schemes at the central as well as state levels that are targeted towards mitigation, in areas such as drought-proofing, flood and water management, soil erosion and promotion of earthquake-resistant structures. While we realise that the current levels of funding of these schemes may not be adequate, it is our view that this aspect is best left to be decided by the Planning Commission and the NDMA.

11.84 Our view is broadly in line with the approach taken by the other bodies that have looked into this aspect. The Second Administrative Reforms Commission (SARC) has dealt in great detail with issues relating to disaster mitigation and disaster management plans, as envisaged under the DM Act. It has recommended that disaster plans should be included in the development plans of the line agencies (i.e., central ministries/departments and State Governments) and local bodies. SARC has also recommended that the incorporation of disaster mitigation plans into development plans should be specially monitored at the Five Year and Annual Plan discussions at the state and Planning Commission levels.

11.85 With regard to financing arrangements, SARC had recommended the setting up of the funds mentioned in the DM Act from 1 April 2007. However, except for a nominal beginning by a handful of states, there has been little progress on this front.

11.86 The Eleventh Five Year Plan document emphasises the necessity of mainstreaming disaster management into development planning. It mentions that every development plan of a ministry/department

should incorporate elements of impact assessment, risk reduction, and the 'do no harm' approach. It further states that the State Governments need to give priority to hazard identification and risk assessment in their plans and schemes.

11.87 On financing, it states that a portion of plan funds should be earmarked for efforts that, directly or indirectly, help in disaster management. It suggests that every project should provide adequately for disaster mitigation and management.

### **Allocations for the SDRFs**

11.88 We are aware that, ideally, the best methodology to assess the requirement of the SDRF would be to base it upon the Hazard-Vulnerability-Risk profile of the states, as it would be a good indicator of the disasters that a state may face. However, we have found that there is no reliable exercise that maps the states on such a scale. Since the DM Act mandates the preparation of Disaster Management Plans at the national, state and district levels, we recognise that it would be both possible and useful to take up such an exercise in the future.

11.89 In the absence of any such reliable indicator at present, we have continued to adopt an expenditure-based approach, in line with the practice of the previous Commissions. To arrive at the allocations to the SDRFs of various states, we have taken into account the expenditure on calamity relief in the period 2001-08. We have opted for this time period keeping in mind the creation of three new states in the year 2000.

11.90 The expenditure on relief is booked under the major head of account 2245. Within this account, three sub-major heads, viz. 01, 02 and 80, pertain to actual expenditure, while 05 pertains to book adjustments between the Consolidated Fund and the Calamity Relief Fund. We cleaned up these transactions to obtain the actual expenditure on calamity relief. We found that while in some states the prescribed accounting practice is being followed, in some other states, expenditure has been debited directly from the public account. To correct for this deviation, the disbursement from the public account, which was not matched with an equal adjustment in the consolidated fund, has been

added back to the total expenditure on calamity relief from the consolidated fund. Despite this, in some states, we found that the expenditure was not fully accounted for. Due to this lack of uniformity in complying with the stipulated accounting practices, we have adopted the methodology of using total expenditure under 2245 followed by previous Finance Commissions.

11.91 We have followed the methodology outlined below to arrive at the average expenditure under calamity relief :

- i) We classified expenditure under calamity relief under the major head 2245, the total of which was taken for the relevant years. This has been used as the basis for the allocation.
- ii) In some states, we found that a major portion of the expenditure was debited directly from the CRF maintained in the public account. We have added such expenditure to (i) above. In some cases of exceptionally high expenditure booked under finance accounts, the additional information and notes submitted by the states were taken into account to correct for accounting inconsistencies.
- iii) Annual releases from the NCCF were deducted from the total expenditure under 2245 as these had been earmarked for specific calamities of an exceptional nature.
- iv) We have taken the total obtained in (iii) above as the expenditure on calamity relief for that particular year. We have adjusted these figures for inflation in the respective years to arrive at the value of these expenditures at 2009-10 prices and the average expenditure for the period 2001-08.
- v) We found that in the past, there has been some lack of clarity regarding states which were entitled to an additional amount on account of low fiscal capacity. We decided to include in this category all special category states, and all states with per capita income below the all-state average per capita GSDP of Rs. 30,203 (2006-07), viz. Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Orissa, Rajasthan and Uttar Pradesh. We

have, therefore, allowed the above-mentioned states an increase of 30 per cent on the figures arrived at in (iv) above in order to compensate for the possibility of lack of resources constraining their average expenditure on calamity relief.

- vi) We further compared the figures arrived at above, with an amount 10 per cent above the CRF size for the year 2009-10, as recommended by FC-XII and adopted the higher of the two numbers as the base year estimate, to ensure that at least the current level of funding is maintained across states.
- vii) Finally, we have allowed a 5 per cent increase every year to arrive at the projection for the award period.

11.92 We recommend the aggregate size of all SDRFs as Rs. 33,581 crore, the state-wise year-wise breakup of which is given in Annex 11.1.

11.93 We recommend that 75 per cent of the SDRF for general category states and 90 per cent for special category states, as arrived above, be contributed by the Centre as grants-in-aid. Along the lines of the present CRF, these funds should be released to the states by the Ministry of Finance as per the guidelines that may be put in place by the Ministry of Finance/nodal ministry. The central and state-wise share for each year is given in Annex 11.2. As a prerequisite to this, the states should create the State Disaster Relief Fund in their respective public accounts (under interest bearing deposits) and transfer the balances under the CRF as on 31 March 2010 to the SDRF.

11.94 On the accounting practice, we are of the view that the current practice, of meeting the expenditure under sub-major heads 01, 02 and 80 of the major head 2245, showing transfers to the fund under 05-101 and showing a 'deduct amount met from SDRF' under 05-901, needs to be continued. This brings in more transparency in expenditure reporting and enables effective audit. Direct expenditure from the public account should be eschewed in future. Even if, for administrative reasons, expenditure on relief has to be met under a head of account other than 2245, it should be finally booked under 2245 through an inter-account transfer. A similar accounting

mechanism should be followed for the amounts received from NDRF as well.

11.95 We recommend that those states that have not been following this accounting system should switch over to this arrangement from 1 April 2010. The Ministry of Finance should ensure that these norms are adhered to and that release of the second instalment of 2010-11 as well as subsequent instalments should be linked to strict adherence to the accounting norms given above. The C&AG may appropriately review the adherence to these prescribed accounting practices.

11.96 In our opinion, the provision to mandatorily constitute DDRFs under the DM Act merits a review. If DDRFs were to be maintained in the manner of the NDRF or the SDRF, states would lose the flexibility of pooling of resources for calamity relief and such an approach would only lead to fragmentation of resources without any tangible benefit. Hence, it may be left to the states to decide on whether they should constitute DDRFs or whether funds could be effectively routed to each district with the approval of SECs from the SDRF in the manner currently being followed under the CRF. Section 48(1) of the DM Act may, therefore, need to be amended to provide for such an option to the states.

### List of Calamities

11.97 The scope of the scheme is another issue where the Act has brought about a paradigm shift. Till date, the Finance Commissions have been prescribing a list of natural calamities, relief expenditure on which could be funded under the scheme. This list was originally drawn by FC-II and last modified by FC-XII.

11.98 With the Act coming into force, the definition of disaster widens to cover even man-made causes and accidents. As stated earlier, the focus of the definition of the Act is on the impact of the calamity. However, for the purpose of operationalisation of the provisions of the Act, there is a need to have a concrete list of events and stipulation of the norms of funding under the Act.

11.99 The states have requested the addition of certain events such as cold and heat wave, frost, lightning, and sea erosion to the list of calamities.

We feel that events like heat and cold wave and frost are very difficult to quantify and the scale of severity would vary from region to region. Lightning is a localised event which does not have widespread impact. Sea erosion is an occurrence which takes place over a period of time, and hence, may be best tackled through mitigation efforts.

11.100 In our opinion, as far as the SDRFs are concerned, the existing list of natural disasters adopted by the Finance Commissions has covered the needs of the states to a very large extent. The list covers most of the prevalent events. However, for very specific events that could even be man-made and require very high level of funding, but may have low chance of occurrence, financing of relief arrangements should best be left out of the SDRFs. The Government of India may consider financing disaster relief in respect of such man-made disasters out of the NDRF, after the list of eligible disasters has been drawn and the norms for funding carefully stipulated. If such man-made disasters are to be included, adequate additional budgetary allocations may have to be provided.

11.101 The Public Liability Insurance (PLI) Act, 1991, notified presently for specified quantities of 179 explosive, toxic and highly reactive chemicals, establishes the principle of liability for enterprises engaged in hazardous activities. Setting up of the Environment Relief Fund (ERF) under the Act in 2008 has further strengthened its provisions. As on 31 March 2009 the ERF has a corpus of Rs. 285 crore. The legal framework, therefore, provides another source of relief for financing man-made disasters. The PLI Act needs to be strengthened by appropriate inflation indexation of the amount of relief provided in the schedule and by expanding the list of chemicals covered under the Act.

### Capacity Building

11.102 Effective disaster response requires trained manpower to deal with complex situations where effective and speedy handling can reduce the impact of a disaster on human life and property. It is necessary to continuously undertake measures to build capacity amongst those handling response and creating awareness amongst people. An additional grant of Rs. 525 crore is being recommended on the

basis of the overall size of the SDRF of a state, wherein the allocated amount has been fixed at Rs. 5 crore, Rs. 15 crore, Rs. 20 crore and Rs. 25 crore if the average annual allocation for the concerned state is less than Rs. 50 crore, Rs. 100 crore, Rs. 200 crore and Rs. 500 crore respectively and at Rs. 30 crore if the allocation is more than Rs. 500 crore. This amount may be used for taking up activities for building capacity in the administrative machinery for better handling of disaster response and for preparation of district and state level disaster management plans as envisaged in the DM Act. The allocation for each state is given in Annex 11.3.

### Fund for Pooled Procurement

11.103 The role of the recently created National Disaster Response Force is crucial in responding to disasters that are of a severe nature and require immediate relief to the affected. Our discussion with the NDMA and the State Governments highlighted the fact that procurement of relief material on short notice often comes with an associated premium in pricing and could adversely impact quality. It is suggested that a national inventory of equipment and material is maintained for providing immediate relief. It is also advisable to keep ready an inventory of items such as life saving equipment and tents etc. with the National Disaster Response Force. We, therefore, propose that an initial grant of Rs. 250 crore, in the form of a revolving fund, be provided to the National Disaster Response Force for the purpose. Whenever these articles are used for responding to a calamity, the cost (or rent for those items that can be reused) should be booked to the overall cost of relief operations incurred by the concerned State Government and the inventory replenished on a regular basis.

### Risk Pooling and Insurance

11.104 As regards risk pooling and insurance, we are inclined to agree with the views expressed by the earlier Finance Commissions on this subject, that the pooling of disaster risk at the individual level poses huge administrative challenges in a country like India where the majority impacted by disasters are primarily the poor who have, consequently, very little capacity to pay the risk premia involved. Apart from the fact that payment of risk premia towards insurance against

natural disasters could be a highly unpopular step, the administrative cost of collection of such premia from a large number of potential beneficiaries spread over a wide geographical area would, indeed, be daunting. Disaster relief has long come to be viewed as a public good, to be delivered *gratis* by the state, and in the very likely event that no (or an insignificantly small) insurance premia can be levied, the very concept of risk pooling would become infructuous. In our view, for high-frequency-low intensity disaster events, it would indeed be cheaper for the State Governments to directly provide disaster relief, as is being done presently, instead of going through an insurance intermediary. For low frequency-high impact disasters, financing through insurance mechanisms is certainly a feasible option. However, given the low level of insurance penetration in India, insurance products covering disaster events may only materialise sometime in the future.

#### Administrative Mechanism

11.105 The administrative mechanism envisaged in the DM Act needs to be put in place, clearly spelling out the powers and responsibilities at each level of the structure. The NDRF may be operated by the National Executive Committee, as provided in the Act, under the overall directions of the NDMA. Further, the SDRFs, including the grant, as recommended by the Commission, along with the state's share, may be operated by the State Executive Committee, as provided under the Act, under the overall directions of the SDMA.

11.106 Currently, while the administrative aspects are dealt with by the Ministry of Home Affairs (other than a few disasters, as mentioned earlier), the financial matters are handled by the Ministry of Finance. We feel that this mechanism should be continued for the administration of the NDRF as well as the SDRF under the overall structure mandated by the DM Act.

#### Summary of Recommendations

11.107 Our recommendations are summarised below:

- i) The CRF to be merged into the SDRFs of the respective states and the NCCF into the NDRF. Contribution to the SDRFs to be shared between the Centre and states in the

ratio of 75:25 for general category states and 90:10 for special category states (paras 11.78, 11.79, and 11.82).

- ii) Balances as on 31 March 2010 under NCCF and the state CRFs to be transferred to the NDRF and respective SDRFs (paras 11.78 and 11.93).
- iii) Budgetary provisions for the NDRF to be linked to expenditure of the previous year from the fund. With cesses being subsumed on introduction of the GST, alternative sources of financing to be identified (Para 11.78).
- iv) Total size of the SDRF has been worked out as Rs. 33,581 crore to be shared in ratio given above. (Para 11.92)
- v) An additional grant of Rs. 525 crore provided for capacity building (Para 11.102).
- vi) Assistance of Rs. 250 crore to National Disaster Response Force to maintain an inventory of items required for immediate relief (Para 11.103).
- vii) Provisions relating to the DDRF in the DM Act may be reviewed and setting up of these funds left to the discretion of the states (Para 11.96).
- viii) Mitigation and reconstruction activities to be kept out of the schemes funded through FC grants and be met out of overall development plan funds of the Centre and the states (Para 11.83).
- ix) The list of disasters to be covered under the scheme financed through FC grants to remain as it exists currently. However, man-made disasters of high-intensity may be considered for NDRF funding once norms have been stipulated and requisite additional allocations made to the NDRF (Para 11.100).
- x) The administrative mechanism for disaster relief to be as prescribed under the DM Act, i.e., the NDMA/NEC at the Centre and the SDMA/SEC at the state level. Financial matters to be dealt with by the Ministry of Finance as per the existing practice (paras 11.105 and 11.106).
- xi) Prescribed accounting norms to be adhered to for the continuance of central assistance to the SDRFs (Para 11.95).

## CHAPTER 12

# Grants-in-Aid

### Introduction

12.1 Our Terms of Reference (ToR) require us to make recommendations on the principles that should govern the grants-in-aid of the revenues of states out of the Consolidated Fund of India and the sums to be paid to 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 provisos to Clause (1) of that article.

12.2 Grants-in-aid are an important component of Finance Commission transfers. The size of the grants has varied from 7.7 per cent of total transfers under FC-VII to 26.1 per cent of total transfers under FC-VI. Grants recommended by FC-XII amounted to 18.9 per cent of total transfers. In their memoranda to us, a few states have argued that grants should be restricted to only a small portion of the states' share in FC transfers. They have argued that grants have been directed to particular sectors and with conditionalities that restrict the expenditure options of the states. In our assessment, grants-in-aid are an important instrument which enable the Commission to make its scheme of transfers more comprehensive and address various issues spelt out in the ToR. Grants also allow us to make corrections for cost disabilities faced by many states which are possible to address only to a limited extent in any devolution formula. The Commission has accordingly suggested several categories of grants-in-aid amounting in aggregate to Rs. 3,18,581 crore which constitutes 18.03 per cent of total transfers.

12.3 The first of such grants is the post-devolution Non-plan Revenue Deficit (NPRD) grant. NPRD

grants have ranged from a maximum of 100 per cent of total grants, as recommended by FC-IV and FC-V, to 33.1 per cent, as recommended by FC-IX. NPRD grants comprised 39.86 per cent of the total FC-XII grants. Our recommendations for NPRD grants, as detailed in a later section of this chapter, amount to 16.26 per cent of the total grants, the lowest ever in FC recommendations. This has been possible due to the sustained efforts of states to adhere to the fiscal reform path laid down by their respective Fiscal Responsibility and Budget Management (FRBM) legislations. Particularly gratifying has been the fact that three special category states, viz. Uttarakhand, Assam and Sikkim, have graduated from NPRD. In recognition of their successful efforts, we have recommended a performance grant for these three states with the hope that other states would be incentivised to show similar improvements in future.

12.4 The second of our grants is recommended in pursuance of the goal of universalisation of elementary education, underpinned by the constitutional right of all children, in the age group 6 to 14, to free and compulsory schooling. This targeted grant is designed to help states overcome their resource constraint in funding this sector, while the national character of the programme is sought to be underscored by ensuring that all states receive a share of this grant.

12.5 Two new 'considerations' in our ToR are the need to improve the quality of public expenditure to obtain better outputs and outcomes and the need to manage ecology, environment and climate change consistent with sustainable development. We have addressed these issues at length in

subsequent sections of this chapter and recommended the third and fourth sets of grants to enable and incentivise performance for better governance and delivery of public services and for protection of the environment respectively. In doing so, we have designed some of these grants, such as those for promotion of renewable energy, better water sector management and reduction of infant mortality, to be forward looking and linked to attainment of goals in the future.

12.6 Our fifth grant is for maintenance of roads. A proper road infrastructure is vital, not only for economic development, but also for better delivery of services such as education and health. There is evidence to show that road networks lead to, among other things, improved teacher attendance, quicker medical assistance and a greater number of institutional deliveries. We hope that the enhanced provisioning for maintenance, including the focus on the newly created Pradhan Mantri Gram Sadak Yojana (PMGSY) roads, will help in sustaining road connectivity.

12.7 Some states, in their memoranda and in their interaction with us, have raised concerns about the conditionalities attached to grants. We have been careful to adopt a non-intrusive approach in this regard. Grants, other than for NPRD, are sector-specific. However, a large portion of the forest grant, which is given in recognition of the economic disabilities imposed by forests, has been freed for use as a development resource of the states. Like previous Commissions, we have tried to ensure non-substitution so that our grants are indeed an additionality to the provisions in state budgets for the purpose for which they are earmarked wherever relevant. Further, where the grants are forward-looking, the conditionalities stipulate release of incentive amounts on attainment of benchmarked targets. States, therefore, have an incentive to improve their performance.

12.8 Grants for local bodies in line with Para 4(iii) of the ToR and for disaster management in terms of Para 8 of the ToR have been dealt with at length in chapters 10 and 11, respectively. These grants also flow to the states under Article 275 of the

Constitution. We have listed these grants in Table 12.1 of this section in order to be comprehensive. The grants-in-aid of the revenues of states, as recommended by us for the award period 2011-15, are indicated below:

**Table 12.1: Grants-in-Aid to States**

		(Rs. crore)
I	Local Bodies	87519
II	Disaster Relief (including for capacity building)	26373
III	Post-devolution Non-plan Revenue Deficit	51800
IV	Performance Incentive	1500
V	Elementary Education	24068
VI	Environment	15000
	(a) Protection of Forests	5000
	(b) Renewable Energy	5000
	(c) Water Sector Management	5000
VII	Improving Outcomes	14446
	(a) Reduction in Infant Mortality Rates	5000
	(b) Improvement in Supply of Justice	5000
	(c) Incentive for Issuing UIDs	2989
	(d) District Innovation Fund	616
	(e) Improvement of Statistical Systems at State and District Level	616
	(f) Employee and Pension Data base	225
VIII	Maintenance of Roads and Bridges	19930
IX	State-specific	27945
X	Implementation of model GST	50000
	<b>Total</b>	<b>318581</b>

### Post-devolution Non-plan Revenue Deficit Grant

12.9 The assessment of revenues and expenditure of states, along with the norms adopted by us, has been provided in Chapter 7. On the basis of this assessment, we have worked out the pre-devolution non-plan revenue deficits for each state. In Chapter 8 we have laid down the share of each state in central taxes and projected the share of each state based on the tax revenue of the Centre, as estimated in Chapter 6. Further, based on the pre-devolution non-plan revenue deficit and share of each state in central taxes, we have projected the post-devolution non-plan revenue deficit/surplus for each state for the award period.

12.10 The normatively assessed post-devolution non-plan revenue deficit for a state signifies the existence of a vertical imbalance yet to be corrected and an assessed need still to be met. As explained in Chapter 7, we have followed a normative approach in assessing the revenues and expenditure of states, which ensures that the assessed deficit is not due to inadequate revenue effort or excessive expenditure by any state. We have, therefore, decided to provide grants-in-aid to those states that have a post-devolution non-plan revenue deficit to meet this assessed deficit.

12.11 Table 12.2 shows the pre-devolution non-plan revenue deficit of each state as assessed on a normative basis in Chapter 7. Eight states, viz.

**Table 12.2: Pre-Devolution Non-plan Revenue Deficit/Surplus (-)**

(Rs. crore)					
State	2010-11	2011-12	2012-13	2013-14	2014-15
Andhra Pradesh	-8651	-11839	-6745	-11137	-16143
Arunachal Pradesh	1203	1262	1548	1608	1651
Assam	7149	7211	9248	9298	9225
Bihar	14890	15399	18940	19659	20277
Chhattisgarh	-2129	-2480	-439	-762	-1160
Goa	-536	-763	-762	-1085	-1457
Gujarat	-8363	-12149	-12638	-18245	-24837
Haryana	-13814	-16394	-17774	-21235	-25235
Himachal Pradesh	3825	3923	4086	3912	3471
Jammu & Kashmir	6777	6993	7280	7511	7558
Jharkhand	1013	683	2075	1615	1111
Karnataka	-11099	-14404	-14597	-19139	-24652
Kerala	4705	3967	4210	2826	1134
Madhya Pradesh	2646	2331	4755	4353	3728
Maharashtra	-14325	-19147	-19617	-26665	-34702
Manipur	2106	2184	2651	2773	2884
Meghalaya	1225	1295	1970	2067	2173
Mizoram	1263	1327	1667	1777	1859
Nagaland	2239	2319	2604	2710	2827
Orissa	4718	4617	6495	6364	6088
Punjab	1204	546	372	-739	-2065
Rajasthan	3990	1480	1796	334	-864
Sikkim	422	448	624	596	555
Tamil Nadu	-6528	-8452	-7275	-10135	-13479
Tripura	2096	2156	2472	2535	2606
Uttar Pradesh	14903	14126	19758	18343	16485
Uttarakhand	2129	2179	2940	2922	2703
West Bengal	14360	12687	13280	9908	5738
<b>Gross Deficit</b>	<b>92864</b>	<b>87137</b>	<b>108771</b>	<b>101108</b>	<b>92071</b>
Gross Surplus	-65446	-85630	-79847	-109140	-144593
Net Deficit	27417	1507	28924	-8032	-52522

Andhra Pradesh, Chhattisgarh, Goa, Gujarat, Haryana, Karnataka, Maharashtra and Tamil Nadu, have pre-devolution surpluses for all five years, while Punjab and Rajasthan have a surplus for the last two years and one year respectively.

12.12 The post-devolution deficits, obtained by adding the respective states' share in central taxes to the pre-devolution deficit, are shown in Table 12.3. It can be seen from the table that all general category states have surplus over the entire award period. Amongst the special category states, three states, viz. Assam, Sikkim and Uttarakhand, have post-devolution surplus for the entire award period. The remaining eight special category states have deficits for all five years during the award period.

