



# **Second State Finance Commission**

## **Government of Tamil Nadu**

### **GOVERNMENT OF TAMIL NADU**

#### **FINANCE (FC.IV) DEPARTMENT**

EXPLANATORY MEMORANDUM ON THE ACTION TAKEN ON THE RECOMMENDATIONS MADE BY THE SECOND STATE FINANCE COMMISSION IN ITS REPORT SUBMITTED TO THE GOVERNOR ON MAY 21, 2001.

The Report of the Second State Finance Commission constituted vide Government gazette notification No.908, dated 2nd December 1999 together with the Explanatory Memorandum on the action taken on the recommendations of the Second State Finance Commission is being laid on the table of the House in pursuance of Article 243 I (4) and Article 243 Y (2) of the Constitution of India. The decisions of the Government on the recommendations of the Second State Finance Commission in the following Chapters of its report are indicated below:

Chapter VII - Debt Management

Chapter VIII - Accountability & Audit

Chapter X - Payment of Pension

Chapter XI - Eleventh Central Finance Commission's Recommendations

Chapter XII -Issues germane to Terms of Reference

(Paras: 21.6 & 21.7 only)

Chapter XIII -Devolution Mechanism.

Assigned Revenue – Entertainment Tax :

(i) Government has accepted the recommendation of Second State Finance Commission to continue the transfer of 90% of the Entertainment Tax collection to the local bodies. (XIII-9.3.1)

(ii) Government has accepted the recommendation of Second State Finance Commission for transferring the Entertainment Tax in the form of "deduct entries" . (XIII-12(f))

### **Assigned Revenue - Surcharge on Stamp duty:**

(i) Government has accepted the recommendation of Second State Finance Commission to continue the existing system of pooling and to modify the distribution formula in respect of Panchayats by according 50% weightage to population and 50% weightage to Surcharge on Stamp Duty collections.

(ii) Government has accepted the recommendation of the Commission to restrict the collection charges for the surcharge collected at 5% for Urban Local Bodies and 3% for Panchayats. (XIII-9.3.1)

### **Assigned Revenue – Local Cess and Local Cess Surcharge:**

(i) The recommendation of the Second State Finance Commission to compensate the loss of Local Cess and Local Cess Surcharge when there is waiver or remission of land revenue will be taken up while considering the issue of delinking of the Local Cess and Local Cess Surcharge from the land revenue.

(ii) The recommendation of the Commission to adjust the Local Cess and Local Cess Surcharge dues for the period 1997-2002 on the basis of G.O. issued in 1982 has been accepted.

(iii) Government has accepted the recommendation of the Commission to enhance the rate of levy of Local Cess Surcharge from Rs.5 to Rs.7 and Local Cess from Re.1 to Rs.2 on the rounded land revenue and to transfer half of this incremental revenue to Panchayats and Panchayat Unions as assigned tax revenue and the remaining 50% to Water Users Associations. In areas where Water Users Associations have not been formed, the funds will be used for the maintenance of tanks under the control of Panchayat/Panchayat Union.

(iv) Recommendation for the sanction of incentive at 2.5% of the collection of Local Cess and Local Cess Surcharge to Village Administrative Officers has not been accepted by the Government. Recommendation for retaining 2.5% of the collection of Local Cess and Local Cess Surcharge towards collection charges by the Government has been accepted. (XIII-9.3.1)

### **Fiscal Devolution from the State Government to the local bodies :**

Government has decided to transfer 8% from out of State's Own Tax Revenue after excluding the Entertainment Tax to the local bodies for each year from 2002-03 to 2006-07. (XIII-9.3.2)

### **Five percent share to local bodies from Central devolution:**

Government has not accepted the recommendation. (XIII-9.5)

### **Formula-based and Discretionary Transfers:**

The Commission recommended that out of total transfer of funds by the State, 80% needs to be by way of formula-based transfer ( Pool-A and Pool-B) and the plan, non plan and other discretionary transfers outside the State Finance Commission devolution need to be 20%. Government has decided that the existing system may be continued without such ceilings. (XIII-9.7)

