

TAX SHARING IN INDIAN FEDERAL FINANCE

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CHAPTER I

INDIAN FEDERATION

The federal principle in the Indian constitution is clearly reflected in the distribution of legislative and financial powers among the Union and the State Governments. Under the constitution, the distribution of legislative powers between Union and the States is in three categories viz. Union list, State list and concurrent list. The Union list enumerates 97 subjects which are of national importance. These important subjects include, inter alia, defence, atomic energy, defence industries, foreign affairs, railways, currency, foreign exchange. The state list consists of 66 items, more important of which are public order, police, administration of justice, education, medical and public health, agriculture etc. The concurrent list contains 47 items. These include criminal laws, labour disputes, social legislations, social security, economic and social planning etc. This list provides an in-built mechanism of cooperation between the Union and States, and covers subjects of common interest. In case of conflicts the policy adopted by the Central Government prevails over the policies of the units.

The scheme of division of revenue is a combination of division of taxing powers and borrowing powers between the Union and the States. It is to be noted that resources which

are allowed to the Central Government are not meant exclusively for the benefit of the Central Government. In many cases they are also meant for subsidising centrally preferred and/or sponsored schemes to be executed by the States so as to ensure a reasonably possible uniformity in public services.

Most of the taxes having an inter-state base have been allocated to the Central Government. These include taxes on income (other than agricultural income), corporation tax, custom duties, estate and succession duties on property other than agricultural land etc. Many of the taxes allocated to the State Governments have a local character e.g. land revenue, tax on agricultural income, succession and estate duties in respect of agricultural land, sales taxes and certain excises. It is noteworthy that not a single tax power is involved in the concurrent list. The major consideration in this case seems to be the avoidance of the overlapping of the tax jurisdiction between the Central and State Governments as also the avoidance of unnecessary multiplicity in tax legislation in different states, which tend to distort inter-state resource flows.

In a sense, fiscal federation is best realised in the Indian constitution. It provides the legislative powers and financial resources between the Union and the State Governments in an elaborate manner. The areas of friction are minimized and a great scope for financial cooperation is provided. The political harmony between the federal and Unit Governments

has received careful attention. Indian constitution is a good example of cooperative federalism existing by consent.

Transfer of Financial Resources

In an earlier section, it has been noted that the transfer of financial resources from the Union to States is a basic feature of federal polity. It is proposed to examine why such federal transfer of resources is made. In this respect, Prof. D. T. Lakadawala observes, "The fundamental aim of the Union-State transfers is to ensure equalisation of public services among different state especially in social overheads like health, medicine and education and to a larger extent also economic overheads like communications, irrigations and power."¹ However, the major objectives of resource transfers from Centre to States are (a) to reduce the vertical fiscal imbalance and (b) to equalise and promote levels of infra-structural development and services in the constituent units of the federation.

The principle of fiscal equalisation adopted by the constitution logically indicates the pre-existence of both vertical and horizontal fiscal imbalance. Of course, vertical and horizontal fiscal imbalances are attributable to certain provisions of the constitution as well as the changing socio-

1 D. T. Lakadawala, 'Centre State Financial Relations' (Key paper), Indian Economic Association, 55th Annual Conference, 1972, p.V.

economic conditions in the country. Let us consider vertical imbalance to begin with.

The vertical fiscal imbalance means an excess of current expenditure over revenue at the states level and a current surplus at the Centre. The Indian constitution assigns more flexible and productive sources of revenue like income tax, corporation tax, union excise duty to the Union Government. As against this, the limited, inadequate and inelastic* sources are allocated to the States. This is done on grounds of fiscal efficiency. At the same time important functions such as agriculture, education, medical care, public health, law and order assigned to states. These can be effectively administered, in a vast country, according to the Sixth Finance Commission, only by the State Governments, who are closer to the people and more keenly alive to their problems and needs.² It is clear that State Governments are assigned important functions. Therefore it is desirable that State Governments should have adequate resources to discharge these important responsibilities. However, it is a fact that resources that are allocated to the States are not only inadequate but are also inelastic excepting to some extent sales tax. This peculiar situation in our federal economy is the result both of political expediency and needs of economic integration of the whole economy. Consequently the major objectives of

2 The Report of the Finance Commission, 1973, p.6.

* The reference here is not to income elasticity or inelasticity of taxation but merely to revenue productivity of a tax as is commonly done in literature in Indian federal finance.

resource transfers mentioned above assume greater significance. Resource transfer should additionally aim at redressing the disabilities of some of the federal units.

Table 1.1 given below establishes the real nature of vertical fiscal imbalance. The data in this table require some explanation. The data relates to overall receipts of Central Government i.e. receipts on both revenue and capital account. In the case of Central Government receipts, these include among other things, the total receipts from shareable taxes collected by the Central Government i.e. not only the Centre's share in shareable taxes but also shares of these taxes which ultimately get transferred to the State Governments. This approach is justified because it shows how much is collected by Central machinery and the extent to which it can influence the state receipts. On the other side, the receipts of States have to depend on the Centre for this transfer. In the case of expenditure, the central figures are exclusive of loans and advances made and grants-in-aid because these do not in any way show the direct expenditure responsibility of the Central Government. The data regarding the expenditure of the State Governments includes both revenue and capital expenditure of developmental and non-developmental nature. These figures indicate relative functional responsibilities of the State Governments. Moreover, arrangement of data in this manner reveals the in-built nature of the fiscal imbalance in the Indian federation.

Table 1.1 : Revenue and Capital Account of the Central and State Governments

(Rs. in crores)

Year	Central Government				State Governments					
	Receipt 1	Expendi- ture 2	Imbalance 3	3 as % of 2 4	3 as % of 4 4a	Receipt 5	Expendi- ture 6	Imbalance 7	7 as % of 6 8	7 as % of 5 8A
1974-75	11078.7	6885.8	+4192.9	60.89	37.8	5278	8634	-3356	38.87	63.5
1975-76	14371.7	8698.1	+5673.6	65.23	39.4	6420	10457	-4037	38.61	62.8
1976-77	16035.3	9337.1	+6698.3	71.74	41.7	8289	11872	-3583	30.18	43.2
1977-78	17178.7	10197.9	+6980.8	68.45	59.36	7574	13358	-5784	43.30	76.36
1978-79	20135.0	11332.5	+8772.5	77.38	43.5	9132	15778	-6646	42.12	72.7

- Notes :**
1. Receipts of the Centre includes States share from income tax, estate duty and excise duty including additional duties of excise.
 2. Expenditure of the Centre is exclusive of loans and advances, grants-in-aid to states and Union territories for development and non-development purposes.
 3. Receipts of the States exclude resources transferred from the Centre (shared taxes, grants-in-aid, loans from Central Government).

Source : RBI Bulletins, December 1976, p.864; November 1977, p.750; September 1978, p.627; September 1979, p.572; August 1980, p.598; September 1980, p.647.

The data from Table 1.1 clearly shows how Central Government is placed in a strong fiscal position as against the unfavourable fiscal imbalance which the States have to face. On an average, the overall surplus of the Central Government is around 69.5 per cent of its expenditure responsibility whereas the States' fiscal adversity is of the tune of 39.52 per cent of the expenditure requirements.

The fiscal imbalance in respect of the States can be shown also by the ratio of Central transfers (tax revenue + grants + loans) to the States' total expenditure inclusive of both capital and revenue accounts. This directly depicts the States dependence on the Central devolution and so directly reflects the adverse nature of fiscal imbalance for the States. The data from Table 1.2 reveals the situation.

Table 1.2: Transfer of Resources

(Rs. in crores)			
Period	Total transfer from Centre to States	Total expenditure of the States	Ratio of transfer to expenditure
1951-56	1431	3463	41.3
1956-61	2868	4622	44.7
1961-66	5600	11981	46.7
1966-69	5347	11637	45.9
1969-74	15101	31766	47.5

Source : A. S. Nadkarni "Satwa Witta Ayog", Arth Samvad (Marathi), April-June, 1979, Vol.3, No.1, p.4.

During the period 1951-56 the ratio of total transfers from Central Government to States' total expenditure was 41.3 per cent. It increased upto 47.5 per cent during the period 1969-74. During the period of 1951-56 to 1969-74, the average degree of dependence of States on Government of India resources was 45 per cent of their expenditure. This conclusively shows that States have been constantly dependent on the Centre with whom resources are centralised.³ Inevitably transfer of resources from Centre to States becomes imperative to enable the States to carry out the functions assigned to them.

Horizontal federal fiscal imbalance refers to a fiscal situation of individual constituent States of a federation where the extent of non-correspondence between the States' own revenues and expenditures varies from State to State owing to differences in their fiscal capacity, level of economic development etc. The other important reason for federal resource transfer derives from regional economic (fiscal) disparities. The problem of uneven fiscal potentials of the State Governments is familiar. Some states are relatively more endowed with natural resources than others. Consequently the rates of growth in different States are different. Naturally some states lag behind the others, particularly in the development of public services. These disparities can roughly be adjudged in terms of per capita incomes which differ significantly from

³ cf. I. S. Gulati, Refer to his "Centre-State Financial Relations", The M.S.University Economic Series, No.6, Baroda, 1979, p.17.

State to State. Consequently transfer of resources from the Centre to States becomes necessary to ensure balanced regional development on which ultimately hinges the stability of the federal structure. This kind of resource transfer necessarily involves some transfers at the cost of more developed States.

Channels of Transfer of Resources

In this section, it is now proposed to examine the mechanism by which certain kinds of Central revenues are transferred to the States. The constitutional provisions regarding the process of resource transfers are given below.

1. Finance Commission

We have already established the fact that there has always been a fiscal imbalance both at the Central and State level in the Indian federation. We have also pointed out that the emergence of fiscal imbalance is attributable not only to the differences in fiscal capacities of the States but is more importantly attributable to the constitutional provisions regarding the division of functions and financial powers between the Centre and State Governments. As we know the constitution has provided more elastic financial resources to the Central Government while states have been given most of the growing functions. However, the constitution-makers in India have been quite aware of this fiscal imbalance and therefore they made a number of constitutional provisions to ensure a regular transfer of resources from the Centre to the States. The

Finance Commission deals with the more important constitutional provisions related to transfer of revenue which are enumerated below.

Article 280 of the Constitution requires the President of Indian Union to constitute the Finance Commission at least once in every five years. The recommendatory functions of the Finance Commission are laid down under clauses of 3 of Article 280 of the Constitution which are as follows:

1) The distribution between the Union and the States of the net proceeds of taxes which are to be or may be divided between them and allocation between the States of the respective shares of such proceeds;

2) The principles which would govern the grants-in-aid of the revenue of the States out of the Consolidated Fund of India; and

3) Any other matter, referred to the Commission by the President of India in the interests of establishment of sound financial system.

The other important fiscal provisions of the constitution regarding sharing of taxes and other ways of transferring resources under the jurisdiction of Finance Commission are briefly explained below:

1) Article 269

Under Article 269 are included seven taxes.

1) duties in respect of succession to property other than agricultural land;

ii) estate duty in respect of property other than agricultural land;

iii) terminal taxes on goods or passengers carried by railway, air, sea;

iv) taxes on railway fares and freights;

v) taxes other than stamp duties on transaction in stock exchanges and future markets;

vi) taxes on the sale and purchase of newspapers and on advertisements published therein;

vii) taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-state trade or commerce. Of these seven taxes coming under Article 269, only two i.e. (ii) and (iv) have been actually imposed by the Central Government. The tax on railway fares and freights repealed and merged with the basic fares in 1961. As railway is the Central subject, the proceeds from railway fares and freights are not shareable with the States. This resulted in a revenue loss to the States which the Central Government decided to offset by giving compensatory grants in lieu of taxes on railway passenger and freights. The Finance Commission has to make recommendations regarding the inter-State distribution of grants in lieu of taxes on railway fares and freights and revenue from estate duty.

The inter-state distribution of net proceeds of estate duty is recommended by Second Finance Commission on the following principles:

a) the net distributable proceeds are first apportioned between movable and immovable property.

b) the amount apportioned to immovable property is then distributed in proportion to the gross value of such property located in each and brought into assessment in each State.

c) the amount apportioned to movable property is distributed on a population basis.

