Introduction

It has been stated earlier that in a federation, no rigid formula for allocation of resources between the general and regional governments, however just and efficient, can cope with their changing financial needs and obligations arising from time to time. In almost every federation, there has supervened a dis-equilibrium between the functions and financial resources of the two governments. In all or most of them, the general government has emerged with a surplus of revenue resources while the regional governments have been left with more functions than they can pay for. The allocation thus made, therefore, necessitates adjustments and re-allocation in the light of changing conditions. Attempts have been made in various federations, to redress the resulting imbalance in different ways. But the method most usually adopted to adjust the situation is the transfer of funds by the general government to the regional governments. The other methods attempted are the transfer of functions from the units to the general government or the transfer of tax resources from the general to unit governments. But none of these solve the problem for while the former gives rise to serious political objections, the latter tends to increase the financial inequalities among the units. Thus if taxing power cannot be distributed between the Centre and the Units according to the level at which their respective functions have to be discharged in national interest, tax proceeds can perhaps be better distributed. It may also assuage the bitter feelings among the Units if they are given a definite right to participate in certain tax proceeds levied by the Centre.

1. Setalvad, 104.
The Constitution-makers realised the fact that the sources of revenue allocated to the States may not be sufficient for their purposes and that the Government of India would have to subsidise their welfare activities out of the revenue collected by the Union Government. They, therefore, embodied in the Indian Constitution, specific provisions, both mandatory and enabling, for facilitating the Parliament to set aside a portion of the Central revenue, whether forming part of the Consolidated Fund of India or not, for the benefit of the States, not in stated proportion, but according to their needs. The resources of the Union Government are thus, not meant exclusively for the benefit of the Union activities, they are also meant for subsidising the activities of the States in accordance with their respective needs. 2

To put it otherwise, while all revenue accruing to the States from their taxes is used by them, all taxes leviable by the Centre are not meant for its exclusive use. The Centre is required to share some of its taxes with the States.

The Indian Constitution provides for Centre-State tax sharing on a big scale. 'Tax-sharing' is, rather, inherent in the tax structure of the Constitution, without which the budgets of practically all the States will be run into huge deficits. 3

From this point of view, the Central taxes may be arranged in the following four categories:

(A) **Exclusively Union Taxes**: These taxes are levied and collected by the Union and retained in full by it. This category includes the following taxes.

- (a) Corporation tax;
- (b) Duties of customs including export duties;
- (c) **Taxes** on the capital value of assets exclusive of agricultural land, of individuals and companies and taxes on the capital of companies;

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2. *In Re the Sea Customs Act*, AI R 1963 SC 1760, at 1771.
(d) Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, profits and receipts;

(e) Surcharges on taxes mentioned in categories B and C below1; and

(f) Residuary taxes.5

(B) Central Taxes Compulsorily Shared With States6: This category includes taxes on income other than agricultural income. The expression 'taxes on income' excludes corporation tax also. Article 270 requires the Centre to hand over a part of the revenue, accruing from this tax, to the States. It says that "such percentage as may be 'prescribed' of the net proceeds" of this tax in a financial year, except the proceeds attributable to the Union Territories or to taxes payable in respect of Union emoluments",8 is to be distributed among the States in such manner as may be 'prescribed'. The divisible pool of income tax does not even form part of the Consolidated Fund of India. The word 'prescribed' here means prescribed by the President by order after considering the recommendations of the Finance Commission. Also, no law is to be enacted by Parliament in this matter.9

(C) Central Taxes Shareable Under A Parliamentary Law10: This category includes the Central excises (other than on medicinal and toilet preparations). They are to be imposed and collected...
by the Union but unlike the income tax, Centre-State-tax-sharing in this area is not compulsory but optional for the Centre. The revenue accruing under this head goes to the Consolidated Fund of India and if Parliament provides by law, payments out of this are made to the States.  

(D) **Central Taxes - Wholly Assignable to States** : This category may be classified into following two kinds of taxes:

(a) **Taxes levied and collected by the Centre but the whole proceeds thereof made over to the States** :

The taxes falling in this category are:

(i) Duties of succession and estate duty on property other than agricultural land;

(ii) Terminal taxes on goods and passengers carried by rail, sea or air;

(iii) Taxes on railway fares and freights;

(iv) Taxes other than stamp duties on transactions in stock-exchanges and future markets;

(v) Taxes on sale or purchase of newspapers and on advertisements published therein;

(vi) Taxes on sale or purchase of goods other than newspaper, taking place in the course of inter-State trade or commerce.