### **Distribution of funds between Rural and Urban Local Bodies :**

Government has accepted the recommendation of Second State Finance Commission for sharing 87% of the recommended devolution between Panchayat Raj Institutions and Urban Local Bodies in the ratio of 58:42. (XIII-11.2(e))

### **Allocation among Rural Local Bodies :**

The Second State Finance Commission had recommended that after allocating the salary requirements of District Panchayats, the balance funds shall be distributed between Village Panchayats and Panchayat Unions in the ratio of 60:40 respectively. Government has decided to continue to adopt the existing ratio of 47:45:8 for Village Panchayats, Panchayat Unions and District Panchayats respectively, for distribution of funds. (XIII-11.4)

### **Allocation among Urban Local Bodies:**

(i) The Second State Finance Commission had recommended that the vertical sharing of devolution among Corporations, Municipalities and Town Panchayats would be in the ratio of 33:32:35 respectively. Government has decided to adopt the ratio of 31:34:35 for Corporations, Municipalities and Town Panchayats respectively. (XIII-11.5.1)

(ii) Government has accepted the recommendation of the Second State Finance Commission to share 10% of State Finance Commission devolution allocated to Chennai Corporation with ' Metro Water'. (XIII-11.5.2)

Horizontal distribution of State Finance Commission devolution amongst various tiers of Panchayat Raj Institutions and Urban Local Bodies:

(i) The Government has not accepted the weightages recommended by the Second State Finance Commission and has decided to share the State Finance Commission devolution horizontally within each class of rural and urban local bodies by assigning the following weightages :

Total Population : 40%  
Women Population : 40%  
SC/ST Population  
including slum population : 20% (XIII-11.8)

(ii) Government has decided to adopt 2001 Census population including slum population while considering population as a criterion for devolution.(XIII-11.9)

**Ceiling on deduction towards Debt and Non-Debt liabilities from State Finance Commission devolution:**

Government has not accepted the recommendations on fixing any ceiling for deduction. (VII-10.4 & XIII-11.10)

**Reserve, Equalisation and Incentive Funds:**

Government has accepted the recommendation of the Commission to set apart 13% from the devolution towards the constitution of Reserve, Equalisation and Incentive funds subject to the following modifications:

(i) Government has agreed to earmark 2% for Reserve Fund, 6% for Equalisation Fund and 5% for Incentive Fund from the recommended devolution.

(ii) The Reserve Fund will be earmarked for the Collector's Development Fund and rain water harvesting schemes equally.

(iii) The principles governing the utilisation of Incentive and Equalisation funds will be decided later.

(iv) Government has decided to change the nomenclature of the Urban Development Fund which is a component of Equalisation Fund as Urban Development Grant Fund.

(v) The principles governing the utilisation of Urban Development Grant Fund will be decided later.

(vi) The guidelines for utilizing the Collector's Development Fund will be issued at the Government level in Rural Development / Municipal Administration and Water Supply Departments.

(vii) Earmarking separately 30% of Eleventh Central Finance Commission's Calamity Relief Fund towards Disaster Management in local bodies is not necessary in view of the decision as in item no.(ii) above.

(viii) The vertical sharing ratio of 58:42 adopted for devolution of funds shall be adopted for the distribution of Reserve, Equalisation and Incentive Funds. (XIII-13)

**Debt Relief on Principal and Interest on Water Supply and Drainage loans given to local bodies :**

(i) Government has accepted the recommendation of the Second State Finance Commission to give separate treatment for water supply and drainage loans taken by Tamil Nadu Water Supply and Drainage Board, for debt relief. (VII-7)

(ii) Government has decided to constitute a Committee in Municipal Administration and Water Supply Department to examine the recommendations of the Second State Finance Commission relating to the relief on principal, interest and penal interest on the outstanding water supply and drainage loans of Urban Local Bodies. The Committee will be asked to submit its report within one month. (VII-8,9,10)

**Audit of Accounts of local bodies :**

The recommendation of the Second State Finance Commission to continue the auditing of accounts of local bodies by Director of Local Fund Audit and not to entrust the job to Accountant General has been accepted. It has also been decided to keep the administrative control of employees of Local Fund Audit Department with State Government and to get technical guidance only from the Accountant General on a continuing basis. (VIII-3.7(c) & XI-8.20)