In the case of distribution of grants in lieu of taxes on railway fares and freights upto sixth plan, the principle of compensation and route milage was used. The Sixth Finance Commission made slight changes and allocated States' share on guagewise route lengths of railways and passenger earnings for each zonal railway. The Seventh Finance Commission adopted proportion of non-suburban passenger earnings from traffic originating in each state to the total earnings in all the States as the basis for the inter-State distribution of this grant.

2) Article 270

As per the provision of Article 270 of the Constitution, tax on income other than agricultural income is to be ^elevied and collected by the Central Government but the net proceeds from this are to be compulsorily shared with the States. Here again the quantum of the States' share and its inter-state distribution is to be determined on the basis of principles derived by the Finance Commission.

3) Article 272

This Article provides for taxes which are levied and collected by the Central Government, but which may be shared with the State Governments. The taxes coming under this Article are Union excise duties other than such duties of excise on medicinal and toilet preparation. This Article simply makes permissive provision with regard to sharing of these duties. Parliament has been empowered to exercise discretion to make law providing for their sharing as well as laying down the principles of distribution. It is to be noted that the Parliament has acted in a positive manner by using this Article to make Government of India share the revenue from excise duties with the States according to the recommendations of the Finance Commission.

4) Article 275

Grants-in-aid of the revenue of the State Governments to be made by the Central Government derive their validity from Article 275 of the constitution. These grants need not be given to all the states and not be necessarily of the same amount in the case of the States receiving the grants. They are to be paid out of the Consolidated Fund of India. The basic condition which a state must fulfil to get grants-in-aid is that in Parliament's opinion on the basis of Finance Commission's recommendation it should be in need of the Central assistance. These grants are known as statutory grants. A

Finance Commission is required to assess the budgetary needs in view of the fiscal efforts of the States and recommend the principles which will govern the grants-in-aid of revenue to the States. It cannot be disputed that the constitution itself makes the reference to the need criterion to determine the grants-in-aid. However, the constitution does not specify the purposes for which the grants-in-aid can be made. Under Article 280(3)(b) of the constitution, it becomes the responsibility of the Finance Commission to recommend to the Parliament the principles which should govern the grants-in-aid of the revenues of the States. It is however, necessary to realise that the Finance Commission assesses only the non-plan need elements as reflected by the gap between the normally growing committed non-plan expenditure on revenue account on the one hand and the anticipated revenue receipts at the existing rates of taxation and receipts accruing to a State from tax sharing on the other.

It is clear that the resource transfers in the form of tax sharing and grants-in-aid under Article 275 are the major types of resource transfers to be recommended by the Finance Commission. More particularly, the Finance Commission recommends the principles on which receipts from shareable taxes wholly or partly are to be transferred to the States and then distributed among them as also the principles on which grants-in-aid under 275 are to be made.

In 1957, additional duties of excise on mill-made

textiles, sugar and tobacco were imposed replacing the States sales tax on these commodities. According to an agreement between the States and Central Government, the net proceeds of additional duties of excise are to be distributed among the States on the basis of recommendations made by the Finance Commission.

2. Planning Commission

Eventhough planning as a subject falls under the concurrent list of the Constitution, there is no specific provision for the establishment of the Planning Commission. However, the Central Government by a Cabinet resolution approved by the Parliament constituted the Planning Commission in 1950. It is entrusted with the responsibility of formulating the plan for the entire economy, assess the available resources and allocate them in accordance with the priorities of the plan. One of the important functions of the Planning Commission is to recommend the distribution of plan grants and loans to different States. The Planning Commission grants are made under the provisions of Article 282 of the Constitution. This Article empowers the Central Government as well as State Governments to give grants for certain public purposes. This Article can be used for transfer in the form of grants from the States to the Central Government. However, the reverse flow has never taken place since the Constitution came into force after independence. The extensive use of this Article

by the Government for making plan grants to the States is one of the important and significant phenomena in fiscal affairs of the Indian Federation. This is easily corroborated by the fact that on an average nearly 35 per cent of the total transfers from the Centre to the States during 1951-74 period are accounted for by the Planning Commission, these transfers being even greater than the transfers made by the Finance Commission (31.5 per cent).⁴ In the subsequent period this tendency has become more pronounced as is reflected in the Fifth Plan (1974-79) transfer where 41 per cent of the total transfer are made by the Planning Commission.⁵

In other words, a non-constitutional body like Planning Commission has assumed an important role in Central transfers to the States.

3. Discretionary Transfers

The Central Government is authorised to give loans to the State Governments under Article 293 of the Constitution. This Article confers on State Governments the power to borrow within the territory in India on the security of their Consolidated Funds and guarantees with such limits as may be fixed

⁴ The Report of the Finance Commission, 1973, p.6, the following data about total transfers of revenue from Centre to States during 1951-74 period agencywise are given:

- 1) The Finance Commission - Rs.10053 (31.5%)
- 2) The Planning Commission - Rs.11109 (34.9%)

⁵ The Report of the Finance Commission, 1978, Appendix IV 1 (iii), p.217.

by the Legislature. Simultaneously this Article empowers the Central Government to give loans to the States or to stand surety for the loans raised by the States. This Article explicitly states that the States in Indian Federation cannot borrow from outside the country.

The loans provided by the Central Government to the States under this Article have been consistently increasing and have been made for purposes like expenditure on the national calamities, improvement of police force, developmental works and schemes, education, medicinal aid, health etc. It is under this Article only that the Central Government makes it possible for the State Governments to avail of loans in foreign currency.

Apart from grants made by the Central Government with the recommendations of Finance Commission and Planning Commission under provision of Article 275 and 282 respectively, there is one more category of resource transfers which includes discretionary grants and loans which are made by various Central ministries to State Governments for specific non-plan purposes. Most of the time they are reimbursement of expenditure already incurred by the State Governments. The objective of these discretionary grants and loans appears to be to assist the State Governments in specific areas of public expenditure outside the plan. It is exactly for this reason that these discretionary grants and loans are outside the scope of the Finance Commission as well as Planning Commission.

This study concentrates mainly on the issues involved in the sharing of income tax and union excise duties. The sharing of other taxes, viz. estate duty and taxes on railway fares and freights i.e. Article 269 taxes is not taken up for the following reasons. Firstly, the contribution of these two taxes to the total quantum of transferred resources in the form of shared taxes is insignificant which is evident from the data in Table 1.3. Moreover, tax on railway passenger fares and freights was abolished in 1961, and even the contribution of the grants-in-aid in lieu of this tax to the total transferred tax revenue has been both inelastic and insignificant. This was inevitable because the amount of grants in lieu of this tax was determined according to the compensation principle for which the then income from this tax was considered as the basis. Further more there is no possibility of reimposition of these taxes as pointed out by the Fifth Finance Commission Report.⁶ The Fifth Finance Commission agreed with the Third and Fourth Finance Commissions and considered that the principle of distribution should be such that the States were generally in the same position in this matter as they were before the repeal of the Act. Finally, income tax has been for a long time the most important direct tax though lately Corporation tax is usurping its place, and the excise duties are the most important indirect tax which are shared with the States by the Central

6 The Report of the Finance Commission, 1969, p. 74.

Table 1.3 : Composition of Revenue from Shared Taxes

(Rs. in crores)

Period	Total revenue of shared taxes transferred	Income tax revenue transferred		Excise duty revenue transferred *		Estate duty revenue transferred		Total of railway passenger grants revenue transferred	
		Abso- lute amount	% to the total revenue trans-ferred	Abso- lute amount	% to the total revenue trans-ferred	Abso- lute amount	% to the total revenue trans-ferred	Abso- lute amount	% to the total revenue trans-ferred
1951-56	344	278	80.81	64	18.60	2	0.58	-	-
1956-61	668	375	56.13	281	42.06	12	1.79	-	-
1961-66	1196	555	46.40	615	51.42	26	2.17	63	5.26
1966-69	1282	507	39.55	757	59.04	18	1.40	49	3.79
1969-74	4562	2138	46.86	2385	52.27	39	0.85	81	1.77
1974-79	8337	3310	39.70	4979	59.72	48	0.57	49	0.58

* Includes additional duties of excise.

Source : The Report of the Finance Commission, 1978, Appendix IV I (11), p.174.

Government. The examination of these taxes naturally makes the analysis representative in theoretical sense also because it covers both direct and indirect taxes and accounts almost for more than 99 per cent of the transferred tax revenue.

In this study, we are mainly interested in revenue account transfers which come under the scope of Article 280 of the Constitution and are mainly related to sharing of taxes. As such resource transfers in the form of loans are excluded from this study because they relate to the capital account. The Finance Commission has no authority to make recommendations in this respect, except in a limited way when the President asks a Commission to consider the problem of non-plan capital gap of States. As for the grants under Article 275 of the Constitution, they have become relatively less significant because of the growing importance of plan grants. Moreover, their significance in the transfer recommended by the Finance Commission is also not very important as it reflected in the fact that in the First Five Year Plan, out of total transfers Rs. 447 crores only Rs. 27 crores were in the form of grants. Similarly in the Fifth Five Year Plan, out of the Rs. 11168 crores transferred by the Finance Commission only Rs. 2740 crores were in the form of grants. It is also to be noted that in Indian Federal Finance grants have three different channels and three different controls, therefore, they are excluded from study.

CHAPTER II

SHARING OF INCOME TAX

The Central Government is bound by Article 270 of the Indian Constitution to share the net revenue from the Income Tax with the State Governments. Article reads as follows:

1) Taxes on income other than agricultural income shall be levied and collected by the Government of India and distributed between the Union and the States in the manner provided in clause (2).

2) Such percentage, as may be prescribed of the net proceeds in any financial year of any such tax, except in so far as those proceeds represent proceeds attributable to Union territories or to taxes payable in respect of Union ^{emoluments} ~~amendments~~ shall not form part of the Consolidated Fund of India but shall be assigned to the States within which that tax is leviable in that year and shall be distributed among these states in such a manner and from such time as may be prescribed.

3) For the purpose of clause (2), in each financial year such percentage as may be prescribed of so much of the net proceeds of taxes on income as does not represent the net proceeds of taxes payable in respect of Union emoluments shall be deemed to represent proceeds attributable to Union territories.

4) In this Article -

a) "taxes on income" does not include a corporation tax.

b) "prescribed" means -

1) Until a Finance Commission has been constituted, prescribed by the President by order and

ii) After a Commission has been constituted prescribed by the President by order, after considering the recommendations of the Finance Commission;

c) "Union emoluments" includes all emoluments and pensions payable out of the Consolidated Fund of India in respect of which income tax is chargeable.¹

A careful reading of the above provisions highlights the following points. First, the revenue from the income tax only on non-agricultural income is shareable because agriculture is state's subject. Second, the sharing by States in the revenue of income tax is compulsory and not at the discretion of the Centre. Third, the revenue from income tax according to the present provision of the constitution means revenue net of the cost of collection and also excludes union emoluments, share attributable to union territories and revenue from corporation tax. Before the amendment of Income Tax Act 1959, the divisible pool of income tax included net proceeds from basic income tax both on individuals and companies but excluded

¹ The Constitution of India (As modified upto 15th January 1980), pp. 164-165.

revenue from income tax on union emoluments and super tax on Company incomes - which was known as Corporation tax.² Fourth, this Article clearly indicates Finance Commission as the agency to recommend the sharing of proceeds from income tax between Centre and the States. Before the adoption of the Constitution in 1950, the sharing of income tax was governed by the provisions of Government of India Act, 1935. For the purpose, Government of India appointed periodical committees. The reports of these committees are known as Neimeyer Award and Deshmukh Awards. This arrangement was later substituted by Finance Commission.

A. Sharing between Centre and States

In the sharing of revenue from any tax between the Central and State Governments, the first and foremost question that comes up is to determine as to how much is to be transferred to the States and why? The answer to this question as given by the Constitutional provisions is very vague. Our Constitution does not specify the rules or proportion on the basis of which the proceeds of income tax may be shared with the states. The Finance Commission is to recommend States' share. The Constitution provides that the net revenue from income tax is to be shared with the States as per the recommendations of the Finance Commission. The Seven Finance Commissions so far

2 J. N. Sharma, The Union and the States - A Study in Fiscal Federation, 1974, pp. 73-74.

appointed, have recommended increasing percentage share to the States which is evident from Table 2.1.