The net proceeds, in a financial year, of the above taxes except insofar as the proceeds attributable to the Union Territories, do not form part of the Consolidated Fund of India, but are distributed among the States in accordance with the principles formulated by Parliament by law. No part of the revenue arising from the taxes mentioned here is kept by the Centre. But the Centre may levy a surcharge on any of these taxes for its own purposes, which is not divisible among the States.

11. Ibid.
12. Article 269.
15. Article 271.
(b) **Taxes levied by the Centre but collected and appropriated by the States:**

Under this category fall stamp duties and duties of excise on medicinal and toilet preparations. The net proceeds except those collected by the Government of India for the Union Territories, in this area, do not form part of the Consolidated Fund of India.

The States themselves, collect the duties though under a Union Law. It is provided merely for legislative purposes so that there may be a uniformity of taxation throughout the country, and also for enabling the Centre to coordinate these excises with its own wider scheme of excises on other commodities.

A tax on the sale or purchase of goods taking place in the course of inter-State trade or commerce, also belongs to this category of taxes for it is levied by the Centre, but, under the Central Sales Tax Act 1956 is assessed, collected and appropriated by the exporting State.

**Conclusion**

The revenue transferred to the States by way of tax sharing under the above scheme is unconditional, which they can utilize in the manner they like. Thus the major burden of taxation, under the Constitution, falls on the Centre, while the States enjoy a part of the fruit of its efforts. The above scheme appears to augment appreciably the tax resources of the States and to curtail correspondingly those of the Centre. But politically and economically speaking, the Centre is in a much stronger position to tax than the States. Many-a-time, the States have claimed that the scheme works to their disadvantage for they do not have control over the level of taxation and that they do not enjoy flexibility of varying the rates of taxation to suit their needs as they could have done had the taxes been within their legislative field. However, the existing situation

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16. Article 268.
17. Section 9, Central Sales Tax Act 1956.
brings out that the rates at which the Centre is presently levying these taxes are pretty high and it is very doubtful according to Dr. M.P. Jain, if the States could have collected as much revenue themselves from these taxes as they secure now by way of their share from the Centre.  

As to the "taxes on income other than agricultural income", the net proceeds of which are required by the Constitution to be shared between the Centre and the States, the latter have been made to feel aggrieved. Article 270, as originally enacted, excluded corporation tax out of the expression 'taxes on income'. But the income-tax paid by the companies formed part of "taxes on income", thus shareable between the Centre and the States. The Finance Act of 1959, however, altered the definition of 'corporation tax' so as to include the income tax paid by the companies within its purview and classified it as 'corporation tax'. It is thus said that by a slight of hand, a goodly amount that used to be shared earlier was taken out of the shared tax pool. Such action, though not unconstitutional, had the effect of depriving the States of their share in that tax and creating a legitimate feeling of grievance among the States.

Excluding income tax paid by the Companies, which was historically a part of income tax, from the divisible pool of income tax receipts and thus classifying it as corporation tax, according to Dr. V.K.R.V. Rao amounts to "a violation of the spirit of the Constitution." The States argue that its


19. Giving expression to the grievances of the States, the Fourth Finance Commission observed: "Practically all the States have urged that ..., as a result of the change in the classification of the income-tax paid by the Companies brought about by the Finance Act of 1959, the rate of growth of the divisible pool has been adversely affected... that what the framers ... had intended to be a flexible and expanding sources of revenue to the States has ceased to have the significance that what once contemplated. Report, 17, 1965.

exclusion has reduced the elasticity of the income tax as a statutory part of the States revenue. It may be noted that the increase in the quantum of corporation tax has been far more rapid than that in income tax. In 1952-53 corporation tax yielded Rs. 43.8 crores as against Rs. 143.2 crores of income tax. The figure for corporation tax jumped from Rs. 54.3 crores in 1958-59 to Rs. 106.6 crores in 1959-60, while that for income tax slumped from Rs. 172.8 crores to Rs. 149.2 crores in the same period. By 1961-62 the corporation tax yield had caught up with income tax yield (Rs. 161.0 crores). In 1978-79 the yield of corporation tax even outstripped that of income tax, grossing respectively Rs. 1420.0 crores and Rs. 1140.0 crores. In 1980-81, corporation tax brought in Rs. 1515 crores against Rs. 1641.0 crores by way of income tax. The accompanying table shows the corresponding progress of the two taxes from 1952-53-1980-81.21

This increase in the share of corporation tax revenue in total direct tax revenue may be partly due to relatively faster growth of corporation income vis-a-vis non-corporate taxable income and partly due to relatively greater effort by the Central Government on mobilising corporation tax, a non-divisible revenue vis-a-vis personal and other income taxes which are shared with the States. Besides, with the development of the public sector, household industries and business enterprises are becoming bigger and may eventually become public limited companies. It is, therefore, argued that relatively greater stress on corporation tax as compared to personal and other income taxes will lead to potential revenue loss to the States.