**Eleventh Central Finance Commission's Recommendations on local bodies :**

- (i) Government has decided to distribute Eleventh Central Finance Commission's grants on population basis only with effect from 1.4.2002 and to allow the purchase of new vehicles required for the maintenance of core civic services under Eleventh Central Finance Commission grants. (XI-8.18)
- (ii) (ii) Government has accepted the recommendation to engage outside agencies for upkeep of accounts of local bodies which do not have trained staff. For flexibility needed in the matter, Government of India and Comptroller and Auditor General will be addressed. (XI-8.19(e))

**Payment of pension to local body employees :**

- (i) Government has decided to consider 'Contributory Pension Scheme' for local body employees as and when the scheme is introduced in respect of Central/ State Government employees and to amend the Acts suitably. (X-16.2&16.3(c))

- (ii) (ii) Government has also decided to involve professional agencies like LIC, Banks etc. to administer Contributory Pension Scheme and commutation of pension in respect of local body employees coming under the scheme. (X-16.5 &16.6)

The decisions taken by the Government on the other recommendations in the chapters mentioned in this Memorandum are as follows:

## **Chapter VII**

### **Debt Management**

#### **I. Recommendations accepted by the Government:**

- 1) Since water supply and sewerage functions are entrusted to Chennai Metropolitan Water Supply and Sewerage Board, Chennai Corporation is not entitled for debt relief . ( Para :10.1)
- 2) The local bodies may be encouraged to explore the options of obtaining loans from Infrastructure Development Finance Company Ltd. (IDFC) also in addition to TUFIDCO/TUIFSL depending on the terms of IDFC. (Para:12)
- 3) Heads of the Departments should limit the borrowings at certain prudent level especially in Urban Local Bodies through case-by-case analysis. A ceiling of four times on own resources could be fixed for borrowing by the Urban Local Bodies. After detailed scrutiny, this norm may be incorporated in Tamil Nadu Urban Local Bodies Act. ( Para:13.3)
- 4) The debt servicing ratio to annual revenue receipts should not cross 25% in order to ensure that the local bodies have sufficient funds to meet establishment ( upto 49% ) and O&M expenses ( about 25%) ( Para:14.4)
- 5) Collective attempt can be taken to get common credit rating and market borrowing by grouping select municipalities under a front organization like Tamil Nadu Urban Infrastructure and Financial Services Ltd. ( TUIFSL)/ Tamil Nadu Urban Finance and Infrastructure Development Corporation (TUFIDCO) ( Para : 14.5)
- 6) Incentive Fund may be set apart for Urban Local Bodies which have successfully launched the public health projects through public participatory approach and through private sector involvement. ( Para:17)
- 7) Better placed village panchayats adjoining Corporations can be permitted to avail loans. The borrowing may also be permitted at the Panchayat Union level for remunerative purposes. ( Para :19.2)

## **II. Recommendation accepted with modifications:**

8) Tamil Nadu Urban Finance and Infrastructure Development Corporation ( TUFIDCO), Tamil Nadu Urban Infrastructure and Financial Services Ltd (TUIFSL) and Directorate of Town and Country Planning are giving financial assistance for various urban development programmes in Urban Local Bodies. The Government has decided that the number of agencies shall be restricted to two only. (Para:11.2 )

## **III. Recommendations accepted by the Government in principle:**

9) Out of the sustainable investment capacity ( Rs.525 crores) of Chennai Corporation as assessed by the Second State Finance Commission, 35% needs to be met from grants and own funds. The balance 65% has to be met from borrowings for the period 2002-03 to 2006-07 by raising tax free bonds as explained in the relevant para in the report. Based on this experience, other better off Corporations may also float municipal bonds in the market.(Para:15.3)

10) In the National River Conservation Action Programme, special packages are needed to be worked out by the Government for Urban Local Bodies like Tiruchendur and Rameswaram Town Panchayats, Thanjavur and Karur Municipalities and Madurai Corporation that cannot bear debt service obligations. (Para:16)