Table 2.1 : Percentage Share of the Central and the States Governments in Divisible Pool of Income Tax

Commission	Percentage Share	
	Central Govt.	State Govt.
1st Finance Commission	45	55
2nd Finance Commission	40	60
3rd Finance Commission	33 1/3	66 2/3
4th Finance Commission	25	75
5th Finance Commission	25	75
6th Finance Commission	20	80
7th Finance Commission	15	85

However, a critical examination of the Finance Commission's reports as well as the Memoranda submitted by the State Governments indicate that the following consideration guided the Finance Commissions to recommend the increasing percentage share of the shareable pool of the State Governments.

First, prior to 1959, the shareable pool of income tax revenue, included revenue from Corporation tax also, but by amendment of the Income Tax Act, the entire revenue from Corporation Tax was made non-shareable and was made available

exclusively to the Central Government. This reduced the size of the shareable pool and naturally the States emphatically asked for a higher percentage of smaller pool to maintain their position. The effect of exclusion of Corporation tax from shareable pool is clearly seen from Table 2.2.

Table 2.2 : The Position of Corporation Tax

Year	(Rs. in crores)	
	Total Receipts	Revenue Account
	Income Tax	Corporation Tax
1960-61	167.0	111.0
1965-66	272.0	305.0
1969-70	448.5	353.4
1974-75	874.4	709.5
1976-77	1194.4	984.2
1977-78	1002.0	1220.8
1978-79	1177.4	1251.5
1979-80 (B.E.)	1247.1	1529.5
1979-80 (R.E.)	1320.0	1380.0
1980-81 (B.E.)	1476.0	1515.0

Source : RBI, Report on Currency and Finance, 1971-72, p.588; 1974-75, p. 100; 1979-80, p.104.

It is clear from the above table that had the whole of the corporation tax remained a part of the shareable pool, the

States would have received a much larger quantum of income tax revenue than what they have received so far after the exclusion of the corporation tax from the shareable pool.

Second, Article 271 of the Constitution empowers the Central Government to levy a surcharge on revenue from income tax which shall be exclusively used for the national purposes at any time.³ However, the surcharges have become a permanent feature of the income tax system. It is again commonsense that a surcharge of permanent nature should become shareable with the States. In the absence of this the States naturally feel that they are not getting a part of this revenue which should form a part of the shareable pool, Table 2.3 highlights this point.

Table 2.3 : Revenue from Surcharge

	(Rs. in crores)					
	Finance Commission					
	1	2	3	4	5	6
Receipts from sur-charge on income tax	26	34	40	28	134	299

Source : Government of Karnataka, Memoranda submitted to Seventh Finance Commission, 1978, p. 17.

³ The Constitution of India (As modified upto the 15th January, 1980), p. 165.

From the above discussion, it becomes clear that above considerations emerging from the view points of the State Governments persuaded the Finance Commissions to increase the share of the States in revenue from the income tax. However, these view points cannot be taken as objective criteria to enhance the share of the States. The Constitution also does not provide for objective criteria as stated earlier. Naturally it becomes very necessary to know in depth the considerations which might have guided the Finance Commissions to determine the share of the States as against the Central Government.

The First Finance Commission took into consideration the demand of the majority states to increase their share in the divisible pool of the income tax revenue and conceded that some increase in share assignable to the States is justified.⁴ This position of the First Finance Commission was based on two considerations. First, the need for reducing the emphasis on the role of income tax as a balancing devolutionary measure, because the Finance Commission felt that an increase in the States' share of this tax should not be used as a major factor in the devolution of further revenues to the States. Second, unanimity of demand of the States for an increase in the share from the divisible pool of revenue of income tax. The Second Finance Commission also justifies the increased share for the States on the grounds of unanimous desire of the States for the same.⁵ The Third Finance Commission made a very typical

⁴ The Report of the Finance Commission, 1952, p. 71.

⁵ The Report of the Finance Commission, 1957, p. 39.

statement regarding the basic principle on which sharing of the divisible pool of income tax revenue between Central Government and State Governments should be decided. In the opinion of the Third Finance Commission, the division of the pool between the Centre and the States should have some relations to the responsibility for levy and efficient collection of the tax. It would mean that the Centre being responsible it should get some share in the yield of the tax to maintain efficiency in levying and collection of the tax.⁶ However, the same Commission also agreed to increase the share of the State Governments from 60 per cent to 66 2/3 per cent mainly on the basis of the clamour of the higher share made by the States in an unanimous manner.⁷ The Fourth and Fifth Finance Commissions broadly adhered to the view point expressed by the Third Finance Commission to justify some increase in the shares of the State Governments in the divisible pool of income tax revenue.⁸ Similarly the Sixth Finance Commission also agreed with the view of the Third Finance Commission that the Central Government which is responsible for levy and collection of income tax should continue to have a significant share in it,⁹ which by implication suggest that the increased share to the States is permissible

6 The Report of the Finance Commission, 1961, p. 17.

7 Ibid.

8 The Report of the Finance Commission, 1969, pp. 25-26.
The Report of the Finance Commission, 1965, p. 18.

9 The Report of the Finance Commission, 1973, p. 12.

so long as the quantum of the share available for the Central Government suffices to motivate to levy and collect income tax in an efficient manner. The Seventh Finance Commission re-emphasises the views of the earlier Finance Commissions by saying that "It would be necessary and proper to give weight to the strong feelings of the States on the subject by increasing the size of the divisible pool."¹⁰ However, the changes contemplated require a long drawn out process of constitutional amendment and realising this implicitly, the Seventh Finance Commission once again increased the states share from 80 to 85 per cent.

Therefore even at the cost of redundancy it has to be emphasised that no objective criteria apart from the practical considerations earlier mentioned have been formulated by the Seven Finance Commissions which have reported so far regarding the shares of the Central and State Governments in the divisible pool of income tax revenue. Moreover, the Finance Commissions emphasised the need for continuing the interest of the Central Government in efficient administration of income tax. This however, does not conflict with the States' demand for increased share in income tax revenue for reasons mentioned above.

B. Inter-State Distribution of State's Share

Compared to the determination of all the States' share

10 The Report of the Finance Commission, 1978, p. 63.

in the divisible pool of income tax revenue, the problem of determining the shares of the individual States and the principles which should guide them presents a ^{very} complex problem. It should be noted that the net proceeds of income tax which are to be shared between the Central Government and State Governments are equal to gross proceeds from income tax minus the following items (a) cost of collection (b) income tax payable in respect of union emoluments (c) income tax attributable to Union territories. Similarly revenue from surcharges on income tax and the corporation tax which is essentially a tax on net income of the Companies, do not form a part of the net proceeds of the income tax. The States' share in the net proceeds of income tax is first determined by the Finance Commission, keeping in view the practical considerations which have been mentioned earlier. Now comes the problem of determining the criteria on which individual states share can be based. In this connection we shall first discuss various criteria which could be and have been considered by the Finance Commissions so far. The criteria are the basis of origin, the basis of residence, the basis of collection of taxes, the basis of population, the relative volume of industrial labour in each State, the relative wealth indices of the different States and the relative per capita income.¹¹

While discussing these ^{criteria} interia as guides to allocation of

11 The Report of the Finance Commission, 1952, p. 73.

States' share among different States, it must be realised that it is very difficult to prepare a mix of the bases which will ensure the fulfilment of requirements of justice as well as need as between States. In this regard the Report of the Expert Committee on Financial provisions of the Union Constitution had clearly rejected origin as a criteria for inter-state distribution. In their opinion, origin is a relevant factor but in the complex industrial and commercial structure of modern times, where a single point of control often regulates a vast net work of transactions, it is difficult to conceptualise, so unreliable.¹² Secondly, the criterion of residence has also been rejected for reasons of definitional complexities, dispersal of share holders and simultaneous residence.¹³ Now we come to the accepted criteria of collection and population which seem to have clicked with all the Finance Commissions and have now become almost inviolable principles of inter-state distribution. It is true that different Finance Commissions have given different weightage to the criterion of collection but none of them has discarded it. More importantly even those states which clamoured for complete reliance on population as a criterion, have reconciled themselves to the criterion of collection.¹⁴ Here it is also important to note that even the constitution implicitly admits the criterion of collection when

12 The Report of the Expert Committee on Financial Provisions of the Union Constitution, 1948, p. 12.

13 Ibid

14 The Report of the Finance Commission, 1952, p. 62.

it provides for exclusion of income tax collected by Union territories and revenue from tax on Union emoluments from the divisible pool. In fact, the criterion of collection can be supported on the basis of the principle of reciprocal immunity,¹⁵ which has always been accepted as one of the principles of federal finance. According to this principle federal property etc. should be immune from State Taxes and State property etc. should be immune from Central tax. Indian Constitution provides that income tax revenue from Union territories and Union emoluments shall be excluded from the divisible pool. Applying the same logic, it becomes clear that income tax on State emolument and property etc. also should not form a part of the divisible pool. And if for the sake of administrative convenience it becomes a part of the divisible pool then a major part of the divisible pool should be assigned to the States and a significant part of the States' share should be assigned to the States on the principle of collection. In my opinion the views of the Government of Maharashtra about the criterion of collection expressed in the Memorandum submitted to the Sixth Finance Commission deserve special mention.¹⁶ The Government of Maharashtra strongly argued for a large weightage for the collection criterion for the following

¹⁵ B. P. Adarkar, "The Principles and Problems of Federal Finance", 1933, p. 48.

¹⁶ Government of Maharashtra, Memorandum submitted to Sixth Finance Commission, 1973, pp. 2-3.

reasons:

- 1) The proceeds of income tax are compulsorily shareable with the States.
- 2) The States' share does not form a part of Consolidated Fund of India.
- 3) No state where income tax not leviable is entitled to share in the States' share which by implication means the right is conferred on States in the proceeds of income tax as it is levied and collected by them.
- 4) Exclusion of the tax proceeds attributable to Union territories clearly indicates the principle of collection.
- 5) The proceeds from Corporation tax have been excluded from divisible pool and thus made non-shareable for the reasons that income of corporate sector has no local origin as such.
- 6) Excessive dependence on population as a basis for inter-State distribution may have adverse effect on national programme of Family Planning. It means that the State making greater efforts at Family Planning and population control is punished rather than encouraged. Therefore collection becomes a more relevant principle from the foregoing discussion. We can conclude that the collection criterion is a valid and relevant factor in the inter-State distribution of States' share of the divisible pool of income tax revenue. It is understandable that there may be differences about the weightage that should be given to this principle.

The criterion of population comes a proxy for the consideration of need of the different states for federal fiscal assistance. The Expert Committee on Financial Provisions of the Union Constitution felt that the need of the state should form a possible guide to regulate inter-State distribution of income tax revenue. However, need is a very vague criterion to determine in case of which so many different States, will have to be examined and compared. This will require elaborate enquiries which would not be feasible in view of the size of the problem as well as the lack of requisite data. So the Expert Committee mentioned above assumes that population can be taken as a rough measure of the needs of the states.¹⁷ In other words it amounts to saying that the need of a state is directly proportional to the size of the population. A larger population reflecting a larger need consequently entitles the state to a larger share.

Table 2.4 shows that the weightage given to the population criterion has varied between 80 per cent and 90 per cent.

Table 2.4 : Weightage to the Criterion of Population

	Finance Commission						
	1	2	3	4	5	6	7
Weightage in %	80	90	80	80	90	90	90

Source : Various Finance Commissions' Reports.

¹⁷ Op.cit., p. 12.

The inference is not far to see. It can be noted that all the Finance Commissions fully agreed that the size of the population is a definite indicator of the fiscal needs of the states. Moreover, it cannot be denied that the criterion of population is definitely unambiguous and based on authoritative data and thus a clean objective criterion.¹⁸ Theoretically speaking, the per capita income of the different states will also serve as an objective measure of the need of the state. But the concept of per capita income requires the knowledge of the size of the population. Moreover, up-to-date data regarding per capita income of different States is generally not available and when available it is very tentative, non-comparable and unreliable. If it is accepted that the basic objective of financial devolution is the equalisation of fiscal means as per the needs of the States then population along with some weightage to differences in socio-economic levels obtaining in different states, becomes a dependable measuring rod which can quantify the fiscal needs of the states with reasonable precision.¹⁹ The view that the criterion of collection which, if given more weightage will allocate more funds to economically prosperous states presumed to have higher fiscal capacities, directly conflicts with the objective of redistributive allocation cannot be questioned. G. Thimmaiah²⁰ goes to the other extreme

18 The Report of the Finance Commission, 1952, p. 75.

19 Government of Rajasthan, Memoranda submitted to the Seventh Finance Commission, Vol.7, 1978, p.21.

20 G. Thimmaiah, Studies in Federal Finance, Bangalore, 1973, p. 76.

and suggests that the net yield from income tax should be distributed entirely on the basis of population. It is evident that this approach will conflict with the needs of economic efficiency. Therefore an increased weightage to collection along with a reduced weightage for population will ensure both redistributive justice and developmental efforts which depend certainly on fiscal rewards rather than on fiscal punishments.