**Table 12.3: Post-Devolution Non-plan Revenue Deficit/Surplus (-)**

(Rs. crore)					
State	2010-11	2011-12	2012-13	2013-14	2014-15
Andhra Pradesh	-22796	-28430	-26314	-34221	-43371
Arunachal Pradesh	534	478	623	517	364
Assam	-248	-1466	-986	-2774	-5015
Bihar	-7370	-10710	-11857	-16668	-22572
Chhattisgarh	-7166	-8387	-7407	-8981	-10855
Goa	-1079	-1399	-1513	-1970	-2501
Gujarat	-14564	-19422	-21216	-28364	-36773
Haryana	-15951	-18900	-20731	-24722	-29348
Himachal Pradesh	2232	2055	1883	1313	406
Jammu & Kashmir	3940	3665	3355	2881	2096
Jharkhand	-4700	-6015	-5830	-7709	-9886
Karnataka	-19924	-24755	-26806	-33540	-41640
Kerala	-69	-1632	-2394	-4963	-8055
Madhya Pradesh	-11872	-14697	-15330	-19339	-24218
Maharashtra	-24926	-31581	-34283	-43964	-55108
Manipur	1186	1105	1379	1272	1114
Meghalaya	393	319	819	709	571
Mizoram	715	684	908	882	804
Nagaland	1599	1568	1719	1666	1595
Orissa	-5026	-6812	-6986	-9538	-12670
Punjab	-1628	-2776	-3546	-5361	-7517
Rajasthan	-7945	-12518	-14715	-19142	-23837
Sikkim	-65	-124	-50	-200	-383
Tamil Nadu	-16660	-20336	-21292	-26669	-32982
Tripura	1054	934	1030	835	600
Uttar Pradesh	-25219	-32933	-35751	-47132	-60747
Uttarakhand	-155	-500	-220	-805	-1693
West Bengal	-452	-4685	-7212	-14263	-22773
<b>Gross Deficit</b>	<b>11653</b>	<b>10808</b>	<b>11716</b>	<b>10074</b>	<b>7550</b>
Gross Surplus	-187814	-248079	-264441	-350326	-451942
Net Deficit	-176161	-237271	-252726	-340252	-444392

Table 12.4: Non- plan Revenue Deficit Grant

(Rs. crore)

State	2010-11	2011-12	2012-13	2013-14	2014-15	Total
Arunachal Pradesh	534	478	623	517	364	2516
Himachal Pradesh	2232	2055	1883	1313	406	7889
Jammu & Kashmir	3940	3665	3355	2881	2096	15936
Manipur	1186	1105	1379	1272	1114	6057
Meghalaya	393	319	819	709	571	2811
Mizoram	715	684	908	882	804	3991
Nagaland	1599	1568	1719	1666	1595	8146
Tripura	1054	934	1030	835	600	4453
<b>Total</b>	<b>11653</b>	<b>10808</b>	<b>11716</b>	<b>10074</b>	<b>7550</b>	<b>51800</b>

Note: Totals may not tally due to rounding off

For these states, in order to meet the post-devolution non-plan revenue deficit, we recommend a total grant of Rs. 51,800 crore for the award period. The state-wise, year-wise details are given in Table 12.4.

### Performance Incentive

12.13 Three special category states, Uttarakhand, Assam and Sikkim, received NPRD grants from FC-XII to make up for their assessed deficits. Of these, Uttarakhand, as a newly created state, received the NPRD grants for the first time during the period of FC-XII. Assam has benefited from the NPRD grants under all the Finance Commissions since FC-I, except under FC-VII. Sikkim became a state of the Indian Union in 1975 and has received NPRD grants since FC-VII onwards. After normatively assessing the revenues and expenditure of these three states, as indicated in Chapter 7 and taking into account the devolution, as given in Chapter 8, these states are not found to be in need of NPRD grants any longer. In our view, this marks major progress by these three states, particularly in view of the known cost disabilities and other fiscal challenges that special category states face. In recognition of their efforts, we recommend a performance grant as an incentive for them to continue on their path of fiscal prudence, as indicated below:

(Rs. crore)

State	2010-11	2011-12	2012-13	Total
Assam	150	150		300
Sikkim	80	60	60	200
Uttarakhand	400	300	300	1000

### Grant for Elementary Education

12.14 The Twelfth Finance Commission had provided grants for the education sector based on the rationale of equalising expenditure on this sector across states. The grants were fixed on the basis of a two-stage normative measure of equalisation. In the first stage, states with low expenditure preferences (i.e., those states which had a lower expenditure on education as a proportion of total revenue expenditure) were identified and benchmarked to the average expenditure on education (as a proportion of adjusted total revenue expenditure) incurred by the respective groups, i.e., special and general category states. In the second stage, states which had lower per capita expenditure than the group average, even after the adjustment made in the first stage, were identified and grants to the extent of 15 per cent of the difference between per capita expenditure of the state on this sector and average per capita expenditure of the group were provided. Under this approach eight states, viz. Assam, Bihar, Jharkhand, Madhya Pradesh, Orissa, Rajasthan, Uttar Pradesh and West Bengal, qualified for this grant.

12.15 The Ministry of Human Resource Development (MHRD), in its Memorandum dated 16 March 2009, has urged the Commission to provide grants, specifically for elementary education, on the basis of actual estimation of resource requirements and gaps in each state, rather than in accordance with the earlier methodology of equalisation. The ministry has suggested that the gaps may be worked out against a set of nationally

accepted norms, in a manner such that all states may be able to access this grant.

12.16 We agree with the views of MHRD that this Commission should focus on the elementary education sector. We do so because the right of children in the age group 6 to 14 years to elementary education is a fundamental right under Article 21A of the Constitution as amended in 2002. The Right of Children to Free and Compulsory Education (RTE) Act provides the legislative framework as envisaged in Article 21A of the Constitution. The universalisation of quality elementary education is a critical foundation for secondary education and employment skills which have a significant impact on economic development.

12.17 In its memorandum of March 2009, MHRD presented its estimates of state-wise requirements of resources for elementary education using the alternative norms of the Sarva Shiksha Abhiyan (SSA) and the RTE Act. When MHRD estimates were provided, the RTE had not been enacted. The Bill underwent some modifications during its passage in Parliament and was subsequently legislated in August 2009. Section 7(iv) of the RTE Act contains a provision whereby the Central Government may request the President to make a reference to the Finance Commission under sub-Clause (d) of Clause 3 of Article 280 to examine the need for additional resources to be provided to any State Government in order to enable payment of the state's share of funds to carry out the provisions of the Act. While we received a fresh set of estimates from MHRD on the requirement of states for implementing the provisions of the RTE Act, we have not received any formal reference on this issue. We also find that there is no unanimity on the financial estimates for the implementation of RTE Act. The MHRD has projected a requirement of Rs. 1,73,946 crore for the period 2010-15. The Planning Commission, on the other hand, in their note dated 10 November 2009, has estimated the cost at Rs. 1,44,871 crore and has further observed that state-wise estimates need to be worked out. The Ministry of Finance has not given us any estimates on this account. Consultations are yet to be held with the states on details of MHRD projections. Since

there is lack of clarity on the basis of which projections of expenditure on account of the RTE Act are to be made as also a lack of agreement on the funds required, we are unable to use these projections in making our recommendations. We do, however, recognise that the implementation of RTE Act would require considerable increase in the funding requirements for elementary education, which is likely to put state resources under severe strain.

12.18 The SSA, the national programme for universalisation of elementary education, through its various components takes a holistic view of the gaps and needs in terms of access, infrastructure, human resources and outcomes, of the elementary education sector. Besides providing for basic items like teachers' salaries and school maintenance grants, it also includes items aimed at improving quality with equity such as teachers' training, remedial teaching, innovation funds, inclusive education for the differently-abled and intervention for out-of-school children. The scheme addresses the investment needs of districts by making allocations under Annual Work Plans and Budgets (AWP&B) through its normative framework. Reviews show that the SSA has had an 'equalising' effect as the disadvantaged and more needy states and districts receive proportionately more funds than the relatively better-placed states and districts.

12.19 In view of the above, we have adopted the SSA norms and the estimates of annual funding requirements, state-wise, as given by MHRD on the basis of these norms. In providing these estimates, the MHRD has focused only on the recurrent items of expenditure on the grounds that they eventually need to become part of the state non-plan budgets. Our projections, therefore, exclude the requirements of civil works. We have made certain modifications to maintain consistency with assumptions made in other parts of our report where we have assessed the non-plan expenditure requirements of the Centre and the states, as explained below. The MHRD estimations have assumed a minimum salary of Rs. 5000 per month for primary teachers and Rs. 7000 per month for upper primary teachers. There is no uniform pattern

in the manner of appointment and pay scales of SSA teachers across states. In some states such teachers are appointed by the State Government on regular pay scales, whereas in many others, such teachers are appointed by local governments on local body pay scales or on contract. The implementation of the Sixth Central Pay Commission (CPC) would, in any event, create an upward pressure on teachers' salaries, whatever the mode of appointment. We have, therefore, assumed an increase of 30 per cent over the base year, in view of the fact that the bulk of these teachers are located in rural areas. We have also provided for an annual increase of 6 per cent on these salaries, in conformity with our assumption of the post-CPC yearly increase in salaries of government servants. Similarly, while SSA does not provide for any annual increase in the quantum of funds on account of inflation, we have provided for an annual increase of 5 per cent across all non-salary components of the scheme.

12.20 The SSA began with a matching fund requirement of 15 per cent from states in 2001-02. Till 2006-07, the matching fund requirement was 25 per cent. It has increased progressively to 35 per cent in 2007-08 and 2008-09 and to 40 per cent in 2009-10. It is expected to go up to 45 per cent in 2010-11 and to 50 per cent in 2011-12, the terminal year of the Eleventh Five Year-Plan. We assume that the same ratio will continue in the remaining years of the award period. Various states have expressed difficulties in providing this matching share, especially since the size of their annual plans has increased over the years.

12.21 We are of the view that, in the given circumstances augmenting the resources of the states to cater to this need will be the most appropriate way to provide grants for the elementary education sector. This will also provide some fiscal space to the states to meet a part of the additional resources required to implement the RTE Act. We have also considered the fact that given the resource scarcity faced by the states as a result of the economic slowdown, several states have not been able to provide for their share of 40 per cent in 2009-10. In fact, we estimate that, due to the adverse fallout of the economic downturn, the states

may not be able to provide more than 35 per cent from their resources over the current year and the next year. Hence, we recommend for the award period, a grant of 15 per cent of the estimated SSA expenditure of each state. This amount will cover the difference between the targeted state share of 50 per cent by the terminal year of the Eleventh Plan and the contribution required to be made in 2008-09, i.e., 35 per cent of the individual states' SSA share.

12.22 The north-eastern states are required to provide only 10 per cent from their resources as their share for SSA. However, as the MHRD has pointed out in a supplementary memorandum, several of these states have not been able to provide even this amount, leading to slowdown in implementation of SSA. In order to alleviate the fiscal constraints of these states we recommend a grant amounting to the difference between the average amount contributed by each state in the years 2007-08 and 2008-09 and the amount they need to contribute (on the basis of a 10 per cent share) in each of the five years of the award period, subject to a minimum of Rs. 5 crore per year. The requirement of the north-eastern states, calculated on this basis, is Rs. 367 crore over a period of five years.

12.23 The recommended grant for elementary education for all states, in aggregate, works out to Rs. 24,068 crore. The state-wise and year-wise allocations are given in Annex 12.1. In order to ensure that these grants do not substitute for the current expenditure of states, we stipulate that the expenditure (plan + non plan) under elementary education, i.e., major head 2202, sub-major head - 01, exclusive of the grants recommended herein, should grow by at least 8 per cent, the assumed growth rate in our projections of the non-salary component of the social sector during the award period, annually, during 2010-15.

### **Environment Related Grants**

12.24 In making its core recommendations, this Commission is charged with having to keep in mind a set of ten considerations. The eighth in that list reads: 'The need to manage ecology, environment

and climate change consistent with sustainable development.’

12.25 The National Action Plan on Climate Change 2008 estimates the per capita emissions of carbon dioxide in India at 1.02 metric tons per capita which is well below the world average of 4.25 and that for China at 3.60. The energy intensity of the economy is also demonstrated in this document as having declined very considerably since the 1980s, to a present level comparing favourably with that of the least energy-intensive developed countries.

12.26 There are, nevertheless, considerable environmental risks facing the Indian economy, which are structurally underpinned by the location of the territory of India among those areas identified as the most vulnerable to climate change, the high population density and the economic dependence of more than half the labour force on the natural resource base. These risks need to be identified and call for immediate preventive and remedial attention. To assist in these tasks we commissioned two studies, one on environment, ecology and climate change and the other on forestry-related issues, by The Energy Research Institute (TERI) and the Indian Institute of Forestry Management (IIFM) respectively.

12.27 The risks are of three types. Growth-related risks resulting from uncontrolled release of industrial pollutants into the air and into water bodies, exacerbate poverty-related risks resulting from inadequate access to potable water, absence of adequate sanitation and indoor air pollution from burning freely collected biomass for cooking. These have been further added to by policy-induced environmental risks, several of which fall within the decision sphere of states. The widespread practice in states of zero-pricing electricity for farmers, has resulted in an alarming fall in ground water levels in many zones in the country, accompanied by soil salinity due to the conjunction of over-application of underpriced groundwater and poor drainage. In many states, surface irrigation water has a crop-specific rate structure, which is not crop-neutral and frequently carries an adverse incentive in terms of encouraging cultivation of

water-intensive crops, even in regions that are water-scarce. There are also Government of India (GoI) policies which have added to the environmental risks facing the country. Perhaps the most egregious example is the national fertiliser subsidy scheme. Uneven price interventions across nutrients have led to a decline in soil quality due to application of a distorted nutrient mix. These impacts have been alluded to earlier in the discussion on the fiscal bite of the subsidy (Para 4.23).

12.28 The forests of India constitute the first line of defence against pollution resulting from economic activity, whether of agricultural or industrial origin. Recognising this, FC-XII provided a grant of Rs. 1000 crore to states, distributed between them in accordance with the share accounted for by each in the total forested acreage in the country. Clearly, there is a paramount need to carry that grant forward. Forests provide a wide variety of services. These encompass, first and foremost, the class of regulatory services such as carbon sequestration; sediment control and soil conservation; ground water recharge; protection from extreme weather events and preservation of bio-diversity. These services, by their very nature, accrue beyond the boundaries of the state in which the forest lies. Although there are benefits that do accrue exclusively to the state, from forest produce and recreational services yielded by standing forests, there are national restrictions on timber felling which impose the costs of having land under forests exclusively on the state in whose jurisdiction it lies. The Forest (Conservation) Act, 1980 restricted the diversion of forest lands for non-forestry purposes without prior approval from GoI. The Supreme Court, in its order of 12 December 1996, restricted irregular felling of forests and mandated management of forests according to a scientifically prepared working plan, approved by GoI. Harvesting of forests was allowed only within the prescriptions of the working plan, with additional restrictions on felling in high altitude regions. The combination of benefit externalities and internalised costs clearly calls for federal compensation. Accordingly, a grant calibrated to the share of the national forested area falling in a state,

as well as to economic disability on the basis of the percentage of forested area in each state, is the first of the three environmental grants provided for. These factors go into calculating the share of each state in the total grant specified for forests which, in its total quantum, is determined within the overall fiscal constraint governing transfers to states over the projection horizon.

12.29 As a consequence of the Forest (Conservation) Act, 1980 and following a Supreme Court judgement in 2002, there is already in place a national provision for compensatory afforestation and Net Present Value (NPV) payments when land under forests is diverted to non-forest uses for industrial or other purposes. These payments were to flow into a Compensatory Afforestation Fund Management and Planning Authority (CAMPA). There is, presently in place, an *ad hoc* CAMPA with which the funds deposited by way of compensatory afforestation and NPV now lie. This body has been authorised to release about Rs. 100 crore annually to the respective states' CAMPA for the next five years. The principle of allocation to states of the funds so collected is in accordance with the jurisdiction in which the diversion of forest land took place. In contrast to CAMPA flows to states, which are in the nature of compensation to states for diversion of forest land, the forest grant envisaged here is calibrated to the extent of standing forest in each state. It is hoped that states will thereby see the advantages of retaining land under forest cover and will efficiently and effectively direct CAMPA funding towards afforestation, so as to reap the advantages of future provisions of the kind started by the present Commission.

12.30 The benefit externalities yielded by forests are a function of a host of factors, including, but not confined to, the density of the forest and the biodiversity contained within it. Ideally, the entitlement of each state should have factored these in, in the form of data on the growing stock and its composition by species, rather than, as we have done, by area under dense, moderate and open forests, as reported by the Forest Survey of India (FSI) in the latest India State of Forest Report (SFR-2009). Though the SFR-2009 does provide data on state-wise growing stock,

these have been estimated using the 'small area estimation technique', whereby small-sampling area results are used to generate the estimates for growing stock at the state level. A sample of 10 per cent of districts has been used for estimating the detailed inventory of forest at the national level. On the other hand, data for categorisation of forest cover by density is quite elaborate, and is mapped on a 1:50,000 scale using Geographic Information System (GIS) and remote sensing across all forest types of the country. We have, therefore, decided to use the categorisation by density of area under forest cover for calibrating the incentive grant.

12.31 The forest grant is based on data at a point in time. The formula used is essentially a reward for the present stock. It is hoped that the size of the grant will provide the wherewithal for preservation, going forward, so as to halt and hopefully reverse past declines in the quantum and quality of area under forests. Further, the grant is so configured that, subject to a mandated floor, the funds are not tied to any further expenditure on forests. Beyond the mandated floor, the intent is to provide fiscal resources by which the state can enable alternative economic activities as a substitute for the economic disability imposed by forest cover. The only conditionality is that states develop working plans for each of the several forest zones into which they are divided. The initial grant provision will provide funding to develop the working plans within a stipulated period of two years. This conditionality is intended as an enabler of governance capacity within the state, so that subsequent use of the grant, coming on-stream two years into the projection horizon, is based on a detailed plan of action. Even more importantly, from the point of view of the prospective ravages that climate change is feared to bring, these working plans will provide a benchmark data base to assess changes in forest cover over time. Each working plan will have the customary horizon of ten years. Such an approach, when sustained, will provide incentives to better manage the existing forests and also to increase forest cover.

12.32 Next to preservation of the forest wealth of the country, there is a paramount need to address

environmentally adverse policies currently in place. Where these originate at the level of national government, such as the fertiliser subsidy, correction can only happen at the national level. There is every expectation that the Government of India will move to a nutrient-based subsidy configuration, which will have a salutary impact, not only in terms of preventing further decline in soil quality, but also on the quantum of fiscal resources expended on the subsidy. The normative projection of Union finances in Chapter 6 accordingly phases down the fertiliser subsidy to a level in 2014-15 which is approximately one-fifth of that budgeted for 2009-10.

12.33 Several of the policy-related risks, however, fall within the decision sphere of states in the Indian federal structure. Although this permits variation, in principle, in the degree of risk across states, there are surprisingly robust tendencies in place across all states. In the paras following, each of the major categories of policy risk at state level is examined in turn, for amenability to incentivised correction. Where there is already an incentive-configured scheme in place, among the centrally sponsored or Central Plan Schemes (CPS), there is no add-on incentive introduced by us. This is merely in order to avoid duplication and quite emphatically, not to de-emphasise the need for policy correction in that sphere.

12.34 In the pricing of electricity, over which states have full decisional latitude, political compulsions have led to disregard, in many states, of the pricing structure recommended by state electricity regulators. Some states have not revised their tariff structures for as many as seven years. In recognition of the burden imposed by unrevised tariffs on state power utilities, which, in most states, are state-owned public sector undertakings with accounts independent of the state budget, states are required under the Electricity Act of 2003 to compensate the utilities if tariffs imposed fall below those set by the regulator, for any category of consumers. We have dealt in detail with the losses and funding requirements of the power sector in Chapter 7. The Restructured Accelerated Power Development and Reform Programme (R-APDRP) carries an incentive

for the reduction of Aggregate Transmission and Commercial (AT&C) losses. Given this incentive scheme in place for correction of both technical and commercial inefficiencies within the system, albeit confined to urban centres, no further explicit incentives for enhancing power sector supply efficiency are included in our package of environmental grants.

12.35 Apart from mispricing of electricity, with the several environmental risks attendant upon it, reliance on coal-based thermal generation to the extent of 60 per cent of the total, is a major contributor to carbon dioxide emissions. Additionally, Indian coal has a high ash content and studies have estimated the land required for disposal of extracted ash at about one acre per mega watt (MW) of installed capacity. There are some tax incentives to private sector entrants for power generation from renewable sources, but no system of incentives in place for states to encourage clean power generation from renewable sources.

12.36 Thus, the second of our three environmental grants is a forward looking incentive for generation of grid electricity from renewable sources. The grant is so structured as to reward states for renewable generating capacity that comes on stream into the grid during the first four years of our projection horizon. The reward falls due in fiscal year 2014-15, after having allowed enough time to states to respond to the incentive hereby recommended.

12.37 The perilous situation in terms of ground water is, in part, a consequence of underpricing of electricity for agriculture, resulting in inefficient overuse of a scarce natural resource. Additionally, industrial output per cubic metre of water usage is very low in comparison to international standards. There is no way by which prevention of further deterioration in ground water levels can be directly incentivised, except in the form of a forward incentive, based on data pertaining to groundwater levels coming on stream during the projection horizon. Our discussions with the relevant authorities led us to conclude that data of this kind do not become available with the regular periodicity required for effective design of such a grant. There

is, however, an urgent need to correct such deterioration as has already occurred, in terms of watershed development to enhance groundwater recharge. Since there are a number of central and Centrally Sponsored Schemes (CSS) in place to address these issues, no additional corrective measure is built into our grant provisions.

12.38 Surface water irrigation is also in urgent need of policy correction. The problems here stem from poor maintenance of irrigation networks, poor recovery of user charges from farmers which then feeds back into poor maintenance, and overstuffed irrigation administration departments such that expenditure on irrigation does not deliver commensurate benefits in terms of services delivered. This then feeds back into poor collection compliance. The perverse incentive in the crop-specific rate structure has already been alluded to, in terms of encouraging cultivation of water-intensive crops in water scarce regions.

12.39 Thus, the third of our grant provisions is for the purpose of incentivising states to establish an independent regulatory mechanism for the water sector and improved maintenance of irrigation networks. With improved maintenance and delivery, simultaneous enhancement of recovery is necessary for an input which is publicly provided, but is excludable and rival, and therefore, amenable to user charges that cover (normatively assessed) maintenance. Since so many of the problems in this sector stem from lack of systematic attention by technically qualified people to the issue of the structure and level of user charges, the grant provision is conditional on setting up by states of an independent Water Regulatory Authority by 2011-12. The Maharashtra Water Resources Regulatory Authority set up in August 2005 serves as a possible model for consideration by other states. It is expected that an independent body of this kind would incentivise water user associations that would self-regulate the use of water among members and decentralise maintenance of water bodies, with funding locally recovered from users, so improving compliance with cost recovery. In recommending these user communities we are in line with the work of Elinor

Ostrom, the Nobel laureate for Economics in 2009.