The States further argue, and it is submitted rightly so that where the bulk of the revenue from a tax is transferred to the States, the Centre is far freer with slashing rates, and giving exemptions then in cases where it does not share the revenue with others. They allege that all or most of the important

21. Figures for 1981-83 are not available.
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<th>Year</th>
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<th>Surcharge</th>
<th>Total (1) &amp; (2)</th>
<th>Percentage of (4) to (8)</th>
<th>Corporation tax</th>
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*Separate figures for Income tax and Surcharge are not available.
concessions that have been recently granted to tax payers have been under the personal income tax. The States anxiety generally is that they should have the scope for sharing in an item of revenue which is much more buoyant than income tax and is bound to grow in future as it has been in the past. The States have therefore been pleading for the inclusion of corporation tax in the divisible pool of income tax. Such a suggestion is also made by Rajamannar Committee and many other writers.\textsuperscript{22}

In view of the strong representations made by the States for inclusion of corporation tax into the divisible pool, the Seventh Finance Commission suggested that the Central Government may consider holding consultations with the States in order to settle the point finally.\textsuperscript{23}

However strangely enough, not all the States are in favour of augmenting the divisible pool of income tax by the inclusion of corporation tax. This diversified stand of the States is the product of the peculiar way in which the system of resource transfers through the Finance Commission, has operated. The devolution of tax resources, which according to some industrial and surplus States, should be on the basis of origin only, has been to a degree on the basis of mixed criteria of need and origin, the former carrying a greater weightage. Even then, some States are revenue surplus while others are 'revenue-deficit' ones. As the procedure goes, the former with non-Plan revenue surplus, do not get grants-in-aid of revenue though they are not required to surrender their surplus. On the other hand, the non-Plan deficit States are given grants-in-aid to fill the gap. Accordingly, it is in the interest of the deficit States that the transfer of resources through tax devolution should be curtailed.


There may be a case for sharing corporation tax with the States. But it would be wrong to exaggerate the "definitional tricks" read in the changes made in 1959 in the nature of income and the corporation tax. The change was made primarily to increase total revenue and hence the Central revenues. But the financial loss to the States was calculated and the States were being compensated by increasing their share in the divisible pool of income tax and Union excise duties.

It is argued by the States that sharing of the corporation tax would add a flexible element in their revenue for it is much more buoyant than income tax and is bound to grow. But if corporation tax gets included in the divisible pool of income tax, for a given quantum of vertical transfer, it is a transfer from Union excise duties which is likely to get displaced by a transfer from direct taxes (i.e. income-taxes and the corporation tax combined). In this eventuality, the States will gain only if the latter sub-pool (viz. direct taxes) is more buoyant than Union excise duties. But the experience of the last few years proves the reverse. During the period 1976-77 to 1980-81, for which the figures are available, income plus corporation taxes increased by only 29 per cent as compared to a buoyancy of about 54 per cent in Union excise duties. In other words, States will in practice stand to lose rather than gain if some part of Union excise duties are replaced by an equivalent part from a pool of income and corporation tax.

However looking at the well known fact of inelasticity of States revenue and the importance of the States getting a due share from the incremental national income resulting from development, it is suggested that corporation tax should be made divisible with the States. It is further suggested that this should be done by taking corporation tax to a separate head and a provision be added to the Constitution making corporation tax compulsorily shareable with the States, as in the case with income tax. The whole question, however, relates to augmenting
the States divisible pool and is not an isolated one and has to be viewed later in an overall context.

The States have another complaint against the Centre. Article 271 authorises the Union to levy surcharge on income-tax for its own purposes. In the exercise of this power the Union has levied large surcharges on taxes on income for a series of years, which have, in substance, become permanent levies of tax. A cursory study of the accompanying table reveals that the Union has levied surcharge on the income tax almost on a permanent basis. The States do not dispute the Central levy, but what they contend is that resort to Union surcharge should only be made for some major unforeseen events and should be continued only for the period the contingency lasts, and till the appointment of a new Finance Commission, when it should become a part of the distributable pool. The Fourth Finance Commission stated the viewpoint of the States on the question in the following words:

... though the Government of India was competent to levy any surcharge wholly for purposes of the Union under Article 271, such a levy in the very nature of things, was intended to be a temporary measure to serve a particular situation. It was therefore urged that during normal times, there should be no need for any surcharge exclusively for the Union. However, if at all such a surcharge was levied, it should as a matter of course be merged with the basic rates after a period of three years.