These various points discussed so far highlight two important things. First, excepting industrial states like Maharashtra and West Bengal which try to underplay the criterion of population, most other states have repeatedly and often emphatically demanded greater weightage for the need criterion as reflected by the size of population in determining inter-State distribution of states' share. Secondly, all the Seven Finance Commissions have more or less accepted the criterion of population as measuring the need and requirements of redistribution and therefore a principle of inter-state distribution. However, their acceptance to a limited extent of the criterion of collection shows their awareness of the consideration of the fiscal efficiency of the states.

Other criteria like the relative volume of labour in each state, the relative wealth indices, the areas of different states, have been discussed by the Finance Commissions as relevant factors but were not considered important because the criterion of population in a way covers them all for practical purposes. With increasing availability of up-to-date and

reliable data regarding these criteria, it may be possible to devise a composite criterion on which inter-state distribution can be based.

C. Views of the Finance Commission

In this section, it is proposed to stress the evolution of the acceptance of the criterion of collection and population for inter-state distribution of the income tax revenue allocated to the states. First we discuss the criterion of collection.

C.1 Criterion of Collection

Table 2.5 shows the weightage given to the criterion collection by different Finance Commissions so far.

Table 2.5 : Weightage given to Collection Criterion

	Finance Commission						
	1	2	3	4	5	6	7
Weightage in %	20	10	20	20	10	10	10

The first thing clear from this table is the fact that the collection criterion has been accepted by all the Seven Finance Commissions. Secondly, it is evident that the collection criterion has been given a relatively very small importance in inter-state distribution of states' share of the

income tax revenue. A scrutiny of the memoranda submitted by the different state governments to the Finance Commissions so far helps us to classify the states into two groups. First, the industrial states like Maharashtra, West Bengal, Gujarat and second, less industrialised and undeveloped states like Uttar Pradesh, Bihar, Assam, Rajasthan etc. The states belong to first group have consistently argued for increasing weightage given to criterion of collection. The states belonging to the latter group have successfully opposed to increase in the weightage given to the collection criterion. In fact Prof. A. K. Chanda argued that, "In doing so (i.e. recommending 20 per cent only) the Commission lacked the courage of its intention. An analysis had clearly shown that it would have been correct to allocate 40 per cent of the yield as attributable to incomes of local incidence. The only justification perhaps was that such a distribution would have been lopsided and would have given by itself, two or three states more than their requirements of finance including partly that needed to meet their liability towards the execution of the respective components of the Third Plan The consideration of equity has dominated the scheme of overall distribution of federal assistance. It has been generally assumed that the aim of the assistance should be to equalise the standard of administration and provision of social services in the states. As an abstract principle, this postulate is unexceptional but

it should not be foregotten that whether rich or poor, all the states have a constitutional right to a share of income tax. A principle of distribution (i.e. collection) which is sound itself, should not be discarded and adjusted just because it would give unequal benefits to the states.²¹

From the reference quoted at length above, it is clear that collection as a criterion of inter-state distribution has the basic validity of specific principles and requires some increase in its weightage. The views of the Government of Maharashtra elaborated in Section B earlier can be taken as representative of industrial states. All strengthen the case for the increase weightage for the collection criterion in a convincing manner.

Notwithstanding all these arguments, the Finance Commissions have lacked the courage of their intention and they have stuck to the position of the marginal weightage to the collection criterion. Naturally it becomes necessary to critically summarise the views of the different Finance Commissions on which they supported the limited weightage and rejected the pleas of the industrial states to increase the weightage to be given the collection criterion.

The First Finance Commission rejected higher percentage

21 A. K. Chanda, Federalism in India - Study of Union State Relations, 1965, p. 242. The reference is to the recommendations of Third Finance Commission, 1961.

to the collection criterion mainly on the ground that, the basis of collection either unadjusted or adjusted with reference to residence to tax payers will not secure by itself an equitable distribution among various states.²² Income tax from a person who resides in Bombay but has property and income in say, Bihar, cannot be attributable to Maharashtra. The Second Finance Commission went a step ahead and totally opposed the principle of collection as a criterion of inter-state distribution. The Commission was of the view that income tax is paid by an infinitesimal portion of the population and the bulk of the tax arises out of the business incomes. The principle of collection in the context of economic integration of the country and the disappearance of barriers to inter-state trade, can no longer be considered an equitable basis of distribution. Therefore the Commission contended that it should be completely abandoned in favour of population as the basis of distribution.²³ The collection criterion received a more sympathetic consideration from the Third Finance Commission which is evident from the increased weightage of 20 per cent assigned to it. This increase in weightage given to the collection criterion was justified by the Third Finance Commission on the consideration of incentive to the industrial and urban states to maintain the environments which promote industrial and trade

22 The Report of the Finance Commission, 1952, p. 75.

23 The Report of the Finance Commission, 1957, p. 40.

activities, as also a compensation for the increased expenditure by the states on administration consequent upon problems of law and order resulting from industrial concentration.²⁴ The Fourth Finance Commission in a way thought that the problem of criteria for distribution need no further analysis and controversy.²⁵ At the same time it opposed any increase in the weight for the collection criterion for the reasons that a sense of certainty and stability as regards the principles to be adopted in the distribution of income tax should prevail.²⁶ The gist of the thinking of the Fifth Finance Commission is almost similar to that of the Second Finance Commission, and therefore, instead of increasing weightage given to the collection criterion, it reduced it once again back to 10 per cent. The reasons for this adduced by this Finance Commission are factors like difficulty in locating the ultimate origin of income, interdependence of the economic activities in different states, the growing impact of development undertaken through national plans and diversion of the point of collection and actual residence of the assessee.²⁷ Dr. D. M. Nanjundappa also seems inclined to agree with this view.²⁸ The Sixth Finance Commission also

24 The Report of the Finance Commission, 1961, p. 18.

25 The Report of the Finance Commission, 1965, p. 19.

26 Ibid.

27 The Report of the Finance Commission, 1959, p. 28.

28 D. M. Nanjundappa, Inter Governmental Financial Relations in India, 1974, p. 47.

examined the controversy regarding the collection criterion and came to the conclusion that it is both inadequate and unsatisfactory because it does not consider the incomes originating outside the states and provides larger transfer to industrial states which conflicts with the aim of redistribution.²⁹ The weightage of 10 per cent given to the collection criterion by the Fifth Finance Commission was reiterated by the Sixth Finance Commission and latter by the Seventh Finance Commission.³⁰ Prof. Rajkrishna, in his note of Dissent, states that any weight given to the collection criterion is regressive because a larger collection is invariably associated with a higher level of the State Domestic Product. The collections are mainly a function of the gross income generated in the factory sector. The more is the factory income of a state, the more is the extra weight it would get in the income tax award. This mechanism will be more favourable to the more industrialised states and therefore the progressivity of transfers due to other criteria is reduced by the regressivity of the weight attached to collection.³¹

The clear conclusion from the comparative examination of

29 The Report of the Finance Commission, 1973, p. 12.

30 Ibid., p. 12 and the Report of the Finance Commission, 1978, p. 63.

31 Rajkrishna, Note of Dissent entitled "A more Equitable Distribution of Resources", The Report of the Finance Commission, 1978, pp. 113-114.

the view of all the Finance Commissions is that none of the Finance Commissions has considered the collection parameter of major importance.³² The reasons for underplaying the collection parameter that emerge from this review belong mainly to two groups. The first group consists of practical difficulties regarding the divergence between the point of actual and real origin of income. The second group of considerations shows anti-redistributive potential of collection criterion in the allocation of national resources.

C.2 Population as a Criterion of Inter-State Distribution

Population has been accepted by all the Finance Commissions as the major criterion of inter-state distribution of states' share of the income tax revenue. It is also noteworthy that not a single state during the last 30 years has either totally rejected or wanted a drastic reductions in the weightage given to population. We have already stated that the population is taken as a proxy to the fiscal needs of the states. It is indeed undeniable that given other things a larger population will require a state government to spend more to provide its citizens with public services at a certain level. By extension of this analysis and on the basis of the historical fact that a larger population is generally an important characteristic of a more underdeveloped area, it is

³² S. Venu, The Finance Commission of India, I.F.M.R., Madras, 1978, p. 51.

evident that the more underdeveloped states will have greater fiscal needs because, on the one hand, their ability to raise revenue is limited and, on the other, their requirement to spend on public services will be larger. Therefore, population becomes a very important, relevant and valid consideration in the context of federal revenue transfers. We propose here to critically review the various arguments put forward in support of overwhelming weightage given to the population criterion in the inter-state distribution of states' share of income tax revenue.

Table 2.4 shows the weightage given by different Finance Commissions to the population criterion. The First Finance Commission gave 80 per cent weight to the population criterion. It means that 80 per cent of the States' share of the income tax revenue was to be distributed directly in proportion to the respective states' population. In the opinion of the First Finance Commission fiscal needs of the states are indicated broadly by the size of the population. Moreover, in their opinion, the population parameter ensures to a certain extent the fulfilment of redistributive justice in the context of allocation of national resources among the different states. The First Finance Commission felt that to secure inter-state distribution satisfying the requirements of distributive equity and at the same time conforming to the relative fiscal responsibilities of the different states, population is a more

efficient guide for policy formulation.³³ Similarly in its opinion the population criterion is definite unambiguous and authoritative. The Second Finance Commission increased the weightage given to the population criterion from 80 per cent to 90 per cent mainly due to following reasons. Firstly, it found that excepting the then Bombay State and West Bengal, all other states demanded a higher weightage to the population criterion. Secondly it believed that the population adequately subserved the consideration of fiscal needs which are a direct function of the size of the population on the one hand and the prevailing economic conditions on the other. The Second Finance Commission is so much in favour of population criterion that it was even prepared to completely abandon the criterion of collection.³⁴ However, it did not do this in view of the following considerations ; some of the incomes have specific local origin; there was going to be some reduction in the share-able pool consequent upon redistribution of income tax and industrial states were staunchly against any ^{reduction} ~~reduction~~ in the weightage of collection. The Third Finance Commission was in general agreement with the preceding Finance Commission's views regarding the population criterion.³⁵ However it reduced

33 The Report of the Finance Commission, 1952, p. 75.

34 The Report of the Finance Commission, 1957, p. 40.

35 The Report of the Finance Commission, 1961, p. 70.

weightage given to the population criterion from 90 per cent to 80 per cent in order to compensate the states' for the loss of revenue they had to suffer because of exclusion of company taxes from divisible pool of income tax revenue in the wake of constitutional amendment making all revenue from taxes on company profits a part of corporation tax which is excluded from sharing by the Constitution. It is interesting to note here that the chairman of the Third Finance Commission Mr. A. K. Chanda had reconsidered the issue and was more inclined to reduce the weightage given to population criterion.³⁶ The Fourth Finance Commission instead of going into the merits of the population and collection criteria emphasises the need for certainty and stability in the principles of inter-state distribution of income tax revenue and therefore it retained the formula recommended by the First and the Third Finance Commissions i.e. 80 per cent on the basis of population. According to the Fifth Finance Commission, the main purpose of federal devolution is to augment the resources of the States in an equitable manner and enable them to meet their growing needs.³⁷ Naturally it accepted the consideration of equity without questioning its validity and thought it necessary to increase the weightage for population criterion. Moreover, in order to secure a more balanced correspondence between needs and resources

36 A. K. Chanda, op.cit., p. 42.

37 The Report of the Finance Commission, 1969, p. 28.

of the states having different socio-economic circumstances and to avoid market disparities between more or less developed states resulting from a higher weightage for the collection criterion, the Fifth Finance Commission wanted that the weightage for population criterion should be increased.³⁸ The weightage given to population criterion by the Sixth and the Seventh Finance Commissions is the same as that of the Fifth Finance Commission. These two commissions were in general agreement with the analysis given by the Fifth Finance Commission in support of the higher weightage to population criterion.