## **Chapter – VIII**

### **Accountability & Audit**

#### **I. Recommendations accepted by the Government :**

1) Director of Local Fund Audit shall be the statutory auditor for Municipal Corporations, Municipalities, Town Panchayats, District Panchayats and Panchayat Unions. (Para:3.6 (a))

2) The Village Panchayats audit shall continue to be done by Deputy Block Development Officer as at present. However, test audit by Director of Local Fund Audit as tabulated in Annexure – VIII-1 is recommended. (Para : 3.6 (b))

3) Accrual Accounting system shall be progressively extended to all Town Panchayats and Panchayat Unions from 2003-04 after due and extensive training to the staff. ( Para:3.7(a))

4) Wherever Section 14 of the Comptroller and Auditor General Act 1971 permits scheme audit exceeding the financial limits, it can continue. Government may take up with Comptroller and Auditor General and Union Finance Ministry for raising the financial limits as it was fixed about two decades ago.( Para : 3.7 (b) )

5) Formation of High Power Committees at the district level for Urban Local Bodies for clearing the accumulated audit objections. ( Para: 3.9)

6) Implementation of management audit so as to instill a sense of responsibility among the executing agencies. ( Para :4.1 & 4.2)

7) (i) The Acts enacted by the Governments of Kerala and Andhra Pradesh conferring statutory status to their Directors of Local Fund Audit may be studied and similar enactment made in Tamil Nadu to improve the expertise of auditors qualitatively.

(ii) 25% of the posts of Assistant Directors in Local Fund Audit Department may be earmarked for direct recruitment so as to induct professional auditors such as Chartered Accountants and Cost and Works Accountants. Subordinate service personnel may be trained in SAS Test. ( Para : 5)

8) To ensure a regular planning at the field level for both maintenance and improvement of existing assets and creation of new assets, schematic budget for a period of two years should be prepared in the local bodies to start with. (Para:6.6)

9) (i) Preparation and presentation of Urban Local Bodies' Budget as per the provisions in Section 70 and 71 in the proposed Tamil Nadu Urban Local Bodies Act.

(ii) Except Village Panchayats, others can take advantage of Internet and host website in the Net giving salient features of their area including budget.

(iii) Data like works chosen, budget etc. of Village Panchayats can be made available through the information kiosk at Panchayat Union. (Para :6.9)

10) For each Panchayat Union as explained in the relevant para of the Report, a qualified para – accounting professional from the panel approved and maintained by the Director of Local Fund Audit can be appointed by the concerned District Collector, who is the Inspector of Panchayats. While computerizing the accounts of the Village Panchayats, the present registers maintained may be reviewed and reduced to the extent possible. ( Para:8.1)

11) The amount earmarked by Eleventh Central Finance Commission for data base may be set apart for Town Panchayats for computerizing the accounts. ( Para : 8.2)

12) The amount sanctioned by Eleventh Finance Commission for database for Panchayat Raj Institutions may be earmarked for the balance 244 Panchayat Unions since this work has been completed in 78 Panchayat Unions already and this will be completed in 63 other Panchayat Unions in 2002. ( Para : 8.3)



13) The audit report incorporating major irregularities noticed in the local bodies may be compiled and presented before a Committee of MLAs for which Director of Local Fund Audit can function as a Secretary or Convenor. (Para : 9)

14) Computerised Information Kiosks may be opened in all the Corporations, Municipalities and Panchayat Unions in the first instance. Once computerization is introduced in Town Panchayats, such kiosks can be opened there also. ( Para : 10.5)

15) Detailed shelf of projects needs to be prepared dovetailing with the Tenth Five Year Plan and this can be got approved by the Grama Sabha.( Para:11.6)

16) (i) Grama Sabhas may be conducted by rotation twice a year covering all the habitations in Village Panchayats.

(ii) Grama Sabhas may approve all the works taken up in the village by Panchayat Unions, District Panchayats, District Rural Development Agency and works taken up under MLA LADP funds.

(iii) Recommendations and suggestions made in the report of Director of Evaluation and Applied Research & Gandhigram Rural Institute may also be implemented after examination. ( Para : 15.4 (i, ii & v) )

## **II. Recommendations accepted with modifications :**

17) The time frame recommended by the Commission to keep the audit upto date is accepted by the Government subject to the following modifications:-

(i) Corporations must complete the compilation of accounts and produce them to audit by 30th June of the immediate succeeding year.