12.40 India has an elaborate legal framework of national laws for control of environmental pollution. The overarching legislation in this context is the Environment Protection Act of 1986, which was a response to the Bhopal gas tragedy of 1984, the worst such industrial disaster in the world. The network of national laws is enforced and monitored by State Pollution Control Boards (SPCBs), but they have, unfortunately, been unable to deliver enforcement in the manner and to the degree expected of them. Over the years, a number of national committees and study groups have investigated the functioning of SPCBs. They have identified a number of disabilities facing SPCBs, one of them being that their ambit in many states excludes vehicular pollution. There is also the major issue of inter-state pollution externalities, of which one example is untreated sewage deposited upstream in a river from a municipality falling in the jurisdiction of another state. On balance, the issue of pollution control, with its national legal structure, which requires inter-state as much as intra-state enforcement, is one which is best left to the national government to co-ordinate and fund. Our meetings with industry bodies in the states suggest that Indian industry has yet to absorb the 'polluter pays' principle. Unless this message is internalised by Indian industry, pollution control will be seen as a needlessly obstructive, even unfair, element of the cost of doing business in India. SPCBs have to be seen as facilitative of the rights of the ordinary citizen and not as obstructive of the rights of industrialists.

12.41 Policy risk to the environment is not typically found at the local level, although there are a few instances of this as well, as for example where municipal zoning laws are flouted and buildings constructed on drainage channels, bringing disastrous consequences in the form of urban flooding during monsoons. With these exceptions, local bodies are not themselves responsible for policy-enhancing environmental risk, although the neglect at the local level of sanitation, sewerage and solid waste removal and processing carries grave environmental risks in the

form of pollution of ground water, in addition to public health risks.

12.42 We have recommended a substantial increase in the grants to local bodies, linking these grants to a share of the previous year's divisible pool (Chapter 10). One of the reasons for this enhanced level of funding is to enable local bodies to address mitigation of environmental risks. There are no usage conditionalities attached to local grants in that chapter, since certification of usage has been found to act as an obstruction to the regular flow to local bodies of funding provisions made by previous Commissions. Although there are no strictures imposed on usage, it is hoped that the considerably enhanced funding for local bodies will address the woefully inadequate sanitary conditions that prevail over the majority of human habitations in the country.

12.43 Finally, although our grant for renewable energy generation is targeted at state-level on-grid capacity, local bodies have a variety of small-scale technological options for off-grid generation of renewable energy. These could even feed into the grid. There is the oft-cited example of the 350-kilowatt windmill established by the Odanthurai Village Panchayat in Coimbatore district of Tamil Nadu. The windmill generates 7.5 lakh units of power annually, of which the panchayat uses 4.5 lakh units, while the rest is sold to the State Electricity Board (SEB) grid for an annual income of Rs. 19 lakh to the panchayat. These conditions, however, may not be replicable everywhere. What this example demonstrates is that the several funding provisions made by this Commission enable states, in partnership with local governments, to manage their ecology and environment in a manner consistent with sustainable and inclusive development.

12.44 The following section deals with the specific grants recommended by us in the three critical areas highlighted in the preceding paras.

### Forest Grants

12.45 The forest formula has been designed to take into consideration three factors. The share of the

total forest area in the country falling in any particular state is clearly the first of the three. This has been further enhanced for those states where the share of forested area in the total area of the state is greater than the national average. The enhancement serves to add a further compensation for the economic disability posed by forest cover. The entitlement of each state, so obtained, has been further weighted by the third factor, which is the quality of the forest in each state, as measured by density. The weights are progressively higher for area under moderately dense and dense forest cover. All data on forested area and on density, are as defined and quantified in SFR-2009 (data pertaining to 2007). Thus, the *inter se* allocation of forest grants within all states is given by the following formula:

$$G_i = \frac{\left\{ \left[ \frac{F_i}{\sum F_i} + R_i \right] \times \left[ 1 + \left( \frac{M_i + 2H_i}{A_i} \right) \right] \right\}}{\sum_{i=1}^n \left\{ \left[ \frac{F_i}{\sum F_i} + R_i \right] \times \left[ 1 + \left( \frac{M_i + 2H_i}{A_i} \right) \right] \right\}}$$

Where

- $G_i$ : Share for state  $i$
- $A_i$ : Geographical area of state  $i$
- $F_i$ : Total forest area of state  $i$
- $M_i$ : Moderately dense forest area of state  $i$
- $H_i$ : Highly dense forest area of state  $i$

$$R_i = \max \left[ 0, \left\{ \frac{F_i}{A_i} - \frac{\sum F_i}{\sum A_i} \right\} / 100 \right]$$

12.46 We have allocated a grant of Rs. 5000 crore for this purpose. The year-wise allocation and state shares in the total are given in Annex 12.2.

12.47 Grants for the first two years are untied. However, priority should be given to preparation of working plans for all forest divisions in the state. For the remaining three years of the award period, the release of the grant within a state's entitlement is linked to the number of approved working plans. Of the total released, 75 per cent can be used by states for development purposes. The remaining 25 per cent of the grants in these three years is for preservation of forest wealth and is meant to be an additionality to the states' budget for development of forestry and wildlife. Release of grants in the last

three years of the award period shall be subject to the following release and monitoring mechanism:

- i) The grants shall be linked to progress on approval of working plans. The entire amount should be released after approval of more than 80 per cent of the working plans of the state. Till this is achieved, releases shall be in the ratio of number of working plans approved to 80 per cent of the number of working plans for the state.
- ii) Twenty-five per cent of the grants shall be over and above the non-plan revenue expenditure (NPRE) projected in Annex 12.3 and the same shall be monitored as explained therein.

12.48 The Ministry of Environment and Forests (MoEF) shall assign to the Forest Survey of India the task of developing a uniform inventory design for information on growing stock and related parameters like bio-diversity and Non Timber Forest Produce (NTFP) as well. This would help bring clarity to the role of the country's forest wealth in climate change mitigation and also help to base fiscal transfers on more robust parameters in future.

12.49 Large forest areas in many of the north-eastern states are privately/community owned. The respective State Governments should play the role of facilitator in the management of these forests through the working plans.

### Incentive for Grid Connected Renewable Energy

12.50 The power sector has great potential for reduction of greenhouse gases. There is, hence, a need to incentivise states to promote clean energy. With this objective, we recommend an incentive grant for generation of grid electricity from renewable sources. We have allocated Rs. 5000 crore for this purpose.

12.51 The grant is configured after taking into consideration the following issues:

- i) Renewable resources are limited to certain states. Often the states achieve a certain threshold of capacity and are, thereafter,

reluctant to encourage more development. This is particularly true in the case of wind.

- ii) Several states have small or negligible potential.
- iii) The consuming states are located far from the generating states. Access to markets in the consuming states is an issue.
- iv) Even as the law requires setting of Renewable Purchase Obligations (Section 86 of Electricity Act, 2003), there is no national level target that has been set. However, at the state level, some State Electricity Regulatory Commissions (SERCs) have initiated action in this regard and these Renewable Energy Obligation targets are being set at the state level.
- v) The costs of renewable energy sources are often higher than those of conventional sources. This results in reluctance of cash-strapped state utilities to procure from these sources.

12.52 To overcome these difficulties, we have proposed the following guidelines for implementation of the incentive scheme, with the objective of broad-based development of renewable energy sources across states.

- i) The incentive is to be based on states' achievement in renewable energy capacity addition in MW from 1 April 2010 to 31 March 2014.
- ii) The incentive component will comprise of two sub-components:

- a) Incentive for achievement in installed capacity addition (over a four-year period) relative to unachieved potential. This will be accorded a weightage of 25 per cent. This factor has been considered in view of the fact that renewable energy potential is unevenly distributed. The following formula has been used:

$$\frac{CA_i}{\sum_{i=1}^{28} CA_i}$$

$$\text{where } CA_i = \frac{X_i}{Y_i - A_i}$$

and for the *ith* state

$CA_i$  = Capacity addition achieved as a percentage of unachieved capacity as on 31 March 2009

$X_i$  = Installed capacity addition during 2010-14

$A_i$  = Total achievement in installed capacity as on 31<sup>st</sup> March 2009

$Y_i$  = Total renewable energy potential as assessed by MNRE

For a particular state whose total achievement in installed capacity of renewable energy as on 31 March 2009 equals or exceeds its total potential of renewable energy, we assign the same figure as that of the state which will achieve the highest capacity addition as percentage of total unachieved capacity between 1 April 2010 and 31 March 2014.

- b) Incentive for achievement in installed capacity addition (over a four year period) relative to the aggregate of installed capacity addition across all states. This will be accorded a weight of 75 per cent, in order to ensure accelerated capacity addition. The following formula has been used:

$$\frac{X_i}{\sum_{i=1}^{28} X_i}$$

- iii) We recommend a cap on the incentive reward in the following manner:

- a) A cap of Rs. 1.25 crore/MW of  $X_i$  for general category states.
- b) A cap of Rs. 1.50 crore/MW of  $X_i$  for special category states, to account for factors related to access and consequent cost disability.
- iv) The performance review will be based on data published by the Government of India on capacity addition by states.
- v) The achievement in installed capacity addition may be on account of any/all renewable energy sources of electricity generation (namely, wind, biomass, small

hydro, bagasse based cogeneration, geothermal energy and any other resource as defined as 'renewable energy' by the Ministry of New and Renewable Energy (MNRE).

- vi) The state should permit renewable energy developers/projects access to competitive power markets. Charges for such access in any form should not exceed the levels specified by the Central Electricity Regulatory Commission (CERC) as guidance for such market access.
- vii) Transmission charges and losses applicable for renewable energy targets are not to exceed a level of Rs. 0.25/kwh and 5 per cent, or, the state transmission utility should have implemented rational alternate transmission pricing frameworks (including point of connection tariffs) if so recommended by the CERC, within 12 months of such recommendation.

12.53 Upon submission of the details on achievement of results by the states to the Ministry of Finance, GoI, the ministry may seek validation of the data from MNRE before the incentives are disbursed. Validation would be based on publicly available information on achievements and adequate proof of the policy measures required to be implemented.

12.54 The incentives proposed by us for grid-connected renewable energy generation will be over and above the existing incentives by the Central and State Governments. A sample of calculations for assumed levels of  $X_i$  is given in Annex 12.4.

### Grants for Water Sector Management

12.55 Injudicious inter-sectoral and intra-sectoral distribution of water amongst various categories of water users, low water use efficiency, fragmented approach to water resources planning and development, low water user charges and meagre recovery are some of the major problems associated with the management of water resources in the country. A statutory autonomous institution at the state level could help in addressing these issues.

12.56 We recommend setting up of a Water Regulatory Authority in each state and specification of a minimum level of recovery of water charges. The proposed regulatory authority may be given the following functions:

- i) To fix and regulate the water tariff system and charges for surface and sub-surface water used for domestic, agriculture, industrial and other purposes.
- ii) To determine and regulate the distribution of entitlement for various categories of uses as well as within each category of use.
- iii) To periodically review and monitor the water sector costs and revenues.

12.57 An incentive grant of Rs. 5000 crore is recommended for this purpose. The *inter se* allocation of this incentive grant to the states will be in proportion to their respective share in the total NPRE across all states of expenditure on irrigation (under major heads 2700/2701 and 2702) and their respective share in all-states Irrigation Potential Utilised (IPU) at the end of the Tenth Plan. Equal weights are assigned to each of these two shares. This amount shall be released in two equal instalments over the four year period 2011-12 to 2014-15. States are given one year to make the necessary preparations to absorb these funds. State-wise amounts recommended as incentive grants-in-aid for the water sector are indicated in Annex 12.5.

12.58 Release of grants would be subject to the following conditionalities:

- i) States should set up the Water Regulatory Authority by 2011-12, to be notified latest by 31 March 2012. However, due to the small size of the irrigation sector, this condition would not be applicable to the north-eastern states, except Assam.
- ii) We have calculated the recovery rates for irrigation, separately for special category and general category states, on the basis of revenue receipts (major heads 0700, 0701 and 0702) as per cent of NPRE (major heads 2700, 2701 and 2702) for 2009-10 (BE)

(Annex 12.6). Based on these rates, state-specific recovery rates for the period 2011-12 to 2014-15 have been normatively projected. States are required to achieve the projected recovery rates to become eligible for grants.

- iii) The incentive grants for water sector are an addition to normal maintenance expenditure to be incurred by the states. These grants should be released and spent in accordance with the conditionalities detailed in annexes 12.7 and 12.8.
- iv) Where the State Water Regulatory Authority mandates recovery rates, those would replace the recovery rates prescribed by us for that particular state for the purpose of eligibility and release of grants. A state shall be eligible for grants if it recovers at least 50 per cent of the water charges mandated by the Authority.

### Grants for Improving Outcomes

12.59 The Commission is required to consider, while making its recommendations, the 'need to improve the quality of public expenditure to obtain better outputs and outcomes'.

12.60 The scope of this mandate is vast. All government expenditure is rooted in policy decisions. The transformation from policy to plan, programme, expenditure, output and outcome takes place over a number of successive steps. Policy decisions, by themselves, have a significant bearing on outcomes. We have reviewed the merits of policy decisions which have significant fiscal impact as part of our normalisation exercise while discussing central and state finances in earlier chapters. We, therefore, do not examine them here. For the purpose of evaluating outcomes, we confine ourselves to an analysis of the modalities through which public expenditures are converted to the desired outcomes. We identify three issues which need to be addressed: (i) how to ensure that intended expenditure reaches the target group; (ii) how to ensure that expenditure contains the right mix of inputs and (iii) how to ensure that the

service provider has the required capacity and is fully incentivised to provide the service at the desired standard. The first issue is vital as eliminating untargeted groups from the scope of benefits improves the focus of the programme and reduces expenditure without diluting its intended impact. The second issue is crucial as a service can be provided at an acceptable level only if all its required components are in place and situations like 'hospitals with doctors but no medicines' are overcome. The third issue is important as it deals with the capacity of the service provider to provide the service and his willingness to do so at the desired standard. Delays in project implementation, inability to exploit Information Technology for improving operational efficiencies, extension officers not providing relevant training and doctors not providing quality services, are some of the many symptoms of this problem. Lack of frameworks for monitoring, training, incentivisation and accountability characterise such situations.

12.61 We are conscious that the task of enhancing outputs and outcomes by addressing all the three issues identified above cannot be comprehensively undertaken by the Commission. The Government of India has recently announced its intention to create an Independent Evaluation Office (IEO) to concurrently evaluate the impact of its flagship programmes. The reports of the IEO are proposed to be put on the public domain. This is an excellent initiative aimed at putting in place a monitoring and feedback loop. This Commission, on its part, has attempted to incentivise proper composition of public expenditure through our maintenance and environmental grants discussed elsewhere in this chapter. We, therefore, propose to restrict ourselves in this section to three areas where the issues identified earlier are addressed in a limited fashion. These areas are: (i) putting in place an incentive framework to target public expenditure; (ii) promoting innovation to improve outcomes in public policy and district governance and (iii) improving transparency in government accounts to better reflect and measure outputs and outcomes and concomitantly improve accountability.

### Incentive Grants

12.62 The citizens' primary interface is with the state and local governments. It is, therefore, necessary to improve these interfaces if service levels are to improve. For putting in place a suitable incentive structure to do so, suitable parameters need to be identified and credible data used to measure relevant outputs. Such data should have an acceptable lag, must be available at a reasonable frequency and must be published by a reliable source. These constraints impose significant limitations on our choice of parameters and data to represent them.

#### *Better Targeting of Subsidies Through the UID*

12.63 Government of India's expenditure on subsidies is expected to be about Rs. 1,11,000 crore in 2009-10, or nearly 18 per cent of the non-plan revenue expenditure. State level subsidies for power, irrigation and food, as shown in their respective budgets for 2009-10 aggregate to about Rs. 34,000 crore. This figure is conservative as it does not include losses incurred in the power sector. Containment of subsidies has been discussed while assessing the revenue and expenditure of the Union and states. We consider here the issue of improving the targeting of subsidies and related social safety net programmes. The data base of eligible persons presently maintained has both Type I (exclusion) and Type II (inclusion) errors. The first error arises from the difficulty faced by the poor in establishing their identity in order to be eligible for government subsidies and social safety net programmes. The second error arises because of the inability to cross-verify lists of eligible persons across district-level and state-level data bases to eliminate duplicate and ghost entries. We need to ensure that only eligible persons are provided subsidies and benefits and that all eligible persons are covered.

12.64 Creation of a biometric-based unique identity for all residents in the country has the potential to address both these dimensions simultaneously. It will provide the basis for focusing subsidies to target groups. Possession of such an

identity will also enable the poor and underprivileged to leverage other resources like bank accounts, cell phones, which can empower them and catalyse their income growth. These benefits cannot be accessed by them presently due to their inability to provide acceptable identification. The initiative to provide unique IDs has the potential to significantly improve the governance and delivery framework of public services while substantially reducing transaction costs, leakages and frauds.

12.65 We believe that support to the initiative for creation of unique, biometric-based identities will trigger significant improvement in outputs and outcomes. The Unique Identification Authority of India (UIDAI) plans to issue identities to at least 600 million residents of India by 2014. Their aim is to co-opt central and state governments and other agencies like banks as registrars, who would process the UID applications, connect to the Central ID Data Repository (CIDDR) to be managed by the UIDAI, confirm the uniqueness of each applicant and receive a UID number from UIDAI, which they would then allot to the applicant.

12.66 There will be two categories of registrars. One category will comprise banks, insurance companies, income tax departments and passport offices, with whom prospective clients will have a strong incentive to register, because of the benefits that will accrue to them. The identity seekers, in such cases, will largely be above the poverty line and willing to seek a UID and bear its costs.

12.67 The second category of registrars will be the State Government departments implementing programmes like the Public Distribution System (PDS) and the Rashtriya Swasthya Bima Yojana (RSBY). These programmes cater to people below the poverty line. Such people may already be availing the benefit of these schemes and may see no immediate benefits for them or for their family members in registering for a UID. Further, there would be some cost involved in terms of all the members of a family travelling to the place of registration, as well as the opportunity cost of their time. This may be a disincentive and may hinder

their inclusion into the UID programme. Additionally, State Governments will be required to make significant investments in infrastructure and logistics to collect the biometric data, verify it with the CIDR and issue the respective ID cards incorporating the biometric features.

12.68 We believe that there is a strong case for incentivising states to enrol such of their residents who participate in welfare schemes within the UID programme. Such support could be utilised by the state, either to directly subsidise residents who participate, or to provide better facilities for enrolment to residents such that their cost of participation is lowered.

12.69 We propose to incentivise issue of UIDs only to those people below the poverty line who are beneficiaries of public welfare schemes like the National Rural Employment Guarantee Scheme (NREGS) and PDS. The state-wise list of number of persons below the poverty line (Uniform Recall Period : 2004-05) as published by the Planning Commission is placed in Annex 12.9.

12.70 We propose that an incentive of Rs. 100 per person (effectively Rs. 400-500 per family) would be adequate for incentivising citizens below the poverty line to register for the UID. We recommend a grant of Rs. 2989.10 crore to be given to State Governments in this regard.

12.71 The UID grant for State Governments as indicated in Annex 12.9 would be disbursed subject to the following scheme:

- i) States may use this grant either to directly assist the intended beneficiaries or create convenient facilities for them such that the cost of registration of beneficiaries is minimal.
- ii) The assistance, if provided, will be restricted to beneficiaries of NREGS, RSBY, PDS, old-age pensioners and other welfare schemes of the State and Central Governments targeted at persons below the poverty line.
- iii) The grant will be released in five annual instalments, with two tranches per year, on

1 July and 1 January of each year. The first tranche, amounting to one-tenth of the state's allocation shown in Annex 12.9 will be released on 1 July 2010 without any conditions. All subsequent instalments will be released on a reimbursement basis as per the following procedure. The UIDA will certify the number of persons from those mentioned in (ii) above who have been registered in that state and included in the CIDDR. The eligibility of a state will be computed on the basis of a grant of Rs. 100 for every UID issued from that state and included in the CIDDR. The amount paid earlier will be deducted from the entitlement so computed and the balance will be released as that tranche.

#### *Incentive for Reducing Infant Mortality*

12.72 A major challenge for this Commission has been the possibility of inducing change through the use of forward looking criteria. Traditionally, Finance Commissions have used historical data for measuring devolution criteria, resulting in the creation of a system of rewards and punishment for past behaviour, which locks a state's entitlements for the next five years, irrespective of its future performance. FC-XII, through its recommendations, incentivised fiscal reform. We recognise that the area where change is sought to be promoted and the data used to measure it must find acceptance with all stakeholders. In our view, incentivising states to improve their Human Development Indicators (HDIs) is desirable. Within the HDIs, we propose to focus on improvement in the Infant Mortality Rate (IMR). Unfortunately, the proposed Census in 2011 cannot be used as a data source. This is because the record date for the Census will be 1 March 2011, providing little lead time to the states. We, therefore, propose to use results of the survey under the Sample Registration System (SRS) conducted annually by the Registrar General of India (RGI).

12.73 The SRS measuring IMR for 2009 will be the base line from which improvement of each state will be measured. The annual improvement in these

indicators, as determined from the SRS bulletin/statistical report for the succeeding years will be measured from the base line.

12.74 The states are at different levels of achievement in respect of these parameters. The Administrative Staff College of India (ASCI) Hyderabad, in its study on improving outcomes sponsored by this Commission, pointed out that bringing about improvement from a higher base is often more difficult and requires more effort than bringing about improvement at from a lower base. Keeping this in mind, ASCI suggested that reward for performance in such cases should be based upon a formula with two components: the first component is to reward positive movement in the value of the parameter and the second component is to provide a premium if such change is made above the median value of the parameter for all states. Thus, states are rewarded both for improvement in the parameter as well as the level at which the improvement is made. The Commission has accepted the formula proposed by ASCI, details of which are placed in Annex 12.10. Each state's eligibility will be determined annually, based upon improvement in the IMR index. We recommend an amount of Rs. 5000 crore for this grant over a three year period between 2012 and 2015. Details of scheduling of this grant are placed at Table 12.5 below.

**Table 12.5: Scheduling of IMR Incentive Grant**

Year	Amount (Rs. crore)	Calendar Year of Measurement	Year of Release of SRS report
2010-11	Base Line	2009	2010
2012-13	1500	2011	2012
2013-14	1500	2012	2013
2014-15	2000	2013	2014

12.75 Data pertaining to 2009-10, which will be available in 2010 will be the base line for computing eligibility for all the succeeding years. Disbursal of grants will commence from 2012-13. This will give the states a period of two years to make improvements. During 2012-13, the cumulative change in IMR between the years 2009, 2010 and 2011 for each state will be applied to the formula in Annex 12.10. For 2013-14, the cumulative change

between 2009 and 2012 will be applied to the formula. The same procedure will be followed for succeeding year. A simulated calculation applying this formula is placed in Annex 12.11. The grant will be released in three annual instalments between 2012-13 and 2014-15 after the publication of the annual SRS bulletin/report incorporating state-wise IMR statistics for the relevant year as shown in Annex 12.11.