38 Ibid.

CHAPTER III

SHARING OF DUTIES OF EXCISE AND ADDITIONAL DUTIES OF EXCISE

In the preceding chapter we have examined the centre-state and inter-state distribution of revenue from income tax which is one of the important direct taxes in the Indian tax system. Duties of excise along with additional duties of excise constitute the other important central revenues coming from the indirect taxes. In this chapter we critically review the evolution of the criteria according to which the centre-state and inter-state distribution of revenue from central excise duties is done. Similarly a critical examination of sharing of revenue from additional duties of excise is also attempted. This review is divided into three parts. The first part briefly presents the constitutional provisions regarding the federal sharing of revenue from excise duties. The part two discusses the evolution of principles which governed actual sharing so far, as well as the changing pattern of the quantum of the revenue share. The third part deals with genesis of the additional excise duties and examines the changing principles which govern the federal sharing of the revenue from them.

Part I - Constitutional Provisions
Regarding Excise Duties

Excise duties belong to that group of taxes which are to be levied and collected by the Central Government but the revenue from which may be distributed between the Union and the states. Article 272 of the Indian Constitution reads thus -

"Union duties of excise other than such duties of excise on medicinal and toilet preparations as are mentioned in the Union list shall be levied and collected by the Government of India, but if Parliament by law so provides, there shall be paid out of the Consolidated Fund of India to the states to which the law imposing the duty extends sums equivalent to the whole or any part of the net proceeds of that duty, and those sums shall be distributed among these states in accordance with such principles of distribution as may be formulated by such law".¹

If we read carefully the wording of Article 272 of the Constitution following important aspects become evidents.

- 1) The entire revenue from excise duties form a part of Consolidated Fund of India.
- 2) The excise duties can be levied and collected only by the Central Government.
- 3) The revenue from excise duty need not necessarily be shared with the states and the discretion lies with the

¹ The Constitution of India (As modified upto the 15th January 1980), p. 166.

Parliament to make a law making this revenue shareable with the states.

4) The Parliament may decide to transfer even the entire net proceeds of excise duties to the states.

5) Just as in the case of income tax, only those states where the law imposing the excise duties is applicable, will have a right to share in the excise revenue provided it is made shareable.

Part 3(a) of Article 280 of the Constitution says that the principles regarding the distribution of revenue of excise duties shall be laid down by the Finance Commission.

Although the federal sharing of revenue from excise duties is permissive its contribution to the shared revenue went on becoming more and more significant. Earlier, the sharing of income tax was the only important and effective balancing factor (i.e. a factor in the form of inter-governmental transfer of resources, which can reduce both vertical as well as horizontal fiscal imbalance in a federal structure) in the context of reallocation of national resources between the Centre and the States. It might be true that the framers of the Constitution thought that the sharing of income tax revenue only will not be adequate in the changing circumstances of the states resulting from increasing functional and developmental responsibilities assigned to the states. As such they incorporated an additional discretionary measures of reallocation

of revenue in the constitution itself. The choice of excise duties in this regard is justified on the grounds of its national coverage and high revenue productivity.

Eventhough the constitutional provision virtually empower the Parliament to appropriate all the revenue from the excise duties, the President took a wise decision in asking the First Finance Commission to make recommendations regarding the federal sharing of excise revenues. The wisdom of this decision has been accepted so far by succeeding Parliaments.

The quantum and revenue significance of this sharing of excise revenue will be evident from Table 3.1. From this table it is clearly seen that the total revenue of excise duties increased by about 3576* per cent during the period of 1955-56 to 1978-79. Similarly during the same period the central share in the excise revenue increased by 3077* per cent and the states share in excise revenue increased by 7445* per cent. In other words, the growth of the States' share in excise revenue is much greater than in the case of the Central Government. This shows that the sharing of excise duty has become more and more important for the states. Similarly the revenue from income tax which was transferred to the states was Rs. 53 crores in 1951-52, it increased to Rs. 706 crores in 1978-79. This is a growth by 1332 per cent. We therefore can say that the sharing of excise revenue has become more important for the states

* These figures are arrived at by calculating the percentage growth of 1978-79 figure related to the figure for 1955-56.

Table 3.1 : Quantum of Revenue Significance of Excise Duties for the Centre and State Governments

Year	Total tax revenue (centre)	Total revenue of excise	Central Share		States' Share		Total tax revenue (States)	Revenue significance for states*	Revenue significance for centre*
			Abso- lute amount	Per- cen- tage	Abso- lute amount	Per- cen- tage			
1951-52	357.0	67.54	-	-	-	-	281.10	-	-
1955-56	411.47	145.25	128.68	88.60	16.57	11.40	356.10	4.65	31.27
1960-61	730.14	416.35	341.25	81.96	75.10	18.04	624.80	12.01	46.73
1965-66	1784.62	897.20	751.28	83.74	145.92	16.26	1117.80	13.05	42.09
1969-70	2201.40	1524.31	1202.80	78.90	321.51	21.10	1980.90	16.23	54.63
1973-74	3899.80	2602.10	1971.40	75.76	630.70	24.24	3467.80	18.18	50.55
1977-78	7060.30	4221.50	3193.50	75.64	1028.00	24.36	6155.10	16.70	45.23
1978-79	8568.30	5367.20	4127.70	76.90	1239.50	23.10	6923.10	17.90	48.17

* Revenue significance of excise duties (or any other tax) is the percentage ratio of revenue of excise duties (or any other tax) to the total gross collection of the tax revenue of the particular (Centre/State) Government under consideration.

Source : RBI Bulletin, June 1971, July 1979 and August 1980.

than even the sharing of income tax revenue. Consider the revenue significance i.e. the percentage ratio of revenue from excise duties (or from any other tax) to the total gross collection of tax revenue of the particular government under consideration. In the case of excise duty the revenue significance for the Central Government was 31.27 per cent in 1955-56 which became 42.09 per cent in 1960-61 and rose to 48.17 per cent in 1978-79. The revenue significance of excise duty for State Governments was 4.65 per cent in the year 1955-56 which was became 16.23 per cent in 1969-70 and rose to 17.90 per cent in 1978-79. These figures show clearly that both for the Central as well as the State Governments, revenue significance of excise duties has grown over the years and is now quite high.

Naturally we are inclined to agree with the view of A. K. Chanda that 'Just as excise become the dominant element in the revenues of the Centre; so has it now become the major element in the devolution of resources to the States.'²

In view of the facts that sharing of excise revenue has become more important than the sharing of income tax and it has equally significant revenue importance both for the Central and State Governments. Critical examination of distribution between Centre and States, and further inter-state distribution of excise revenue, assumes great importance. Part two discusses all these issues involved.

² A. K. Chanda, Federalism in India - A Study of Union State Relations, 1965, p. 25.

Part II - Centre-State Distribution

Institutional provision for some kind of sharing of revenue from excise duties were made in the Government of India Act, 1919. Previously excise duties on salt, cotton, cloth and petroleum were fully appropriated by the Central Government. In some of the provinces these duties were partially shared and in some provinces the revenue from such duties accrued entirely to the province concerned. However, the 1919 Act wholly provincialised the excise duties on intoxicating spirit and drugs. In the subsequent period the number of goods covered by excise duties went on increasing. Salt is the only exception as a mark of respect for Mahatma Gandhiji. The Statutory Commission under the Government of India Act, 1935 made the first attempt to devise a scheme under which the Government of India would share Central revenue with the provinces in an indirect manner. It was suggested that a provincial fund should be established from the proceeds from certain new excises and possibly of the salt duty. The amount of the fund was automatically distributed among the provinces on a per capita basis accepting totally the population criterion. In 1932 the Parsee Committee suggested that the Federal Government should be empowered to assign to the provinces the whole or any part of the proceeds of federal excises. This proposal was also included in the Government of India Act, 1935, which was also approved by the Expert

Committee on financial provisions of the union constitution, 1948, providing explicitly that 50 per cent of the proceeds from excise duties on tobacco be assigned to the states. However, no explanation was given as to why only 50 per cent and not more or less. This ambiguity regarding the determination of Centre-State distribution was continued even in the Indian Constitution with one modification i.e. the distribution was made permissive.

In 1952, the First Finance Commission considered this issue breaking new grounds in the inter-government's fiscal transfers in India. In view of the constitutional provision for permissive sharing of excise revenue, the nature of the tax, the declining importance of income tax sharing, it became necessary that the role of a balancing factor be played more and more by sharing of excise revenue. This means that at least in absolute terms the states' share is the excise revenue must go on increasing. However, the relative share of the States has been reduced from 40 per cent revenue from these commodities as per recommendations of the First Finance Commission to 20 per cent as per that of the Sixth Finance Commission. However, the latter proportion actually resulted in a sizeable growth of the absolute quantum of excise revenue going to states. The Seventh Finance Commission increased the state's share further, as we shall presently see.

We shall examine in the following paragraphs the grounds on which changes have been made by the different Finance Commissions.

The rationale for the increasing number of excisable goods revenue from which will be shareable with the states was given by the First Finance Commission. It stated that the selected excises should be such as are levied on commodities which are of common and widespread consumption and which yield a sizeable sum of revenue for distribution. There should also be reasonable stability of yield and comparative immunity of the duties selected from the fluctuations related to changes in the custom's tariff.³ It is evident that duties on tobacco, matches, vegetable products were selected because they presumably satisfy the above conditions. Subsequently the number of commodities were increased from three to eight by the Second Finance Commission, 8 to 35 by the Third Finance Commission and after that the revenue from basic excises on all commodities became shareable. Finally revenue from all kinds of excise duties was made shareable by the Seventh Finance Commission except that from cesses covered by special acts. However, the States' overall share^{of} excise revenue oscillated between 20 per cent and 40 per cent only.

The convenient reason for this, given by these commissions seems to be that the absolute amount of the states' share went on increasing even on the basis of small percentage because of the inclusion in the divisible pool of the excise revenue from increasing number of commodities as also of different types of

3 The Report of the Finance Commission, 1952, p. 82.

excises. In fact the percentage of overall share of the states in the excise revenue suggested by the various State Governments to the First and Second Finance Commissions varied from 50 per cent to 70,⁴ 50 per cent maximum in case of Fourth Finance Commission,⁵ 30 per cent to 50 per cent in case of Fifth Finance Commission,⁶ 33.33 per cent to 50 per cent in the case of Sixth Finance Commission,⁷ and finally around 50 per cent of in the case of Seventh Finance Commission.⁸

The increase in the percentage of states share was expected because of increase in the number of commodities, excise revenue from which was to be shared. It is interesting to note that the reduction in the percentage share of excise revenue to be assigned to the states was justified by the Fourth Finance Commission in the following manner : "We take the view that in determining the overall shares of the states, due regard has to be given to the requirements of the states on the one hand and the needs of the Union Government on the other."⁹ However, the report of the said Commission did not specifically explain how the requirements of the Centre and the State Governments are to

⁴ The Report of Finance Commission, 1952, p.82 and the Report of the Finance Commission, 1957, p. 42.

⁵ The Report of the Finance Commission, 1965, p. 26.

⁶ The Report of the Finance Commission, 1969, p. 32.

⁷ The Report of the Finance Commission, 1973, p. 14.

⁸ The Report of the Finance Commission, 1978, p. 84.

⁹ The Report of the Finance Commission, 1965, p. 26.

be determined and whether needs of the Central Government as such are the justification for reducing the share of the states. The Sixth Finance Commission has a more explicit view regarding this matter in so far as it pointed out that increased share of the states would benefit the industrial states, more than the backward states. In its opinion it is necessary to strike a balance between the plea of the states for a substantial increase in the divisible pool and the needs of the Central Government while at the same time equity in the aggregate transfer of resources as between surplus and deficit states has to be ensured. It further maintained that an increased divisible pool will give more benefits to the surplus states than to the deficit states.¹⁰ However, whether undefined condition like needs and equity are germane¹¹ to tax sharing and can form the basis for reducing a particular states' share in the excise revenue, remains still inadequately explained.