(ii) The time limit for placing the audited accounts of all local bodies before the Council will be changed and fixed as two months from the date of issue of audit report or 15th November whichever is earlier.

(iii) The recommendation for constituting a separate monitoring committee is not accepted by the Government in view of the existing arrangements at the Office of the Commissioner of Municipal Administration / Director of Town Panchayat / Director of Rural Development and in the Secretariat. (Para:3.8)

18) One copy of Panchayat's budget may be pasted on the notice board.(Para:6.9&15.4(iv))

19) Field functionaries of major line departments should be in attendance while Grama Sabhas are in session. (Para:15.4(iii))

20) Government will take a decision on the recommendations of the Second State Finance Commission to strengthen the accountability of the elected representatives to the public including the creation of a separate Ombudsman for local bodies, after studying the Kerala's experience. (Para:7.2)

### **III. Recommendations not accepted by the Government:**

21) The recommendation of Second State Finance Commission for introduction of pre-audit for work-bills in Municipalities, Town Panchayats and Panchayat Unions has not been accepted. ( Para:3.6 ( c))

22) The recommendation to amend election laws relating to local bodies to the effect that the incumbents of dissolved Council are debarred from standing for election for a period of six years on account of proven financial mal-administration and malfeasance has not been accepted. Appropriate provisions for the purpose can be examined separately. ( Para:7.3)

## **Chapter – X**

### **Payment of Pension**

#### **I. Recommendations accepted by the Government:**

1) The pension payment system under Director of Local Fund Audit may be continued. Municipal pensioners in 'below Rs.90 categories' may also be transferred to Director of Local Fund Audit so as to centralize the functions. The DLFA will take action to computerise the functions and the existing staff will be trained on computers. (Para:16.1)

2) A ceiling of 14% of the total revenue of local bodies may be fixed for pension payment. Total outgo on salary and pension out of the total revenue shall be restricted to 49% ( Para : 16.3(a) )

3) The level of replacement of personnel shall be within 50% of the vacancies as and when they arise. After ensuring need based replacement, the remaining vacancies shall be surrendered. This needs to be an annual exercise. (Para:16.4)

4) Computerisation of pension payment by deploying more computer systems to Director of Local Fund Audit. The present restriction of payment through five nationalized banks may be changed so as to bring more banks under the net by making use of computers. ( Para : 16.7)

5) (i) Payment of local body pensions need not be transferred to treasuries /sub-treasuries. ( Para: 16.9 (d))

(ii) The DRD/DTP/CMA need to organize release of withheld gratuity immediately on settlement of audit objections. (Para :16.9(e))

(iii) A database may be set up for personnel to avoid delay in the sanction of pension and that the Director of Local Fund Audit may be requested to scrutinize the service particulars one year prior to retirement. (Para: 16.9 (f) )

(iv) The Rural Development Department shall make full payment to Director of Local Fund Audit based on his demand so as to ensure timely payment for which the relevant rule may be suitably amended. (Para:16.9 (g))

## **II. Recommendations accepted with modifications:**

6) (i) The recommendation of the Commission to change the death gratuity now in vogue so as to place it on par with those retiring on superannuation, voluntary retirement and invalidation will be given effect as and when Pension Rules of Government of India and Government of Tamil Nadu are amended.(Para:16.9(a))

(ii) The recommendation of the Commission not to sanction another family pension to a person who is in receipt of one civil/ family pension will be examined as and when Pension Rules of Government of India and Government of Tamil Nadu are amended. (Para:16.9(b))

(iii)The recommendation of the Commission to cancel G.O.Ms.No.600/MA&WS Department Dated 14.9.89 relating to the provincialisation of employees of Urban Local Bodies will be examined by MA&WS Department separately. (Para:16.9(c))

## **III. Recommendations accepted by the Government in principle:**

7) In future, all concessions available to State Government pensioners need not be extended to local body pensioners as a matter of routine. Each issue may be studied for which a separate Local Bodies Pay-cum-Administrative Reforms Committee may be constituted. This Committee will balance the need for reasonable levels of pension against sustainability. ( Para : 16.8)