### Improving Justice Delivery

12.76 The improvement of justice delivery is a critical component of the initiative to ensure better outputs and outcomes. This can be done by supporting the judiciary, while simultaneously strengthening the capacity of the law enforcement arm. We discuss here the support required to improve judicial outcomes. There are over 3 crore cases pending in various courts in the country today. At the very least, current filings need to be disposed off, to prevent accumulation of arrears. The enormous delay in disposal of cases results not only in immense hardship, including those borne by the large number of under-trials, but also hinders economic development.

12.77 The Department of Justice has identified a number of initiatives which are part of this action plan and need support. The first is increasing the number of court working hours using the existing infrastructure by holding morning/evening/shift courts. The second entails enhancing support to Lok Adalats to reduce the pressure on regular courts. The third initiative involves providing additional funding to State Legal Services Authorities to enable them to enhance legal aid to the marginalised and empower them to access justice. The fourth is promoting the Alternate Dispute Resolution (ADR) mechanism to resolve part of the disputes outside the court system. The fifth is enhancing capacity of judicial officers and public prosecutors through training programmes. The sixth relates to supporting creation of a judicial academy in every state to facilitate such training.

12.78 The department has also proposed creation of the post of Court Managers in every judicial district to assist the judiciary in their administrative

functions. A number of courts in each state are housed in heritage buildings, which reflect the cultural heritage of the areas. It is proposed that a grant be provided for maintaining these buildings.

12.79 The Commission, after careful consideration has agreed to support the proposals made by the Department of Justice by approving a grant of Rs. 5000 crore to be allocated as describe below. These allocations may be released in two annual instalments subject to accounts being maintained and Utilisation Certificates (UCs)/Statements of Expenditure (SOEs) provided as per General Financial Rules (GFR 2005).

12.80 *Operation of morning/evening/special judicial-metropolitan magistrate/shift courts:* The present 14,000 district and subordinate courts in the country are disposing off both important as well as petty cases. The pressure on judicial time on account of the petty cases can be relieved by allotting them to morning/evening courts/courts of special judicial/metropolitan magistrates. These courts will be staffed either by the regular judiciary on payment of additional compensation, or by retired officers. The morning courts in Andhra Pradesh and the evening courts in Gujarat have demonstrated the feasibility of such models. It is expected that about 14,825 such courts can dispose off 225 lakh pending as well as freshly filed cases of a minor nature within a year. This aggregates to 1125 lakh cases over the period 2010-15. An amount of Rs. 2500 crore is being provided to facilitate setting up of such courts, which has been allocated to each state in accordance with the number of sanctioned courts.

12.81 *Establishing ADR centres and training of mediators/conciliators:* Section 89 of the Civil Procedure Code provides for settlement of disputes outside courts through mediation, conciliation, arbitration or through Lok Adalats. We feel that the scope of this section needs to be tapped fully to reduce the pressure on the courts system. At present, mediation and conciliation centres are being set up at the High Court level, but there are few centres at the district level. Apart from investment in physical infrastructure, judges and advocates need to be trained as mediators/

conciliators in each judicial district. The Justice Department has proposed that one ADR Centre be set up in each judicial district of the country at an estimated cost of Rs. 1 crore per district. It has also proposed that 100 judicial officers and advocates be trained in each district over a period of five years to act as mediators/conciliators to provide the necessary services to the litigants at an estimated cost of Rs. 0.25 lakh per person. This scheme would require an estimated amount of Rs. 600 crore for setting up of ADR centres and Rs. 150 crore for providing training over a period of five years. These amounts have been allocated to the states in proportion to the number of judicial districts within their jurisdiction.

12.82 *Lok Adalats*: We are providing a grant of Rs. 20 crore per year as support to hold about 10 mega Lok Adalats per High Court per year and about five Lok Adalats for each of the 1500 court locations per year. It is expected that this would enable about 15 lakh cases to be disposed off per year – a total of 75 lakh cases for the five-year period 2010-15. The total grant of Rs. 100 crore has been allocated amongst State Governments based upon the number of courts.

12.83 *Legal aid*: Provision of legal aid is an important measure to assist the marginalised sections of the populace in accessing the justice system. The National Legal Services Authority (NALSA) and State Legal Services Authorities (SALSAs) have the responsibility to provide legal services to eligible persons. However, their present resources do not match up to the requirements. To strengthen their efforts, we propose that Rs. 200 crore may be earmarked for providing legal aid over five years. The amount has been allocated to the states in proportion to the number of courts in their jurisdiction. With this, we expect a decline in the number of under-trials in the courts.

12.84 *Training of judicial officers*: Capacity building in the judiciary is a critical need. At present, judicial officers are trained in the State Judicial Academies for one year after their induction and thereafter, in-service training programmes are organised to further build their capacity. Such programmes need to be accelerated through

provision of additional support for these initiatives. A provision of Rs. 250 crore for the period 2010-15 has been made and allocated to states in proportion to the number of courts in their jurisdiction.

12.85 *State Judicial Academies*: The main vehicle for training judges is the State Judicial Academy. While some state judicial academies are well equipped, most have little infrastructure and few facilities. It is necessary to support the state judicial academies to enable them to operate programmes throughout the year to promptly complete the training of judges and reduce vacancies. We propose an amount of Rs. 15 crore per High Court for the 20 High Courts, which works out to Rs. 300 crore. These funds may be utilised for creation of new academies in states where they do not exist, or for providing additional facilities where they do exist. Three High Courts cover more than one state. The release for Guwahati Judicial Academy (which covers the North-East) is proposed to be made through the Government of Assam. The release for Mumbai Judicial Academy (which covers Maharashtra and Goa) is proposed to be made through the Government of Maharashtra. The release for Chandigarh Judicial Academy (which covers Punjab and Haryana) is proposed to be made through the Government of Punjab.

12.86 *Training of public prosecutors*: Given the fact that the government is a major litigant, poor quality of prosecution is often one of the main reasons for delay in disposal of court cases where the Government is a party. Presently there are inadequate facilities for training of Public Prosecutors. A provision for training of 2000 Public Prosecutors in the country at an estimated cost of Rs. 1.5 lakh per Prosecutor has been made. An amount of Rs. 150 crore for the period 2010-15 has been sanctioned for this purpose, which has been allocated to states in proportion to the number of courts in their jurisdiction.

12.87 *Creation of posts of court managers*: Enhancing the efficiency of court management would result in improving case disposal. Providing support to judges for performing their administrative duties would allow them more time for their judicial functions. Adopting an innovative

approach, the Department of Justice has proposed that professionally qualified Court Managers, with MBA degrees, be employed to assist judges. These Court Managers will also be useful in feeding the proposed National Arrears Grid that would be set up to monitor disposal of cases in all the courts. We support this innovation, the impact of which may be evaluated after 2015. The post of a Court Manager would be created in each judicial district to assist the Principal, District and Sessions judges in the administrative functioning of the courts. Similarly, posts of two Court Managers may be created for each High Court and one for each bench of the High Court. This is estimated to require Rs. 60 crore per year and works out to Rs. 300 crore for the period 2010-15. These amounts have been allocated to the states in proportion to the number of judicial districts in their jurisdiction.

**12.88 Maintenance of heritage court buildings:** A number of court buildings in the country have been declared as heritage buildings under the appropriate national, state, or local laws. It is proposed that 150 such buildings may be taken up for restoration and conservation, in collaboration with the Archaeological Survey of India (ASI)/ Indian National Trust for Art and Cultural Heritage (INTACH) during the five year period at an estimated cost of Rs. 450 crore. We expect that preference will be accorded to larger and older buildings. Due to lack of data on heritage structures, we have allocated these funds to all states as per the number of courts in their jurisdiction.

**12.89 Conditionality:** The government is the single largest litigant in the country today. There are a very large number of pending cases where either a State Government or the Central Government is a party, which significantly add to the burden of arrears. It is necessary that all State Governments frame state litigation policies aimed at responsible litigation. The Central Government is planning to put in place a National Litigation Policy shortly. It is proposed that this policy will include steps for: (i) reviewing the existing cases and wherever necessary, withdrawing cases identified as frivolous and vexatious; (ii) formulating norms for defending cases as well as for filing appeals and (iii) setting

up of Empowered Committees to eliminate unnecessary litigation. States could formulate their State Litigation Policy based upon the National Litigation Policy. The grants indicated in Para 12.91 onward will be provided in five equal annual instalments. The details of state-wise eligibility for these grants are placed in Annex 12.12. A state will be eligible to draw down instalments only if it puts in place a State Litigation Policy. Such a policy must be put in place by the State Government before the end of a fiscal year to be eligible to draw down the instalment for the succeeding fiscal years. This condition will not apply to the first annual instalment (2010-11) which can be drawn down without the policy in place. A state will thereafter be entitled to the grants only prospectively after framing its policy.

### **Police Training**

**12.90** Training of police personnel has been accorded low priority by most state governments for two reasons: (i) the available staff are so stretched that there is no time for police personnel to be sent for training and (ii) lack of training infrastructure in most states. As per the Home Ministry, a police official, on an average, undergoes training only once in 15 years. Given the present security environment as well as rapid changes in technology, this priority needs to be reordered if outcomes in the supply of justice are to be improved. We, therefore, propose to support State Governments in training their police personnel in the manner proposed by them. We have made suitable allocations for this, as part of the state specific grants discussed later in this Chapter . Our grant provisions for police upgradation and training are shaped to the requests made by states, but we require and expect that the contents of police training include gender sensitization so that the police are seen by all segments of the population as protectors.

### **Promoting Innovation**

**12.91** The President of India, in her address to Parliament in June 2009, committed the nation to a path of promoting innovation and unleashing the creativity of a billion people. She announced that the next ten years would be dedicated as the 'Decade

of Innovation'. Innovation can play an important role in providing better alternatives, reducing costs, improving service levels and filling in availability deficits. The task is, therefore, not only to foster innovation, but also to promote it zealously. A number of appropriate, low cost and people oriented innovations already introduced in various states have been documented by the National Innovation Foundation (NIF) and are being disseminated by them. These innovations relate mostly to individual initiatives in the private sector. The Commission feels that a number of equally relevant innovations exist in the government sector which need to be recognised, documented and promoted amongst all State Governments. We note that a number of national programmes, like the mid-day meal scheme, were rooted in innovative schemes initially adopted at the state level. We, therefore, obtained from State Governments a description of the major innovations they have introduced in different sectors to improve service levels and reduce costs. These innovations are in a variety of sectors like health, education, tourism and natural resource management and are aimed at improving service delivery. They also cover improvement of governance and supply of justice. Based upon an analysis of the data received and suggestions of NIF, we have recommended a two-pronged initiative.

#### *Centre for Innovations in Public Systems (CIPS)*

12.92 The first initiative is embodied in the request of the Andhra Pradesh Government for assistance to set up the Centre for Innovations in Public Systems (CIPS) at ASCI, Hyderabad. The CIPS will actively promote and disseminate among states practices which have enhanced service delivery, increased efficiency and led to cost reduction in public systems. It will also continuously scan the environment for new practices which it will add to its data base, which will then be made available across states. It will conduct training programmes and enable experience sharing.

12.93 The functioning of CIPS will be guided by an advisory council with all the chief secretaries of State Governments as its members, apart from

Central Government representatives and independent experts. The grant of Rs. 20 crore will be utilised for running the CIPS for a five-year period, after which it is expected to become self-sufficient. The grant will be released in one instalment during 2010-11. The modalities of the grant are further detailed in Annex 12.13. This provision is included under the state specific grants for Andhra Pradesh (Para 12.127).

#### *District Innovation Fund (DIF)*

12.94 The second initiative is the creation of a District Innovation Fund (DIF) aimed at making cutting edge levels of governance responsive to felt needs and innovations. This fund of Rs. 1 crore, to be made available to every district in the country, aims at increasing the efficiency of capital assets already created. This investment will be used to fill in vital gaps in public infrastructure already available in the district, which is not being fully utilised for want of a relatively small investment. Examples include a government hospital with non-functional diagnostic equipment; a minor irrigation tank with sizeable command and leaking sluice gates; an area with poor agricultural productivity without soil testing facilities. The object will be to renew or better utilise an existing capital asset and provide immediate benefits. We accept that the examples listed above can and, ideally should, be funded by the states' budget. However, with the increasing pressure on establishment costs, we also recognise that a number of critical gaps in public infrastructure are yet to be filled and it may take time before all such needs are recognised and addressed at the state level. Such projects with immediate welfare returns for comparatively low investment are best identified at the district level. There is also tremendous scope to innovate at the district level and even a relatively small allocation per district can be effectively leveraged as a force multiplier.

12.95 Projects undertaken under the scheme should be demand driven rather than supply driven. The scheme should be also conducive to triggering innovative measures in order to make government accessible and accountable to all sections of society.

We recommend that at the district level, only 90 per cent of the cost be met from the District Innovation Fund and the balance 10 per cent from non-governmental contributions – from either the public or NGOs. This amount must be collected and deposited with the district agency before the scheme is sanctioned. State Governments could prepare guidelines for the scheme using the basic template indicated above, while allowing freedom of choice to the districts. We propose to allot a sum of Rs. 1 crore to every district in the country to be used in the manner stated above. Each State Government will be entitled to its eligible amount as per Annex 12.14 in two instalments. The first instalment will be released in 2011-12 after the State Government finalises detailed guidelines for implementation of the scheme and notifies the authority at the district level which would sanction the projects under the scheme. The second instalment would be released after the State Government submits a report on the end use of the first instalment detailing the benefits created. The districts in the state could be covered in two phases if the State Government so desires. To generate competition, if some districts come up with more innovative projects for support, then unutilised funds from the remaining districts can be reallocated to them.

12.96 We propose a grant of Rs. 616 crore for this scheme. The state-wise allocation based upon the number of districts in each state is placed in Annex 12.14.

### **Improving Transparency in Government Accounts**

12.97 Transparency in government accounts improves the feedback loop, reflects the fiscal impact of all policy initiatives and enhances accountability, thus ensuring greater productivity. We discuss separately various initiatives to aid transparency in Central and State Government accounts, including accrual accounting, maintaining consistency in financial accounts across states and improving audit mechanism. In the following paragraphs, we discuss two specific initiatives for enhancing the quality of data—strengthening statistical systems at the state and

district level and setting up a data base for State Government employees and pensioners.

### *Improving Statistical Systems in State Governments*

12.98 A number of steps have been taken to strengthen the statistical system in the country. The National Commission on Statistics (NCS) was set up to comprehensively steer the growth of the statistical system in the country and oversee all initiatives for its growth. The National Strategic Statistical Plan (NSSP) 2008 sets out the medium term strategy for empowering the existing statistical framework to produce comprehensive good quality relevant economic and social data for policy and decision making. The India Statistical Project (ISP) focuses on strengthening the statistical capacity of all states and Union Territories. In particular, they are being encouraged to effectively meet the national minimum standards with regard to twenty key statistical activities.

12.99 Despite these impressive achievements, a number of important issues remain to be addressed. These are outlined below:

- i) FC-XII noted the need to measure Gross State Domestic Product (GSDP) at market prices consistent with national estimates, instead of at factor cost, as is presently being done. This is still not available. Further, the measurement of GSDP across states should be standardised such that use of comparable GSDP series by the Finance Commission and other bodies is made redundant.
- ii) This Commission has elsewhere made recommendations on the need to incorporate environmental considerations into government policy. As part of this effort the estimation of Green GDP/GSDP would be very valuable. Such an estimate would account for depreciation of natural assets and consider loss of income due to environmental degradation.
- iii) Comparable estimates of district income are extremely relevant for measuring intra-state income disparities. This will enable State

Governments to effectively plan policy and programme interventions. They could also be used as a parameter for horizontal distribution of fiscal transfers. As many as 23 states have generated district income statistics for the period 1999-2000 to 2005-06. For these to be usable, all states should generate this data in accordance with the guidelines of the Central Statistical Organization (CSO). They also need to be validated at the national level to ensure comparability.

- iv) For equitable horizontal distribution, the measurement of cost disabilities is important. The cost of services varies across states due to a large number of factors such as geographic location, population size and distribution and demographic characteristics. Further, to estimate cost disabilities of states, two types of data are required: (a) quantifiable measure of the level of various services available in different states and (b) the corresponding unit cost. As of now, such data are not available.
- v) Measurement of inter-regional trade data would be useful to provide insights in an inter-regional framework.

12.100 We recommend that the Ministry of Statistics take steps to fill in the statistical gaps outlined above. To ensure that the National Strategic Plan is implemented effectively, this Commission recommends grant assistance to State Governments, which should be utilised by them to fill in infrastructure gaps.

12.101 At least 75 per cent of the grant will be utilised for strengthening statistical infrastructure at the district level not covered by the India Statistical Project and the proposed CSS pertaining to Basic Statistics for Local Level Development. A maximum of 25 per cent of the grant can be used for improving statistical infrastructure at state headquarters. States will be eligible for Rs. 616 crore in the aggregate, with Rs. 1 crore being provided to every district. State-wise eligibility for this grant is placed in Annex 12.14.

12.102 The grant will be drawn down in five annual instalments. The first instalment will be drawn down only after the state submits an expenditure plan for the entire grant. All subsequent instalments will be drawn down after submission of UCs/SOEs for the previous instalments. States are provided the flexibility to modify their expenditure plan at any time.

#### *Setting up a Data Base for Government Employees and Pensioners*

12.103 Though direct and indirect employees of State Governments form less than 6 per cent of the paid workforce and roughly 2 per cent of the country's population, aggregate payments towards salaries, lump sum terminal benefits (commutation, gratuity, leave encashment) and monthly pensions amount to about 32 per cent of the states' total revenue expenditure and 67 per cent of the states' own tax revenue for 2008-09 (BE). Between 1990-91 and 2008-09, these costs grew at a compounded annual growth rate of 17 per cent across states. The impact of the implementation of the recommendations of the Sixth CPC has been estimated by us in Chapter 7, as 35 per cent. However, accurate assessment of the impact of such shocks can be made only if data on the number of employees and pensioners, their salary and pension payable and their demographic profile is available. Only if the state can estimate and project its liability on account of salary and pensions into the future can it effectively plan to restrain it and commit expenditure towards development outlays. This exercise cannot be undertaken without the state creating and regularly maintaining an accurate employee and pensioner data base. The Commission sponsored a study on 'Building Employee and Pension Data Bases and MIS for Effective Fiscal Planning by State Governments' which analyzed this issue. The preliminary recommendations of the study were discussed at a State Finance Secretaries' conference held in New Delhi on 30 July 2009. The study report has been published on the Commission's website.

12.104 The study recommends that all states set up employee and pensioner data bases and put in place

frameworks which enable their accurate maintenance on a continuous basis. It points to the need for the data base to be constructed in a format which enables aggregation at state level as well as at the national level. This would require that all states adopt a reasonably similar definition of an employee and use a standard minimum content for the data base. We recommend that states adopt a data base which will enable capture of this data at the minimum. Two data bases need to be built for pensioners, one for those drawing pension under the defined benefit scheme and the other for those who have enrolled under the new defined contribution scheme. This New Pension Scheme (NPS) data base will contain not only employees' data, but will also include details of contributions and accumulations accounting, as well as a facility for providing information to the account holder on balances in the account.

12.105 The challenges facing the implementation of the NPS have been outlined in Para 7.122. The proposed data base will enable speedier implementation of the NPS as it will provide the basis for payroll linked deduction and transfer of contributions to the service providers.

12.106 A data base for employees, pensioners and family pensioners will be prepared, along with a central Management Information System (MIS) and data management system. Ideally, this should be integrated with an electronic payroll and pension payment system to facilitate error-free and real time updates.

12.107 These data bases should be built on a common foundation across all states, viz. a minimum number of uniform financial and demographic data fields for comparability of expenditure data. A suggested template is placed in Annex 12.15. States are, however, free to include additional data fields to meet their specific requirements while creating their data bases. States may like to keep in mind the suggested model for data base creation provided in Chapter 5 of the study report published on the Commission's website.

12.108 All employees, pensioners and family pensioners who are eligible for a defined benefit

pension from the consolidated fund, either directly or indirectly through grants, should be included in such a data base. Employees of local governments should be distinctly identified. We recommend that a grant of Rs. 10 crore be provided to each general category state and Rs. 5 crore to each special category state to set up an employee and pensioners data base.

12.109 The data base should be designed to allow for subsequent extension to include other financial benefits (including GPF, insurance and health benefits) to employees as well as payment of defined benefit pensions and family pensions

12.110 All states who wish to set up this data base will be able to draw down Rs. 2.50 crore during 2010-11 without any precondition to commence work. We expect the work to be completed in three years. The balance, Rs. 7.50 crore, will be released after the state certifies that it has created a data base which provides at least the data mentioned in Annex 12.15 and that this has been functionally integrated with the treasury on a transactional basis. The states should also confirm that they will be able to provide to the Fourteenth Finance Commission projections for salary and pension expenditure based upon such a data base. States who have already taken such steps can be provided their entire allocation (Rs. 10 crore or Rs. 5 crore, as the case may be) as soon as they declare their eligibility in the manner prescribed above. We also urge the Government of India to initiate a parallel effort for preparation of a data base for its employees and pensioners.

### **Grants for Maintenance of Roads and Bridges**

12.111 Till FC-XI, the Commissions assessed the needs of the states for maintenance of roads as part of their non-plan revenue expenditures. FC-XII, recognising the importance of proper maintenance of roads, recommended a specific grant for this purpose. Many states, in their memoranda to us, have requested for continuance of this grant. We have noted the increased expenditure undertaken by the states for the maintenance of roads and bridges post-grants and recognise the fact that a vital infrastructure such as roads should not suffer due to poor maintenance. We have, therefore,

decided to provide grants for maintenance of roads and bridges in addition to the normal maintenance expenditure as assessed within the overall non-plan revenue expenditure of the states.

12.112 We obtained road length data from the states under various categories, viz. State Highways, Major District Roads, Other District Roads and Local Body/Village roads, for each type of road, viz. Black Top (BT)/Cement Concrete (BT), Water Bound Macadam (WBM) and Earthen Roads (ER). For WBM and ER, we have added 50 per cent of the reported road length to BT roads in our assessment of overall expenditure requirement. We obtained the norms for maintenance of roads from the Ministry of Road Transport and Highways and used them to arrive at the annual requirement for maintenance. We have decided to give grants only for ordinary repairs. Norms for ordinary repairs for each category of roads were applied to the road length in that category in a state, separately for hill and plain area roads. Recognising the inherent cost disabilities of special category states, the assessment of annual requirement of maintenance in their case has been increased by 20 per cent.