On the other hand, the demand of the states, for an enlargement of the divisible pool was based on the following arguments.¹²

1) Increasing incidence of the central excise duties adversely affects the levy and collections of the sales tax

10 The Report of the Finance Commission, 1973, p. 15.

11 The Government of Maharashtra, Memoranda submitted to Sixth Finance Commission, 1973, p. 6.

12 The Report of the Finance Commission, 1965, pp. 25-26; The Report of the Finance Commission, 1969, pp. 33-34; The Report of the Finance Commission, 1973, p. 15 and The Report of the Finance Commission, 1978, p. 62.

which is the only elastic and also the most significant tax of the states.

2) Increasing committed expenditure of the plans forms a revenue account item which increases the needs of the states, but for which plan assistance is not obtainable.

3) A larger share of the states, in the excise revenue will achieve the objective of ensuring greater efficiency in the levy and collection of excise duty because only then both Central and State Governments will have common interest in the tax.

4) Excise duties have high elasticity and buoyancy values and therefore states' larger participation in the excise revenue will make their revenue also more elastic.

The arguments made by the states for bringing all excisable commodities within the divisible pool are of the following nature.¹³ First, the commodities subject to the excise duties have almost invariably a country-wide consumption. There is no justification for selecting only new commodities for sharing. Second, inclusion of a larger number of commodities in the divisible pool of the excise revenue would ensure the evenness in the flow of resources to the states because there will be internal neutralisation of fluctuations in the revenue from different commodities subject to excise duties. As a result, the states revenue position will become more stable. Third,

13 Ibid.

if for any reason excise duty on a shared commodity is reduced or abolished and substituted in part or whole by a levy on a related product not included in the shareable list, the states stand to lose. Fourth, in a developing economy new lines of product will emerge and therefore any formula of sharing must include these lines of production also. Finally the states have been arguing again and again that sharing of income tax is becoming less and less significant which makes a larger sharing of revenue from all excises for the states a practical necessity.

In the memoranda submitted to the Seventh Finance Commission by various State Governments, all the above arguments were once again strongly reiterated.¹⁴ For the first time in view of its exercise regarding the measurement of increasing central needs as well as the needs of the state governments, the Seventh Finance Commission agreed to the demand of the states for a larger share in the excise revenue irrespective of categories of excise duties and increased it to 40 per cent of the net proceeds of excise revenue of all commodities.¹⁵

Inter-State Distribution

A look at Table 3.2 shows that weightage given by seven Finance Commissions to population as a criterion for distributing inter-states' share of the excise revenue allotted to the

¹⁴ The Memoranda submitted by the State Governments to Seventh Finance Commission, 1978.

¹⁵ The Report of the Finance Commission, 1978, p. 85.

Table 3.2 : Weightage of the Population Criteria in the Inter-state Distribution of Excise Revenue

	Finance Commission						
	1	2	3	4	5	6	7
Weightage in %	100	90	*	80	80	75	25

* Not specified.

states. All the Finance Commissions used population as a criterion only as a proxy for consumption of excisable goods. They considered consumption as a more relevant criterion. The use of population as a proxy for consumption was accepted by these Finance Commissions in view of the paucity of reliable consumption data. It is against this background that we shall discuss the alternative criteria governing the inter-state distribution of revenue from excise duties.

The First Finance Commission assigned 100 per cent weightage to the population criterion which means that it considered population as only relevant factor measuring the statewide consumption of excise commodities. This implies that the First Finance Commission accepted the naive assumption that a larger population necessarily leads to a larger consumption of the excised commodities, and thus larger excise revenue. It was but natural that this method led to equal per capita transfer of excise revenue to all states. The First Finance Commission

adopted this approach for two reasons. First, there was almost total lack of relevant consumption data which can precisely measure the contribution of the different states to the excise revenue and as such the population became the proxy to measure consumption. Second, it though that population criterion would satisfy both needs and equity consideration in resource transfers.¹⁶

The Second Finance Commission introduced a slight change in the system. It considered population as a major determinant of shares of the states but reduced the weightage given to the population to 90 per cent and give 10 per cent weightage to adjustment mechanism. The adjustment was to be made in favour of the states having a more disadvantageous position in relation to the rest. However, the exact basis of adjustment was not specified by the Commission. In this case also, the weightage given to population criterion was justified on the grounds of non-availability of consumption data and also the consideration of need and equity in resource transfer.

In recommendation of the Third Finance Commission, no specific weightage is given to the population criterion even though the Commission felt that "Population should continue to be the major factor of distribution."¹⁷ However, it considered factors like relative financial weakness of the states,

16 The Report of the Finance Commission, 1952, p. 82.

17 The Report of the Finance Commission, 1961, p. 22.

disparities in the levels of development reached, the percentage of scheduled castes and scheduled tribes and backward classes in their population as relevant factors in interstate distribution of excise revenue.¹⁸ It is inexplicable why the Third Finance Commission did not specify exact weightages given to the above factors as also to the population. Instead, it gave only a schedule of distribution purportedly based on these considerations. The Fourth Finance Commission gave 80 per cent weightage to the population criterion, and the remaining 20 per cent of the states share of excise revenue was to be distributed among the States on the basis of backwardness of the states as reflected by.¹⁹

- 1) per capita gross value of agricultural production;
- ii) per capita value added by manufacture;
- iii) percentage of enrolment in classes I to V to the population in age group 6 to 11;
- iv) population per hospital bed;
- v) percentage of workers (as defined by census) to the total population;
- vi) percentage of rural population to the total population; and
- vii) percentage of population of scheduled castes and scheduled tribes to the population.

The consideration of so many variables by the Finance

18 Ibid.

19 The Report of the Finance Commission, 1965, pp.28-29.

Commission to ascertain the needs of the states as well as to satisfy the dictates of equity shows that population is neither a precise indication of consumption nor a good measure of financial weakness, which in turn is not necessarily a measure of socio-economic backwardness. However, it has to be noted that the Fourth Finance Commission did not specify the weights given to these different indicators of socio-economic backwardness.

The Fifth Finance Commission was broadly in agreement with the Fourth Finance Commission's approach; it did not change the weightages given to the population and economic backwardness criteria namely 80 per cent 20 per cent respectively. However, the indicators of socio-economic backwardness selected by the Fifth Finance Commission are slightly different, namely

- i) Scheduled tribes population;
- ii) Number of factory workers per lakh of population;
- iii) Net irrigated area per cultivator;
- iv) Length of railways and surfaced roads per 100 sq.kms.
- v) Short fall in number of school going children as compared to those of school going age;
- vi) Number of hospital beds per 1000 population.

These factors were to contribute what the Finance Commissions described as the integrated index of backwardness and the weight given to this was 6.66 percent and the remaining 13.33 per cent weightage was given to the criterion of per capita income. In other words, 13.33 per cent of the states

share was to be distributed to all the states in proportion to the shortfall of the states per capita income from all states' average per capita income multiplied by the population of the state.²⁰ Here again the exact method by which the integrated index was constructed was kept undisclosed by the Finance Commissions.

The Sixth Finance Commission reduced the weightage of population slightly from 80 per cent to 75 per cent and the weightage for socio-economic backwardness was increased to 25 per cent. It is interesting to record here that the Finance Commission holdly rejected a long list of 23 indicators of backwardness suggested by different states on the ground that most of the indicators refer either to characteristic that are themselves the causes of low per capita income or to characteristic that are direct or indirect consequences of low per capita income. Moreover, the assignment of weightage among the different indicators is an intractable issue. Therefore the Finance Commissions took per capita income as the sole criterion in assessing the relative economic position of the states.²¹ The exact manner of distributing this 25 per cent share as given by the Sixth Finance Commission is more equitable because larger the distance of a particular states' per capita income from that of the highest per capita income state,

20 The Report of the Finance Commission, 1969, p. 36.

21 The Report of the Finance Commission, 1973, pp. 16-17.

greater and greater will be the share available to the state. More simply, poorer states will get more and relatively better-off states will get less with the state with maximum per capita product getting no share in this portion. The share of the states will be given by distance of the state's per capita income from that of the state with the highest per capita income multiplied by the population of the state concerned according to 1971 Census.

The Seventh Finance Commission made an important contribution to the method of inter-state distribution of states' share of the excise revenue. Along with the population, it considered per capita income as a relevant criterion for inter-state distribution. More importantly for the first time the Seventh Finance Commission related to the inter-state distribution to the problem of poverty. Moreover, to satisfy the condition of the revenue requirements of the states in an objective manner, it suggested the principle of revenue equalisation. In other words Seventh Finance Commission suggested that the states' share in the excise revenue should be distributed among the states on the basis of equal weightage to four criteria i.e. population, inverse of per capita State Domestic Product, the percentage of poor in each state and revenue equalisation.²² In consequence the recommendation of the Seventh Finance Commission significantly reduced the importance of population as a criterion for inter-state

22 The Report of the Finance Commission, 1978, p. 86.

distribution. The reason for this is to minimise the regressivity inherent in the population criterion and to make the inter-state distribution more progressive i.e. more favourable to the economically backward states. The criterion of inverse of the per capita State Domestic Product was brought in. The value of inverse of per capita State Domestic Product will be greater for the backward states than the respective value for the more developed states. Naturally, inter-state distribution, directly in proportion to the inverse of the per capita State Domestic Product, will transfer a larger share to the backward states. The criterion of poverty ratio might be considered as an attempt to relate resource transfer to the states' relative poverty, the contention being that the needs of a state having larger poverty ratio will be greater than the needs of a state having smaller poverty ratio. This is acceptable because the ability of a state having a larger poverty ratio to raise revenues is necessarily limited both by way of direct and indirect taxes, whereas in a federal set-up welfare expenditure responsibilities of the state will be greater precisely for the same reason. Finally revenue equalisation aims at transferring more share to those states whose revenue raising capacities are evidently smaller than the more developed states. This is done by calculating the average of own tax and non-tax revenue for 1975-76 and 1976-77 period. Regressing these on the average per capita income for the period of 1973-76, we get the estimate of per capita revenue potential of

each state. The distance of the per capita revenue potential of a state from that of the state having lowest per capita revenue potential is measured. This distance is multiplied by the estimated population of the state as on 1st March 1976. Similar products will be calculated for all states. The percentage of such product for a particular state to the sum of such products of all states give the percentage share of that state in the 25 per cent of the component of the divisible pool of excise revenue.²³ The Finance Commission felt that the adoption of this composite criteria would satisfy the requirements of equity, need, attributability and at the same time encourage greater tax efforts in so far as state lacking in tax efforts will not be rewarded nor a state will be penalised for mobilisation of resources in excess of its estimated resource potential.²⁴

This survey of the criteria for inter state distribution of the excise revenue highlights the emphasis placed by all the Finance Commissions on the population criterion. It is true that the Seventh Finance Commission drastically reduced the weightage given to population from 75 per cent to 25 per cent. However it can be argued that the population itself even with reduced weightage cannot represent precisely the consumption of excise commodities in a particular state. It is also to be noted that population in itself cannot be

23 The Report of the Finance Commission, 1978, pp. 86-87.

24 Ibid.

accepted as a proxy of collection. The collection will depend only on consumption which in turn depend mainly on levels of income. However, in the absence of consumption data population has been accepted as a proxy for collection because given the level of income, larger population mean larger collection. Moreover, the acceptance by all Finance Commissions of the population criterion derives from the lack of accurate comparable data of consumption of excise goods in different states rather than from the scientific validity. This does not mean that the availability of the precise data will be the justification for making consumption; the only criterion for the inter-state distribution of excise revenue. We know that the sharing of revenue from excises is permissive unlike income tax. The argument for the collection criterion becomes logically as well as legally unassailable in the case of income tax because of constitutional provisions which confers on states a right to share in the income tax revenue which do not form a part of the Consolidated Fund of India. On the other hand and perhaps consequently the constitution makers made the sharing of excise revenue permissive and the entire proceeds of the excise revenue a part of the Consolidated Fund of India. This enables the Parliament through the agency of the Finance Commission to adopt consideration which are more relevant from equity and need point of view. It is indeed a credit to the members of the Third Finance Commission (to a lesser extent, also to the members of the Second Finance Commission) that they

started thinking about different indicators of socio-economic backwardness as criteria for inter-state distribution. The Fourth Finance Commission also adopted the same way of thinking as that preceding Finance Commission. The Fifth and the Sixth Finance Commission refined this approach which has subsequently been perfected by the Seventh Finance Commission. It is felt that instead of continuing with 25 per cent weightage of population, the same should be given to the consumption ^{Criterion} creation and requisite data should be collected in an earnest manner. The lack of this data cannot now be allowed as an excuse to rely on inappropriate and inadequate criterion like population. With this modification, the composite criterion suggested by the Seventh Finance Commission will become ideal because it satisfies condition of needs, redistributive justice and fiscal efficiency.