## **Chapter – XI**

### **Eleventh Central Finance Commission's Recommendations**

#### **I. Recommendations accepted by the Government:**

1) No need to open separate minor/sub-heads under the major head – ‘3604’ since the major head takes care of the views expressed by Eleventh Finance Commission. Issues may be taken up with Comptroller and Auditor General for changes, if any. ( Para: 8.19)

2) Government may take up with Accountant General for the preparation of accounting and budget formats amenable to computerization. ( Para: 8.19(d))

3) The Accountant General may suggest measures for timely preparation of accounts. ( Para:8.19(e))

4) State may create database accessible wherever necessary as for instance the Central grants to local bodies at national-level and that the agency responsible for monitoring the database at Central Government level may scrutinize the functioning at frequent intervals. (Para:8.21)

## **II. Recommendation not accepted by the Government:**

5) Government has not accepted the recommendation of Second State Finance Commission and has decided to agree with the views of Eleventh Finance Commission on the deletion of Article(bb) & ( c ) under Article 280(3) of the Constitution of India. These clauses provide for consideration of respective State Finance Commission's Reports while finalizing Central Finance Commission's recommendations. (Para:8.11(d))

## **Chapter – XII**

### **Issues germane to Terms of Reference**

#### **I. Recommendations accepted by the Government:**

1) The State High Level Committee, among other things, may look into the issues pertaining to the local bodies periodically as indicated in the relevant para and the connected Annexure. (Para:21.6)

2) One section out of the four sections of Finance Department which is presently gathering data related to local bodies and the concerned Deputy Secretary may be made responsible for the issues and works enumerated in the relevant paras for monitoring the State Finance Commission related matters. (Para:21.7)

## **Chapter – XIII**

### **Devolution Mechanism**

#### **I. Recommendations accepted by the Government:**

1) 10% each of State Finance Commission devolution may be reserved for capital works in Municipalities and Corporations, 15% for Town Panchayats and 20% for Village Panchayats. (Para:10.1)

2) While releasing the devolution for the next year the adjustments to be made shall be explained clearly in the first quarter G.O.itself. (Para:10.2)

3) Unspent amount if any under Collector's Development Fund should be pooled in the fourth quarter and taken to general devolution and distributed based on population. (Para:13.7.2)

4) No diversion from one fund should be made to another of the funds earmarked for distinct purposes. Unutilised funds have to be added to general devolution for formula based distribution to be decided by Finance Department in the last quarter of each financial year. (Para:13.10.4)

## **II. Recommendations accepted with modifications:**

5) The recommendation of the Commission to revise the vertical sharing ratio as 59:41 taking into account the reclassification of local bodies and urbanization factors will be reviewed as and when the orders on the reclassification are issued by the Government. (Para:11.3)

6) The recommendation of the Commission to revise the vertical sharing ratio among Urban Local Bodies as 34:31:35 for Corporations, Municipalities and Town Panchayats respectively taking into account the reclassification of Urban Local Bodies will be reviewed as and when the orders on the reclassification are issued by the Government. (Para:11.6)

7) Government will take appropriate decision on the recommendation of Second State Finance Commission relating to the release of State Finance Commission devolution as illustrated in Table 2, after taking into account the liquidity constraint in view. (Para:12(d))

8) The recommendation of the Commission to release Entertainment Tax and Surcharge on Stamp Duty relating to each quarter in the second month of the subsequent quarter and to adjust 50% of Local Cess and Local Cess Surcharge in February and the balance 50% in May every year will be considered depending on the Ways and Means position of the Government. (Para:12(f))

## **III. Recommendations not accepted by the Government :**

9) The recommendations of Second State Finance Commission relating to granite lease revenue have not been accepted. (Para:13.6.1& 13.6.4)

Other recommendations of Tamil Nadu Second State Finance Commission which are not covered in this Explanatory Memorandum are being examined separately by the Government.

**C.PONNAIYAN,  
MINISTER FOR FINANCE AND INFORMATION TECHNOLOGY**