12.113 We have assessed separately the maintenance requirement for the PMGSY roads that would come out of the initial five-year maintenance contracts during our award period. This has been done for two reasons. First, many states, during their discussions with the Commission, represented that PMGSY roads have been excluded while providing road length data to the Commission and second, PMGSY roads are high priority rural roads where quality has been prime focus and, thus, need special attention.

12.114 We have decided to provide grants-in-aid for roads maintenance to the extent of 50 per cent of the requirement assessed for non-PMGSY roads and 90 per cent of the requirement assessed for PMGSY roads for four years starting 2011-12. The total amount of grants works out to Rs. 19,930 crore. The state-wise year-wise breakup of these is given in Annex 12.16. The grants shall be over and above the states' budget and shall be subject to conditionalities given in Annex 12.17.

### State-specific Grants

12.115 During our visits to the states as well as in their respective memoranda, State Governments have highlighted the need for grants to address specific issues and local problems. Some of the central ministries, in their communications to the Commission, have also drawn our attention to issues which arise across states, but are required to be addressed locally. For instance, the Ministry of Home Affairs has drawn our attention to the enormous gaps in training capabilities for the police force across states, while the Ministry of Culture has indicated the states' continued need for assistance, by means of grants, to protect monuments and heritage buildings. We reviewed the outcomes of state-specific grants recommended by FC-XII during our visits to the states. We have also witnessed some of these problems first hand in the course of our field visits and some of our studies, such as the ones undertaken with regard to the problems of border areas, come up with specific suggestions in this context. Subsequently, the Commission had further intensive interactions with the states to ascertain their views and their priorities. These have shaped our recommendations.

12.116 On this basis, we find that priority should be accorded to state-specific grants to address the following issues:

- i) The specific needs of marginal areas and marginal groups within states.
- ii) Provision of infrastructure to alleviate some of the problems faced by the local population in blocks and tehsils along the international borders.
- iii) Protection of historical monuments, archaeological sites and heritage buildings which are not with the Archaeological Survey of India (ASI).
- iv) Provision of safe drinking water, especially in regions afflicted with arsenic, salinity and fluoride related problems.
- v) Gaps in critical infrastructure for health, including care for children.

vi) Setting up and strengthening of skill-building institutions to help provide employable skills.

vii) Meeting the training requirements of police personnel at various levels.

12.117 The state-wise details of grants-in-aid recommended for needs that are specific to each state are given below:

### **Andhra Pradesh**

#### *Providing Drinking Water in Rural Areas*

12.118 The Government of Andhra Pradesh requested grants for provision of drinking water in rural areas on two counts:

- i) The State Government has highlighted problems of water quality in the fluoride affected areas of Andhra Pradesh. Several schemes have been undertaken for improvement of water quality using grants from FC-XII and the state's own resources. The government has now sought additional funds to improve water quality in saline affected areas. We recommend an amount of Rs. 350 crore in this regard.
- ii) Funds have also been requested for provision of drinking water in inaccessible tribal areas. We recommend an amount of Rs. 200 crore for this purpose, with the proviso that this grant may be utilised only for new schemes.

#### *Seed Bank Scheme*

12.119 The state has sought an allocation to increase production of seeds by replacing old machinery, providing new processing and storage facilities and upgradation of seed testing laboratories. We recommend an amount of Rs. 100 crore for this purpose.

#### *Police Training*

12.120 Grants for police training in the state have been requested as follows:

- i) The Greyhounds Regional Training Centre imparts specialised training to the police

forces of Left Wing extremist-affected states. The Government of AP has requested funds to strengthen the training facilities at Premavathipet, Hyderabad and at the regional headquarters in Vishakapatnam. We recommend an amount of Rs. 13 crore for this purpose.

- ii) The state has also requested funds for upgradation of the Police Training College at Warangal, shifting of the old Police Training College from Amberpat to Medak and establishing a new Police Training College at Karimnagar. We recommend an amount of Rs. 100 crore for this purpose.

#### *Construction of Prisons*

12.121 The state has sought a grant for construction of prisons owing to shortage of capacity. We recommend Rs. 90 crore for this purpose.

#### *Development of Culture*

12.122 Grants requested by the State Government for development of culture are as follows:

- i) The state has sought funds to preserve, protect and propagate the composite culture of India. We recommend an amount of Rs. 40 crore for this.
- ii) We further recommend an amount of Rs. 20 crore for the establishment of 'Shilparamam' at Vijayawada, Nellore, Anantpur and Warangal.

#### *Fire and Emergency Services*

12.123 The state has represented for an allocation to strengthen Fire and Emergency Services by providing essential equipment to convert the service into a multi-hazard response unit. We recommend a grant of Rs. 17 crore on this account.

#### *Heritage Conservation*

12.124 The state has requested a grant for works related to conservation, restoration and preservation of 560 protected ancient sites and

historical monuments as well as for improvement and modernisation of its museums. We recommend an amount of Rs. 100 crore for this purpose.

#### *Establishment of Primary Health Centres*

12.125 The memorandum from AP indicates a gap in the number of primary health centres (PHCs) and the imperative to create the necessary facilities for improved provision of rapid, qualitative health and medical services, especially in rural areas. We recommend a grant of Rs. 200 crore to set up new PHCs.

#### *Strengthening the Pollution Control Board*

12.126 The state has requested a grant of Rs. 20 crore to strengthen the Andhra Pradesh Pollution Control Board by providing air and water monitoring equipment and the capital cost of establishing monitoring systems. We support this request.

#### *Establishment of a Centre for Innovations in Public Systems*

12.127 In order to create a climate for accelerating and diffusing innovation in public systems through sharing of experiences across states and to facilitate the establishment of institutional and human capacities for innovation through knowledge sharing and mobilisation of practical help, we recommend an amount of Rs. 20 crore to establish a Centre for Innovations in Public System (CIPS) at the Administrative Staff College of India (ASCI), Hyderabad. The Centre will be governed through an advisory council, with representation from all states. A Steering Committee will assist states to transform creative ideas into sustainable practices. (refer to Para 12.92)

### **Arunachal Pradesh**

#### *Infrastructure Creation for Newly Created Districts and ADC Headquarters*

12.128 The state has asked for a grant towards creation of infrastructure facilities for three newly created districts and 16 new ADC headquarters in

remote and border areas, stating that new centres are currently functioning out of temporary office accommodation. Keeping in view the need to extend and improve the reach of administration in remote and border areas, we recommend an amount of Rs. 75 crore for this purpose.

#### *Strengthening of Law Enforcement and Public Security in Remote Areas*

12.129 It has been stated in a supplementary memorandum that lack of infrastructure in remote administrative headquarters hampers the quality of security and maintenance of law and order. The state has sought a grant for construction of police stations with lock-ups, Type-II buildings and bachelor barracks in 67 remote administrative headquarters. We recommend an amount of Rs. 70 crore for these works.

#### *Repair of Suspension Bridges*

12.130 The memorandum from Arunachal Pradesh has highlighted the importance of suspension bridges for connectivity in hilly and remote areas of the state. The State Government has requested a grant for renovation of 81 identified suspension bridges which require immediate attention. We recommend an amount of Rs. 30 crore for this purpose, as requested by the State Government.

#### *Construction of PDS Godowns*

12.131 As requested by the State Government, we recommend Rs. 15 crore for construction of Public Distribution System (PDS) godowns at vulnerable locations, viz. Santipur (Kangkong), Longding, Daporijo, Kalaktang, Thrizino, Zemithang, Boleng and Kibitho to ensure transportation and storage of essential commodities for the PDS.

#### *Preservation of Archaeological and Historical Sites in the State*

12.132 The state has sought funds for preservation and development of various archaeological and historical sites, for which we recommend a grant of Rs. 10 crore.

*Development of Prisons*

12.133 The State Government has requested a grant for development of prison infrastructure. We recommend a grant of Rs. 10.00 crore to cover the requirement of water supply for the district jail, construction of additional male and female wards of 50 inmates capacity and residential accommodation for staff at Itanagar and Tezu.

*Health Sector*

12.134 The state has projected a requirement of strengthening and adding to its health infrastructure. We recommend an amount of Rs. 50 crore for improving the physical infrastructure in Community Health Centres (CHCs), Public Health Centres (PHCs) and sub-centres in the state.

*Construction and Renovation of Community Hall, Kebang Ghar, etc.*

12.135 As requested by the State Government, we recommend Rs. 15 crore for construction/maintenance/renovation of community halls, *kebang ghars*, etc.

*Infrastructure Development in Tawang District*

12.136 The state has highlighted that the border blocks of Jang-Thingbu, Mukto and Lumla Tawang District do not have the desired infrastructure due to difficult conditions. The district is fast emerging as a tourist destination and the State Government has sought a grant to improve sanitation, drainage system, porter tracks, roads and housing in remote blocks of the district situated along the international border. We recommend an amount of Rs. 25 crore for this purpose.

**Assam**

*Border Area Development*

12.137 The state memorandum mentions that the areas along the international borders are largely forested and extremely underdeveloped in terms of basic facilities such as water supply, roads, bridges and electrification. Substantial funds have been requested

in order to provide these facilities. We recommend an amount of Rs. 230 crore for this purpose.

*Improvement of Buildings, Infrastructure, etc. of Cotton College, Guwahati*

12.138 The State Government has stated that Cotton College, Guwahati, established in 1901, is not only a premier educational institution, but also a heritage site which attracts students from all over the North-East as well as other parts of the country. We recommend an amount of Rs. 50 crore for improvement, upgradation and development works to cope with the increasing number of students and academic disciplines.

*Heritage Conservation*

12.139 The state has sought funds for construction, as well as protection and maintenance of archaeological sites and monuments in the state. We recommend an amount of Rs. 40 crore for this purpose, including Rs. 5 crore for protection, preservation and promotion of the Satras of Majuli Island.

*Promotion of Tourism*

12.140 The State Government has requested a grant for improvement of tourism infrastructure and for implementation of the state tourism policy. We recommend an amount of Rs. 50 crore for this purpose.

*Police Housing*

12.141 The State Government has highlighted the shortage of police housing in the state and requested funds for adding to the housing stock. For the civil works/infrastructure development the State Government has sought an amount of Rs. 971.13 crore. We recommend an amount of Rs. 15 crore for construction of junior staff quarters in hills/remote areas and Rs. 35 crore for construction of junior staff quarters in other areas.

*Police Training*

12.142 In order to make up the shortfall in training facilities, the State Government has sought funds

to expand and strengthen the Training and Armed Police Wing of Assam Police. We recommend an amount of Rs. 25 crore for construction of the Police Academy and Rs. 25 crore for setting up the Counter Insurgency and Jungle Warfare School.

#### *Infrastructure Development of VI Schedule Areas*

12.143 As per the state memorandum, 31 per cent of the total geographical area and 14 per cent population of the state fall under Schedule VI areas. The State Government has requested funds for infrastructure developments in these areas. We recommend an amount of Rs. 130 crore (Rs. 40 crore each for Karbi Anglong District and N.C. Hills District and Rs. 50 crore for Bodoland Territorial Council) for this purpose.

### **Bihar**

#### *Construction of Panchayat Sarkar Bhawans:*

12.144 In order to enable and empower gram panchayats, the State Government has proposed building of panchayat offices to cater to multiple administrative needs. These Bhawans are also expected to be used as temporary shelters in the event of disasters. We recommend a grant of Rs. 1000 crore for construction of the Panchayat Sarkar Bhawans.

#### *Police Training*

12.145 In their memorandum the State Government has explained that as a consequence of bifurcation of the state, Bihar no longer has a police academy. It proposes to set up such an academy at Rajgir for which land has been allotted. The State Government has requested funds to set up this academy which will cater to Deputy Superintendents of Police, Sub-Inspectors and other ranks. We recommend a grant of Rs. 206 crore which has been sought for this purpose.

#### *Police Housing*

12.146 The State Government has requested a grant for the construction of lower subordinate quarters, barrack accommodation for constables and model police stations. We recommend a grant of Rs. 106 crore for this purpose.

#### *Heritage*

12.147 The State Government has sought grants as follows for heritage development:

- i) *Nalanda Heritage Development Plan:* The State Government proposes to create a Nalanda Heritage Zone, involving Buddhist institutions and establishing linkages with other prominent locations lying along the Buddhist trail in Bihar. The Nalanda Heritage Development Plan also includes improvement of infrastructural facilities for tourism. In order to execute this plan, we recommend a grant of Rs. 50 crore as requested by the State Government.
- ii) *Development and Conservation of Archaeological Sites:* We also recommend a grant of Rs. 50 crore for the development and conservation of 29 sites which have been identified by the State Government.

#### *Establishment of New ITIs*

12.148 In a supplementary memorandum, the State Government has apprised the Commission that Bihar needs 105 new Industrial Training Institutes (ITIs) to foster skills amongst its youth and has requested a grant of Rs. 100 crore to create 10 new ITIs, including the recurring cost for the award period. We recommend this grant.

#### *Interlinking of Rivers for Prevention of Floods*

12.149 The State Government has requested funds for Burhi Gandak-None-Baya-Ganga link. This link envisages diversion of 300 cumecs of flood water (i.e., partial quantity of flood discharge) of Burhi Gandak river to the Ganga through linking the None and the Baya rivers so that flood damages in the lower reaches of the Burhi Gandak basin area falling under Samastipur, Begusarai and Khagaria districts may be reduced to a great extent. We recommend an amount of Rs. 333 crore for these works which will be carried out after obtaining the necessary clearances.

### **Chhattisgarh**

#### *Development of the New Capital City*

12.150 The Government of Chhattisgarh has

represented for funding to develop its new capital city of Naya Raipur. FC-XII had provided a grant of Rs. 200 crore for this purpose. The State Government has requested a grant amounting to Rs. 450 crore from this Commission, for office complexes and housing for government employees and Rs. 100 crore for eco-friendly development projects such as conservation of water bodies, development of city parks and use of non-conventional sources of energy. Keeping in view the requirement of the new state, we recommend Rs. 550 crore as grant for the development of Naya Raipur.

#### *Academy of Administration*

12.151 Upon the creation of Chhattisgarh, the Academy of Administration was established in 2004, but has been housed in temporary premises ever since. The state has allotted land for the academy and has sought a grant to build the campus. We propose a grant of Rs. 28 crore for this purpose.

#### *Construction of Anganwadi Centres*

12.152 The state has over 17,000 Anganwadis without their own buildings. While the State Government is also using other sources of funding to construct these buildings, it has requested a grant for construction of Anganwadi Bhawans. We recommend an allocation of Rs. 150 crore for this purpose.

#### *Strengthening of Health Infrastructure*

12.153 The Chhattisgarh government has indicated a huge gap in basic health infrastructure in the state. As per their request, we recommend a grant of Rs. 66 crore for construction of 500 sub-health centres, 25 Primary Health Centres (PHCs), 5 Community Health Centres (CHCs) and 100 Ayush Dispensaries, with the proviso that priority would be given to remote tribal areas.

#### *Police Training*

12.154 In order to increase the training capacity of police training schools and strengthening the upcoming Police Academy at Chandkhuri and Counter Terrorism and Jungle Warfare (CTJW) at

Kanker, we recommend a grant of Rs. 42 crore, as sought by the State Government.

#### *Strengthening of Prison Infrastructure*

12.155 The State Government has stated that the prisons in the state are extremely overcrowded. In order to construct two new prisons, strengthen central prisons and upgrade other existing prisons, we recommend a grant of Rs. 150 crore.

#### *Construction of Residential Accommodation for Police Personnel*

12.156 The state has reported an acute shortage of accommodation for policemen, a problem which has become more acute with creation of new battalions. We recommend a grant of Rs. 250 crore for construction of accommodation for police personnel, especially constables, head-constables and non-gazetted officers.

#### *Conservation of Heritage*

12.157 The State Government has sought a grant for conservation works in monuments as well as related activities such as training and publications. We recommend a grant of Rs. 45 crore for heritage conservation.

### **Goa**

#### *Sea Barricades*

12.158 Given the importance of beaches in Goa, the memorandum of the State Government has presented a case for installation of sea barricades to enhance tourist safety. We recommend a grant of Rs. 100 crore for this purpose.

#### *Construction of New International Airport at MOPA*

12.159 The state has argued that being a major tourist destination, it urgently needs a new airport as the existing airport at Dabolim is under the overall operational control of the Indian Navy. The state has proposed construction of a new international airport at MOPA on Build-Own-Operate-Transfer (BOOT) basis with an expected initial expense of be Rs. 200 crore. The government

has sought Rs. 100 crore as grant, which this Commission recommends in view of the importance of a new airport for the state.

## Gujarat

### *Ingress of Salinity*

12.160 In its memorandum, the Government has noted that 10.69 lakh hectares of land in more than 600 coastal villages have been affected due to the ingress of salinity. We propose an amount of Rs. 150 crore to address this problem.

### *Coastal Erosions*

12.161 The State Government has sought support to tackle the menace of coastal erosion faced by about 450 fishing villages. We propose that Rs. 150 crore be allocated for this purpose.

### *Ground Water Recharge*

12.162 Depletion has been observed in ground water levels of North Gujarat and Saurashtra. The state has requested support for measures to recharge ground water, such as construction of check dams, cleaning and restoration of step wells, deepening of wells and rain water harvesting. A grant of Rs. 200 crore may be provided for this purpose.

### *Police Training*

12.163 Support has been sought for strengthening infrastructure in the four police training establishments in the state. This will enable the state to expand and modernise its training functions effectively. We recommend an amount of Rs. 215 crore for this purpose.

### *Tribal Area Development*

12.164 The State Government has sought support for development of tribal areas in education, agriculture and animal husbandry sectors, as well as in terms of improved administration. We propose an amount of Rs. 200 crore on this account.

### *Public Health*

12.165 The State Government has requested

support for providing integrated quality services through public health schemes. We propose an amount of Rs. 237 crore for this purpose.

### *Construction of Border Roads*

12.166 The Government of Gujarat has sought support for construction of roads in the areas along the international border. We recommend an amount of Rs. 100 crore for this purpose.

### *Gir Lion Project*

12.167 The State Government has requested support for development of the Bruhad Gir area, including support for protection of the Gir lions, maintenance of eco-tourism facilities and environment protection. We support the State Government's request for allocation of an amount of Rs. 48 crore for this purpose.

## Haryana

### *Development of Mewat Region*

12.168 State Government has sought support for multi-sectoral development of Mewat District. We recommend a grant of Rs. 300 crore to this backward district as under:

- i) Augmentation of drinking water supply—Rs. 100 crore.
- ii) Infrastructure for industrial training Institutes—Rs. 100 crore.
- iii) Strengthening health infrastructure, including the setting up of medical college—Rs. 100 crore.

### *Police Training*

12.169 The State Government has sought support for strengthening the infrastructure of the police department to enable them to conduct more effective training programmes. We recommend an amount of Rs. 100 crore for this purpose.

### *Drinking Water*

12.170 The state has sought support to improve drinking water supply facilities in southern Haryana and Shivalik areas of the state, including setting up

of reverse osmosis plants. We recommend a grant of Rs. 300 crore for this.

#### *Fire and Emergency Services*

12.171 With rapid industrialisation of many parts of Haryana, the fire service department has to be upgraded and adequately equipped to face emergencies. We allocate an amount of Rs. 100 crore for this.

#### *Health Infrastructure*

12.172 The State Government has sought support to strengthen its health infrastructure, including additional PHCs, CHCs, Sub Division and district hospital, to fill gaps not covered under other ongoing programmes. We recommend an amount of Rs. 200 crore for this.

### **Himachal Pradesh**

#### *Augmentation of Water Supply Schemes*

12.173 The Government of Himachal Pradesh has sought a grant for rehabilitation and source-level augmentation of water supply in chronically dry and arid mid-Himalayan regions of Dehra/Jaswan/Bilaspur/Palampur from Beas and Sutlej rivers/Kol Dama, as a long term solution to the domestic water needs of the people of the region. Given that these regions are chronically water scarce, we recommend a grant of Rs. 150 crore.

#### *Installation of Steel Crash Barriers and Strengthening of Parapets at Chronic Accident Prone Sites*

12.174 In a supplementary memorandum, the State Government has requested a grant of Rs. 250 crore for installation of steel crash barriers and strengthening of parapets at about 536 identified chronic accident prone sites, asserting that this is essential to reduce human fatalities and accidents, as well as to enhance comfort level on important national and state highways and other roads located at commanding heights. Given the importance of road safety in the state, we recommend a grant of Rs. 100 crore.

#### *Development of New Parking Lots, Sewage, Drainage and Solid Waste Disposal Schemes*

12.175 In view of heavy tourist inflow to the state, the government has requested a grant for development of parking lots, sewerage, drainage and solid waste disposal facilities in 13 important tourist towns and district headquarters in order to improve the environment of these tourist destinations. We recommend a grant of Rs. 50 crore for this purpose.

#### *Border Area Development*

12.176 Grants for development of border areas have been sought as per the following:

- i) The state has sought grants for construction and improvement of roads and bridges in the three border blocks of Kalpa, Pooh and Spiti. The state has highlighted the importance of these projects, which would provide alternative road links in these areas, even in times of heavy snowfall. We recommend an amount of Rs. 25 crore, in line with the State Government's petition.
- ii) The state has also requested a grant towards strengthening of electricity infrastructure in the border areas of Kinnaur and Lahaul-Spiti districts. The four projects identified in these districts will improve the quality of power supply and reduce dependence of the populace on scarce fuel woods and sparse tree cover. We recommend a grant of Rs. 25 crore for this purpose.

### **Jammu & Kashmir**

#### *Fiscal Reform*

12.177 The Government of Jammu & Kashmir, in its memorandum and supplementary communications to the Commission, has highlighted its fiscal burden under the existing mode of financing temporary mismatches in its receipts and expenditure. Currently this gap is met by overdraft facilities from Jammu & Kashmir Bank, at an average interest rate of 14 per cent. Over the years this has assumed the character of a structural deficit, rather

than a temporary facility to bridge the short-term mismatch in receipt and expenditure. The State Government has proposed a fiscal reform path wherein it would move towards ways and means regime of the Reserve Bank of India (RBI) and has requested the Commission to provide a revenue gap grant of Rs. 2300 crore to liquidate the existing overdraft with Jammu & Kashmir Bank. We have considered the proposal of the State Government and recommend a fiscal reform grant of Rs. 1000 crore with following mechanism for operationalisation of the proposed fiscal reform path:

- i) The balance amount of the existing overdraft shall be met through market borrowings raised by the State Government, for which Ministry of Finance would give permission, over and above the annual borrowing ceiling of the State Government. While this would mean that the state's allowable fiscal deficit would be greater than the fiscal deficit consistent with the FRL path, as set out in Chapter 9, this is a one-off incentivisation measure which will have long term benefits for fiscal consolidation. Hence, we would recommend that this amount not be taken into account when calculating the state's FRL-consistent fiscal deficit.
- ii) A Committee with representatives from Ministry of Finance, RBI and Government of Jammu & Kashmir shall be set up by the MoF to operationalise the alternate ways and means arrangements.
- iii) This mechanism should be operationalised, preferably within 2010-11. However it may be extended by one year, i.e., till 2011-12, beyond which the grant would not be available.
- iv) Ways and Means facility of RBI, as modified from time to time, shall be applicable to the State Government in terms of limits, interest rate, over-drafts etc. RBI may supervise and monitor the scheme for compliance with the provisions.
- v) The state shall raise market borrowings and liquidate 50 per cent of the outstanding

overdraft and inform the Ministry of Finance. The Ministry shall then release the grant of Rs. 1000 crore provided for this purpose. In case the market borrowing is raised in tranches, the grant shall be released in equal proportions.