Part III - Additional Duties of Excise

This part examines the problems connected with resource transfers due additional duties of excises. In May 1957, Government of India introduced additional duties of excise replacing sales tax (of the states) on mill made textiles, sugar, tobacco (including manufactured tobacco). For this change the consent of the State Governments was obtained in the form of an unanimous agreement in the National Development Council in December 1956. The net proceeds of such additional duties of excises were to be distributed among the states subject to the condition that the then income devised by each

state from these particular sales taxes in 1956 will be assured to them. Subsequently, the Parliament passed Additional Duties of Excise (goods of special importance) Act 1957. The manner in which the amount will be determined and excess if any distributed among the states, formed an additional term of reference of the Second Finance Commission. The additional duties of excises are in the sense a tax rental agreement because in this case a taxing power constitutionally given to the states is taken over by the Central Government with the consent of the states in the interest of economic efficiency and administrative convenience. It implies the principle of full compensation to the party which vacates the field of taxation, in this case, the State Governments in Indian Federation. The rationale of the additional duties of the excises emanates from following points which have been cited by the subsequent Finance Commissions.²⁵

1) Unlike sales tax which can be single point, two point and multiple point in nature, additional duties of excise will be collected from only the first point i.e. final stage of production. As a result the chances of evasion are reduced and revenue productivity is enhanced.

2) Sales tax being a state subject, will be regulated in each state by different legislation with different administrative structure. This creates inconvenience for trade industry

²⁵ The Report of the Finance Commission, 1965, pp. 31-32 and the report of the Finance Commission, 1969, pp. 38-39.

and consumer particularly when the concerned commodities assumed special importance because of their national production and consumption base. Additional duties of excises remove all these complications.

3) The provision of guaranteed compensation of a certain quantum ensures that the state will not be put to an apparent loss.

4) Unlike sales tax additional duties of excises lead to uniformity in the inter-state incidence of the tax. This facilitates a more effective control of incidence of commodity taxation particularly when the commodities have a national wide mass consumption. Naturally additional duties on excise become useful instrument of national fiscal policy.

Following are some of the important issues which emerge from the introduction of additional duties of excise. Firstly, the guaranteed amount or the concept of present income. The 1957 Act provides that the states will be compensated for the sales tax revenue they lose because of additional duties of excise. The compensation was to be equal to the present income derived from the data on the sales tax of the states on the commodities concerned for the budget 1956-57. This compensation, known as guaranteed amount, should also be determined with reference to the subsequent increases in the sales tax rates, coverage etc.,²⁶ because most of the state governments

26 The Report of the Finance Commission, 1961, p. 26.

had in fact made some increases in the rate and/or coverage of the sales taxation. These increases would have become applicable to the commodities subject to additional duties of excise which would have definitely increased the revenue for the states in the subsequent period in the absence of this tax rental agreement. Regarding this question Second to Fifth Finance Commissions interpreted the meaning of the concept of present income as that which have accrued to the states at the 1956-57, rates of sales tax. The claims of the states regarding subsequent increases in the rates, better collection and future increases in the rate of sales tax were rejected on the ground that it would were discriminating against the states which did not increase the tax rates. Secondly it has to be noted that the states have vacated a part of the field of sales taxation and as a result there could be no inter-state sales taxes in the case of these commodities.²⁷ Upto the Fifth Finance Commission the guaranteed amount was first calculated according to the method adopted by the Second Finance Commission and the excess was distributed among the states on the basis of certain other considerations. However, the Sixth Finance Commission and later also the Seventh Finance Commission thought this unnecessary in view of the enormous increase of the proceeds from the additional excise duties which even if distributed totally on the basis of other considerations would definitely

27 The Report of the Finance Commission, 1957, p. 60; The Report of the Finance Commission, 1961, p.20; The Report of the Finance Commission, 1965, pp. 32-33 and The Report of the Finance Commission, 1969, pp. 42-43.

ensure more than the guaranteed amount to each of the states. The actual proceeds during 1974-79 would be Rs. 1037 crores while the guaranteed amount was only Rs.162 crores. It is interesting to note that only Gujarat, Maharashtra and Uttar Pradesh wanted the practice of setting a part guaranteed amount first and distributing the balance afterwards continued. Other states either kept mum on this or agreed with the Sixth Finance Commission's approach because any way they would be getting more than the guaranteed amount. In short, the Sixth and Seventh Finance Commission discarded the practice of calculating guaranteed amount first and decided to distribute the entire net proceeds of additional duties of excise on the basis of criteria selected.

As to whether the additional duties of excise should be advalorem or specific, the Finance Commissions have conceded the demand of the states that they should be advalorem. Similarly all Finance Commissions which studied the problem felt that on the whole arrangement has worked smoothly and not at all to the detriment of the states.²⁸ The trading and industrial sector has sometimes represented to the Finance Commission that the coverage of the arrangement should be increased by increasing the number of commodities subject to the additional duties of excise. They justified this demand on the grounds of administrative simplicity and commercial convenience. However, the state governments strongly opposed the widening

28 The Report of the Finance Commission, 1969, p. 42.

the coverage of this arrangement because sales tax constitutes the only elastic and productive source for the states. In order to provide larger share of revenue from additional excise taxation, it was decided by the National Development Council in 1970 to increase the incidence of additional excises to the level of 10.8 per cent of the value of clearance.

Inter-State Distribution

Now we come to the principles of inter-state distribution of excess over guaranteed amount or as at present the entire net proceeds of the additional duties of excise. The National Development Council had agreed to the principle of consumption which was almost accepted by the Second Finance Commission.²⁹ The Second Finance Commission made marginal use of population as a corrective factor to minimise the distortion resulting from inadequate consumption data of different states. The Third Finance Commission recommended that the excess amount of the additional duties of excise should be distributed partly on the basis of the percentage increase in the sales tax collection since 1956-57 and partly population.³⁰ However, it did not specify the weightages of these criteria. The Fourth Finance Commission suggested a more direct principle that excess amount be distributed on the basis of the ratio of states sales tax collection to the total sales tax collection

29 The Report of the Finance Commission, 1957, p. 60.

30 The Report of the Finance Commission, 1961, p. 27.

in all the states.³¹ The Fifth Finance Commission suggested that the distribution of excess amount be on the basis of 50 per cent of sales tax collection and 50 per cent on the population size.³² The Sixth and Seventh Finance Commissions as noted earlier discarded the concept of the guaranteed amount and suggested a uniform set of criteria for the inter-state distribution of the entire proceeds of additional duties of excise. According to the Sixth Finance Commission were sales tax collection cannot reflect the consumption of commodities subject to additional duties of excise. It argued that consumption is directly related to the levels of income and that the latest data on the state domestic product could be taken as a broad indication of the likely consumption of these commodities in the states.³³ However, it also accepted the claim of the states that they should be compensated for the loss of revenue which they could have obtained by way of inter-state sales tax in the absence of additional duties of excise. In this regard, the Finance Commission accepted the production of excised commodities as the proper indicator because revenue from inter-state sales tax is directly related to the export of excised commodities from a state. It can be presumed that with increasing production exports also tend to increase. In the absence of data regarding exports the production of such

31 The Report of the Finance Commission, 1965, p. 34.

32 The Report of the Finance Commission, 1969, p. 44.

33 The Report of the Finance Commission, 1973, p. 20.

commodities in a particular state can be taken as a proxy for exports and thus for possible revenue from the inter-state sales tax. The Finance Commission suggested the following formula for the inter-state distribution of the entire net proceeds of additional duties of excise.

- i) 70 per cent on the basis of population;
- ii) 20 per cent on the basis of State Domestic Product at current prices;
- iii) 10 per cent on the basis of the production of commodities.

At the time of Seventh Finance Commission, the states like Maharashtra and Gujarat,³⁴ objected to the cancellation of the provision for guaranteed amount by the Sixth Finance Commission. The Government of Maharashtra and Gujarat maintained that this was against the spirit of the agreement reached in the National Development Council 1957. Moreover, they once again emphasised tax rental nature of the additional duties of excise as a result of which the states have a full claim to the revenue being collected in their areas. Therefore the Government of Gujarat suggested that the practice of guaranteed amount should be revived and these amounts should be taken as indicators of sales tax collection in the different states and maintain that the excess amount of the revenue from additional duties of

³⁴ The Government of Maharashtra, Memoranda submitted to the Sixth Finance Commission 1977, p. 15 and the Government of Gujarat, Memoranda submitted to the Sixth Finance Commission, 1977, pp. 45-46.

excise should be distributed among the states in proportion to the guaranteed amount only. The Seventh Finance Commission accepted the view that the principle of compensation is appropriate in regard to inter-state distribution of the revenue. It therefore adopted the following approach. The sales tax is ultimately paid by consumers. Naturally larger the consumption of the taxed commodities larger will be the revenue from the tax. So it would be appropriate to distribute the revenue from additional duties of excise on the basis of statewise consumption data. In view of the paucity of reliable consumption data earlier Finance Commissions had suggested population, sales tax revenue, State Domestic Product and production of commodities as criteria. The Seventh Finance Commission tried to find out indirect indicators of consumption of tobacco, textile and sugar. In the case of sugar, it relied on the figures of dispatches of sugar from Central Government to State Governments ^{as} and indicators of consumption³⁵ of sugar in a particular state. On the strength of the advice given by the Food and Agricultural Department, Government of India, finally it suggested that the revenue of additional duties of excise on sugar should be distributed among the states on the average of dispatches for three year period ending 1976-77.³⁶ Regarding tobacco and textiles, the Commission could not get even the reliable indirect indicators, so

35 The Report of the Finance Commission, 1978, p. 48.

36 The Report of the Finance Commission, 1978, p. 62.

it argued that consumption of these commodities will be directly related to the state domestic product and recommended that the revenue from the additional excise duties on tobacco and textiles should be distributed among the states in direct proportion to the product of the average per capita state domestic product for the period 1973-76 and population according to 1971 Census. In the process the Seventh Finance Commission rejected states' (Kerala, Haryana, Maharashtra and Tamil Nadu) view that collection of total sales tax revenue in the states should be taken as an indication of also the collection of additional excise duties on tobacco and textiles and inter-state distribution related to it.

CHAPTER IV

SUMMARY AND CONCLUSION

In a country having a federal political structure, inter-governmental fiscal relations assume strategic significance. A smooth working of fiscal federalism is, if not a sufficient condition, at least one of the necessary conditions of the stability and continuity of the federal organisation. In this study an attempt has been made to examine critically a major aspect of Indian Federal finances i.e. tax sharing mainly with reference to the system that generally evolved from 1952 onwards.

A review of the fiscal provisions in the Indian constitution shows that legislative powers and financial resources are divided between the Union and the State Governments in a very elaborate and explicit manner. The areas of frictions are minimised and a great scope for financial cooperation is provided. The political harmony between the Federal and Union Governments has received careful attention.

Chapter I shows how both vertical and horizontal fiscal imbalances have grown in Indian set up despite the elaborate and careful division of functions and fiscal powers. It is clearly seen that the Central Government is placed in a strong fiscal position as against the state which have to face unfavourable fiscal imbalance. It is seen that the Central

Government has had consistently an average of 69.5 per cent surplus revenue in relation to its expenditure responsibility, whereas the States' fiscal adversity (excess of expenditure over revenue) has been on an average of the tune of 39.52 per cent. This vertical imbalance can also be measured by the ratio of central transfers to states' total expenditure. This ratio in the First Plan period was 41.3 per cent which increased to 47.5 per cent during the Fourth Plan period. This tendency has continued in the subsequent period also. The existence of horizontal fiscal imbalance in Indian Federation is the result of regional economic disparities. Different states have different fiscal potentials because of differences in economic endowments. These lead to differences in the rate of economic growth and naturally some states lag behind others particularly in provision of public services. In such a situation redistributive transfers of resources from the Centre to States become necessary to ensure balanced regional development because the stability of the federal structure depends on this.