It has been argued by the States that the Central Government has raised the level of Union surcharge simply as a revenue measure rather than for meeting any specific Union purposes. In their view, the basic tax and the surcharge are substitutable and that a surcharge continued indefinitely could well be called as additional income tax shareable with the rest of the proceeds of income tax. The Seventh Finance

Commission felt it necessary and proper to give weight to the strong feelings of the States on this subject. Rajamannar Committee has also recommended that surcharge should be merged with the basic rates of income tax. The Committee further recommended that no surcharge should be levied except with the consent of a substantial majority of the States.

It is pointed out here that Article 271 does not in express terms lay down that the Union surcharge should be for meeting the burdens of the Centre arising from any emergent requirements. However, there is an underlying assumption that a surcharge should only be levied for meeting the requirements of some unexpected events and that it should only be for the period during which it lasts. It is precisely what the Centre is doing. There is no denying the fact that the Centre is being faced with one or the other situation when it is to rush additional revenue to meet it. The country has faced aggression from the Chinese and it had been involved twice in war with Pakistan. Draughts, floods and riots have become the order of the day. A State Government in distress claims money from the Centre, since it is the constitutional obligation of the Central Government to come to the rescue of the States. All this may be the cause for the continuing use of Article 271 by the Centre to raise additional revenue. It is therefore submitted that there is no case, presently, for Central surcharge to be merged with the basic rates so as to be shareable with the States. The Centre may continue the levy so long as the circumstances are there which burden it with unforeseen eventualities.


We may now consider the Union 'duties of excise', which are levied and collected by the Union, but "if Parliament by law so provides, there should 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 those States in accordance with such principles of distribution as may be formulated by such law.\textsuperscript{27} The States' share in these duties has been a valuable source of revenue to them. These duties also have a tremendous potential for growth. Under the Constitution, it is Parliament, who is to lay down by law the principles of their distribution, but a convention has been established that Parliament, in this matter accepts the recommendations of the Finance Commission. The Union excise levies may be broadly divided into the following classes:

(i) Basic excise duties on a number of items levied under the Central Excises and Salt Act 1944, as amended from time to time by the Finance Act of each year.

(ii) Cesses or excise duties levied on certain goods under Special Acts, the proceeds of those duties being earmarked for specified uses. For example, excise duties and cesses levied on the production of copra oil extracted from oil seeds, salt, coal, iron ore, rubber and mill made cloth.\textsuperscript{28}

(iii) Additional duties of excise in lieu of sales taxes on sugar, tobacco and textiles under the Additional Duties of Excise (Goods of special importance) Act, 1957. These duties are essentially in the nature of a tax-rental agreement, the States having agreed not to levy sales taxes on these goods.\textsuperscript{29}

(iv) Additional Excise Duties on motor spirit, kerosene refined diesel oil and vapourising furnace oil, levied under the Mineral Oils (Additional Duties

\textsuperscript{27} Article 272.

\textsuperscript{28} Some of these Special Acts are The Indian Coconut Committee Act 1944, The Indian Oil Seeds Committee Act 1946, Coal Mines Labour Welfare Fund Act 1947, The Rubber Act 1947. See also Setalvad, 113.

\textsuperscript{29} For details see infra, Chapter VIII.
of Excise and Customs) Act 1958. These duties are basically in the nature of excise duties levied under the Central Excises and Salt Act 1944.

(v) Special duties of excise on certain goods levied for the first time in 1963, in the form of surcharges on basic duties on those items under the Finance Act of 1963. These levies were made in 1963 in the context of the national emergency arising due to Chinese aggression, but were continued by subsequent Finance Acts.

(vi) Regulatory duties of excise levied under the Finance Acts, the purpose being to give to the Executive, powers to vary rates of duties on any item within certain limits. These were for the first time introduced in 1961 and did not assume any financial importance until 1971 when credit was taken under this head. The levy of regulatory duties of excise was replaced under the Finance Act of 1973 by auxiliary duties on excisable goods. The Finance Act 1973 specifically laid down that these auxiliary duties have been levied for purposes of the Union and the proceeds therefrom would not be distributed among the States. However, under the recommendations of the Sixth Finance Commission they were brought within the divisible pool.31

A constant struggle has ensued between the Centre and the States for widening of the items of excise duty, in which the States should be permitted a share and for a higher percentage of the revenue derived from these duties. The States have contended that if there is to be a gradual coordinated policy for the substitution of an excise duty for the sales-tax which is the most lucrative source of revenue for them, it was necessary to give them a substantial interest in the collection and levy of all the Central excise duties and to increase gradually the field of commodities on which the duties are to be levied.