- vi) If at any stage the State Government violates the WMA/OD (Ways and Means Advance/Overdraft) limits as applicable, the fiscal reform grant to that extent shall be considered as NPRD grant. Consequently, the NPRD grants to the state will decrease by that amount.

#### *Legislative Complex, Jammu*

12.178 The Government of Jammu & Kashmir has, in its memorandum, stated that the existing State Legislative building is located within the Civil Secretariat complex in Jammu and that there is pressing need for a new, modern legislative complex at Jammu. The government has requested a grant of Rs. 50 crore for its construction. We recommend this grant.

#### *Mubarak Mandi, Jammu*

12.179 During the visit of the Commission to Jammu, the State Government highlighted the importance of the cultural heritage of Mubarak Mandi and the heritage tourism potential of the site. We recommend a grant of Rs. 50 crore for conservation and restoration of these heritage buildings.

#### *Protection and Reinforcement of Tawi River, Jammu*

12.180 The State Government has requested funds for protection and reinforcement of the Tawi front to protect the river from pollution, improve drinking water supply and prevent damage to property during floods. We recommend a grant of Rs. 25 crore in this regard.

#### *Construction of PSC Building, Srinagar*

12.181 The Public Service Commission (PSC) has a building at Jammu but is housed in temporary

accommodation in Srinagar. As requested by the State Government, we recommend Rs. 15 crore for construction of the PSC building at Srinagar.

*Wullar Lake, Kashmir*

12.182 In its memorandum the Government of Jammu & Kashmir has stated that Wullar Lake is the biggest fresh water lake in Asia and the first 'Ramsar' site declared in the state. Funds have thus been sought for management of intervention measures for the lake. We recommend an amount of Rs. 120 crore for this purpose.

*Road Connectivity in Kargil District, Ladakh*

12.183 Funds have been requested for upgradation of existing roads and new road connectivity in the remote areas of Kargil District. We recommend a grant of Rs. 20 crore to meet this requirement

*Upgradation of Power Distribution Network in Leh District*

12.184 The power distribution network in Leh District was laid more than three decades ago and since then no renovation/modernisation has been carried out. It was reported that the region has not had access to Accelerated Power Development and Reforms Program (APDRP) funds. For the purpose of renovation and modernisation of transmission and distribution system in Leh District, we recommend an amount of Rs. 15 crore, as sought by the State Government.

*Sports Complex and Youth Hostel, Leh*

12.185 The state has sought funds for construction of an ice hockey rink and other sports facilities for overall development of the youth. We recommend an amount of Rs. 20 crore for the ice hockey rink, including its roofing and other associated works and for an archery stadium, as well as a multipurpose hall for other sports.

*Cold Storages and Marketing Facilities for Agricultural and Horticultural Products in Leh*

12.186 The State Government has highlighted that the agriculture season is very short, with most of

the agricultural produce flooding the market between June and August, but that there are no storage facilities and modern markets to ensure optimal utilisation of the produce. The state has sought funds for setting up of cold storage units at Leh, Khamti and Nubra, as well as construction of godowns for storage of grains, setting up of vegetable cellars and promoting vegetable processing units. We recommend an amount of Rs. 15 crore for this purpose.

*Bridges in Leh District*

12.187 Road connectivity is one of the major issues in this region due to its harsh terrain and there is pressing need for some bridges. We recommend a grant of Rs. 15 crore for construction of bridges.

*Tourism*

12.188 We recommend a grant of Rs. 5 crore for development of eco-tourism in the Leh to benefit the local people, meet their economic needs and guarantee long term conservation of wildlife .

## **Jharkhand**

*Construction of Anganwadi Centres*

12.189 The supplementary memorandum from the Government of Jharkhand indicates that 20,000 Anganwadi centres in the state do not have proper buildings, which adversely affects the delivery of services at these centres. While the state is utilising its available funds, including those from Backward Regions Development Fund (BRGF) and Rural Infrastructure Development Fund (RIDF), it has requested Rs. 432 crore for construction of 10,000 centres. Given the importance of early childhood care, we recommend the amount sought for this purpose.

*Police Training*

12.190 In view of the importance of adequate training for police personnel, especially in the context of extremist problems, the State Government has requested grants for establishment of a Jharkhand Police Academy, upgradation of the Jungle Warfare School and for

enhancing capacity of the Constable Training School at Padma. We support these initiatives of the State Government and recommend grants as follows:

		(Rs. crore)
a) Jharkhand Police Academy	:	14
b) Upgradation of Jungle Warfare School	:	29
c) Constable Training School	:	30
<b>Total</b>	<b>:</b>	<b>73</b>

#### *Police Housing*

12.191 The State Government has proposed integrated police colonies to provide family accommodation to the police force posted in extremist-affected areas. We recommend a grant of Rs. 225 crore for this purpose.

#### *Construction of ITIs*

12.192 The state currently has 20 ITIs, including six for women. It has requested funds for establishing additional ITIs. We recommend a grant of Rs. 200 crore to set up 20 new ITIs. Preference may be given to the 10 districts of the state affected by Left Wing extremism.

#### *Heritage Conservation*

12.193 The state has identified 18 sites to conserve and develop monuments and antiquarian remains. It has also proposed to construct heritage galleries for the benefit of tourists as well as the local people. We recommend a grant of Rs. 100 crore for this purpose.

#### *Upgradation of Block Level Infrastructure*

12.194 The state's supplementary memorandum has pointed out the gap in infrastructure in 260 blocks where there is shortage of proper office buildings and staff quarters. We recommend a grant of Rs. 270 crore for construction of these buildings.

#### *Development Scheme for PTGs*

12.195 The state memorandum has mentioned that there are nine Primitive Tribal Groups (PTGs) in the state. Among other things, the State Government has projected a requirement of

additional hostels and vocational institutes for students from the PTGs. We recommend a grant of Rs. 125 crore for this purpose.

### **Karnataka**

#### *Restoration of Tanks and Traditional Water Bodies*

12.196 The State Government has sought assistance to rehabilitate more than 30,000 minor irrigation tanks which are not covered under the existing rehabilitation projects. This initiative will support irrigation and drinking water, while also improving ground water levels. We recommend an amount of Rs. 350 crore for this purpose.

#### *Drinking Water*

12.197 The State Government has sought assistance for addressing water quality problems in more than 5800 localities with fluoride-affected water supply and over 300 habitations with arsenic contaminated water supply. The State Government has requested for support, supplementary to the regular funding under the Accelerated Rural Water Supply Programme. We recommend an amount of Rs. 300 crore for this purpose.

#### *Infrastructure in Bengaluru*

12.198 Bengaluru is one of India's fastest growing cities and is consequently experiencing immense pressure on its civic infrastructure. Substantial investments are required for water supply, sewerage, solid waste management, roads, storm water drainage, roads, street lighting, etc. As proposed by the State Government, we recommend support for the following initiatives:

- i) Upgrading and investment in solid waste management infrastructure - Rs. 200 crore.
- ii) Upgrading and investment in traffic management infrastructure for developing parking areas and junctions improvements - Rs. 200 crore.

#### *Heritage*

12.199 We support the State Government's request

for grants to protect the large number of monuments and buildings reflecting the state's heritage and recommend an amount of Rs. 100 crore on this account.

#### *Police Training*

12.200 The State Government has requested support for setting up range-level and district-level police training schools all over the state to create additional capacity for training its police personnel. We recommend Rs. 150 crore for this purpose.

### **Kerala**

#### *Upgradation of the Police Department*

12.201 To enhance the efficiency and effectiveness of the Police Department, the State Government has sought support for providing Community Police Resource Centres, Tourist Protection and Police Assistance Centres, Senior Citizens Protection Schemes, Foreigner Facilitation Centres and construction of dormitories for policemen. We recommend an amount of Rs. 100 crore in this regard.

#### *Inland Waterways*

12.202 The State Government has sought assistance for development of inland waterways and coastal zone management, including reformation and construction of sea walls. We propose an amount of Rs. 200 crore for this purpose.

#### *Primitive Tribal Groups*

12.203 An amount of Rs. 148 crore has been requested for development of primitive tribal groups in Kerala through additional interventions in the health, soil conservation, primary education, drinking water and nutrition sectors. We recommend the allotment of this amount.

#### *Health Infrastructure*

12.204 In order to enhance infrastructure in government hospitals, the State Government has requested an amount of Rs. 198 crore for setting up Trauma Care units, strengthening diagnostic

facilities, providing geriatric care and for disposal of bio-medical waste. We recommend this amount for the purpose of improving the health infrastructure in the state.

#### *Fisheries*

12.205 The State Government has sought support for development of the fisheries sector, including construction of model fishing villages, provision of drinking water, setting up fish marketing centres, constructing fishing schools, etc. We recommend an amount of Rs. 200 crore for this.

#### *Upgradation of Prisons*

12.206 The State Government has sought support for improving facilities in prisons and providing vocational training to prisoners. Installation of solar lighting systems in the prisons is also proposed. We recommend a grant of Rs. 154 crore for this purpose.

#### *Animal Husbandry*

12.207 Support has been sought to strengthen the animal husbandry sector, including constitution of hi-tech dairy complexes, a commercial layer farm and setting up of a pharmaceutical production unit. We recommend an amount of Rs. 150 crore for this.

#### *Water Bodies*

12.208 The State Government has sought support for restoration of tanks through desilting, repairing sluices and constructing retaining structures. We recommend a grant of Rs. 50 crore on this account.

#### *Kuttanad Development*

12.209 State Government has sought support for implementing the Kuttanad Development package which aims at strengthening the ecological security of the Kuttanad wetland eco-system. We recommend a grant of Rs. 300 crore for this purpose.

### **Madhya Pradesh**

#### *Construction of Anganwadi Centres*

12.210 The Government of Madhya Pradesh has

drawn attention to the large number of Anganwadi Centres without their own buildings in the state. In view of the importance of these centres for tackling malnutrition and the problems of adolescent girls and mothers, we recommend a grant of Rs. 400 crore for Anganwadi buildings. Priority may be given to areas with high proportion of tribal and SC population as well as other areas with high rates of malnutrition.

#### *Development of Tourism*

12.211 The state memorandum has submitted details of requirements of the Government of MP in view of the recent growth in tourism in the state. We are, however, not inclined to support items involving recurring costs, such as publicity and promotion and the Statistical Cell, included in the proposal. We, therefore, recommend a grant of Rs. 180 crore for the tourism sector.

#### *Police Training*

12.212 Given the large number of untrained police personnel, the State Government has asked for grants in order to upgrade five police training centres in the state and to establish a new basic constable school at Sagar in line with the standards and norms of the Bureau of Police Research and Development. We recommend a grant of Rs. 180 crore for this purpose.

#### *Conservation of Heritage*

12.213 Madhya Pradesh has a large number of heritage sites, including three world heritage sites. The State Government has requested a grant for conservation, development and management of heritage. We recommend a grant of Rs. 175 crore for this purpose. Priority may be given to the large number of monuments which have not received any funds so far.

#### *Health Infrastructure*

12.214 The State Government has represented for a grant for critical health infrastructure in the state. In order to improve the delivery of health care

system in the state, we recommend a grant of Rs. 250 crore as follows:

(Rs. crore)	
Details of Activity	Amount
Pediatric Intensive Care Unit for District Hospitals @ Rs. 40 lakh each	20.00
100 Nutritional Rehabilitation Centres (NRCs) for block level institutions, including cost of construction for a 20-bed Children's Ward @ Rs. 15 lakh each	15.00
Casualty wing including trauma unit for district hospitals @ Rs. 125 lakh each	125.00
Microbiology Laboratory for district hospitals @ Rs. 15 lakh each	15.00
Maternity wings in district hospitals @ Rs. 15 lakh each	75.00

#### *Establishment of Virology Laboratory at Gandhi Medical College, Bhopal*

12.215 In its supplementary memorandum the Government of Madhya Pradesh has presented a proposal for setting up a Virology Laboratory in the state to identify causative viruses and plan appropriate lines of treatment. We recommend a grant of Rs. 24 crore to establish such a laboratory.

#### *Upgradation of MTH Hospital, Indore*

12.216 Funds have been requested to upgrade the hundred year-old MTH Hospital in Indore, which provides safe motherhood and institutional child birth. We recommend a grant of Rs. 22 crore to increase the number of beds from 65 to 300.

### **Maharashtra**

#### *Construction of Anganwadi Centres*

12.217 The State Government has noted that about 35,000 Anganwadis do not have buildings of their own, which affects the quality of services. We recommend an amount of Rs. 300 crore for construction of new buildings.

#### *Anti-Sea Erosion Measures*

12.218 The State Government has sought support for taking up 110 anti-sea erosion bund works in six districts. We recommend an allocation of Rs. 205 crore for this purpose.

*Development of Roads in Difficult Areas*

12.219 The State Government has sought support for construction of roads in remote areas in their districts which are not being covered by the Border Roads Organisation. We recommend an amount of Rs. 200 crore on this account.

*Police Training*

12.220 State Government has sought assistance for enhancing police training facilities through upgradation of its various police training schools as well as the police academy and detective training schools in the state. We recommend a grant of Rs. 223 crore as proposed in this regard.

*Heritage Conservation*

12.221 To protect and conserve various sites, including forts and monuments which are under the care of the State Government, an amount of Rs. 100 crore has been sought. We recommend that this amount be provided.

*Prison Department*

12.222 Funds have been sought by the State Government for upgradation of facilities in prisons and improvement in prison security. We propose a grant of Rs. 60 crore for this purpose.

*Food Testing Labs*

12.223 As requested by the State Government, an amount of Rs. 32 crore is allocated for setting up of food testing laboratories at six divisional headquarters.

*Strengthening Industrial Training Institutions*

12.224 There are 407 ITIs in the state, many of which were established more than 40 years ago. A number of them have not been modernised since then. We recommend a sum of Rs. 115 crore for strengthening these ITIs through additional infrastructure and replacement of machinery.

**Manipur**

*Development and Maintenance of Kangla Fort*

12.225 In its memorandum submitted to the

Commission, the Government of Manipur has highlighted the importance of Kangla Fort, Imphal as the epicentre of the history and culture of the state. In response to this request, we recommend a grant of Rs. 8 crore for the development of Kangla Fort.

*Renovation and Maintenance of Raj Bhavan*

12.226 The state has drawn our attention to the fact that the present Raj Bhavan Complex was constructed in 1898. In view of its structural design, maintenance of the building is a difficult task. The State Government has sought an amount of Rs. 10 crore for renovation to ensure that the heritage building is maintained for future generations. We recommend this grant.

*Upgradation of Manipur Police Training School (Pangei) to Manipur Police Training College (MPTC)*

12.227 It has been stated in a supplementary memorandum received from the state that Manipur State Police has only a police training school catering to basic training of constable/riflemen recruits and that there is no capacity to impart basic training or in-service training to other police personnel. The State Government has sought funds to improve training capability for the police force in the state. Given the security scenario in the state and the importance of police training, we recommend a grant of Rs. 84.00 crore for this purpose.

*Infrastructure for Police Stations in Rural and Remote Areas*

12.228 The State Government has sought funds to strengthen police infrastructure in remote and rural areas, the State Government has proposed nine new police stations. We recommend a grant of Rs. 23 crore for this purpose.

*Border Area Development*

12.229 The State Government has sought funds for improvement and upgradation of internal roads, sewerage and drainage, water, street lighting and basic urban amenities at Moreh, a small urban

pocket in the hill district of Chandel along the international border. We recommend a grant of Rs. 25 crore for this purpose.

#### *Special Upgradation Grants for Sports*

12.230 In the supplementary memorandum submitted by the state, attention has been drawn to the consistently outstanding performance by sportspersons from Manipur at the national/international level. The State Government has received grants from both FC-XI and FC-XII for upgradation of the main sports complex at Imphal. The state has sought a further amount of Rs. 100 crore for maintenance of its ten year-old infrastructure in line with international standards. We recommend this grant, keeping in view the contribution of the state to national achievements in sports.

#### *Infrastructure for Autonomous District Councils*

12.231 The State Government has indicated that the delimitation exercise for the district councils has been completed and that preparations for elections in the state are underway. Once the autonomous district councils (ADCs) are constituted, there would emerge huge demand for administrative infrastructure. The state has sought an amount of Rs. 51 crore for construction of this infrastructure. Keeping in view that the Manipur (Hill Areas) District Councils (Third Amendment) Act, 2008 has been passed by the Manipur Legislative Assembly, in October 2008, with the objective of strengthening the councils, we recommend the amount sought by the state.

### **Meghalaya**

#### *Setting up of the Meghalaya Police Academy*

12.232 The Government of Meghalaya has sought funds to strengthen its infrastructure for training of police personnel by setting up the Meghalaya Police Academy. We recommend an amount of Rs. 50 crore for this purpose.

#### *Augmentation of Tura Phase I & II Water Supply Schemes*

12.233 The state has submitted that Tura Phase I

and II Water Supply schemes were formulated in 1970 and 1980 respectively and that the sources for these have been depleted over the years. In view of the rapid expansion of towns in Tura district, the State Government has proposed an augmentation scheme to provide safe and adequate water supply to all households. We recommend an amount of Rs. 50 crore for the scheme.

#### *Heritage and Tourism*

12.234 The state has sought an amount of Rs. 25 crore for protection, preservation and development of heritage sites, museums and buildings, including survey, research and documentation activities. The state has some of the longest and deepest caves in the subcontinent and has requested Rs. 5 crore for development of cave tourism. We recommend an amount of Rs. 30 crore for preservation of heritage as well as cave tourism.

#### *Infrastructure for Horticulture*

12.235 The state has petitioned for funds for upgradation of its existing infrastructure to promote expansion in horticulture, including traditional horticulture and plantation crops. We recommend an amount Rs. 38 crore in this regard.

#### *Warehousing Facilities*

12.236 As requested by the State Government, we recommend Rs. 2 crore for construction of warehouses at Tura and Baghmara of West Garo Hills and South Garo Hills District, respectively, for storage of essential commodities.

#### *Construction of Bridges*

12.237 The State Government has highlighted that there are a large number of semi-permanent timber bridges (SPTs) which often collapse during monsoon season and require frequent maintenance. The state has sought a grant for the purpose of converting 4.22 kilometres of SPTs into two-lane reinforced cement concrete bridges. We recommend an amount of Rs. 80 crore for this purpose.

## Mizoram

### *Sainik School*

12.238 The Government of Mizoram has highlighted the importance of a Sainik School for Mizoram to enhance the scope of students from the state joining the Defence Services. Currently, the state shares a Sainik School with Manipur, located in Imphal. We recommend an amount of Rs. 50 crore for a Sainik School in Mizoram.

### *Construction of Raj Bhavan*

12.239 Based on a request from the state, we recommend a grant of Rs. 30 crore for construction of a new Raj Bhavan.

### *Construction of Jails*

12.240 The state has highlighted lack of capacity to accommodate inmates in its prisons and has requested assistance for completion of three new district jails and two sub-jails. We recommend an amount of Rs. 30 crore for this purpose.

### *Infrastructure Schemes for the Three Autonomous District Councils*

12.241 The state has sought amounts of Rs. 5.80 crore, Rs. 7.91 crore and Rs. 11 crore for construction of the respective secretariat/office buildings for Mara ADC, Lai ADC and Chakma ADC. We recommend a grant of Rs. 25 crore for these upgradation works.

### *Construction of Playground in Khatla Village, Aizawl*

12.242 The state has submitted a proposal for construction of a playground in Khatla Village for the promotion of sports and culture among the youth, as well as for social purposes and has sought funds for this purpose. We recommend an amount of Rs. 2 crore for the playground.

### *Construction of Police Station Buildings in Border Areas*

12.243 The State Government has sought funds for construction of 24 police stations, along with

residential quarters and 15 police outposts in the border areas. We recommend a grant of Rs. 31 crore for this purpose.

### *Construction of Primary Health Centres and Health Sub-Centres*

12.244 The State Government has highlighted the need to construct proper buildings for PHCs and SCs. We recommend an amount of Rs. 30 crore for construction of 15 PHCs and 150 sub-centres along with staff quarters.

### *Fire and Emergency Services*

12.245 In response to the State Government's memorandum, we recommend an amount of Rs. 20 crore for building new fire stations to revamp the fire and emergency services in the state.

### *Construction of Additional Building for Civil Secretariat*

12.246 In view of the need for increased office space in the new Capital complex, we recommend a grant of Rs. 20 crore for construction of additional buildings for the Civil Secretariat.

### *Heritage Conservation*

12.247 The State Government has sought an amount of Rs. 7 crore for transforming the residence of the late chief of Hliappui village, handed over to the government, into a heritage centre by construction of an auditorium and public library in the vicinity of the building. Further, the state has requested funds for improving connectivity to the existing heritage places which are located at some distance from the villages or main roads. We recommend a grant of Rs. 12 crore for these works.

## Nagaland

### *Social Welfare*

12.248 The state has sought funds for establishment of Blind Schools and Vocational Training Centres for differently-abled persons. We recommend a grant of Rs. 30 crore on this account.

*Police Infrastructure*

12.249 In view of the shortage of police housing pointed out by the State Government, we recommend an amount of Rs. 100 crore for construction of Type-I units for lower functionaries of the police department in remote areas.

*Health*

12.250 The state has sought an amount of Rs. 72.20 crore for construction of staff quarters for PHCs, CHCs and SCs in rural areas. We recommend an amount of Rs. 30 crore for construction of staff quarters for PHCs and SCs.

*Tourism*

12.251 We recommend an amount of Rs. 35 crore against the state's request for a grant for development of rural tourism across 30 destinations.

*Development of Horticulture*

12.252 As requested by the State Government, we recommend Rs. 20 crore for construction of warehouses for storage as well as development of horticulture markets in the state.

*Development of Border Areas*

12.253 The state has highlighted that the villages along the international boundary have fallen behind the rest of the state in terms of connectivity, basic health care facilities, potable water supply and other infrastructural facilities and has sought funds to bridge these gaps. We recommend an amount of Rs. 35 crore to develop roads and to provide clean drinking water in the border areas.

**Orissa***Consolidation and Strengthening: Echo Restoration of Chilika Lake*

12.254 Chilika Lake in Orissa is the largest brackish water lagoon in Asia. Past Commissions, including FC-XII, have provided grants for undertaking various works related to the lake. The Government of Orissa has requested funds for various works,

including participatory watershed management, bio-diversity conservation and an outreach programme. Given the importance of the lake eco-system, we recommend an amount of Rs. 50 crore for works related to Chilika Lake.