In Indian federal structure, federal resource transfers are done through three channels. (1) On the recommendations of the Finance Commissions appointed under Article 280 of the Constitution. These relate to mainly to obligatory and permissive sharing of taxes under Articles 269, 270 and 272 and grants under Article 275; (2) by the Planning Commission mainly in the form of grants under Article 282 and Central loans;

(3) by discretionary transfers made by various Central Ministries in the form of grants and loans to the states mainly for specific purposes.

The Finance Commission is entrusted with the responsibility of making recommendations regarding the principles of Centre-State distribution and inter-state distribution. Our study clearly shows that resource transfers in the form of tax sharing constitute the major task of the Finance Commission. During 1951-56 of the total transfer made by the Finance Commissions 72 per cent were in the form of transferred tax revenue and in the 1974-79 period this increased to 74 per cent.

The Sharing of Income Tax

According to the provision of the Constitution under Article 270, net revenue from the tax on income (excluding agricultural income, corporation income, union emoluments) has to be shared with the State Governments. The Finance Commission recommends the principles according to which the shares of the Central Government and the State Governments are determined as also the principles on which inter-state distribution is to be made. Our review has shown that in the pre-independence period Centre-State sharing of this tax was considered mainly as an instrument for correcting vertical imbalance. From 1952 onwards, it started being considered as a corrective factor not only for vertical fiscal imbalance, but also for horizontal fiscal imbalance. All Finance Commissions

thought of two criteria namely population and collection in inter-state distribution of states' share. The population is getting overwhelming weightage. This review also shows that consecutive Finance Commissions increased all over share of the states from 55 per cent to 85 per cent of the income tax revenue. This increase in the states' share seems to be justified on the following grounds : (1) The redefinition of income, which excluded tax on corporation incomes from sharing. (2) The continuous use of surcharges made by the Central Government and kept non-shareable. (3) Exclusion of tax on Union emoluments from sharing. The more interesting point is the exclusion of the corporation tax from sharing. If we look at the growth of revenue from income tax and corporation tax overtime, it becomes clear that the corporation tax is assuming a greater revenue significance. In 1960-61 revenue from income tax was Rs. ¹⁶⁷160 crores which rose to Rs. ¹⁴⁷⁶1546 crores in 1980-81 while the revenue from ^{Corporation} income tax was only Rs. 111 crores 1960-61, but increased to Rs. 1515 crores in 1980-81. Moreover, the revenue significance of income tax for both Central and State Governments has generally decreased because of the increasing importance of indirect taxation at both levels. It is for this reason that demands for making revenue from corporation tax shareable will go on becoming more and more emphatic.

Inter-State Distribution of States' Share of Income Tax Revenue

The problem of determining the inter-state distribution

of states' share of income tax revenue has consistently attracted the attention both of the state governments and Finance Commissions. Generally it can be said that the Finance Commissions have given importance to the criterion population varying between 80 per cent and 90 per cent and made changes in the criteria of collection from 20 per cent to 10 per cent. In fact the weightage given to population has remained between 80 per cent and 90 per cent mainly on the consideration of need element. Most of the Finance Commissions thought that the need of the states as reflected by population constitutes a more relevant factor than collection. The collection was given limited consideration on the grounds that collection relates the presumed origin of income which in itself is not traceable regionally in view of the complex inter relation of economic factors which are spread in a continuous manner over all the regions of the country. Secondly, in a federal structure, where the Central Government is entrusted with the responsibility of redistributive of ~~an~~ justice, population becomes a more direct indicator of the need element in view of the differences in economic endowments among states. A perusal of view points of State Governments as reflected in their memoranda submitted to the different Finance Commissions reveals two different approaches; (a) more industrialised and richer states want a greater weightage to the collection criterion and (b) less industrialised and poorer states want greater emphasis on population criterion. It is indeed very difficult to resolve

this conflict because the consideration of economic efficiency justify greater emphasis on collection and consideration of redistributive justice demands greater emphasis on population criterion. In a developing economy where economic efficiency should be guiding principle, some increase in weightage given to collection criterion may seem to be in the right direction; lest, the allocation of resources may go against the dictates of the needs of economic development.

Discussion regarding the appropriateness of the criterion for inter-state distribution of the states' share compel us to make some concluding remarks. Firstly, it is clear that the population criterion has been accepted by all Finance Commissions on the ground of equity considerations of enabling states with different capacities to have more revenue adequately so that they correspond with their needs. In spite of the fact that an eminent authority like Mr. A. K. Chanda emphasised the objective soundness of collection criterion to be more important, it has been given a marginal weightage only, the major reason of this being the regressivity of resource transfers that will result from its adoption.¹ According to D. M. Nanjundappa, population is a very simple indicator of the need of the states. If the inter-state distribution of the states' share is made on the basis of population criterion it will simply be ^a tantamount to equal per capita grant. As a result

1 A. K. Chanda, op. cit.

per capita resources transferred according to this principle will become regressive.² This is clear from the fact that per capita transferred based on population criterion will be equal for the citizens of both more developed and less developed states. Moreover, one has to take into consideration the problem of the area of the state as well as the density of population of the state which affect significantly per unit cost of providing the same standard of public goods. It, therefore, is doubtful whether population criterion is really a non-regressive criterion of inter-state distribution. This apprehension is substantially strengthened by the recent feelings among leading experts like S. Venu, R. Chellia that the resource transfers effected by the Finance Commissions so far have in fact tended to be regressive.³ It is therefore necessary to persuade the next Finance Commission to discontinue the practice of inter-state distribution of income tax revenue on the basis of collection and population criteria only. Indeed it is now high time that states' share of revenue of income tax is distributed among states on the basis of relative needs which can be measured precisely only on the basis of a composite index consisting of several indicators of the stage of economic development, the actual performance (tax efforts and expenditure economy and efficiency), population, area and social

2 D. M. Nanjundappa, op.cit., p. 50.

3 S. Venu, op.cit., p. 62 and R. Chellia, Trends and Issues in Indian Federal Finance, NIPFR, 1981.

measures of backwardness as also the special problem and features of the states. Fortunately, beginning of this thinking on these lines have been made with the work of the Third Finance Commission and improved by the subsequent Finance Commissions but only in regard to the inter-state distribution of excise duty.

Sharing of Revenue from Excise Duties

In Chapter III, a critical examination of the sharing of excise duties and additional duties of excise has been made. Article 272 of the constitution provides for the permissive sharing of union duties of excise with the states. The revenue from these duties forms a part of Consolidated Fund of India first and then by a law of Parliament provides for this share according to the recommendations of Finance Commissions; even the whole of the revenue from excise duties may be transferred to the states.

Although the sharing of excise duties is permissive its contribution to the shared revenue went on becoming more and more significant. Well from the beginning, the Central Government made sharing of excise revenue a part of the terms of reference of the Finance Commissions. In fact the sharing of excise revenue has become more important for the states than sharing of income tax revenue. The revenue significance of excise duties for the Central Government was 31.37 per cent in 1953-56 and 48.71 per cent in 1978-79. Similarly the

revenue significance of the excise duties for the State Governments was only 4.65 per cent in 1955-56 which rose to 17.90 per cent in 1978-79. Therefore, it is evident that excise duties have become a major element of the devolution of the resources to the states.

It is also interesting to note that over the last 30 years, the scope of this sharing has increased because of the increased number of shareable excise duties as also the inclusion of special auxiliary and other types of excise duties in the shareable pool. However, the states' overall share of excise revenue oscillated between 20 per cent to 40 per cent only. In fact the states' share was gradually decreased from 40 per cent to 20 per cent till the Sixth Finance Commission. The Seventh Finance Commission increased this share of the states to 40 per cent of the net proceeds. The reasons for the plea for increase in share adduced by the State Governments to the Finance Commissions mainly related to : (1) adverse effects of increasing incidence of central excise on the levy and collection of sales taxes. (2) increasing committed expenditure of the states for which plan assistance was not obtainable. (3) high elasticity and buoyancy values of excise duties so that larger share for the states will make the states' revenue also more elastic. (4) the over all consideration determining the Centre-States distribution related mainly to predominant revenue significance of excise duties, the needs

of sufficiency of the Central Government as also growing needs of the State Governments on account of rapid growth of committed expenditure.

Inter-State Distribution

All the Finance Commissions considered population as one of the major criteria for inter-state distribution of the states' share in the excise revenue. The weightage given to this population factor was 100 per cent in case of First Finance Commission which was marginally decreased to 75 per cent by the Sixth Finance Commission. The Seventh Finance Commission, however, reduced the weightage of population to only 25 per cent. In this regard initially, population was considered to be the only relevant factor measuring statewide consumption of excised commodities. This was done because statewide consumption data of excised commodities are not available. In other words, the predominant weightage given to population by First Six Finance Commissions is based on assumption that consumption is proper indicator of the states' share and population is a proxy to consumption. Beginning with the Second Finance Commission other criteria came into for the inter-state distribution of excise revenue. The Second Finance Commission gave 10 per cent weightage to adjustment mechanism to be in favour of the weaker states. The Third Finance Commission considered factors like relative financial weakness of the states, disparities in the level of

development and percentage of scheduled castes, scheduled tribes and backward classes in the states population. It did not, however, specify the exact weightage for any of these criteria including population. This approach of the Third Finance Commission however became a routine consideration for subsequent Fourth and Fifth Finance Commissions, which discussed a host of indicators of socio-economic backwardness of different states accepting the principle that more the socio-economic backwardness of the states greater will be the share in a portion of the divisible pool. The Sixth Finance Commission discarded the practice of considering these indicators and took the per capita income as a sole criterion in assuring the economic position of the states. It recommended that after allocating 75 per cent of the states' share on the population criterion, the remaining 25 per cent should be allocated on the test of socio-economic backwardness. The Seventh Finance Commission broke new grounds in inter-state distribution of excise revenue. The criteria of distribution recommended by the Commission, comprising of population, inverse per capita Domestic Product, poverty percentage and revenue equalisation with 25 per cent weightage given to above factors. It is felt that by adopting the above criteria, it would be possible to reduce the chances of the formula becoming either unduly favourable to certain states or working harshly against some others. However, it is not appropriate to rely continuously on population as a proxy for consumption and as

such this composite criteria should be modified slightly by replacing population by consumption with 25 per cent weightage. For this purpose, collection of consumption data commoditywise and statewise on a permanent footing is evidently a precondition.

Additional Duties of Excise

Additional duties of excise were not visualised in the constitution. They were introduced mainly in the interest of economic efficiency and administrative convenience by replacing sales tax of the states on textiles, sugar and tobacco, which are commodities of mass consumption throughout the country. The introduction of these duties was possible because the Central Government agreed to the principle of full compensation to the State Governments which vacated a part of these sales tax area. The net proceeds of additional duties of excise used to be distributed (upto Fifth Finance Commission) between the states in two ways. First, every state gets the guaranteed amount calculated on the basis of 56-57 revenue from sales taxes on these commodities in respective states. The inter-state distribution of the excess over the guaranteed amount also led to a gradual evolution of changing sets of criteria. These different criteria include consumption, population as a corrective factor, percentage increase in the sales tax collection, ratio of the states' sales tax collection to the total states' sales tax collection upto the Fifth

Finance Commission. The Sixth and Seventh Finance Commissions, however, scrapped the practice of guaranteed amount and started distributing the whole of the additional duties of excise on the basis of population, per capita income, and production of commodities of this tax. In fact both Sixth and Seventh Finance Commissions considered consumption as the most appropriate indicator of the states' share in the additional duties of excise.

In view of the tax rental nature of the arrangement, regarding the additional duties of excise, made possible through the mechanism of National Development Council's deliberations, the adoption of the principle of compensation by the Finance Commissions seems to be satisfactory. The opposition of the State Governments to extending the scope of this arrangement to other commodities is also justifiable on the grounds of fiscal autonomy comprising independence of both expenditure decision and revenue collection. The arguments of uniformity of tax system, administrative efficiency and convenience to the trading and industrial sector are alright but in a federal organisation the State Governments must have some sources of revenue significant for productivity and elasticity on the basis of which the State Governments can get required budgetary flexibility. To preserve sanctity of the National Development Council agreement regarding the guaranteed amount we feel that the review of the practice of calculating and setting aside the guaranteed amount should be a step in the right direction.

Apart from these considerations, the agreement evolved by the Finance Commissions regarding additional duties of excise and their inter-state distribution have characteristics which make them acceptable.

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