As the requirements of the States are growing and the excise duties being an elastic source of revenue, granting a

30. Ibid.
share to the States in all the excise duties levied by the Union, would strengthen the financial position of the States. Moreover, the larger the number of duties brought within the divisible pool, the greater would be the evenness in the flow of resources to the States. Further, any unfavourable fluctuations in the yield of certain items would be off-set by a favourable turn in the yield of some other items.\(^2\)

It has been noticed above that the States' share in the Union excises has been enlarged from time to time, and that the stage has reached when the Union would not attempt to withdraw this sharing. Yet it would give a psychological satisfaction to the States if the sharing of these excise duties is made compulsory as is the case with Income tax.\(^3\) It must be remembered that when the Constitution provided for the compulsory sharing of income tax and only a permissive sharing of Union excise duties, taxes on income other than corporation tax, amounted to Rs. 132.7 crores (in 1950-51) as against only Rs.67.5 crores for Union excises. Obviously says Dr. Rao that "the idea was to give the States a statutory claim on what was the most elastic and very nearly the largest yielding item in the Central list of taxes."\(^4\) As the position has changed considerably and excise duties have come to stay as the largest and most elastic of the Central taxes leaving income tax far behind, it would be advisable if the Constitution is suitably amended so as to make Central excises compulsorily shareable with the States.

The scheme of tax-sharing discussed above has some other weaknesses. Taking the 'taxes and duties' which, for enforcing a uniform rate of taxation, have been placed in the Union List and are leviable by the Centre, but the proceeds thereof are collected by the States and appropriated by them.\(^5\)

\(^2\) Setalvad, 115.

\(^3\) This point was also made out by Prof. P.K. Bhargava, "Bases of Distribution of Income Tax and Union Excises", \textit{Yojana}, 11-14, November 16,1978.


\(^5\) See Article 268.
The fact remains that in regard to this source of revenue, the States are made to some extent, dependent on the Centre. For the power to levy these taxes and duties is vested in the Union, so that, the proceeds of these taxes would be available to the States only if the Union decides to levy them. Further, the rates at which they should be levied would also be a matter for the decision of the Centre.

The position is not very different in respect of 'duties and taxes' which are both levied and collected by the Centre but the net proceeds thereof are assigned, in full, to the States. The only tax of this nature which is, at present, being levied and collected is the 'estate duty' on property other than agricultural land. Another tax mentioned in this category is the taxes on 'railway fares and freights'. Such a tax was levied by the Union in 1957, but it was abolished in 1961 and merged with the basic fares, with the result the railway fares were increased. The Union, however, decided to make an ad hoc grant to the States in lieu of the tax. But the substitution of an ad hoc grant worked to the disadvantage of the States for they were deprived of a valuable and potentially elastic source of revenue. It is also made out by the successive increase of passenger fares since the abolition of the tax. This act of the Centre also illustrates how by a mere terminological change, the Union can affect the receipts by the States from a particular source of the revenue. Apart from the question of the legality of the action of the Centre, it brings out that how even in respect of revenues assigned to the States, leviable and collected by the Union, the States are in no manner independent of the Centre.

36. Infact, the Centre has levied taxes on all the items mentioned in Article 268.
37. See Article 269.
38. Under the Railway Passenger Fare Act, 1957.
It may be further taken into notice that out of a large list of taxes enumerated in Article 269, only two are being levied by the Union. The States which are chronically in need of more resources have thus been deprived of potential sources of revenue by the mere omission of the Centre to levy tax on under these heads. It would not be wrong to say that such an omission on the part of the Centre goes against the spirit of the Constitution which does require it to be worked in a cooperative manner, particularly, in the matter of taxes, the proceeds whereof are wholly assignable to the States. \(^{42}\)

It may be noted that the Fifth Finance Commission was asked to look into the possibility of utilizing these taxes and duties as a source of revenue for the States. The Commission was, however, of the opinion that the imposition of such taxes would not have brought in enough of revenue. \(^{43}\) The Central Government again has referred the matter to the Eighth Finance Commission to find out the possibility whether some of these heads could be utilized for raising revenue for the States.

It is submitted that with an all round increase in economic activities, the possibility of raising revenue through these taxable heads should be explored. The question should be reviewed for the possibility of adding some taxes with greater revenue potential under this Article and incorporating a kind of compulsion for the Centre to levy these taxes for the benefit of the States, such as if one-third of the States pass resolution in the Assemblies that such taxes should be imposed, then the Union Parliament should be obliged to do so.

\(^{42}\) Setalvad, 110.