*Construction of Anganwadi Centres*

12.255 The Government of Orissa has reported that over 24,000 Anganwadi centres in the state do not have their own buildings. Given the critical role of Anganwadis in improvement of nutrition, child health and reproductive services, we recommend that an amount of Rs. 400 crore be provided for construction of the centres, with priority to the tribal areas of the state.

*Upgradation of Health Infrastructure*

12.256 The State Government has requested funds for upgradation of health infrastructure as follows:

- i) The state memorandum draws attention to large gaps in provision of buildings and staff quarters for sub-centres and PHCs and has requested a grant for this purpose. We recommend a grant of Rs. 275 crore with the proviso that the state makes a concerted effort to fill all gaps in the tribal districts of the state.
- ii) The State Government has also requested funds for additional buildings in the three existing medical colleges. We recommend a grant of Rs. 75 crore for this purpose.

*Incentive Grant for Development and Upgradation of the Distribution System*

12.257 The state has represented that it had not received adequate support in its pioneering effort in terms of a radical reform programme involving private sector participation in power distribution. Agricultural power consumption in Orissa is extremely low at only 2 per cent of the total power consumption in the state. The State Government has proposed an investment plan of Rs. 1000 crore to strengthen its power distribution, to be shared between the State Government (Rs. 200 crore), Gridco (Rs. 147 crore) and the various Discoms (Rs.

153 crore) and has requested a Finance Commission grant of Rs. 500 crore towards this programme. Given the need to strengthen the distribution system in the state, we recommend the grant as sought by the State Government, on the condition that the remaining Rs. 500 crore is contributed by the State Government, Gridco and the Discoms in equal proportion.

#### *Police Training*

12.258 Based on proposals from the State Government, we recommend the following amounts for police training in the state:

i) Establishment of a basic training school for civil police at Byree, Jagpur District	Rs. 20 crore
ii) Establishment of a basic training school for armed police at Burla, Sambalpur District	Rs. 30 crore
iii) Establishment of a new anti-extremist training school at Koraput/Rourkela	Rs. 20 crore
<b>Total</b>	<b>Rs. 70 crore</b>

#### *Upgradation of Jails*

12.259 The State Government has drawn the Commission's attention to overcrowding in jails and the need for upgradation of security of jails in view of the extremist problem in the state. We recommend that Rs. 100 crore be given for this purpose. Besides additional fortifications and security measures, the state should also use this amount to ensure better amenities to prisoners, such as improvement in sanitation, water-supply and medical care.

#### *Preservation of Monuments and Buddhist Heritage*

12.260 The state has a large number of ancient heritage structures which require conservation. These include a large number of Buddhists heritage sites. Previous Commissions have provided grants for conservation work which the State Government has found useful. We recommend Rs. 65 crore for this purpose.

#### *Fire Services*

12.261 The state memorandum has highlighted the enormous gap in provision of fire services in the state, based on which, we recommend an amount of Rs. 150 crore for this purpose. The state should ensure that part of this fund is utilised to upgrade the fire service training institution and to provide training to fire service personnel.

#### *Establishment of Market Yards at the Block Level*

12.262 The state has requested a grant for construction of 150 market yards to provide an efficient marketing structure at the block level. We find this a useful intervention and recommend a grant of Rs. 60 crore for this purpose.

### **Punjab**

#### *Measures to Improve Adverse Sex Ratio*

12.263 The Government of Punjab has requested support for various programmes to improve the adverse sex ratio in the state. We consider this as an extremely critical intervention and recommend a grant of Rs. 250 crore.

#### *Development of Kandi Areas*

12.264 The state has requested support for development of Kandi areas, including funds for maintenance of infrastructure constructed earlier and measures for soil conservation and water harvesting. We propose an amount of Rs. 250 crore for this.

#### *Border Areas*

12.265 The state has sought support for upgradation and maintenance of infrastructure in areas along the international border. It has sought assistance to upgrade power and road connectivity and health infrastructure, as well as to provide water supply and sanitation. We recommend an amount of Rs. 250 crore for this purpose.

#### *Irrigation*

12.266 The State Government has requested support to strengthen the irrigation infrastructure

in the state, in terms of maintenance and repairs, flood control works and measures to address the problem of water logging in the south-west districts of the state. We recommend an amount of Rs. 200 crore to upgrade the irrigation infrastructure and another Rs. 200 crore to address the problems in water-logged areas.

#### *Police Training*

12.267 The state has sought support for upgrading training facilities for police personnel. We propose an amount of Rs. 200 crore for this purpose.

#### *Heritage*

12.268 The State Government has sought support for protection and maintenance of historical monuments and archaeological sites. We propose an amount of Rs. 100 crore for this purpose.

#### *Support to EC's Initiative towards Capacity Building*

12.269 The Empowered Committee of State Finance Ministers (EC), in its letter to the Commission on 16 December 2009, has requested support for research capacity building and establishment costs, to be routed through the Government of Punjab on behalf of all states. The EC is playing a pivotal role in the introduction of the Goods and Service Tax and requires all possible assistance. We recommend a grant of Rs. 30 crore to the Punjab Government which would be earmarked for support to the Empowered Committee of the State Finance Ministers for the activities stated above.

### **Rajasthan**

#### *Drinking Water*

12.270 The Commission has sanctioned grants for strengthening the drinking water infrastructure in the state through:

- i) Rehabilitation and expansion of the water distribution system.
- ii) Replacement of old machinery.
- iii) Addressing fluoride nitrate, salinity and iron-affected areas.

Given the criticality of this requirement, we propose that an amount of Rs. 500 crore be allocated for these projects, of which Rs. 100 crore be allocated to border districts.

#### *Irrigation*

12.271 The state has sought support for the 60 pending irrigation projects which could be completed within the next three years. Given the substantial area which will thus be brought under irrigation, we propose an amount of Rs. 300 crore for this purpose.

#### *Public Health Infrastructure:*

12.272 The state has sought support for strengthening infrastructure in public hospitals, including diagnostic equipment and generators. We recommend an amount of Rs. 150 crore for this purpose.

#### *Highways*

12.273 The State Government has requested support for upgrading and improvement of those state highways and minor district roads which are not being taken up by other programmes. We recommend an amount of Rs. 150 crore for this.

#### *Training of Police, Prison Personnel and Home Guards*

12.274 The State Government has sought assistance for strengthening training infrastructure for various departments such as police, jails, home guards and civil defence. We propose an amount of Rs. 100 crore for this purpose.

### **Sikkim**

#### *Development of Tourism*

12.275 In view of the importance of tourism for the state's economy, the Government of Sikkim has sought grants for promotion of tourism as follows:

- i) The state has highlighted their project for the construction of a 'sky walk' at Bhaley Dung, South Sikkim. It has been argued that this will be the first of its kind in the country. It

is expected to be a major tourist attraction as it would be exciting to walk over transparent glass overlooking the skies below, at a height of almost 5000 ft. The project would, thus, have a major impact on infrastructure development and enhance commercial activities in the state. We recommend a grant of Rs. 200 crore, while urging the State Government to ensure that the fragile ecosystem in the region is not disturbed in the course of implementation of the project.

- ii) The second project highlighted by the state relates to development of village tourism and requires funds for improvement of village surroundings, connectivity and the natural attractions in rural areas. We recommend an amount of Rs. 80 crore for this purpose.

*Repair/ Renovation of Suspension Foot Bridges under North District of Sikkim*

12.276 The state memorandum has highlighted the need for replacement of old and dilapidated timber bridges by steel members as well as replacement of old cables and suspenders. Since, these bridges ensure connectivity of villages in remote and backward areas, we recommend a grant of Rs. 35 crore, as sought by the State Government.

*Water Security and Public Health Engineering*

12.277 The state has requested funds for upgradation of the Namchi Water Supply Scheme, overhauling of the Lower Changay Source for Gyalshing Water Supply and Rabdentse Water Supply Scheme. It has stated that these schemes will take care of drinking water supply in two districts of South and West Sikkim. We recommend Rs. 20 crore for this purpose.

*Police Training and Infrastructure*

12.278 Grants have been sought by the State Government for police training and infrastructure as follows:

- i) The state has sought funds to set up a police training centre at Yangang in order to

augment this training capacity, including additional residential accommodation and equipments. We recommend a grant of Rs. 10 crore for this purpose.

- ii) The State Government has also represented shortage of both residential and non-residential buildings for the police force. We recommend a grant of Rs. 15 crore for this purpose.

*Border Area Development*

12.279 For development of its border areas, the State Government has requested funds as per the following requirements:

- i) The state has sought grants of Rs. 6 crore to create additional storage facilities for essential commodities since the transportation of these commodities has often been disrupted upon closure of the National Highway due to unavoidable circumstances. We recommend the amount sought by the State Government.
- ii) The state has emphasised the need to reinforce the existing security infrastructure along both domestic and international borders by creating new monitoring checkpoints, improving road transport links, strengthening security equipments, etc. We recommend that a grant of Rs. 15 crore be given to the state towards this end.

*Establishment of State Capacity Building Institute*

12.280 For the purpose of imparting training, facilitating transfer of knowledge and building and developing the potential capacities of unemployed youth, the state has proposed setting up of a Capacity Building Institute at Burtuk. In order to enable the state to help the youth gain knowledge and skills for various career options, we recommend a grant of Rs. 10 crore as sought by the State Government.

*Conservation of Heritage and Culture of Sikkim*

12.281 The State Government has stated that a number of monuments have been conserved with the grant provided by FC-XII and has sought grants

for conservation of the remaining monuments in the state. We recommend a grant of Rs. 9 crore in this regard.

## **Tamil Nadu**

### *Slum Improvement*

12.282 Tamil Nadu is the most urbanised state in the country. The State Government has requested support for its effort to progressively cover the entire slum population in the state in terms of housing, drinking water, nutrition and education. We recommend an amount of Rs. 300 crore towards this end.

### *Coastal protection*

12.283 To protect the long coastline of the state from sea erosion, the State Government has proposed to take up anti-sea erosion measures in nine districts. These include construction of groyne fields, rubble mound sea walls and training walls on river mouths. We recommend a grant of Rs. 200 crore for this purpose.

### *Marine Discharge Project*

12.284 The State Government has sought support to implement the Marine Discharge Project as a permanent solution to effluent discharge from the bleaching, dyeing and processing units of the state. We allocate an amount of Rs. 200 crore for this project. It is expected that the textile industry and the State Government will also share the costs of the project.

### *Traditional Water Bodies*

12.285 The government has sought support to take up works for restoring 525 water bodies in the state, which are not covered by other programmes. These tanks require desilting and strengthening of bunds and sluices. They will contribute to drinking water security, while also raising the ground water level. We recommend an amount of Rs. 200 crore for works related to these water bodies.

### *Heritage Conservation*

12.286 The State Government has sought support for renovation and maintenance of ancient temples

of historical importance, which reflect the state's heritage. We recommend a grant of Rs. 100 crore in this regard.

### *Health Infrastructure*

12.287 The State Government has sought support for provision of health and infrastructure in public hospitals, including construction of health centres and water analysis laboratories and purchase of diagnostic equipments. We allocate an amount of Rs. 200 crore for this.

### *Police Training*

12.288 The State Government has requested support for strengthening infrastructure facilities to provide training to its police personnel. We recommend an amount of Rs. 100 crore for this purpose.

## **Tripura**

### *Police Training*

12.289 The Government of Tripura has sought funds to establish a police academy to meet the training needs of police personnel in the state, including training needs for counter-insurgency. At present the State Government has to send large numbers of its police personnel for training to other states at considerable cost. Given the importance of police training, we recommend a grant of Rs. 10 crore to establish a police academy in the state.

### *Construction of Battalion Headquarters for Tripura State Rifles*

12.290 The Memorandum indicates that the state has raised 13 Battalions of Tripura State Rifles (TSR) to strengthen the police force, as well as to tackle the insurgency problem. Five of these battalions do not have proper headquarters. The State Government has requested a grant to construct headquarters comprising an administrative block, barracks, staff quarters and other buildings for these battalions. In order to strengthen the security forces in the state, we recommend a grant of Rs. 75 crore.

*Development of Infrastructure for Zonal Offices under Autonomous District Council*

12.291 The Tripura Tribal Autonomous District Council (TTADC) is spread over all four districts of the state, with zonal headquarters in each of the districts. The State Government has requested a grant to develop zonal offices for the TTADC. In view of the need to provide proper outreach for the Council in all four districts, we recommend Rs. 20 crore for development of infrastructure in its four zonal offices.

*Construction of Drainage System in Agartala*

12.292 It has been stated in a supplementary memorandum received from the state that the city of Agartala suffers from periodic floods due to lack of a storm water drainage system. Several areas of the city are situated such that gravity discharge into the surrounding rivers is severely hindered. The State Government has requested funds for construction of about 3 lakh metres of drains and pumping stations. In our view, this would be a worthwhile investment to improve health and sanitation in the city and we therefore recommend a grant of Rs. 200 crore. However, the cost of electricity for pumping may not be borne by this grant.

*Technical Education*

12.293 The State Government has sought a grant for setting up of four polytechnic institutions in the Schedule VI Areas at Khumulwng, Ambassa, Bagbassa and Fulkumari. The MHRD has already provided certain grants for the polytechnic at Fulkumari and we see no merit in providing another source of funds for it. In order to promote technical education in TTADC areas, we recommend a grant of Rs. 75 crore for the three polytechnics.

*Development of Kok-Borok Language and Culture*

12.294 The main language of the inhabitants of the TTADC area is Kok-Borok. The State Government has sought a grant for development of the language to preserve the linguistic identity of the Tripura tribes. We recommend a grant of Rs. 10 crore for this purpose.

*Development of Maharaja Bir Bikram College (MBBC) Complex at Agartala*

12.295 The State Government has stated that the Maharaja Bir Bikram College (MBBC) at Agartala is not only a premier educational institution of the state, but also an important heritage site. In response to the request from the State Government, we recommend a grant of Rs. 30 crore for conservation and development of MBBC.

*Modernisation of Churaibari Checkpost Complex*

12.296 The State Government has emphasised the need for a modern checkpost on the only National Highway (NH-44) connecting the state at Churaibari. This is expected to have a favourable impact on state revenues. The Commission recommends a grant of Rs. 20 crore for modernising this check post.

*Construction of the New Raj Bhawan*

12.297 The present Raj Bhawan is located in a building constructed more than a century ago. Many parts of this heritage building have now become unfit for use, whereas a portion of this complex has been converted into a public park. The Government of Tripura has identified a site for the new Raj Bhawan at the new capital complex and has requested Rs. 30 crore for its construction. We recommend this amount.

*Improvement of the Prison System*

12.298 The Twelfth Finance Commission had provided Rs. 30 crore in the first phase of the 'prison system improvement project' for construction of a central jail with modern amenities at Bishalgarh. The State Government has requested funds to complete the second phase of this project comprising construction of staff quarters, additional wards and a playground. We recommend Rs. 15 crore, as sought by the state, to ensure that these works are completed.

*Construction of Fire Service Headquarters*

12.299 As requested by the State Government, we recommend Rs. 15 crore for construction of the headquarters of fire services in the state.

## Uttar Pradesh

### *Border Roads*

12.300 The State Government has requested assistance to develop roads along the international border for improvement in connectivity and rapid development. We recommend that an amount of Rs. 250 crore be provided for this.

### *Infrastructure Support to Varanasi*

12.301 The city of Varanasi is a centre of national and international importance for pilgrims and tourists and thus, needs support to improve its infrastructure.

- i) The State Government has sought support for development of ghats and kunds. We recommend a grant of Rs. 45 crore for this purpose.
- ii) The State Government has also requested funds for laying of branch sewer lines to complement the works being undertaken through a JICA (Japan International Cooperation Agency) assisted project in District III of CIS Varuna area of the city. We allocate an amount of Rs. 60 crore for this work.
- iii) Funds have been requested separately to strengthen fire services in the state. We propose a grant of Rs. 20 crore to upgrade the fire and emergency services in Varanasi.

### *Development of Backward Areas*

12.302 Grants have been sought by the State Government for development of backward areas as follows:

- i) *Drought proofing*: The State Government has sought support for drought proofing and strengthening of irrigation facilities in the Bundelkhand region. It proposes to strengthen and restore tanks, build check dams and refurbish tube wells. We recommend an allocation of Rs. 200 crore for this purpose.

- ii) *Improving connectivity*: (a) Support has been requested for improving road connectivity between tehsil and block headquarters and with district headquarters in Bundelkhand region. We propose to allocate an amount of Rs. 150 crore for this purpose. (b) Another proposal has been presented, for connectivity between the block headquarters, tehsil headquarters and district headquarters in the 12 districts of Poorvanchal region. We propose a grant of Rs. 150 crore for construction of these roads.

### *Police Department*

12.303 To enhance the functioning of the police department and strengthen training infrastructure, the State Government sought support for a number of initiatives. We recommend allocations as under:

- i) Support for construction of residential buildings for non-gazetted police officers – Rs. 200 crore.
- ii) Support for strengthening of the present training infrastructure and setting up of new police training centres – Rs. 132 crore.

### *Development of Agricultural Market Yards*

12.304 Given the criticality of agriculture to the state, the State Government has requested support for setting up 2101 agriculture marketing hubs, each of which would provide grain storage, farmer service centres, banks and primary processing units. We support this request and recommend a grant of Rs. 354 crore.

### *Heritage*

12.305 The State Government has requested support for development of museums, conservation of monuments, as well as strengthening of roads connecting important heritage sites. We propose an amount of Rs. 100 crore for this purpose.

### *Upgradation of Civil Service Training Facilities*

12.306 The State Government has proposed to enhance its training facilities by strengthening the

UP Academy of Administration and Management. This includes setting up of a Disaster Management Cell, a centre for good governance and a cell for WTO (World Trade Organization) matters. We propose an amount of Rs. 18 crore for construction of academic, administrative and hostel blocks.

## **Uttarakhand**

### *Sewerage Scheme for Dehradun:*

12.307 The memorandum from the Government of Uttarakhand has highlighted the population pressure on the city of Dehradun after creation of the new state. At present, only a part of the town is covered by the sewerage system. The State Government has sought a grant to cover the entire city. We recommend a grant of Rs. 150 crore for this purpose.

### *Police Training and Upgradation of Police Infrastructure*

12.308 The State Government has sought a grant for construction of a Police Training Centre and construction of administrative buildings for police stations and police outposts. Uttarakhand, being a new state, requires upgradation of police training and infrastructure. We recommend Rs. 20 crore for construction of the Police Training Centre and Rs. 50 crore for construction of police stations and police outposts.

### *Development of Tourism*

12.309 The state has sought funds for construction works for basic facilities like drinking water, accommodation and electrification at various tourist destinations. To improve the facilities for tourists, we recommend Rs. 100 crore for this purpose.

### *Establishment of Five Nursing Training Colleges*

12.310 The State Government has requested Rs. 100 crore for establishing five nursing training colleges in Pithoragarh, Almora, Tehri, Chamoli and Pauri Districts of the state to address the issue of acute shortage of nursing staff in the state, particularly in remote areas. We recommend this grant.

### *Construction of a New Legislative Assembly Building*

12.311 Since Uttarakhand is a new state, it has no Assembly building and the state legislature is functioning from one of the existing office buildings. The State Government has requested a grant of Rs. 88 crore for construction of a new Assembly building. We recommend the amount sought by the state.

### *Development of Culture*

12.312 While highlighting the rich culture and availability of large quantities of artifacts and antiquities in the state, the State Government has proposed the construction of a state level museum at a cost of Rs. 25 crore. It has also requested a grant of Rs. 20 crore for construction of an auditorium for various cultural activities. We recommend a total grant of Rs. 45 crore to meet these requirements.

### *Creation of International Level Sports Complex at Haldwani (Nainital)*

12.313 The state has proposed the construction of an international level sports complex at Haldwani at a cost of Rs. 25 crore, since there is no such facility in the state at present. We recommend the amount sought for this purpose.

### *Upgradation of Uttarakhand Board of Technical Education, Roorkee*

12.314 The state has sought an amount of Rs. 17 crore for construction of a building for establishment of a separate cell for Joint Entrance Examination, Institute of Research, Development and the Training and Board of Technical Education. We recommend the amount sought by the State Government.

### *Border Area Development*

12.315 The state has highlighted the acute shortage of infrastructure for rural development in remote and border areas of the state and has requested a grant for community development-cum-marketing

centres and residential buildings for the Gram Vikas Adhikari and Agriculture Assistant in each Naya Panchayat of the five border districts. We recommend an amount of Rs. 105 crore for this purpose.

## West Bengal

### *Police Training*

12.316 The Government of West Bengal has requested grants for police training as follows:

- i) The State Government has requested a grant for augmentation of training capacity for the West Bengal Police, involving creation of training schools for 1600 additional personnel annually. We recommend a grant of Rs. 91 crore, as sought by the state.
- ii) The State Government has also sought a grant for Subsidiary Police Training Schools for the Kolkata Police to ramp up training facilities for 1500 additional personnel annually. We recommend a grant of Rs. 72 crore for these training schools.

### *Police Housing*

12.317 The state memorandum has drawn the Commission's attention to the acute shortage of residential accommodation for West Bengal and Kolkata police. We recommend a grant of Rs. 90 crore, as requested, for the construction of 2000 housing units.

### *Strengthening of River Embankments*

12.318 The State Government has emphasised that strengthening, along with armouring of the riverside slope of embankments of the most vulnerable portions in the Sunderban region, is essential to prevent damage from tidal floods. During our field visits, the Commission witnessed the damage done to many of the embankments. We recommend a grant of Rs. 450 crore for strengthening of embankments, as well as construction and renovation of drainage structures in the Sunderban region.

### *Upgradation of Fire and Emergency Services*

12.319 Having converted the West Bengal Fire Service Department into the West Bengal Fire and Emergency Department in view of new challenges, the State Government has requested a grant for its upgradation and strengthening. We recommend a grant of Rs. 150 crore to fill the infrastructure and equipment gaps in the Department.

### *Strengthening of Public Health Infrastructure*

12.320 In response to the State Government's request, we recommend a grant of Rs. 300 crore for construction of sub-centres, primary health centres and additions to the sub-divisional and district hospitals in the state.

### *Construction of Anganwadi Centres*

12.321 The State Government has pointed out that over 74,000 Anganwadi Centres in the state do not have their own buildings. We recommend a grant of Rs. 300 crore for construction of Anganwadi Centres.

### *Improvement of Road Infrastructure in Border Areas*

12.322 In a supplementary memorandum, the State Government has drawn our attention to the critical need for better connectivity in blocks on the international border. We recommend a grant of Rs. 150 crore for construction of roads for this purpose.

### *Heritage Conservation*

12.323 It has been indicated to the Commission by the State Government that although the state has numerous historical monuments, museums, archives and archaeological sites, their maintenance needs to be improved. We recommend an amount of Rs. 100 crore on this account.

## General Conditionalities

12.324 In addition to the stipulations prescribed in paras 5.52 and 9.82, the following conditionalities

shall apply with regard to the state-specific grants recommended above:

- i) No funds from any of the state-specific grants may be used for land acquisition by the states. Wherever land is required for the project/construction, such land may be made available by the State Government.
- ii) The phasing of the state-specific grants given in Table 12.6 is only indicative; states may communicate their required phasing to the Central Government. The grant may be released in a maximum of two instalments in a year. However, no grants would be released in 2010-11 except the three grants indicated in the Table.
- iii) Accounts shall be maintained and Utilisation

Certificates (UCs)/Statements of Expenditure (SOE) provided as per General Finance Rules (GFR 2005).

12.325 A statement indicating total transfers to the states is given in Table 12.7.

### Monitoring

12.326 The Twelfth Finance Commission had recommended that a High Level Monitoring Committee headed by the Chief Secretary should review the utilisation of grants on a quarterly basis and take corrective actions as required to ensure proper utilisation of these funds. In our view this committee has served a useful purpose and should be continued in the future to monitor the grants recommended by us.

**Table 12.6: Grants-in-Aid for State-specific Needs**

(Rs. crore)

State	2010-11	2011-12	2012-13	2013-14	2014-15	2010-15
1	2	3	4	5	6	7
Andhra Pradesh	20.00	312.50	312.50	312.50	312.50	1270.00
Arunachal Pradesh	0.00	75.00	75.00	75.00	75.00	300.00
Assam	0.00	150.00	150.00	150.00	150.00	600.00
Bihar	0.00	461.25	461.25	461.25	461.25	1845.00
Chhattisgarh	0.00	320.25	320.25	320.25	320.25	1281.00
Goa	0.00	50.00	50.00	50.00	50.00	200.00
Gujarat	0.00	325.00	325.00	325.00	325.00	1300.00
Haryana	0.00	250.00	250.00	250.00	250.00	1000.00
Himachal Pradesh	0.00	87.50	87.50	87.50	87.50	350.00
Jammu & Kashmir	1000.00	87.50	87.50	87.50	87.50	1350.00
Jharkhand	0.00	356.25	356.25	356.25	356.25	1425.00
Karnataka	0.00	325.00	325.00	325.00	325.00	1300.00
Kerala	0.00	375.00	375.00	375.00	375.00	1500.00
Madhya Pradesh	0.00	307.75	307.75	307.75	307.75	1231.00
Maharashtra	0.00	308.75	308.75	308.75	308.75	1235.00
Manipur	0.00	75.25	75.25	75.25	75.25	301.00
Meghalaya	0.00	62.50	62.50	62.50	62.50	250.00
Mizoram	0.00	62.50	62.50	62.50	62.50	250.00
Nagaland	0.00	62.50	62.50	62.50	62.50	250.00
Orissa	0.00	436.25	436.25	436.25	436.25	1745.00
Punjab	30.00	362.50	362.50	362.50	362.50	1480.00
Rajasthan	0.00	300.00	300.00	300.00	300.00	1200.00
Sikkim	0.00	100.00	100.00	100.00	100.00	400.00
Tamil Nadu	0.00	325.00	325.00	325.00	325.00	1300.00
Tripura	0.00	125.00	125.00	125.00	125.00	500.00
Uttar Pradesh	0.00	419.75	419.75	419.75	419.75	1679.00
Uttarakhand	0.00	175.00	175.00	175.00	175.00	700.00
West Bengal	0.00	425.75	425.75	425.75	425.75	1703.00
<b>Total States</b>	<b>1050.00</b>	<b>6723.75</b>	<b>6723.75</b>	<b>6723.75</b>	<b>6723.75</b>	<b>27945.00</b>

Table 12.7: Total Finance Commission Transfers to States (2010-15)

(Rs. crore)

States	Share in Central Taxes & Duties	Grants-in-aid (2010-15)															Total Transfers (col.2 + col.17)
		Post De-velopment NPRD	Performance Incentive	Local Bodies	Disaster Relief (including capacity building)	Elementary Education	Improvement in Justice Delivery	Incentive for UIDs	District Innovation Fund	Im- prove- ment in Issuing Justice Delivery	Environment re- lated Grants	Mainte- nance of Roads and Bridges	State of Specific	Total Grants-in-aid [sum of col.3 to col.16]			
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
1 Andhra Pradesh	100616.0	0.0	0.0	7195.1	2138.7	942.0	270.7	126.1	23.0	23.0	10.0	268.6	284.0	981.0	1270.0	13532.3	114148.3
2 Arunachal Pradesh	4755.6	2516.2	0.0	305.7	187.7	24.0	77.6	2.0	16.0	16.0	5.0	727.8	8.0	162.0	300.0	4348.2	9103.8
3 Assam	52620.6	0.0	300.0	1892.8	1336.8	238.0	121.1	55.8	27.0	27.0	5.0	184.6	88.0	336.0	600.0	5212.1	57832.7
4 Bihar	158341.2	0.0	0.0	5682.1	1411.2	4018.0	385.0	369.2	38.0	38.0	10.0	38.4	304.0	464.0	1845.0	14602.8	172944.1
5 Chhattisgarh	35825.2	0.0	0.0	2267.2	647.1	857.0	125.1	91.0	18.0	18.0	10.0	411.1	88.0	362.0	1281.0	6175.5	42000.7
6 Goa	3857.8	0.0	0.0	172.0	17.3	11.0	15.0	2.0	2.0	2.0	10.0	36.9	8.0	40.0	200.0	516.2	4374.0
7 Gujarat	44107.1	0.0	0.0	3757.6	2110.9	483.0	299.8	90.7	26.0	26.0	10.0	81.9	236.0	1261.0	1300.0	9682.9	53789.9
8 Haryana	15199.5	0.0	0.0	1521.3	824.4	229.0	124.2	32.1	21.0	21.0	10.0	8.8	212.0	267.0	1000.0	4270.8	19470.3
9 Himachal Pradesh	11327.3	7888.8	0.0	641.5	670.3	113.0	64.8	6.4	12.0	12.0	5.0	100.6	64.0	436.0	350.0	10364.4	21691.6
10 Jammu & Kashmir	20182.7	15936.3	0.0	1122.6	877.6	449.0	104.5	5.9	22.0	22.0	5.0	133.0	88.0	140.0	1350.0	20255.9	40438.7
11 Jharkhand	40640.3	0.0	0.0	2239.8	1100.2	1528.0	177.5	116.4	24.0	24.0	10.0	151.4	108.0	334.0	1425.0	7238.4	47878.6
12 Karnataka	62774.9	0.0	0.0	6496.7	687.1	667.0	269.8	138.9	29.0	29.0	10.0	221.0	128.0	1625.0	1300.0	11601.4	74376.3
13 Kerala	33954.3	0.0	0.0	2676.1	563.2	140.0	140.1	49.6	14.0	14.0	10.0	135.5	176.0	953.0	1500.0	6371.5	40325.8
14 Madhya Pradesh	103268.9	0.0	0.0	5833.5	1652.7	2216.0	407.4	249.7	50.0	50.0	10.0	490.3	148.0	986.0	1231.0	13324.5	116593.4
15 Maharashtra	75406.9	0.0	0.0	8743.6	1859.6	744.0	542.7	317.4	35.0	35.0	10.0	309.6	368.0	2103.0	1235.0	16302.8	91709.8
16 Manipur	6541.2	6056.6	0.0	315.9	40.9	15.0	11.6	4.0	9.0	9.0	5.0	150.3	8.0	100.0	301.0	7026.3	13567.5
17 Meghalaya	5918.5	2810.9	0.0	432.4	77.9	52.0	4.2	4.5	7.0	7.0	5.0	168.1	4.0	101.0	250.0	3923.9	9842.4
18 Mizoram	3901.3	3991.4	0.0	310.7	47.5	5.0	13.0	1.2	8.0	8.0	5.0	171.2	4.0	89.0	250.0	4904.0	8805.3
19 Nagaland	4552.9	8146.1	0.0	415.7	29.7	7.0	6.2	4.0	11.0	11.0	5.0	138.6	8.0	159.0	250.0	9191.3	13744.2
20 Orissa	69316.1	0.0	0.0	3270.9	1647.8	1016.0	193.6	178.5	30.0	30.0	10.0	331.0	184.0	1022.0	1745.0	9658.8	78974.9
21 Punjab	20146.4	0.0	0.0	1753.8	948.8	224.0	120.8	21.6	20.0	20.0	10.0	9.2	320.0	612.0	1480.0	5540.3	25686.6
22 Rajasthan	84892.2	0.0	0.0	5163.8	2519.3	1766.0	268.5	134.9	33.0	33.0	10.0	88.3	224.0	1509.0	1200.0	12949.8	97842.0
23 Sikkim	3466.8	0.0	200.0	187.2	118.1	5.0	21.8	1.1	4.0	4.0	5.0	40.6	4.0	68.0	400.0	1058.8	4525.7
24 Tamil Nadu	72070.4	0.0	0.0	5455.9	1241.4	700.0	252.4	145.6	31.0	31.0	10.0	142.5	192.0	1865.0	1300.0	11366.9	83437.3
25 Tripura	7411.5	4453.3	0.0	369.8	101.0	23.0	24.0	6.4	4.0	4.0	5.0	95.5	8.0	122.0	500.0	5716.1	13127.6
26 Uttar Pradesh	285397.1	0.0	0.0	12740.5	1622.1	5040.0	645.8	590.0	70.0	70.0	10.0	80.5	1364.0	2831.0	1679.0	26742.9	312140.0
27 Uttarakhand	16245.1	0.0	1000.0	781.3	605.1	197.0	102.2	36.0	13.0	13.0	5.0	205.4	76.0	329.0	700.0	4063.0	20308.1
28 West Bengal	105358.6	0.0	0.0	5773.1	1288.3	2359.0	210.9	208.4	19.0	19.0	10.0	79.0	296.0	673.0	1703.0	12638.7	117997.2
<b>Total</b>	<b>1448096.0</b>	<b>51800.0</b>	<b>1500.0</b>	<b>87519.0</b>	<b>26373.0</b>	<b>24068.0</b>	<b>5000.0</b>	<b>2989.0</b>	<b>616.0</b>	<b>616.0</b>	<b>225.0</b>	<b>5000.0</b>	<b>5000.0</b>	<b>19930.0</b>	<b>27945.0</b>	<b>258581.0</b>	<b>1706676.0</b>

Note: 1. An amount of Rs. 60,000 crore is not included in the total Grants-in-aid figure in column 17. This comprises three grants (a) GST Compensation grants (Rs. 50,000 crores),

(b) Grants for reduction in IMR (Rs. 5000 crores) and (c) Renewable energy grant (Rs. 5000 crores). The state-wise allocation of these grants is not possible at this stage as this is dependent on their future performance. Adding these forward looking grants to the total grants figure in column 17, the aggregate Grants-in-aid figure works out to Rs. 318581 crores and the total transfers work out to Rs. 1766676 crores.

2. Total may not tally due to rounding off.

## CHAPTER 13

# Looking Ahead: Towards a New Architecture for Federal Finance

13.1 The Terms of Reference (ToR) of the Thirteenth Finance Commission reflect the emerging need for India to respond transformationally, rather than incrementally, to national and global imperatives that are causing fundamental changes to the national development agenda. In the context of federal finance this poses its own specific challenges which this Commission has sought to address in its recommendations using the instruments at its disposal. However, it must be recognised that the change process is not confined to the time horizon of the Commission's recommendations or, even, to the ambit of these recommendations. In this chapter we identify areas where complementary actions need to be taken in the medium and long term to secure for India a fiscal framework equipped to meet the challenges of the future and to enable India to make the most of its demographic dividend.

13.2 This Commission's deliberations have been conducted in a fiscal environment which has been dominated by the proposal to implement the Goods and Services Tax (GST). When implemented in the manner proposed by us, this reform measure will put India's indirect tax system at the forefront of international best practice. The review of the GST in Chapter 5 of this report has highlighted the significant benefits that the model GST, can provide to the Indian economy. It will reduce the vertical imbalance between the Centre and the states. It will foster a common market across the country and accelerate growth. It will reduce distortions by completely switching over to the destination principle. It will make the Indian manufacturing sector more competitive and boost exports. It will

facilitate investment decisions being made on purely economic concerns and thus help lagging regions. It will be a landmark effort in cooperative fiscal federalism, with all stakeholders contributing to the national welfare by accepting its framework. Such a Model GST will be a cornerstone of the new architecture of federal finance.

13.3 The emergence of rural and urban local bodies as key players in bringing about a development transformation has been recognised by this Commission and supported by a number of measures that we have recommended. This process needs to be fostered. Local bodies must be increasingly empowered to fulfill their responsibilities, and we are of the view that this would, in the future, involve a fundamental rethink of the Constitutional arrangements regarding inter-governmental allocation as well as devolution of resources to the third tier. To this end, we would urge careful thinking about Constitutional changes that would allow the third tier to access resources directly from the divisible pool. The introduction of the GST also needs to keep the local bodies in mind in the future since, being a consumption based and incentive compatible tax, it is well suited for direct allocation to the third tier. Such sharing of GST with local bodies will help in eliminating distortionary taxes such as octroi.

13.4 The above, in turn, signals the need to rethink the basis of allocation of different revenue bases to different parts of the inter-governmental fiscal framework. An important example is the allocation of revenues arising from the 'fiscal commons'. These are national resources and should be at the collective disposal of the central and all state governments.

Important examples of these would be profit petroleum, profit gas and revenue shares from spectrum. There may be other natural resources which also fall in this category. Hitherto, these non-tax revenues were considered to be exclusively in the domain of the Centre. We are persuaded of the case to view these as being shareable between the Centre and the states collectively. To do this, it would be necessary to include these as a part of the divisible pool. This would require a constitutional amendment. This is an important issue involving, *inter alia*, the optimal utilisation of natural resources and, therefore, requires careful further consideration.

13.5 Further reforms will be necessary to enable future policy initiatives, including those taken by succeeding Finance Commissions, to be in consonance with contemporary policy imperatives. In the context of future Finance Commissions, an important example would be the updating of award parameters (such as the parameters for horizontal devolution and those entering grant formulae), within the time horizon of the award period and not just (as is the case upto the present) when the award recommendations are made. To do this, however, there would have to be major structural improvements in the timely, accurate and regular availability of the required data. This is also true of dimensions of fiscal policy design and implementation, other than those directly covered by this Commission. It is for this reason that we have devoted considerable thought and attention to incentivising improvement in data quality and availability, and have made specific provisions for the same in our grants. Areas of special importance include data pertaining to forest cover, district level data on social and economic indicators that would enable better understanding and specification of intra-state disparities, as well as data on domestic and cross-border remittances and inter-state trade. We also need better data on human development and Millenium Development Goals (MDG).

13.6 It is widely acknowledged that improving governance is at the heart of securing a transformation in the quality of public expenditure in India. This is true at every level of government

and it is important that Finance Commissions play their part in incentivising changes in governance using the instruments at their disposal. At the present time, criteria for horizontal devolution and for deciding the distribution of specific purpose grants use largely static parameters, such as population and area, as well as parameters that are proxies for fiscal capacity, fiscal need and revenue effort. To introduce the governance dimension, it would be necessary to consider dynamic parameters such as those related to indicators of MDG progress. Use of such parameters would incentivise states to think about ways in which to improve governance and outcome based service delivery. However, the lack of reliable, universally understood and regularly produced data has not made it possible for the present Finance Commission to consider such indicators. We would urge that attempts be made to remedy these lacunae.

13.7 FC-XII emphasised the need for statistical agencies to design and implement a plan to produce more timely data on Gross State Domestic Product (GSDP). In Chapter 9, paras 9.85 and 9.86, we have been constrained to use the latest available estimates of GSDP which are for years less recent than we would have liked. This is an issue that requires most urgent attention in order to eliminate time lags in the availability of data and to bring to a close the cumbersome process of generating comparable GSDP data. There should, in our view, be no hesitation on the part of all agencies concerned, whether at the central, state or district level, to put aside any perceived questions of mandate or primacy and collectively agree to a blueprint and methodology for delivering comparable GSDP data on a regular and timely basis. It is equally important that the Central Statistical Organization (CSO) assume greater responsibility for producing GSDP at market prices, and for generating estimates of income accruing to states inclusive of net inward remittances. It is important to recognise that data is vital for the business process underpinning effective policy making, monitoring and devolution, and that the availability of quality data is a factor that will determine whether future policy making is able to rise to the challenges posed by a rapidly changing social and economic environment.

13.8 Environmental issues are increasingly becoming important in the construction of optimal inter-governmental fiscal arrangements. In this report, we have sought to highlight how actions taken by states to maintain and enhance the supply of environmental public goods and to foster positive environmental externalities have resulted in benefits for the nation as a whole. We have made a beginning, therefore in introducing an environmental dimension into inter governmental fiscal arrangements. We envisage that this dimension will grow in importance in the future as environmental sustainability becomes one of the centrepieces of development policy formulation and the role of incentives in securing such sustainability can be expected to commensurately increase over time. The multidimensional approach to environmental policy within public finance is thus the need of the hour, looking across different dimensions of environmental sustainability and, especially, those that directly affect the poor and vulnerable in their daily lives like soil quality, water, sanitation, pollution and bio-diversity. The environment is a shared legacy with future generations and it is of the first importance that inter-governmental fiscal arrangements protect and foster this legacy for their benefit.

13.9 FC-XII recommended the introduction of accrual based accounting systems. Recognising that this changeover would require considerable preparation and training, it also recommended the introduction of eight financial statements as a precursor to this changeover. These statements, to be appended to the finance accounts, were to provide details on financial obligations and expenditure not presently available in the accounts. The Government of India accepted the recommendation to introduce accrual based accounting and asked the Government Accounting Standards Advisory Board (GASAB) in the office of the Comptroller and Auditor General (C&AG) to recommend an operational framework and a detailed roadmap for its implementation. The Second Administrative Reforms Commission (SARC) in its Fourteenth Report appraised the issue of accrual accounting and recommended that a task

force be set up to examine the costs and benefits to the system as well as its applicability in the case of appropriation accounts and finance accounts. The report also underlines the need for training and capacity building; ensuring alignment of the plan, budget and accounts; as well as putting in place a viable financial system of accounts. The Ministry of Finance, in its presentation to the Commission, urged that the changeover to accrual accounting be managed with care and circumspection, given that the process is resource and time intensive, and that its benefits have not been unambiguously proven by international experience. We are satisfied that the issue is receiving close attention from the relevant authorities, and that extant actions by the Central, State and Local Governments are facilitating a 'bubble up' approach to the transition.

13.10 We have recommended several measures to enhance institutional deepening in our report, such as the creation of a council of finance ministers, a fiscal council, a local body ombudsman, etc. This should not be seen in isolation; rather, these are part of the overall effort that needs to be made to improve the quality of public institutions to deliver a framework that is suited to the demands of India, emerging as an important contributor to the growth and stability of the global economy.

13.11 Our report raised several important issues regarding the classification of revenue and capital expenditures. In Para 9.25 of the report, we have made the point that no provision exists to define a grant for creation of assets as a 'capital grant', under existing administrative arrangements. We would urge some thinking on this issue in the medium term. This will also be necessary if disinvestment proceeds are to be deployed for capital investments at the state and local body levels. There are several examples, globally, of solutions to the problem of classification of grants used for capital expenditures. In some cases, grants to finance capital expenditure are classified as 'capital spending' by both the disbursing and the recipient entities. In some other cases, grants provided by one unit of government for capital spending by another unit are classified as 'capital receipts' by the recipient of the grant, but as 'revenue

expenditure' in the accounts of the unit providing the grant.

13.12 The fiscal position of many states has undergone a transformation. The states today are, collectively, at the cutting edge of best practices in maintaining prudent and pro-development fiscal policies. For each state taken individually, there is much to learn in terms of best practice from this hugely positive collective experience. Important areas where such best practices can be emulated and implemented include timely and accurate reporting of public sector accounts, engagement with legislative oversight bodies such as Public Accounts Committees, initiatives to independently review and monitor compliance with Fiscal Responsibility Legislation (FRL), effective design of medium term fiscal frameworks and significant progress in the fiscal and operational empowerment of local bodies. Improving quality of public expenditure, which is important for all states, would require independent evaluation of major schemes and projects on a regular basis.

13.13 In the context of modernisation, a comprehensive overhaul of the institutional arrangements for fiscal policy design and formulation is a vital challenge. The principal responsibility for this is vested with the Ministry of Finance. At the central level, the MoF needs to focus more closely on its primary function, which is to deliver and implement a prudent fiscal policy in consonance with the needs of overall development policy making. This would require an acceleration of the measures to shift regulatory and administrative functions into specialised agencies which are distinct from the ministry. In this context, the Commission supports the move to create a National Debt Management Agency (NDMA). Also, in such an economy, MoF, as the main force behind the fiscal responsibility and budget management processes, has to calibrate and implement an increasingly sophisticated roadmap for future fiscal consolidation. This requires considerably enhanced policy formulation and analysis capabilities and a more horizontal and integrated approach to the task than has historically been the case. As India is now a trillion dollar-plus economy, these are

requirements for effective implementation of regulation and improved administration.

13.14 The proposed Fiscal Council and Council of Finance Ministers would require such a restructured ministry to be able to do its work optimally and effectively. Further, the issue of disinvestment and public private partnerships will require greater analytical depth to decision making, to make the most of these high-potential policy windows and to maintain and enhance public accountability in these areas. The challenges of medium term fiscal and budget design will also require fundamental changes in the business process of budget and tax policy formulation.

13.15 Finally, and most important in the context of Finance Commissions, we recommend the creation of a new State Finances Division in the Ministry of Finance (MoF) which will have the analytical capabilities to provide policy advice on matters pertaining to inter-governmental fiscal arrangements and financial relations. This division will serve as a national think tank on inter-governmental fiscal matters, a service which, at this point, is only provided by the Reserve Bank of India. It will also be pro-active in monitoring the progress of state level fiscal reforms and implementation of forward looking recommendations of the Finance Commission in letter as well as in spirit.

13.16 We would also recommend the setting up of an ongoing research programme on issues of inter-governmental fiscal federalism in India that could provide inputs to the Ministry of Finance and also serve as a research resource for the work of future Finance Commissions. This research programme should be independently managed by reputed national institutions.

13.17 The Ministry of Finance that is to take charge of policy making in the twenty first century will thus need to be very different in shape and form from that presently in place. We would urge all parties to immediately initiate this important institutional deepening.

13.18 In Chapter 3, we looked at the challenges posed to fiscal federalism by the differential impact

of the growth process on different segments of the population and different areas of the country. It is a matter of great potential concern that increases in disparities in growth should not lead to demonstrable differences in access to opportunities and public goods. This is not an issue which can be tackled using the limited instruments of inter-governmental public finance available to the Finance Commission. It is a wider policy issue on which we feel the institutions charged with designing the overall development

policy framework of the country, particularly the Planning Commission, should reflect on and address. Fiscal interventions to correct against real and perceived disparities generated by the growth process can only address the symptoms and alleviate the consequences of not securing inclusive growth in all its multiple dimensions. Hence, we would wish to reiterate the importance of securing growth that is inclusive across all the multifarious dimensions that are pertinent in a large, vibrant and variegated country like India.